Obtaining and Providing Outside International (and Other) Tax Advice in the Current Enforcement and Compliance Environment

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I. Introduction

The current tax enforcement and compliance environment is becoming increasingly difficult for taxpayers and their advisors. Rules are becoming more numerous and more strictly enforced; court decisions are continuing to blur the lines between acceptable and objectionable tax planning; public and shareholder relations factors are becoming increasingly dominant in tax decision-making; full transparency is becoming the norm (or, as some others might say, financial privacy and tax advisor privilege are becoming extinct); and accounting firms that used to play the role of tax planning idea-generator and advocate are now playing the role of financial statement guardian. Obviously, some of these developments are good for the system, and constitute an overdue reaction to previous excesses, but it cannot be denied that this combination of developments has made the lives of tax directors and tax advisors more complicated, and has itself resulted in excesses that in a given case do more harm than good.

This article attempts to examine and assess the factors that have contributed to this enforcement and compliance environment. These factors include the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"); recent cases dealing with the attorney-client privilege with respect to tax opinions; recent developments regarding tax reserve preparation and analysis; including

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developments relating to tax accrual workpapers; recently enacted tax shelter disclosure and penalty provisions; and revised Circular 230 rules.

II. Sarbanes-Oxley

A. The Law

Sarbanes-Oxley was enacted in response to the Enron scandal and other corporate failures. The ensuing media coverage highlighted several controversial issues, such as corporate governance failures, aggressive (and maybe questionable) tax planning, and the conduct of corporate officers and employees and their outside advisors, including tax advisors. Sarbanes-Oxley creates the Public Company Accounting Oversight Board (the "PCAOB") to regulate public accounting firms.[1] To address the role of auditors that also provide tax advice, Sarbanes-Oxley sets rules establishing the independence of auditors.[2] Sarbanes-Oxley also increases the transparency of public corporations through heightened disclosure rules.[3] To encourage enhanced standards, Sarbanes-Oxley imposes stricter penalties for historically illegal behavior and requires officials to certify financial statements.[4]

At the core of Sarbanes-Oxley's policy of maintaining auditor independence are the three principles that an auditor should not be an advocate for its client, should not be a member of management, and should not audit its own work. Sarbanes-Oxley prohibits an accounting firm from providing certain non-audit services to companies it audits, such as (1) bookkeeping or similar services, (2) financial information systems design and implementation, (3) appraisal or valuation services, (4) actuarial services, (5) internal audit outsourcing services, (6) management

[1] Sections 101 to 109, Sarbanes-Oxley.
[2] Sections 201 to 209, Sarbanes-Oxley; see also PCAOB Auditing Standard No. 4 (released on July 26, 2005).
[3] Sections 401 to 409, Sarbanes-Oxley.
[4] See e.g., sections 302(a) and 401 to 209, Sarbanes-Oxley.

functions or human resources, (7) broker dealer, investment advisor, or investment banking services, and (8) any other services that the PCAOB determines to be impermissible.[5] In addition, Sarbanes-Oxley requires that a company's audit committee pre-approve any services (except a prohibited activity described above) provided by an auditing firm.[6]

On July 26, 2005, the PCAOB finalized rules that provide greater detail regarding the independence of public accounting firms that perform tax services to the clients that they audit. The final rules adopt in substance rules proposed by the PCAOB on December 14, 2004. Under the final rules, an auditor will be treated as not independent from the audit client if the auditor (i) enters into a contingent fee arrangement with its audit clients, (ii) provides tax services to certain members of management who serve in financial reporting oversight roles at an audit client, or (iii) markets, plans, or opines on transactions that are confidential or that are based upon an aggressive interpretation of applicable tax laws and regulations.[7] An aggressive interpretation of the law is one that cannot support an opinion at a "more likely than not" level.[8] An auditor seeking pre-approval from the audit committee must supply the committee with certain information, discuss with the audit committee the potential effects of the services on the auditor's independence, and document the substance of that discussion.[9]

Sarbanes-Oxley also preserves the independence of an auditor by limiting certain interaction between a taxpayer and its auditor that may compromise the integrity of the auditor. For example, a taxpayer is precluded from taking any "action to fraudulently influence, coerce, manipulate, or mislead" the outside auditor.[10] Although Sarbanes-Oxley prescribes civil

[5] Section 201(a), Sarbanes-Oxley.
[6] Section 302, Sarbanes-Oxley.
[7] PCAOB Rules 3521 to 3523, PCAOB Auditing Standard No. 4.
[8] Id.
[9] PCAOB Rule 3524, PCAOB Auditing Standard No. 4.
[10] Section 303(a), Sarbanes-Oxley.

sanctions for violations of the above rule, violations of the Sarbanes-Oxley rules can nevertheless result in criminal sanctions.[11]

In addition to the auditor independence rules, Sarbanes-Oxley contains a number of provisions that are designed to enhance the overall transparency of publicly traded corporations. For example, certain provisions require not only management, but other employees and advisors (including outside tax advisors) to report any perceived illegality "up the line" (i.e., to the Board of Directors, if required).[12]

In addition, a corporation's senior management is required to file a quarterly certification that: (i) the corporation's financial statements are accurate and complete, (ii) the corporation has designed appropriate disclosure and internal controls; (iii) the effectiveness of these controls has been evaluated, (iv) any material change in these controls has been disclosed, and (v) all significant deficiencies[13] and material weaknesses[14] in these controls and any fraud involving management have been disclosed to the corporation's auditors and audit committee.[15]

The requirement to effectively root out significant deficiencies and material weaknesses under Sarbanes-Oxley section 404 has consumed enormous resources, including in tax departments. In a number of instances, tax directors have been required to establish that controls under their authority are adequate to avoid significant deficiencies and material weaknesses

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[11] Section 303(b), Sarbanes-Oxley; Section 32(a), Securities Exchange Act of 1934.

[12] See, e.g., Section 307 (requiring attorneys to report evidence of a material violation of security laws to the chief legal counsel or the chief executive officer and, if those parties do not appropriately respond, to further report the violation the audit committee (or a similar committee) of the Board of Directors or to the Board of Directors).

[13] A significant deficiency is defined as a control deficiency, or combination of deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data, reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected. See PCAOB Bylaws and Rules.

[14] A material weakness is defined as significant deficiency or combination of significant deficiencies, that results in a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. See PCAOB Bylaws and Rules.

[15] Section 302, Sarbanes-Oxley.

when those same tax directors instituted the very controls that discovered the items of concern to auditors. In other cases, significant dollar items are not viewed as problematic, while small dollar items are cited as the basis for a reporting.

B. Practical Implications of Sarbanes-Oxley

Sarbanes-Oxley is intended to enhance financial reporting, and the rules have important implications for tax departments. A tension exists between the three goals of the corporate tax department: (i) to further the company's mission by reducing tax expense, (ii) to comply with the law, and (iii) to facilitate the transparency in financial reporting. In the government's view, a corporate taxpayer should not implement any tax planning that it does not feel comfortable having reviewed on audit. Corporate taxpayers, however, may be reluctant to have their planning scrutinized. In this environment, it is prudent to assume that all planning will come to light.

The most difficult decisions made by corporate taxpayers today may not be whether the law supports their position, but what the reputational impact will be if their planning ends up "on the front page of the Wall Street Journal." Transactions questioned on audit and/or subject to disclosure under Sarbanes-Oxley can have an immediate impact on a corporation's financial well-being. Whether such a transaction actually works may not matter. Legally irrelevant facts may look bad in the press and, therefore, may make the front page. Exonerating facts, on the other hand, may have little media appeal. In the end, the IRS or a court may agree that a transaction was not abusive, but the damage may have been done; it can take years for the corporation to be vindicated.

The auditor independence rules can create substantial tension between a corporation and its auditors. Although some amount of tension is undoubtedly healthy, anecdotal evidence

suggest that auditors and their clients have a more adversarial relationship than ever before. As either partial cause or effect, auditors are requesting documents that they have not recently requested, including: detailed reserve calculations, additional financial data, factual material such as interview notes, in-house legal analyses, and outside legal analyses including formal tax opinions. Some of these requests can present taxpayers with a difficult choice between protecting privileged documents and obtaining certified financial statements.

III. Privileged Communication

In the current enforcement environment, a taxpayer may simultaneously have great need and little ability to establish and preserve sensitive communications as a privileged communications. The privilege can encourage frank discussions of taxpayer vulnerabilities without providing the IRS with a "roadmap" to sensitive issues. Yet it is fair to say that privilege today is under withering assault.

