Circular 230: Is the Hysteria Over?

By Arthur L. Bailey and Alexis A. Macivor

I. Introduction

On December 20, 2004, the U.S. Department of Treasury published amendments to Circular 230 (hereinafter referred to as “final regulations”), which generally governs practice before the Internal Revenue Service by attorneys, accountants, and other tax consultants and practitioners. The December 2004 amendments relate to the limitations on “written advice” provided by those professionals deemed to practice before the IRS. During the six months leading up to the June 21, 2005, effective date of the regulations, those affected (or potentially affected) by the new rules engaged in what was from time to time referred to as “Circular 230 hysteria.”

Lawyers and accountants howled as their tax partners pleaded to have a Circular 230 disclosure statement (cautioning that any advice contained in the message could not be relied on to avoid penalties) appended to every email emanating from the firm. Some firms adopted such a rule, so that everything from a legal opinion to a luncheon invitation became “stickered” with the now familiar Circular 230 disclosure. Grown men and women debated whether the Circular 230 disclosure should be above or below the email signature line and whether placing the disclosure in its own paragraph in the same font as the email text was sufficient to make the disclosure “prominent.” Hours were spent analyzing and drafting the specific language of the Circular 230 disclosure — should the term “advice” be qualified by a parenthetical, “(if any),” in case the email does not contain “advice”?

Looking back, some of the consternation may have been unnecessary and some of the debates even silly. But the reality is that practitioners have taken seriously their obligations under these regulations to comply with the standards of practice for written tax advice. This is evident from the numerous communications between practitioners and representatives of Treasury and the IRS’s Office of Professional Responsibility (OPR), which identify the practical problems involved in applying the final regulations to everyday tax advice.

In response to some of the concerns from tax practitioners, Treasury responded with important clarifications. Specifically, in May 2005, Treasury modified the final Circular 230 regulations governing written tax advice. The May modifications provide significant guidance in areas relating to post-return advice, in-house tax advice, negative advice, the definition of “prominently disclosed,” and the definition of “the principal purpose.”

While important clarifications have been made, the core question remains whether the end justifies the means. The regulations were developed to curb abusive tax shelter opinions. But do they? Instead of outlawing abusive tax shelter opinions, the regulations provide a road map on how to write a tax shelter opinion that will be “blessed” as Circular 230 compliant. Tax practitioners providing tax shelter opinions may charge higher fees since compliance with Circular 230 requires such opinions to be more complete. But nothing in the regulations prohibits the use of tax opinions in tax shelter transactions. Thus, the “cost” of dealing with abusive tax shelter opinions is being borne daily by taxpayers seeking routine and benign tax advice on non-tax shelter questions. Indeed, given the cost of obtaining written tax advice that is compliant with the covered opinion requirements of Circular 230, an argument can be made that one consequence of the regulations is to discourage taxpayers from seeking tax advice in writing. If true, this is truly unfortunate.

Clearly, a case can be made for taking a fresh look at the basic structure of Circular 230 and the effect of the regulations, which undeniably adds another unnecessary layer of complexity to the task of providing written tax advice. This article, however, sidesteps that question and instead undertakes to summarize and comment on Circular 230 developments since the final regulations were issued in December 2004. This article thus updates an article published in the January-February 2005 edition of The Tax Executive. That article provided an overview of the recently promulgated regulations governing written tax advice, the background relating to the Treasury’s regulation of tax shelter opinions, and commentary on the application of the new rules in current practice. This article discusses the regulation modifications published in May 2005, outlines the topics and questions described in letters to OPR, and reviews the other written recommendations to OPR. The article concludes with suggestions for improving the Circular 230 regulations governing written tax advice.

II. The May Modifications to Circular 230

The May modifications to Circular 230 focus on five specific issues about which practitioners had expressed concern: post-return advice, in-house advice, negative advice, the definition of “prominently disclose,” and the definition of “the principal purpose.” Even though these modifications make important steps toward easing the burden on...

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every day written tax advice, they fall short of curing the fundamental problems with the regulations - their scope and complexity.