A taxpayer can attempt to keep communications confidential under the common law principles of the attorney-client privilege and the work product doctrine. The Federal statutory accountant-client privilege may also be available. Taxpayers seeking to claim privilege must be aware of the prerequisites of privilege as well as how to avoid waiving privilege once privilege is established.

A. Tax Opinions and Attorney-Client Privilege

1. General Overview

The attorney-client privilege is the most recognized privilege afforded to communications between a taxpayer and a tax attorney. It generally protects communications between a taxpayer

and a tax advisor (acting in his capacity as an attorney) if the communication relates to the seeking of legal advice, there is an expectation of confidentiality, and the privilege has not otherwise been waived by the client.[16] The attorney-client privilege is applicable to communications with outside tax attorney-advisors and in-house counsel, although in the latter case, more questions may arise about whether in-house counsel is functioning as an attorney.[17]

Written communication between a taxpayer and a tax attorney can be privileged if the documentation contains a privileged communication.[18] The attorney-client privilege can also apply to direct written communications with a lawyer as well as communications with law firm employees who assist attorneys in providing legal advice.[19] However, attorneys employed by an accounting firm are generally not considered to be functioning as attorneys for purposes of the attorney-client privilege, although communications with such attorneys may be protected under the Federal accountant-client privilege (see Part B, below).

The attorney-client privilege may also extend to communications with a third-party acting on behalf of an attorney who has specific expertise useful to the legal representation of the client. The arrangement between an attorney and the third-party that preserves the attorney-client privilege was established in the Kovel case.[20] For example, a client's communication with an accountant retained by an attorney for the purpose of assisting the attorney in understanding a client's financial information may be privileged. The extension of the attorney-client privilege to

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[16] See John Henry Wigmore, Evidence Vol. 8, § 2292 (McNaughton rev. 1961).

[17] See, e.g., *Upjohn Co. v. United States*, 449 U.S. 383 (1981) (Supreme Court upheld the claim of privilege for communication between employees and in-house counsel acting as such); *In re Sealed Case*, 737 F.2d 94 (D.C. Cir. 1984) (the court recognized that the status of an in-house attorney "alone does not dilute the privilege", but was mindful that the in-house counsel "had certain responsibilities outside the lawyer's sphere").

[18] See, e.g., *Saba Partnership v. Commissioner*, 78 T.C.M. 684 (199) (Tax Court denied taxpayer's claim of privilege for documents that contained no confidential communications).

[19] See John Henry Wigmore, Evidence Vol. 8, § 2301 (McNaughton rev. 1961) (noting that "[i]t has never seriously been questioned that the privilege protects communications to the attorney's clerks [and] his other agents").

[20] *United States v. Kovel*, 296 F.2d 918 (2nd Cir. 1961).

an accountant in a Kovel arrangement is, however, far from absolute. Typically, the attorney-client privilege does not extend to tax work prepared by accountants unless the accountants are translating complex matters into a form intelligible to an attorney at the attorney's behest.[21] An appropriate inquiry to determine if Kovel applies is whether the accounting services are performed primarily to allow the lawyer to give legal advice.[22] Obviously, then, the Kovel doctrine has a narrower scope of application when the attorney is a tax attorney than otherwise is the case.

A tax opinion is a prime example of a communication with outside counsel that can be privileged regardless of whether the opinion is informally or formally provided by the tax advisor. However, a tax opinion prepared for the specific purpose of disclosure to the IRS to avoid tax penalties may be attacked as not privileged, as the privilege would be waived upon disclosure to the IRS and, therefore, no expectation of confidentiality would be reasonable. A taxpayer should ensure that a tax opinion or document not intended to be used for penalty protection will remain privileged, and not waived by the inadvertent actions of the taxpayer.

As stated above, communications with in-house counsel also can be privileged. Thus, communications with employees for purposes of providing legal advice (e.g., tax advice regarding the legal consequence of a transaction) may well be privileged. Additionally, as stated above, because in-house counsel acts in a dual capacity -- as an employee and as an attorney -- a taxpayer's assertion of privilege for communications with in-house counsel may be scrutinized by courts to ensure that the in-house counsel was acting in the capacity of an attorney rather than an employee.

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[21] See, e.g., *United States v. Bornstein*, 977 F.2d 112 (4th Cir. 1992).
[22] Id.

Simply turning over an otherwise non-privileged document to an (in-house or outside) attorney will not make the document privileged.[23] Privilege is not afforded to pre-existing documents "filtered through" an attorney or received and retained by an attorney. Thus, a taxpayer cannot avoid the production of documents after receiving an IRS request by placing the documents in the hands of an attorney.[24]

2. Waiver of the Attorney-Client Privilege

Once the attorney-client privilege attaches to a communication, the taxpayer can prevent disclosure so long as the privilege has not been waived. The attorney-client privilege can be waived by actual waiver or implied waiver. Actual waiver occurs when a privileged communication is voluntarily, or involuntarily, disclosed to a party not covered by the privilege.[25] Implied waiver occurs when the taxpayer makes an assertion of fact that in fairness requires examination of protected communications, such as when the taxpayer relies upon an otherwise privileged tax opinion for penalty protection purposes.[26]

A taxpayer that waives the attorney-client privilege with respect to a single communication can affect the availability of the privilege for other communications. A waiver

[23] See Colton *v. United States*, 306 F.2d 633 (2nd Cir. 1962) (the court noted that "any other rule would permit a person to prevent disclosure of any of his papers by the simple expedient of keeping them in the possession of his attorney").

[24] See *United States v. Clark*, 847 F.2d 1467 (10th Cir. 1988); *United States v. Lyons*, 442 F.2d 1144 (1st Cir. 1971).

[25] Some courts treat an inadvertent disclosure as a waiver, but other courts apply a balancing test to determine whether an inadvertent disclosure constitutes a waiver. Compare *In re Sealed Case*, 877 F.2d 976 (D.C. Cir. 1989) (holding that an inadvertent disclosure constituted a voluntary waiver of the attorney-client privilege) with *United States v. BDO Seidman*, 2005-1 U.S.T.C. ¶ 50,273 (D. Ill. 2005) (noting that, if the disclosure at issue was unintentional, then the underlying documents could retain their privileged status).

[26] To determine whether an implied waiver has occurred, a recent court decision applied a three-factor balancing test. See *Johnston v. Commissioner*, 119 T.C. 27 (2002). In *Johnston*, the court considered whether (i) the privilege was the result on an affirmative act, such as filing suit, by the asserting party (e.g., the taxpayer), (ii) the asserting party put the protected information at issue through the affirmative act by making it relevant to a case (e.g., by relying on tax advice for penalty protection purposes), and (iii) the application of privilege would deny the opposing party access to information "vital" to its defense (e.g., when the IRS must prove that reliance on the tax advice was unreasonable). Id.

of privilege with respect to a single communication generally applies to all other communications with the same "subject matter."[27] The proper scope of subject matter waiver is not consistently defined among courts. Courts that take a narrow approach may limit the scope of the waived "subject matter" to material actually disclosed.[28] In contrast, other courts may adopt a broader formulation and treat the waiver as including privileged material with the same general subject matter of the disclosed communication.[29]

B. Federal Accountant-Client Privilege

Communications between an accountant and a client occurring after July 22, 1998 may be privileged under the Federal accountant-client privilege.[30] This privilege is intended to offer the same protections as the common law attorney-client privilege, but it carries several significant limitations. First, it does not apply to tax return advice. Second, the privilege does not apply to communications regarding "tax shelter" transactions (i.e., transactions with a significant purpose of tax avoidance).[31] Third, the privilege may be asserted only by a taxpayer or an accountant in a non-criminal proceeding before the IRS or brought in Federal court.

The Federal accountant-client privilege generally protects tax opinions prepared by an accountant that are not used for penalty protection, to the same extent as the common law attorney-client privilege protects such tax opinions prepared by an attorney. For example, in *United States v. KPMG, LLP*, 237 F. Supp. 2d 35 (D. D.C. 2003), the court found that a tax opinion prepared by an accountant was not privileged because the analysis in the opinion letter

[27] See, e.g., *In re Grand Jury Proceedings*, 78 F.3d 251 (6th Cir. 1996).