A. Post-Return Advice

Practitioners expressed concern that a memorandum (i.e., something short of a full-blown opinion) expressing post-return advice, such as a conclusion about the hazards of litigation was subject to the Circular 230 regulations. Treasury and the IRS agreed that such written advice should not be subject to the stringent “covered opinion” requirements of Circular 230. Thus, the May modifications exclude from the definition of “covered opinion,” written advice prepared or issued after the taxpayer has filed a tax return reflecting the benefits of the transaction. This exclusion, however, does not include advice if the practitioner knows or has reason to know the taxpayer will rely upon such advice to take a position on a tax return, including an amended return that claims tax benefits not reported on a previously filed return.

The post-return advice exception is an important exclusion for practitioners providing advice in the context of an IRS examination or litigation. Absent this modification, the regulations would literally have subjected most advice regarding the merits of an issue in controversy to the covered opinion rules. Obviously, written advice regarding a transaction under audit or in litigation should not be burdened with the application of rules designed to discourage tax practitioners from providing abusive tax shelter opinions for penalty avoidance purposes.

Nevertheless, the language of the exclusion causes confusion in the context of transactions that have tax effects over multiple years, some of which are under audit and some of which lie in the future. In this situation, the taxpayer has filed a tax return reflecting some, but not all, of the tax benefits of the transaction. Thus, the question arises whether the language of the regulations, which generally refers to “the tax benefits of the transaction,” includes such advice. It seems logical that if the taxpayer has already taken a position on a tax return reflecting the benefits of the transaction – and the practitioner reasonably concludes that the advice will not be relied upon to take a different position in future years – the exception should apply. The answer, however, is not clear.

B. In-House Advice

The exclusion for in-house advice applies to most, but not all, of the advice provided by in-house tax advisers. This exception is limited to advice provided by employee-advisers to their employers with respect to the employer’s tax liability. It is widely accepted that this definition does not, on its face, include advice to someone other than the employer (e.g., company executives, employees, or customers). On the other hand, there is some uncertainty and confusion because the regulations fail to provide a definition of the term “employer.”

In-house practitioners should be concerned with three areas where the in-house exception may not apply: advice to employees, restructurings and other transactions where unrelated third parties are inadvertently the taxpayers, and dealings with outside counsel and other outside tax practitioners. For example, if an in-house tax practitioner sends an email to the CEO discussing the tax benefits of the CEO’s stock options, the email would not seem to be covered by this exception. In restructurings and other transactions, the written advice concerning the tax treatment to shareholders and third parties is not automatically excluded from the covered opinion regulations. Although a strong argument can be made that such advice should be excluded because the advice concerns the tax effects to the corporation (which, in turn, affects the tax treatment of shareholders or third parties), the result is not clear. Accordingly, the in-house practitioner should determine whether the advice is a “covered opinion” (e.g., a reliance opinion) and whether a disclosure is necessary.

Finally, if the company intends to rely on an opinion or advice for the good faith and reasonable cause exception to penalties, the advice should not contain a disclosure asserting that the advice cannot be used for the purpose of avoiding penalties. Even though the IRS has not amended the penalty regulations to provide such a requirement, the preamble to the final regulations state that Treasury intends to amend the regulations under section 6664 to “clarify” that a taxpayer cannot use advice that contains such a disclosure to establish the reasonable cause and good faith defense to the accuracy-related penalties. The preamble suggests that Treasury and the IRS believe that under the existing penalty provisions, a taxpayer cannot claim good faith and reasonable cause based on advice containing such a disclosure.

The exception for in-house advice raises the question of how to define the term “employer.” Informally, Treasury officials have stated that they intended the term “employer” to be broader than a consolidated group. Even though Treasury officials have informally clarified that the rules were intended to be construed fairly broadly, questions remain. For example, it is not clear whether the exception extends to advice provided by an employee of a corporation to a partnership in which such corporation owns an interest in the capital or profits. If the exception applies to such advice, there is no guidance on whether the corporation must have a majority interest in the partnership. It is logical to extend the in-house exception to situations where the corporation controls a partnership and the corporation’s practitioners typically advise the partnership. Adding a definition of employer to Circular 230, even if it is based on broad principles, would eliminate some of this uncertainty.