[28] See, e.g., *Weil v. Investment/Indicators Research & Management, Inc.*, 647 F.2d 18 (9th Cir. 1981) (the court found subject matter waiver "only as to the communications actually disclosed").

[29] See, e.g., *United States v. (Under Seal)*, 748 F.2d 871 (4th Cir. 1984) (the court stated that all otherwise privileged communications relating to the disclosed material lost its privilege).

[30] See 26 U.S.C. section 7525.

[31] The Federal statutory accountant-client privilege does not apply to communications regarding "corporate" tax shelters prior to October 22, 2004, and to any tax shelter after October 22, 2004.

was "prepared in connection with preparation of a tax return." The relevant tax return nexus was found because the opinion related to a transaction to be disclosed on the taxpayer's tax return. Despite this narrow reading of the privilege, a tax opinion delivered by either an attorney or an accountant may be protected under the work-product doctrine, described below.[32]

The Federal accountant-client privilege does not appear to protect investor lists maintained by accounting firms to market "tax shelters." In *United States v. BDO Seidman*, 337 F.3d 802 (7th Cir. 2003), the court held that investors could not have an expectation of confidentiality at the time of investment because the investors should have known that the accounting firm was required to disclose their names.[33] The reasoning in *BDO Seidman* was adopted in substance in *Doe v. KPMG*, *LLP*, 325 F. Supp. 746 (D. Tex. 2004), where an accounting firm notified the investors of the possibility of identity disclosure.

C. Work Product Doctrine

The purpose of the work product doctrine is to protect from disclosure the mental impressions of attorneys (and other representatives) that assist taxpayers during the litigation process.[34] The work product doctrine protects documents prepared "in anticipation of litigation" by or for another party, or by or for that other party's representative.[35] Although the IRS may be able to compel production of a document by establishing a substantial need for the document, an

[32] See *United States v. Adlman*, 134 F.3d 1194 (2nd Cir. 1998) (reversing and remanding lower court's decision to reject claim of work product privilege by reason that the tax opinion prepared by an accounting firm was prepared in anticipation of litigation).

[33] See also *United States v. Arthur Anderson*, 2003-2 U.S.T.C. ¶ 50,624 (D. Ill. 2003) (following the reasoning in *BDO Seidman*).

[34] See *Hickman v. Taylor*, 329 U.S. 495 (1947); F.R.C.P. 26(b)(3).

[35] See *Hickman v. Taylor*, 329 U.S. 495 (1947); F.R.C.P. 26(b)(3).

attorney's mental impression will be entitled to substantial protection, more so than factual information also contained in documents prepared in anticipation of litigation.[36]

The central issue under the work product doctrine concerns the interpretation of the phrase "in anticipation of litigation." Some courts adopt a taxpayer favorable standard that interprets the phrase "in anticipation of litigation" as "because of litigation."[37] Under this broad interpretation, the work product doctrine would apply if the document was prepared or obtained because of the prospect of litigation and, thus, may apply to a dual purpose document (e.g., a document prepared for business reasons and tax controversy purposes). Courts applying a narrower standard may apply the work product doctrine only if the primary motivating purpose behind the creation of the document was to aid in future litigation.[38]

D. Planning to Preserve Privilege

Taxpayers can take affirmative steps in order to maximize the likelihood that documents will be privileged and remain privileged. Generally, the more centrally involved a taxpayer makes its attorneys (inside and outside), the more meaningful the communications regarding legal issues, and the greater the documentation of their substantive role, the more likely it is that a privilege claim will be sustained. In contrast, communications between a taxpayer's attorneys (inside and outside) and its outside auditors should be limited because such communication may not be privileged and, in fact, may waive an otherwise applicable privilege. For the same reason,

[36] See, e.g., *Upjohn v. United States*, 449 U.S. 383 (1981) (Supreme Court noted that an attorney's mental impressions "cannot be disclosed simply on a showing of substantial need and inability to obtain the equivalent without undue hardship).

[37] See, e.g.,*United States v. Adlman*, 134 F.3d 1194 (2nd Cir. 1998); *Simon v. G.D. Searle & Co.*, 816 F.2d 397 (8th Cir. 1987) (the court adopted the standard of "whether in the light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtain *because* of the prospect of litigation (italics added)").

[38] See, e.g., *United States v. El Paso Corp.*, 682 F.2d 530 (5th Cir. 1982); *United States v. Davis*, 636 F.2d 1028 (5th Cir. 1981) (the court stated that "litigation need not be imminent . . . as long as the primary motivating purpose behind the creation of the document was to aid in possible future").

a taxpayer should be wary of the limitations of Kovel agreements with third-party consultants to which privileged information will be shared, such as accountants, but should use them where appropriate. Finally, where disclosure is compelled, a taxpayer must be aware of the potential for subject matter waiver of the attorney-client privilege that could reach of broader range of privileged communication. As such, taxpayers should exercise caution about what communications are put in writing.

A taxpayer should exercise special care with respect to sensitive individual documents for which privilege is sought. These documents should be disclosed to other employees or officers only on a need-to-know basis in order to reduce the likelihood that the document will be transferred to a third-party or will be handled in a manner inconsistent with an expectation of privacy, either one of which could result in waiver. To avoid an inadvertent waiver, the taxpayer should separate and clearly mark the sensitive legal documents. For the same reason, legal documents in general should be stored in a separate location from business documents not entitled to privilege.

Taxpayers seeking to protect a tax opinion from disclosure should try to avoid providing the opinion to an independent auditor in support of their tax reserve analyses (see discussion below regarding tax accrual work papers). Such an action could well result in a waiver of privilege for that document and others with common subject matter. In addition, a taxpayer should also keep tax opinions separate from non-privileged documents to avoid inadvertent waiver.

If the taxpayer wants privileged advice and penalty protection, the taxpayer should consider obtaining separate opinion letters, although the subject matter waiver doctrine may render the strategy ineffective. If a tax opinion has been prepared for penalty protection

purposes, the taxpayer should not treat the opinion as privileged in the taxpayer's files and, likewise, should not claim the opinion as privileged in response to an IDR, as these actions can increase the possibility that ultimate production of the document may be treated as a waiver of privilege. At a minimum, if a taxpayer has decided to use a tax opinion for penalty protection purposes after a prior assertion of privilege, the taxpayer should seek an agreement with the IRS that the IRS will not subsequently assert in the future that the production of the opinion waived privilege for all related communications and documents.

IV. Tax Accrual Workpapers

Tax accrual workpapers are audit workpapers prepared by the taxpayer, the taxpayer's accountant, or its independent auditor that relate to (i) the tax reserve for current, deferred, and potential or contingent tax liabilities, however classified or reported on audited financial statements, or (ii) footnotes disclosing those tax reserves on audited financial statements.[39] Tax accrual workpapers do not include tax reconciliation workpapers, or documents used in assembling and compiling financial data to be placed on a tax return.[40] In addition, tax accrual workpapers do not include other audit workpapers, such as documents that are retained by the independent accountant to establish the procedures followed, the tests performed, the information obtained, and the conclusions reached pertinent to an examination (e.g., work programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules of commentaries prepared or obtained by the auditor).[41]

1. Are Taxpayer Workpapers Privileged?

[39] See Internal Revenue Manual § 4.10.20.2 (July 2004).
[40] See Internal Revenue Manual § 4.10.20 (July 2004).
[41] Id.

The official IRS position is consistent with the general rule that tax accrual workpapers are not privileged. This general rule is derived from the well-established principle that the preparation of tax return information is typically not privileged.[42] However, some courts are reluctant to apply the general rule when the tax accrual workpapers are prepared by an attorney.[43] These courts are hesitant "to hold that a lawyer's analysis of the soft spots in a tax return and his judgments on the outcome of litigation on it are not legal advice."[44] In determining whether a tax reserve analysis is privileged, these courts may look to several factors including (i) whether the document represents legal advice, (ii) who has control over the file, (iii) who was involved in its preparation, and (iv) whether it was intended to be disclosed to third parties such as independent auditors.[45]

2. Why is it Difficult to Prevent Disclosure of Tax Accrual Workpapers?

In the current tax enforcement environment that stresses transparency, it is increasingly likely that the IRS will be successful if it seeks to obtain a taxpayer's tax accrual workpapers. First, the IRS has recently adjusted its position regarding when it will request tax accrual workpapers to require these documents more often. Second, independent auditors are increasingly reviewing tax accrual workpapers with the result that privilege attached to the workpapers may be waived.