In-house practitioners should bear in mind that the in-house advice exception excludes such advice from the “covered opinion” requirements, but not the “other written advice” requirements. Thus, the advice remains subject to the regulations governing written tax advice. While the “other written advice” standard is a flexible facts-and-circumstances test in contrast to the stringent “covered opinion” requirements, its requirements cannot be ignored.

C. Negative Advice

A covered opinion under the May Modifications does not include written advice that does not resolve a federal tax issue in the taxpayer’s favor. Such advice cannot reach a conclusion favorable to the taxpayer at any confidence level.
Treasury and IRS officials have informally stated that this provision is meant to cover only advice that unequivocally tells a client not to engage in a transaction. This exception was also intended to be extremely narrow and, thus, has very limited application for most tax practitioners.

The negative advice exception has relevance in respect of listed transactions and principal purpose transactions, since Circular 230 provides that those covered opinions cannot “opt out” of the stringent written advice requirements by using a disclosure. The negative advice exception permits a practitioner to respond to a taxpayer’s inquiry by saying “Don’t enter into the transaction.” While the exception is welcome, the facts and law rarely dictate such a simple response. More typically, it is not clear whether a transaction is a “the principal purpose” transaction or substantially similar to a listed transaction; in other words, there may be arguments for and against the anticipated tax benefits of the transaction. Thus, the practitioner may respond with something that reflects this uncertainty (e.g., “there is a significant risk that...”). This advice does not reach a conclusion favorable to the taxpayer, but it also does not unequivocally tell the taxpayer not to enter into the transaction. Treasury and IRS officials’ comments suggests that such advice does not fall within the ambit of the negative advice exception because it does not unequivocally say “no.”

Even though this exception initially seems to provide an important exclusion for negative advice, a closer reading and analysis suggests it is very limited. For all practical purposes, the answer is rarely clear enough to merely say “no.” Accordingly, this exclusion applies in very limited cases and does not provide significant relief for routine tax advice.

D. Prominently Disclosed

The May modifications revised the definition of “prominently disclosed” to require that the disclosure is “readily apparent to a reader of the written advice.” Whether an item is prominently disclosed depends on the facts and circumstances surrounding the advice. At a minimum, it must be set forth in a separate section (and not in a footnote) and in a typeface that is the same size or larger than the typeface of any discussion of the facts or law in the written advice.

The original definition required that the disclosed item be set forth in a separate section at the beginning of the written advice in bolded typeface that is larger than any other typeface used in the written advice. Commentators complained that technological limitations made it very difficult, if not impossible, to comply with the prominent disclosure requirement in emails. The May modification thus allows practitioners to add the Circular 230 disclosure to emails in two ways: (1) by adding the disclosure at the bottom of all emails leaving the firm (i.e., the “gateway” approach), or (2) by adding the disclosure as part of each practitioner’s email “signature.”

E. The Principal Purpose

The May modifications also define “the principal purpose” of tax avoidance or evasion. A plan or arrangement has the principal purpose of tax avoidance or evasion if that purpose exceeds any other purpose. The modified definition now explicitly excludes advice if the partnership, entity, plan, or arrangement has as its purpose the claiming of tax benefits “in a manner consistent with the statute and Congressional purpose.”

Again, this modification is very important in clarifying that a practitioner may recommend, in writing, that a taxpayer take advantage of tax benefits clearly intended by the statute and congressional purpose. For example, before the May modifications, suggesting that a taxpayer “check the box” to elect to treat an entity as a partnership or recommending that the taxpayer enter into a section 1031 exchange (i.e., a like-kind exchange) could have been considered “the principal purpose” advice. Tax practitioners welcome the clarification that such advice is excluded from the definition of “the principal purpose” advice. Questions, however, remain. When is a tax benefit “consistent with” the statute and congressional purpose? It would be helpful if Treasury and OPR provided examples of situations where this exception to the principal purpose rules applies.

Moreover, excluding such advice from the “principal purpose” category does not exempt such advice altogether from Circular 230. At a minimum, such advice would be subject to the “other written advice requirements.” Additionally, the advice would be a “covered opinion” if it otherwise fell within a covered opinion definition (e.g., advice concluding at a level of at least more likely than not with respect to an entity, transaction, plan, or arrangement a significant purpose of which is tax avoidance).