The IRS broadened its policy regarding a request of tax accrual workpapers in 2002. Prior to that time, the historic IRS policy was to request tax accrual workpapers only under

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[42] See *United States v. Arthur Young*, 465 U.S. 805 (1984) (stating that no accountant-client privilege exists under the Federal common law and no work product immunity exists for tax accrual workpapers prepared by accountants).

[43] See *United States v. Rockwell International*, 897 F.2d 1255 (3rd Cir. 1990); *United States v. The El Paso Co.*, 682 F.2d 530, 541 (5th Cir. 1982).

[44] See, e.g., *United States v. The El Paso Co.*, 682 F.2d 530, 541 (5th Cir. 1982).

[45] See, e.g., *United States v. Rockwell International*, 897 F.2d 1255 (3rd Cir. 1990).

"unusual circumstances."[46] In 2002, the IRS altered its policy for tax returns filed after July 1, 2002, to request tax accrual workpapers for listed transactions,[47] and for all transactions of a taxpayer if a listed transaction has not been properly disclosed.[48] The IRS has subsequently refined this policy to add a standard for non-listed transactions and a discretionary standard.[49] The IRS will currently only request tax accrual workpapers for non-listed transactions if it cannot obtain the material from another source.[50] In addition, the IRS may request, at its discretion, all of a taxpayer's tax accrual workpapers if (i) the taxpayer participates in two or more listed transactions (even if properly disclosed) or (ii) there are reported financial irregularities.[51] As the IRS designates more and more transactions as listed transactions, and as the "substantially similar" standard puts more and more transactions in the "listed" category, the likelihood of an IRS request for tax accrual workpapers increases.

Along with the shift in IRS policy regarding tax accrual workpapers, independent auditors are requesting tax accrual workpapers with increasing frequency. One reason may be the enactment of Sarbanes-Oxley, which may cause auditors to review the tax reserve analyses of their clients with additional rigor. As a result, auditors may be more likely to request internal legal memoranda and external opinion letters. This position is also supported by the regulatory body establishing standards of practice for auditors. Under guidelines established by the AICPA,

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[46] Announcement 84-46, 1984-14 I.R.B. 18. Note that the IRS may also seek workpapers for transactions that are "substantially similar to" the listed transactions that it has identified. See Treas. Reg. § 1.6011-4(b)(2).

[47] A listed transaction is defined as "A listed transaction is a transaction that is the same as or substantially similar to one of the types of transactions that the Internal Revenue Service (IRS) has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction." See Treas. Reg. § 1.6011-4(b)(2).

[48] Announcement 2002-63, 2002-2 C.B. 72.

[49] IRM § 4.10.20 (July 2004).

[50] Id.

[51] Id.

auditors are required to ask for internal and external legal analyses that are relied upon by taxpayers in establishing tax reserves, notwithstanding that these documents may be privileged.[52]

3. Protecting Tax Accrual Workpapers

A taxpayer may be able to make several arguments to protect the confidentiality of tax accrual workpapers. First, the independent auditor can perform its own tax analysis of the items in question rather than having the taxpayer turn over privileged opinion letters. This addditional work is, of course, at the taxpayer's expense, and there is a risk that the auditor will not agree with the taxpayer's position. Second, a taxpayer can argue that the item is not material. Third, a taxpayer can provide to the auditor analyses of tax positions prepared by in-house counsel and represent to the auditor that its position relies on these analyses, not outside advice. Thereafter, a taxpayer may be able to argue that any opinions from outside advisors regarding a tax issue are merely additional comfort and do not form the basis for taxpayer's position. It should be noted, however, that the in-house analyses themselves may be quite sensitive. In addition, the taxpayer will likely have to overcome a significant burden of proof with its auditor, who can be expected to question whether in fact the taxpayer did rely on the outside advice.

In addition (although the effectiveness of this strategy may be questionable), taxpayers have shown (but not given) their attest auditor relevant background documents with respect to particular transactions. If adequate control over these viewed documents is maintained and copies are not provided to the auditor, these documents may not be considered by the IRS to be tax accrual workpapers subject to disclosure. This technique has been used when a transaction is likely to be viewed as a listed transaction, because the taxpayer is relatively sure that if a document does become a tax accrual workpaper, it will likely be requested.

[52] AICPA AU Section 9326 -- Evidential Matter: Auditing Interpretations of Section 326, ¶.22.

Finally, a taxpayer can rely on the strength of the work product doctrine. One argument would be that the tax reserve is, by definition, a litigation risk analysis. If the work product privilege is so established, it generally cannot be waived even if the privileged document is subsequently turned over to the attest auditor.[53] To the extent that its tax reserve analysis prepared by in-house and outside counsel was prepared in anticipation of litigation, the likelihood that the work product doctrine attaches to tax reserve analyses increases. Moreover, if appropriate, a taxpayer should explicitly label the tax reserve analyses as work product and make sure that such analyses are prepared with input from attorneys that are engaged in a controversy practice as evidenced prior experience litigating tax matters.

V. Recently Enacted Tax Shelter Disclosure and Penalty Provisions

The Code has long provided for disclosure rules designed to provide information perceived vital to IRS enforcement and to deter taxpayers from avoiding their tax obligations. For example, the Code has required disclosure of certain transactions perceived to be abusive in order to deter taxpayers from participating into such transactions and allow the IRS to receive the information necessary to enforce the tax obligations of those who do so participate. The American Jobs Creation Act of 2004 ("AJCA") recently expanded these particular disclosure rules and enhanced the penalties imposed for non-compliance with these rules.

A. Taxpayer Disclosure

[53] See, e.g., *United States v. Massachusetts Inst. of Technology*, 97-1 U.S.T.C. ¶ 50,269 (1st Cir. 1997) (stating that "the cases approach uniformity in implying that work-product protection is not as easily waived as the attorney-client privilege. The privilege, it is said, is designed to protect confidentiality, so that any disclosure outside the magic circle is inconsistent with the privilege; by contrast, work product protection is provided against "adversaries," so only disclosing material in a way inconsistent with keeping it from an adversary waives work product protection.").

As amended by AJCA, section 6011[54] requires a taxpayer to attach a disclosure statement to its tax return if the taxpayer has participated in a "reportable transaction."[55] A "reportable transaction" is defined as any one of six types of transactions: a listed transaction, a confidential transaction, a transaction with contractual protection, a transaction with a significant loss, a transaction with significant tax-book differences, and a transaction involving a brief asset holding period.[56] The above classes are refined by IRS guidance that allows a taxpayer to treat certain transactions otherwise satisfying the general criteria as a non-reportable transaction.[57] For example, the IRS has stated that a casualty loss would not be considered a reportable transaction even though the amount of the loss may otherwise qualify the transaction as a reportable transaction.[58]

A listed transaction is a particular transaction that the IRS considers to be a "tax avoidance transaction."[59] The IRS must notify taxpayers when it considered a specific transaction to be a listed transaction. For example, the IRS recently issued Notice 2005-13, which notified taxpayers that the IRS would consider certain sale-in, lease-back transactions to be a listed transaction.[60] Prior to becoming a listed transaction, a transaction could well be a reportable transaction.

Section 6707A was enacted by AJCA to impose monetary penalties upon taxpayers who fail to disclose reportable transactions. Under this new rule, a taxpayer that fails to disclose a reportable transaction (other than a listed transaction) is subject to a penalty of $10,000 if the

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[54] All section references refer to the Internal Revenue Code of 1986, as amended, and as appropriate.
[55] Section 6011.
[56] Treas. Reg. § 1.6011-4(b).
[57] See Rev. Proc. 2004-65, I.R.B. 2004-50 (for transactions with contractual protection); Rev. Proc. 2004-66, I.R.B. 2004-50, (for loss transactions; Rev. Proc. 2004-67,(for transactions resulting in significant book-tax differences); Rev. Proc. 2004-68, I.R.B. 2004-50 (for transactions with brief holding periods).
[58] Rev. Proc. 2004-66, I.R.B. 2004-50.
[59] See Treas. Reg. § 1.6011-4(b)(2).
[60] Notice 2005-13, I.R.B. 2005-9.

taxpayer is a natural person or $50,000 for all other taxpayers.[61] If a taxpayer fails to disclose a listed transaction, the penalty is increased to $100,000 if the taxpayer is a natural person or $200,000 for all other taxpayers.