In summary, the “consistent with” language is necessary to clarify that written advice concerning a standard section 1031 exchange is not a covered opinion. Even though the clarification creates an important exception, practitioners must still analyze whether simple, routine tax advice is “consistent with” the statute and congressional purpose. Thus, this clarification slightly lowers, but does not eliminate, the hurdle practitioners must overcome when providing routine tax advice.

III. Communications to OPR

Some practitioners have submitted correspondence to OPR, recalling and describing informal, sometimes oral, communications with OPR, in which the Director and Deputy Director of OPR apparently agreed to certain Circular 230 interpretations. While these letters are technically not authority, they illustrate how practitioners are resolving a variety of the Circular 230 issues.

A. Letters and Opinions Incident to SEC Filings

In a letter from two practitioners to OPR, the practitioners provide a description of what they believe is a proper, reasonable, and common-sense approach to Circular 230, which had earlier been discussed in a telephone call with OPR representatives. The practitioners suggested that letters and opinions incidental to SEC filings need not contain the “opt out legend” if the underlying tax disclosure itself complies with section 10.35 (i.e., the covered opinion provision) because such letters and opinions do no more than (i) refer to the disclosure made in the document provided to investors, (ii) confirm the accuracy of the tax disclosure,
or (iii) confirm an opinion described in such tax disclosure. The underlying tax disclosure would be in compliance with section 10.35 because it will either (1) be filed with the SEC and, thus, subject to the SEC exception (assuming the transaction is not a “listed transaction” or a “principal purpose transaction”), or (2) include the marketed opinion legend if the disclosure document is not filed with the SEC.

The letters and opinions referred to by the practitioners are “incidental” to the statements in the disclosure documents. For example, such letters and opinions would include the following: (1) 10b-5 letters, disclosure letters, or negative assurances letters, (2) opinions on the accuracy of the U.S. federal income tax disclosure (often referred to as “fair and accurate summary” opinions), and (3) closing opinions in M&A transactions where the proxy statement describes the closing opinion.

### B. Transaction Documents and Training Materials

Another letter to OPR from the same two practitioners similarly documents a conversation with OPR representatives. The practitioners state that certain transaction agreements, term sheets, and educational materials are not subject to the covered opinion requirements. Transaction agreements and other operative agreements that contain statements relating to U.S. taxes do not constitute “tax advice.” These agreements are binding agreements between the parties to the transaction and not advice from a practitioner. Similarly, term sheets should be excluded because they are merely early versions of the transaction and operative agreements (i.e., they are binding agreements and not advice). Finally, the practitioners state that they believe “it would be inappropriate to interpret the rules to cover” education materials such as articles, books, and training outlines and presentations. Such material is not advice even though other practitioners and taxpayers may refer to it in formulating a view about specific facts and circumstances.

### IV. Other Recommendations

Numerous practitioners have written to OPR expressing their concern about the Circular 230 regulations governing written tax advice.

#### A. In General

Practitioners have generally criticized the breadth of the “covered opinion” definition. Practitioners are particularly concerned with the requirement that practitioners must differentiate between advice “a significant purpose” of which is tax avoidance and advice “the principal purpose” of which is tax avoidance. In the case of the former, practitioners can avoid the stringent covered opinion regulations by placing a prominent disclosure on the advice. In the case of the latter, however, practitioners cannot. Thus, practitioners must decide if informal advice rises to the level of “the principal purpose” before writing a client. This determination is very difficult and time consuming in numerous gray areas. Accordingly, commentators consistently ask Treasury and the IRS to eliminate the distinction between the principal purpose and a significant purpose.

Practitioners have also sought improvements in the definition of a “marketed opinion.” For example, the New York City Bar Association suggested that the definition focus less on the “possible use of the opinion by a person other than the practitioner’s client and more on its use to sell a transaction having a significant purpose of avoiding taxes.” Other commentators also expressed concern that the definition technically includes books, articles, and training publications.

#### B. Mutual Fund Industry

Practitioners in the mutual fund industry have asked for clarification in applying the Circular 230 regulations to their written communications. The mutual fund industry is generally not in the business of providing tax advice, but mutual fund marketing materials sent to potential clients and tax statements sent to shareholders contain tax-related information. One letter to Treasury and the IRS asked for guidance because the common sense answers, which “strongly suggest” that certain communications were not intended to be covered, are at odds with the literal language of the rules.