The IRS does have discretion to waive the section 6707A penalty with respect to a reportable transaction (other than a listed transaction) if waiving the penalty "promotes tax compliance and efficient tax administration."[62] Although regulations have not been issued to provide specific guidance as to when the IRS would waive the penalty, the Conference Report to the AJCA indicates that the disclosure penalty may be waived if (i) the taxpayer has a history of complying with the tax laws, (ii) the violation is due to an unintentional mistake of fact (and not law), (iii) imposing the penalty would be against "equity and good conscience" and (iv) rescinding the penalty promotes tax compliance.[63]

The AJCA also imposes additional consequences, in addition to the monetary penalties, upon certain taxpayers that fail to disclose a reportable transaction. For example, a publicly traded corporate taxpayer must disclose any imposition of a section 6707A penalty in an SEC filing.[64] In addition, a failure to disclose a reportable transaction may increase the section 6662A accuracy-related penalty (described below) and preclude a taxpayer from avoiding the penalty by establishing that it had reasonable cause to believe that its position was correct with respect to a reportable transaction.[65] Thus, a tax opinion that would otherwise assist a taxpayer in avoiding the section 6662A penalty with respect to a reportable transaction would be worthless if the taxpayer had failed to disclose the transaction that gave rise to the accuracy-related penalty.

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[61] Section 6707A(b).
[62] Section 6707A(d)
[63] Conference Report to the AJCA at 374.
[64] Section 6707A(e).
[65] Section 6664(d)(2). Note that the same result obtains even if the IRS waives the penalty for failing to disclose a reportable transaction.

Finally, a failure to disclose a listed transaction would provide the IRS with an unlimited statute of limitations to assess the taxpayer's tax obligation with respect to the listed transaction.[66]

These new reporting rules add an additional layer to a taxpayer's decision making process with respect to any transaction. In addition to determining whether the transaction satisfies any statutory, regulatory, or judicial requirements, the taxpayer must also determine whether the transaction, though otherwise benign, constitutes a reportable transaction that requires disclosure. This is not always a simple task. For instance, whether a transaction creates a book-tax difference is not easily understood. As described above, making an incorrect determination on this issue can have significant consequences, including the obligation, at least in the case a publicly traded corporate shareholder, to publicly disclose any imposition of the section 6707A penalty. Therefore, taxpayers (and their advisors) should attempt to determine as early as possible in any transaction process what the taxpayers' reporting obligations under section 6707A could be.

B. Material Advisor Disclosure

Whether a transaction constitutes a reportable transaction also has significant consequences for tax advisors. Prior to the AJCA, a "tax shelter organizer" was required to register a tax shelter with the IRS.[67] The definitions of both "tax shelter organizer" and "tax shelter" were sufficiently narrow to insure that most tax advisors were not obligated to disclose details of routine transactions for which they had provided tax advice.

The AJCA replaced tax shelter organizer registration with a requirement that "material advisors" must file an information return with respect to reportable transactions for which they

[66] Section 6501(c)(10). Note that a failure to disclose a listed transaction could also result in the IRS seeking all of the taxpayer's tax accrual workpapers.

[67] See prior section 6111.

have provided advice.[68] A material advisor includes anyone who provides material aid, assistance, or advice with respect to insuring, organizing, promoting, selling, implementing, or carrying out any reportable transaction and, in return, receives (directly or indirectly) more than $250,000 (or $50,000 if substantially all of the tax benefits of the reportable transaction are provided to natural persons).[69] Although the extent to which the IRS will limit the scope of the "material advisor" definition through regulatory guidance is unclear, the IRS has taken a small step in that direction by issuing interim guidance. In Notice 2004-80, the IRS stated that a tax advisor opining on a reportable transaction with a significant book-tax difference will be considered a material advisor only if the person makes a statement relating to the financial accounting treatment of the item that gives rise to significant book-tax difference.[70]

It also remains unclear when, in the course of providing advice, a tax advisor will be considered as "organizing" the transaction for which the advice is given and, thus, be treated as a material advisor. For example, a tax advisor may suggest alternative approaches to a particular transaction in the course of giving a tax opinion without structuring the whole transaction. The IRS has attempted to clarify the meaning of "participating in the organization" by stating that the term includes, among other activities, (i) the devising, creating, investigating, or initiating the tax strategy, and (ii) the performance of acts relating to the development or establishment of the transaction, such as preparing a partnership agreement or articles of incorporation.[71]

A material advisor that fails to disclose a reportable transaction is subject to monetary penalties that can be more substantial than those imposed under prior law. Prior to enactment of the material advisor rules, a tax shelter organizer was generally subject to a penalty equal to the

[68] Section 6111.
[69] Section 6111(b)(1).
[70] Notice 2004-80, I.R.B. 2004-50.
[71] Notice 2005-12, I.R.B. 2005-7.

greater of one percent of the amount invested in the tax shelter or $500. The AJCA amended the monetary penalty to provide that a material advisor is subject to a $50,000 fine, which is increased with respect to listed transactions to the greater of $200,000 or 50 percent of the amount received for the material advisor's services.[72]

The AJCA also amended the rules requiring a tax shelter organizer to maintain investor lists (i.e., a list of those taxpayers that participated in the tax shelter).[73] The AJCA altered the existing rules to require that a material advisor maintain a list of each person to whom the advisor has acted as a material advisor regarding a reportable transaction.[74] The revised penalty provision provides that a material advisor is subject to a $10,000 fine for each day the material advisor fails to make the investor list available to the IRS after the 20-day grace period following an IRS request.[75] Prior to the changes made by the AJCA, a tax shelter organizer was subject to a $50 penalty for each person that the tax shelter organizer failed to record on the investor list (up to a maximum penalty of $100,000).[76]

These broader disclosure rules and stiffer penalties obligate tax advisors to carefully review whether a transaction constitutes a reportable transaction. Coordination with the client on these issues is, obviously, crucial. Failure to agree on the status of a transaction may have significant consequences for the client relationship. In addition, it may not be clear where attorney-client privilege ends, and reporting obligations begin. Therefore, advisors should consider the impact of the material advisor and reportable transaction rules from the beginning of a project and ensure that both they and their clients understand what is at stake.

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[72] Section 6707(b).
[73] Section 6112.
[74] Section 6112(a).
[75] Section 6708(a).
[76] Prior Section 6708(a).

C. Requirements under Section 6662 and 6662A

In the current environment, taxpayers seeking to gain penalty protection by relying on a tax opinion may find themselves at the crossroads of complex rules imposed upon them and also upon the tax advisor providing the tax advice. First, the rules described below may not allow a tax advisor to provide an opinion with a sufficient level of certainty to protect the taxpayer from penalties. Second, even if the advisor could provide such an opinion, the opinion may not provide the desired protection if the advisor is a material advisor, or the opinion is a disqualified opinion.

1. Section 6662

Section 6662 imposes a penalty equal to 20 percent of the amount of a substantial understatement.[77] The amount of a substantial understatement depends upon the tax classification of the taxpayer. For corporate taxpayers (other than S corporations and personal holding companies), a substantial understatement is the excess of the amount of an understatement of tax liability that exceeds the lesser of $10,000,000 or 10 percent of the tax required to be shown on the return for the taxable year.[78] For all other taxpayers, a substantial understatement is the amount of an understatement exceeding the greater of $5,000 or 10 percent of the tax required to be shown on the tax return for the taxable year.[79]

The section 6662 penalty does not apply to the extent a taxpayer has substantial authority or a reasonable basis (and the taxpayer discloses the transaction) for the tax position taken on the tax return.[80] The "substantial authority" standard is less stringent that the "more likely than not"

[77] Section 6662(a).
[78] Section 6662(d)(1)(B).
[79] Section 6662(d)(1)(A).
[80] Section 6662(d)(2)(B).

standard but greater than a "reasonable basis" standard.[81] Although there may be considerable disagreement among tax practitioners, the "reasonable basis" standard may require anywhere from 10 to 30 percent chance of success while a "substantial authority" standard may require more than 25 percent but less than 50 percent, the standard for "more likely than not." In any case, although not explicitly required, a taxpayer may seek an opinion from a tax advisor to confirm that a return position satisfies the standard for substantial authority or reasonable basis.