First, the practitioners requested that communications by mutual funds and their affiliates with prospective and current shareholders be excluded from the Circular 230 regulations. Such tax statements, regardless of whether the tax benefits are non-controversial, fall within a literal interpretation of a marketed opinion if any potential investor is motivated by a significant purpose of tax avoidance. Second, the letter asked for guidance that tax information provided to current shareholders, other than the information provided on Form 1099-DIV, is also not subject to the Circular 230 rules. Finally, the practitioners asked that the in-house advice exclusion be extended to include internal communications by in-house practitioners for mutual fund advisers. Such communications are not excluded from the covered opinion regulations under the existing in-house exception because the advice does not concern the tax liability of the mutual fund, but the tax to the shareholders. These comments illustrate the complexity of applying the written advice regulations to various niches in the tax world where routine and benign tax advice is ever present.

#### C. Employee Benefits

There are ongoing discussions between practitioners and OPR relating to employee benefits tax advice. In a recent letter to OPR, a group of practitioners suggested that OPR expand the qualification of qualified plans exception. In the letter, the practitioners urged OPR to clarify that the exception applies equally to section 401(a) plans and other similar tax-favored plans, and to clarify that the exception covers all communications explaining the tax consequences of plan implementation, sponsorship, and participation. While including routine tax advice relating to employee benefit issues in such relief is justified in many respects, it will be impossible for Treasury to provide general relief in this area since several “listed transactions” concern employee benefits.

#### D. Actuaries

In addition, there are ongoing discussions between ac-
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Actuaries and OPR relating to the application of the written advice regulations to actuaries’ practice. In a letter to OPR, the American Academy of Actuaries sought clarification that actuarial reports provided under a confidentiality provision are not “covered opinions.” The confidentiality provisions are generally intended to prevent third parties from using the information in the actuarial reports for unintended and unsuitable purposes. In most cases, this provision does not protect the “tax treatment or tax structure of the transaction” or the “practitioner’s tax strategies.” Therefore, in those general cases, actuarial reports should not constitute advice subject to conditions of confidentiality (a category of covered opinions).

The letter also requested guidance to clarify that incomplete data sets that comply with applicable actuarial standards do not constitute unreasonable factual assumptions. In providing written tax advice, all practitioners are prohibited from basing such advice on unreasonable factual assumptions. This provision requires the practitioner to make a judgment call. The practitioner must believe that the assumptions are reasonable (e.g., if the numbers do not look correct, the practitioner should follow-up with questions for the client). Moreover, the practitioner merely must use “reasonable efforts” to identify and ascertain the facts. Depending on the circumstances, it may not be reasonable to obtain missing data points. This letter questioned the extent to which enrolled actuaries are subject to the covered opinion provisions. Clearly, enrolled actuaries are practitioners who are subject to the regulations, but it is less clear how often enrolled actuaries provide advice that constitutes a covered opinion.

V. Suggestions for Improvement

In contrast to the detailed rules found in the current regulations, the articulation of general principles may yield more appropriate and easier to discern answers when regulating tax opinions and similar correspondence. Indeed, the other provisions of Circular 230 (i.e., those not dealing with written advice) have long embraced a general principles approach and not specific guidelines, and have generally been sufficient to discourage egregious practitioner conduct without adversely affecting routine, everyday tax advice.

Broad principles for written tax advice should be similarly sufficient.

A. “Opt In” Approach

Treasury and the IRS should seriously reconsider the “opt in” approach. As previously explained, the regulations do not prohibit tax shelter advice, but merely provide complex requirements that must be satisfied when providing written advice, whether or not the advice relates to a tax shelter. In some situations, the practitioner is required, or makes the choice, to include a disclosure stating that the taxpayer cannot use the advice to avoid penalties. Clearly, Treasury and the IRS are particularly concerned with advice that taxpayers intend to rely on for the purpose of avoiding penalties, but since the regulations are so broad and unclear, tax practitioners are placing the disclosure on all emails and most correspondence, even though placing disclosures on everything defeats the purpose of the covered opinion provisions.