The substantial authority or reasonable basis exception for an understatement of tax does not apply to the extent the understatement is attributable to a "tax shelter." For purposes of the section 6662 penalty, a tax shelter is defined as a transaction with a significant purpose of tax avoidance.[82] Because the term "significant purpose of tax avoidance" has not been defined by the IRS or the courts, taxpayers may not know what the standard is precisely enough to be comfortable availing themselves of the substantial authority or reasonable basis exception, and may instead opt to avail themselves of the reasonable cause exception.

Taxpayers can avoid the section 6662 penalty by qualifying for the "reasonable cause" exception under section 6664 regardless of whether the understatement is attributable to a "tax shelter" transaction. This is true even if the transaction was successfully challenged by the IRS. Under the "reasonable cause" exception, a taxpayer can avoid the section 6662 penalty by showing that he or she had a reasonable cause for the tax position and the taxpayer acted in good faith with respect to the tax position.[83] To do so, a taxpayer can rely upon the advice of a tax advisor.[84]

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[81] See Treas. Reg. § 1.6662-3(b)(3) (stating that a return position can satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard).

[82] Section 6662(d)(1)(C).

[83] Section 6664(c).

[84] Treas. Reg. § 1.6664-3(c).

Generally, a tax opinion received from a tax advisor is sufficient to establish reasonable cause so long as the taxpayer does not know (or have reason to know) that the opinion has omitted facts relevant to the determination or relies upon unreasonable assumptions.[85] However, as witnessed in a recent high-profile case, a tax opinion does not guarantee a finding of "reasonable cause."[86] A strengthened reasonable cause exception applies to corporations engaging in a tax shelter transaction: the opinion must clearly state that the tax position is "more likely than not" to be upheld if challenged by the IRS.[87]

2. Section 6662A

The AJCA enacted section 6662A to impose an accuracy-related penalty upon a "reportable transaction understatement." A "reportable transaction understatement" is an understatement resulting from either a listed transaction or a reportable transaction with a significant purpose of tax avoidance.[88] The section 6662A penalty for a reportable transaction understatement is generally set at 20 percent of the amount of the understatement.[89] However, this penalty is increased to 30 percent if the transaction is not adequately disclosed to the IRS.[90] The amount of the understatement for section 6662A purposes is the sum of the product of the highest corporate or individual rate, as appropriate, and the increase in taxable income resulting from the proper treatment of an item (and the amount of any decrease in the aggregate amount of

[85] Id.
[86] *Long Term Capital Holdings v. United States*, 330 F. Supp 2d. (DC Conn. 2004).
[87] Treas. Reg. § 1.6664-3(f)(2). Note that the AJCA clarified that non-corporate taxpayers as well as corporate taxpayers could not reduce the amount of an underpayment attributable to a tax shelter by a showing of "substantial authority" or a "reasonable basis" for its tax position. However, the AJCA did not alter the disparate treatment between a corporate taxpayer and a non-corporate taxpayer with respect to the reasonable cause exception (i.e., a corporate taxpayer needs a "more likely than not" opinion to avoid the section 6662 penalty).
[88] Section 6662A(b)(2).
[89] Section 6662A(a).
[90] Section 6662A(c).

credits that results from a difference between the taxpayer's treatment of an item and the proper tax treatment of an item).[91]

The AJCA harmonizes the application of the section 6662 penalty and the 6662A penalty so that any particular understatement cannot simultaneously be subject to both the section 6662 penalty and the section 6662A penalty.[92] An understatement subject to the section 6662A penalty, however, is counted in determining whether a taxpayer has met the "substantial understatement" threshold under section 6662.[93] For example, assume that a corporate taxpayer has a $20 million tax understatement of which $19 million is attributable to a listed transaction, and has a $200 million tax liability after adjustment. The corporate taxpayer is subject to a section 6662A penalty upon the $19 million "reportable transaction understatement." In addition, although the $19 million "reportable transaction understatement" is not subject to the section 6662 penalty as a substantial understatement, the $19 million understatement is taken into account in determining whether there has been a substantial understatement (i.e., in this case, the amount of the understatement exceeding $10 million). As a result, the corporate taxpayer would be subject to a section 6662 penalty for a substantial understatement, but only upon the remaining $1 million understatement of tax liability.

As with the section 6662 penalty, a taxpayer can avoid the section 6662A penalty by showing reasonable cause. However, the AJCA has strengthened the reasonable cause exception with respect to the section 6662A penalty. To prove reasonable cause, a taxpayer (either a corporation or a non-corporate taxpayer) must adequately disclose the transaction, there must be substantial authority for the tax position taken by the taxpayer, and the taxpayer must reasonably

[91] Section 6662A(b)(1).
[92] Sections 6662(d) and 6662A(e).
[93] Section 6662A(e).

believe that that the tax position is more likely than not the proper tax treatment.[94] While this is commensurate with establishing the reasonable cause exception for a corporate taxpayer's understatement attributable to a tax shelter for the section 6662 penalty, the AJCA has strengthened the reasonable cause exception even further with respect to the section 6662A penalty. Under the AJCA changes, a taxpayer is treated as having a reasonable belief only if the belief (i) is based upon the facts and law that exist at the time of the tax return, and (ii) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that the return will not be audited, the treatment will not be raised on audit, or the treatment will be resolved through settlement if raised on audit.[95]

Proof of a reasonable belief may be established by an opinion of a tax advisor; but the opinions of some advisors do not qualify. In particular, section 6664(d)(3)(B)(iii) provides that a tax opinion from a "disqualified advisor" cannot be relied upon to avoid the accuracy-related penalties of section 6662A.[96] The term "disqualified advisor" refers to four separate classes of tax advisors.[97] Two of these classes include tax advisors that have certain financial interests in the transaction to which the opinion is rendered and another includes a tax advisor that is compensated by a material advisor.[98]

The final class, and the arguably broadest class, includes a material advisor that "participate[s] in the organization, management, promotion, or the sale of the transaction" to which the tax opinion relates (or is related to any person who so participates).[99] The term "material advisor" is given the same meaning as under section 6111(b)(1) and, through interim

[94] Section 6664(d)(2).
[95] Section 6664(d)(3).
[96] Section 6664(d)(3)(B)(ii).
[97] Id.
[98] Id.
[99] Section 6664(d)(3)(B)(ii)(I).

IRS guidance, also Treas. Reg. § 301.6112-1(c)(2).[100] As a result, a material advisor must typically receive (directly or indirectly) more than $250,000 from providing the tax opinion to which penalty protection is sought.[101]

Section 6662A penalty protection is also denied for certain "disqualified opinions."[102] For purposes of section 6662A, a disqualified opinion is defined as an opinion that that (i) is based on unreasonable factual assumptions, (ii) unreasonably relies on presumptions, statements, findings, or agreements of the taxpayer or any other person, (iii) does not identify and consider all of the relevant facts, or (iv) fails to meet any other requirement as the IRS may provide.[103] The IRS has not issued guidance on interpreting any of these four types of disqualified opinions. Clarification is provided in the Circular 230 rules, and if the practitioner standards of Circular 230 are designed to complement the requirements under section 6662A, then perhaps Circular 230 would provide appropriate guidance.

VI. Circular 230

The Circular 230 regulations establish the ethical standards required of tax practitioners. These regulations are technically not relevant in determining whether a taxpayer may rely on an opinion for purposes of avoiding tax penalties. However, as described in greater detail below, these regulations can dictate whether a tax advisor can actually provide the advice sought by a taxpayer.

The revised Circular 230 approach to regulating tax advisor conduct provides for an aspirational standard applicable to all tax advisors as well as for specific standards applicable to

[100] Section 6664(d) and Notice 2004-80.
[101] Section 6111(b). The threshold amount is reduced to $50,000 if substantially all of the tax benefits of the reportable transaction are provided to natural persons.
[102] See section 6664(d)(3)(B)(iii).
[103] Id.

written advice, which can subject a tax advisor to sanctions. A tax advisor that fails to meet the specific requirements of Circular 230 may be subject to non-monetary sanctions, such as disbarment or suspension.