Because the rules are so complex and the sanctions are potentially very severe (i.e., disbarment from practice before the IRS), practitioners will continue to place disclosures on routine tax advice unless the regulations are changed. The New York State Bar Association Tax Section has suggested that the problem be addressed by adopting a true “opt in” system. Under such a system, practitioners and their clients may “opt in” to the covered opinion requirements for purposes of an opinion written and intended for penalty avoidance purposes by placing language in the opinion that the advice is intended for penalty avoidance purposes.

B. Reportable Transactions

If Treasury and the IRS do not chose the opt-in approach, they should consider limiting the covered opinion regulations to “reportable transactions” as defined in section 6707A. By limiting the covered opinion provisions to “reportable transactions,” the revised rule would avoid the unnecessary regulation of virtually all routine and benign advice. This approach parallels changes made by the American Jobs Creation Act, which treat reportable transaction noncompliance more severely than noncompliance with respect to transactions in general. As part of this change, practitioners should be given the opportunity to “opt out” of the covered opinion rules because practitioners and taxpayers have a business need for written communications that are less comprehensive than a formal opinion. This approach has the advantage of retaining the covered opinion requirements, the other written advice definition and requirements, and the “opt out” structure found in the current regulations. In contrast to the current regulations, however, it would not subject most routine and benign written tax advice to burdensome and unnecessary requirements.

C. An “Opt Out” for Principal Purpose Advice

Finally, if the Treasury and the IRS do not limit the covered opinion regulations to reportable transactions, they should permit “opting out” from the principal purpose opinions. The definition of “the principal purpose” raises numerous questions and issues. Determining whether a transaction has “the principal purpose” versus “a significant purpose” potentially involves a significant amount of time. The nature of routine, everyday tax advice, however, requires practitioners to make decisions quickly. If the practitioner is providing informal advice, the practitioner may not know all the facts and is not necessarily in a position to make such a determination. Practitioners should not be forced to make these judgment calls in providing benign, routine advice when the potential sanctions are so severe.

VI. Recent Developments

Finally, in December 2005, Eric Solomon, Treasury Deputy Assistant Secretary (Regulatory Affairs) and Acting Deputy Assistant Secretary for Tax Policy, suggested that Treasury may need to rethink its approach to Circular 230. In the event a decision is made to rethink the approach to written tax advice, it would be helpful to reflect upon the pros and cons of the existing regulations and to receive

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comments and proposals from tax practitioners. With such practitioner input, Treasury and the IRS can determine the best ways to improve the Circular 230 regulations governing written tax advice.

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4 70 Fed. Reg. at 28825-26 (May 19, 2005) (codified at 31 C.F.R. § 10.35(b)(2)(ii)(C)).

5 70 Fed. Reg. at 28826 (May 19, 2005) (codified at 31 C.F.R. § 10.35(b)(2)(ii)(D)).


9 In a letter to OPR, the authors recommend that the term “employer” include “related partnerships,” defined as a partnership in which a corporation or an affiliated group in which such corporation has a member owns, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in the partnership, unless such corporation or affiliated group does not control the day to day operations of such partnership. See Arthur L. Bailey, Attorney Suggests Alternatives to Improve Circular 230 Rules, 2005 Tax Notes Today 88-100 n.19 (May 4, 2005).

10 See note 9.


12 70 Fed. Reg. at 28826 (May 19, 2005) (codified at 31 C.F.R. § 10.35(b)(2)(ii)(E)).


14 70 Fed. Reg. at 28826 (May 19, 2005) (codified at 31 C.F.R. § 10.35(b)(8)).

15 70 Fed. Reg. at 28826 (May 19, 2005) (codified at 31 C.F.R. § 10.35(b)(10)).


17 The OPR representatives apparently did not disagree with their position, but what they said or did not say is not clear. Leslie Samuels & Diana Wollman, Attorneys Comment on Application of Circular 230 to Capital Markets, M&A Opinions, Letters, 2005 Tax Notes Today 139-16 (July 1, 2005).


26 Since OPR proceedings are not public, it is difficult to make this determination without relying on statements from OPR.


29 Section 6707A defines “reportable transaction” by referencing the regulations under section 6011. See Treats. Reg. § 1.6011-4.


31 See I.R.C. §§ 662A and 6707A.