A. Best Practices Standard

The aspirational standard set forth in the Circular 230 rules is referred to as the "best practices" standard. The "best practices" standards generally parallel the ABA Model Rules for Professional Conduct. The "best practices" standard provides that a tax advisor "should provide, in fact, clients with the highest quality representation" and that tax group managers are urged to ensure that these guidelines are followed by tax group personnel.[104]

B. Covered Opinion Rules

1. Definition of Covered Opinion

The specific requirements set forth for written communication apply to both a "covered opinion" and "other written communication." A covered opinion is generally written advice, including electronic communication, on one or more U.S. Federal tax issues arising from one of three categories of transactions. Note that the definition of a covered opinion includes not only the formal tax opinion drafted for penalty protection purposes, but also more casual communication, such an e-mail between the taxpayer and the tax advisor. The Circular 230 rules, however, do provide for exceptions to the covered opinion standard described above. A covered opinion does not include certain preliminary advice, certain advice given after a tax return is filed, negative advice, and advice given by in-house counsel with respect to the tax

[104] Section 10.33, Circular 230.

liability of the employer.[105] The exclusion of advice given after a tax return is filed allows a tax advisor and the taxpayer to engage in full and frank discussions during the examination period and litigation with respect to the transaction giving rise to the asserted tax liability.

As mentioned, the Circular 230 rules impose the more stringent covered opinion rules upon three classes of tax advice. First, the covered opinion rules apply to written communication regarding a listed transaction, or any transaction that is substantially similar to a listed transaction.[106] Second, the covered opinion rules apply to transactions[107] with the principal purpose of tax avoidance.[108] The third category, and arguably the broadest and most controversial, includes those transactions[109] that have a significant purpose of tax avoidance, if the opinion constitutes (i) a reliance opinion, (ii) a marketed opinion, (iii) an opinion subject to conditions of confidentiality, or (iv) an opinion subject to contractual protection.[110]

The Circular 230 rules define a reliance opinion as written advice with a conclusion of "more likely than not."[111] A reliance opinion is also not limited to formal opinions or written advice related to tax shelters. A tax advisor otherwise providing a reliance opinion can "opt out" of the "covered opinion" rules if the tax advisor prominently discloses that the written advice cannot be relied upon to avoid penalties.[112]

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[105] Section 10.35(a)(b)(ii), Circular 230. The covered opinion standard also do not include advice given with respect to the qualification of a qualified plan, state or local bond opinions, and documents required to be filed with the SEC.

[106] Section 10.35, Circular 230.

[107] The term "transactions" in this context refers to a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement.

[108] On May 18, 2005, the IRS amended Circular 230 to, in part, clarify that the term "the principal purpose of tax avoidance" means a purpose exceeds any other purpose. Although it is not clear, it appears that the tax avoidance purpose is required to exceed the aggregate of the business purposes rather than all of the business purposes separately.

[109] See note 107.

[110] Section 10.35(b)(2)(C), Circular 230.

[111] Section 10.35(b)(4), Circular 230.

[112] Id.

A marketed opinion is defined as advice the tax practitioner knows (or has reason to know) will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing or recommending a transaction.[113] Similar to a reliance opinion, a tax advisor can "opt out" of the covered opinion rules for a marketed opinion by disclosing that the tax advice cannot be relied upon for penalty protection purposes. For purposes of the Circular 230 rules, the concepts of contractual protection and conditions of confidentiality are given meanings similar to those provided in the context of reportable transactions.[114]

Under these rules, numerous taxpayer communications could constitute covered opinions, even though such communications had not theretofore been accorded such heightened status. For example, these rules technically apply to outlines, articles, or books.[115] A more practical concern may be whether tax disclosures to entities other than the SEC (e.g., the Toronto Stock Exchange) will be excluded from the definition of a covered opinion. Similarly, it is unclear whether tax disclosures in a private placement memorandum ("PPM") would be considered a covered opinion, or whether the PPM would itself be considered a marketed opinion and, thus, a covered opinion.

The apparently broad scope of the term "marketed opinion" raises numerous other issues. For example, it is unclear from the text of Circular 230 whether the definition of the term "marketed opinion" would include an opinion letter issued to an investment bank that confirmed as non-misleading a registration statement containing tax disclosure. This issue has, apparently,

[113] Section 10.35(b)(5).
[114] Section 10.35(b)(6) and (7).
[115] The IRS has informally stated that it would not consider articles, books, outlines, and other similar materials to be covered opinions.

been resolved recently.[116] Similarly, tax advice given to an investment bank for its use on a client matter may be treated as a marketed opinion because the tax advisor may have reason to know that the investment bank is "using" the tax advice to recommend an investment to its client. This may be a concern even if the customer is unaware of the tax advice sought by and provided to the investment bank. As another example, a tax opinion provided to a partner that uses the opinion to influence other partners to retain their partnership interests could be considered a marketed opinion.

Memoranda also raise issues as to the scope of the term covered opinion. While the government has indicated that the covered opinion rules do not apply to a file memorandum, it is not clear whether the same result would obtain if the client is allowed to read the memorandum, or to make a copy of the memorandum. Moreover, it is uncertain whether the covered opinion rules would apply to a memorandum of law regarding a proposed, but not a specific transaction.

It should be noted that the class of transactions subject to the covered opinion rules roughly correspond to the those transactions that would subject the taxpayer to reporting requirements, and those transactions to which the avoidance of tax penalties would require the taxpayer to receive an opinion concluding "more likely than not." For example, a corporation that participates in a transaction that has a significant purpose of tax avoidance can avoid the accuracy-related penalty if it relies upon a tax opinion that concludes with a "more likely than not standard", which would constitute a reliance opinion.

2. Standards for Covered Opinions

[116] "Attorneys Comment on Application of Circular 230 to Capital Markets, M&A Opinions, Letters", Tax Notes Today (July 1, 2005) (written record of a phone conversation with IRS officials in which the IRS confirmed, at least orally, that an opinion that (i) refers to the disclosure made in the document provided to investors, (ii) confirms the accuracy of the tax disclosure in particular, or (iii) confirms an opinion described in such tax disclosure, need not contain an "opt-out" legend if the underlying tax disclosure itself complies with section 10.35 of Circular 230).

If written advice is subject to the covered opinion rules, the tax advisor must satisfy certain requirements in providing a tax opinion. These requirements apply in addition to the aspirational and generally applicable "best practices" standard. To comply with the covered opinion rules, a tax advisor providing a covered opinion must (i) consider all of the relevant facts, (ii) relate the law to the facts, and (iii) evaluate all significant federal tax issues, and provide a conclusion for all such issues.[117]

A tax advisor is treated as considering all the relevant facts if the tax advisor makes reasonable efforts to identify and ascertain the facts and does not base the opinion on unreasonable factual assumptions, factual representations, statements, or findings.[118] Notably, for Circular 230 purposes, it is per se unreasonable to assume that a given transaction has business purpose. As a result, a taxpayer cannot rely on the taxpayer's representation that the transaction at issue has a business purpose.

A tax advisor has not properly related the law to the facts if the tax advisor has assumed the favorable resolution of any significant tax issue.[119] The tax advisor must also consider applicable judicial doctrines. Moreover, the opinion must no contain internally inconsistent legal analyses or conclusions.

The final requirement for a tax advisor providing a covered opinion is that a tax advisor must generally evaluate each significant Federal tax issue, and must provide a conclusion for each such issue.[120] Specifically, the tax advisor must conclude as to the likelihood that the taxpayer will prevail on the merits. If a tax advisor cannot reach a "more likely than not"

[117] Section 10.35(c), Circular 230.
[118] Section 10.35(c)(1), Circular 230.
[119] Section 10.35(c)(2), Circular 230.
[120] Section 10.35(c)(3), Circular 230.

conclusion with respect to a significant tax issue, then the advice must prominently disclose that fact and state that the taxpayer may not use it to avoid penalties.[121]

The Circular 230 rules provide an exception, however, to the general rule that a tax advisor must evaluate and conclude with respect to each significant Federal tax issue. A taxpayer and a tax advisor can agree to limit the scope of the opinion to cover less than all of the significant tax issues.[122] This so-called "limited scope" opinion must prominently disclose that (i) the opinion is a limited scope opinion, (ii) other tax issues may affect the conclusion, and (iii) the taxpayer may not use the opinion for the purpose of avoiding penalties with respect to significant federal tax issues outside of the scope of the opinion.[123]

3. Practical Implications of Covered Opinion Rules

The revised Circular 230 rules governing covered opinions represent a stark change from the previous rules governing the ethical responsibilities of the tax advisor and certainly have impacted both the informal and formal communications between tax advisors and their clients. Casual e-mail advice is already less common and less detailed, and accompanied by the ubiquitous disclaimer along the lines of "the following was not written and cannot be used for penalty avoidance purposes." The new rules will also likely impact formal written advice used for penalty protection, such as for the section 6662 and 6662A penalties. For example, formal written advice may be longer, more detailed and more time-consuming and costly to produce.

C. Other Written Advice Standard

[121] Id.
[122] Section 10.35(c)(3)(v).
[123] Section 10.35(e)(3).

The revised Circular 230 rules also introduce new standards applicable to written advice other than covered opinions. Under the new rules, a tax advisor cannot base its written tax advice (that is not considered a covered opinion) on unreasonable factual or legal assumptions, unreasonably rely on representations, statements, findings, or agreements of the taxpayer or any other person, consider less than all of the relevant facts, and take into account the changes the return will be audited.[124] As may be apparent, these standards are similar to those applicable to covered opinions, but without additional elaboration. Thus, for example, it is unclear whether a tax advisor can rely on the taxpayer's representation of business purpose when providing tax advice that does not rise to the level of a covered opinion.

VII. Recent Supreme Court Decision

In another potentially significant related development, the recent Supreme Court decision in *Pasquantino v. United States*, 544 U.S. __, 125 S. Ct. 1766, (2005), may affect what many practitioners would consider routine international tax advice. In *Pasquantino*, the Supreme Court held that (1) the U.S. federal wire fraud statute, 18 U.S.C. section 1343, could apply to a fraudulent scheme to smuggle liquor into Canada, evading Canadian excise tax laws, and (2) the wire fraud prosecution under review did not violate the common law "revenue rule," a long-standing legal principle that prohibits domestic courts from assisting in the collection of foreign tax liabilities. Regarding the second issue, the Court found no violation of the revenue rule even though, under its holding, the United States would recover the taxes due and remit them to the Canadian government, with the effect that the prosecution would, in substance, enforce the collection of a foreign tax obligation, a result the revenue rule was intended to prevent.

[124] Section 10.37, Circular 230.

The Court did not view the prosecution as a direct enforcement of foreign tax law in the United States. As such, the Court was able to harmonize the wire fraud statute with the revenue rule. It left open the question, however, of how direct the enforcement must be to be barred by the revenue rule. The Court conceded that the criminal prosecution under review did "enforce" a foreign tax obligation, albeit in an "indirect" manner, but stated that the common law had yet to clearly establish the difference between permissible and impermissible indirect enforcement of a foreign tax obligation. The Court distinguished prior cases in which courts have found impermissible indirect enforcement of a foreign tax obligation. In particular, the Court noted that the wire fraud statute that was being enforced is a criminal statute that is intended specifically to deter domestic fraudulent conduct, an object independent of foreign tax enforcement, reasoning that any link between the case and foreign tax collection was incidental and attenuated.

The four dissenting justices believed that the criminal prosecution was inconsistent with the revenue rule because the evasion of foreign taxes was the basis for the criminal prosecution. The dissenting justices also invoked the rule of lenity, which provides that an ambiguous criminal statute should be interpreted so as to result in less severe punishment. Two of the dissenting justices also argued that Congress never intended to grant the federal wire fraud statute extraterritorial effect. They noted that U.S. law specifically allows for the criminal enforcement of foreign customs laws only where the other country has a reciprocal commitment to enforce U.S. customs laws, which Canada does not have. They also pointed out that the United States and Canada have entered into a fairly detailed tax collection agreement as part of their income tax treaty, and such agreement would prohibit collection of the tax in this case.

Pasquantino suggests that, for the revenue rule to bar an action in a U.S. court, there must be a strong relationship between the U.S. action and the foreign tax collection. Even when, as here, the statutory scheme (the Mandatory Victims Retribution Act of 1996, 18 U.S.C. section 3663A) requires that amounts recovered through the action be used to pay the foreign tax, the revenue rule is incapable of interfering with the enforcement of the action. As a result, *Pasquantino* may call into question the result in prior court decisions, such as *Attorney General of Canada v. R.J. Reynolds Tobacco Holdings Inc.,* 268 F.3d 103 (2d Cir. 2001), *cert. denied* 537 U.S. 1000 (2002), that have applied the revenue rule to dismiss civil antiracketeering claims brought by a foreign government in a U.S. court for violations of its customs laws. Although the Court avoided opining on this issue in *Pasquantino*, soon after the decision the Court directed the Second Circuit Court of Appeals to revisit this issue, considering *Pasquantino*, by vacating and remanding the decision in *European Community v. RJR Nabisco*, 150 F. Supp.2d 456 (E.D. N.Y. 2001), *affirmed* 355 F.3d. 123 (2d Cir. 2004), *vacated, remanded, cert. granted* 544 U.S. __ (2005).

The *Pasquantino* decision raises several tax policy concerns. On one hand, it is obviously desirable that revenue laws be rigorously enforced. Toward that end, increased international cooperation in enforcement is a laudable goal. On the other hand, foreign revenue laws may be confiscatory, lack due process, and so forth, and it is arguably not appropriate for one sovereign to have to make judgments about these matters with respect to another sovereign's laws, or to question the policies behind another sovereign's revenue laws. Also, the ground rules covering international tax collection have been reserved to tax treaties, which specifically prescribe conditions under which one country will enforce revenue laws of another. And it is in the context of tax treaty negotiations that those conditions are best determined.

Ironically, although *Pasquantino* seems to strengthen the ability of governments to collect taxes in other countries, it may undermine to some extent the vitality of the tax treaty provisions that govern most international tax collection coordination efforts. Those provisions are predicated on the inability of governments to enforce their tax laws abroad in the absence of those agreements. If, however, this predicate is eroded, treaty negotiators could find it more difficult to obtain the consent of their treaty partners to these reciprocal tax collection pacts.

Perhaps most ominously, *Pasquantino* raises questions about the type of conduct that now can be viewed as criminal under U.S. law. Specifically, it raises a concern that practitioners may be at risk by engaging in routine foreign tax planning in the United States, if that conduct has the effect of avoiding foreign taxes and the foreign tax avoidance is asserted to be a criminal violation by the revenue authorities of the other country. (The asserted criminality may even derive from an ex post facto interpretation by the foreign revenue authorities.) The Court's opinion offers very little basis for comfort on that point, spending a scant two paragraphs analyzing why this avoidance of foreign tax laws constituted a "scheme or artifice to defraud" that resulted in U.S. criminal liability. One reading of *Pasquantino* could easily suggest that the Court has sanctioned criminal prosecution for any conduct asserted to be a criminal violation of a foreign tax law as long as the foreign government could show some concealment. Arguably, *Pasquantino* can be read more narrowly, so that the actions of the taxpayer would have to satisfy a dual criminality standard (that is, the actions would be criminal under foreign law and, if the tax avoided were U.S. tax, would be criminal under U.S. law). But even that reading would represent an expansion of what most practitioners believe current law to be.

Perhaps some comfort could be derived from the fact that the government may be hesitant to prosecute when the violation of foreign tax law is not so obvious, which is usually the case when complex international transactions are involved, but relying on prosecutorial discretion is hardly satisfactory. Finally, one may look for comfort to the fact that the decision to prosecute in *Pasquantino* may have been part of a concerted effort, backed at the highest levels of the Treasury, to crack down on liquor (and tobacco) trafficking. That too, however, may be cold comfort to those who believe that recent high-level government official comments on tax shelters lack a certain appreciation for the shade-of-gray judgment calls that are a regular part of international tax planning.

These issues are important to taxpayers, in-house tax professionals, and advisers. They create significant uncertainty in areas previously thought settled. They also add additional complexity to an area already beset by the unanswered questions discussed earlier in this article. How that uncertainty will ultimately affect taxpayers and tax professionals is currently unclear, but perhaps the Second Circuit will bring some needed elaboration to this corner of the tax world with a well-reasoned opinion in *RJR Nabisco*.

VIII. Conclusion

Corporate tax directors are being forced to do more today than ever before. And, in general, their resources are not being expanded commensurately. It has been observed that, in general, when measured by the relative share of the income statement for which it is responsible, no other function in a corporation is as under-resourced as the tax function. Although it is possible that the pendulum will swing back to provide some relief on the legal and regulatory front, there is no sign of that on the horizon. For those who abused the system, this bitter

medicine may be justified. For the rest of corporate America, however, the cure may be worse than the disease.