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THE APPLICATION OF CIRCULAR 230 TO ESTATE PLANNERS

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Introduction

Effective June 20, 2005, practice requirements will change for individuals and firms providing tax advice and practicing before the Internal Revenue Service. Tax Practitioners will then operate under the revised Circular 230 issued by the Treasury Department on December 20, 2004. Failure to comply with the Circular may result in disbarment or suspension of practice before the Internal Revenue Service, a censure, or fines. It may also result in professional liability. Estate planners often provide written advice and documents that involve Federal tax issues; the Circular may have a significant impact on these planners and their practices.

In this article, we describe some of the significant changes made to the Circular. Taken literally, the changes are extremely broad—inhibiting the free flow of information about Federal tax matters from lawyers to their clients—and will increase the cost of delivering written work product to clients. The Circular 230 amendments represent one of the most significant developments in estate planning practice in recent years.

Overview of Revisions to Circular 230

There are three broad areas of change brought about by revised Circular 230. The first is contained in § 10.33. This section sets forth what is labeled as “best practices.” These are suggested or “aspirational” practices that the Treasury believes tax practitioners should follow. The aspirational practices are worth reading, but are not mandatory. That is, a practitioner who fails to comply with these practices will not be subject to discipline under the Circular. Accordingly, they will not be discussed in this article. Nevertheless, practitioners may wish to consider whether failure to follow these suggested practices could result in liability.

The second change sets forth minimum required practice rules with respect to a written discussion of a Federal tax matter. These rules are contained in § 10.35 and are the subject of this article.

The third set of changes are contained in §§ 10.36 and 10.52, which set forth the requirements for the practitioner who has principal authority for overseeing a firm’s Federal tax practice. The goal of this third area of change is to ensure compliance with the Circular and set forth the consequences (which include disbarment to practice before the IRS) for any practitioner who violates the Circular.

In this article we principally discuss the second area noted above, new § 10.35 relating to minimum required practice rules with respect to a written discussion of a Federal tax matter.

New § 10.35 of Circular 230

Section 10.35 presents new requirements for certain written discussions of a Federal tax matter. A "writing" certainly seems to cover emails and faxes. Failure to meet these practice standards may result in disciplinary action mentioned at the beginning of this article. The writings to which this section applies are referred to as "Covered Opinions" but appear to cover much more than what many practitioners regard as a "formal" written legal opinion.

A Covered Opinion is "written advice" by a practitioner concerning one or more Federal tax issues (quite apparently including any estate, gift, or generation-skipping transfer tax issue) arising in six categories. A writing may fall into more than one category of Covered Opinions. It seems that mere recitals of the provisions of the Code (e.g., "Section 215 provides for a deduction for alimony paid") may constitute advice—arguably, the practitioner is advising as to what the Code states. It is possible that what the practitioner really intends as a transmittal message, if it mentions Federal tax issues or consequences, may be written advice that must be tested to determine if it is a Covered Opinion.

Before turning to the six categories of writings that constitute Covered Opinions, it is appropriate to note that there are two writings that are expressly excluded from being Covered Opinions: (1) written advice provided during the course of an engagement if the practitioner is reasonably expected to provide subsequent written advice to the client that will satisfy the requirements for Covered Opinions, and (2), except for advice related to a Listed Transaction (described below) or an arrangement the principal purpose of which is tax avoidance or evasion, written advice that concerns qualification of a qualified plan, a state or local bond opinion, or is included in documents required to be filed with the Securities and Exchange Commission.

1. Listed Transactions

The first area of written advice that constitutes a Covered Opinion is one arising from a transaction that is the same as or substantially similar to a transaction that, at the time the advice is rendered, the IRS has determined to be a tax avoidance transaction and identified by published guidance as a "Listed Transaction" under Treas. Reg. § 1.6011-4(b)(2). To date, no Listed Transaction seems directly to involve what probably would be viewed as a traditional estate planning arrangement. But the list is constantly expanded by the IRS and practitioners should monitor these notices.

2. Tax Avoidance is the Principal Purpose of an Arrangement

The second area is one arising from any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement (an "arrangement"), the *principal* purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code ("Code").

3. Reliance Opinions

If tax avoidance is not the principal purpose of the arrangement but it is a significant purpose, any written advice about it is a Covered Opinion (requiring compliance with the 230 Circular practices) if it is written advice that concludes at a confidence level of "more likely than not" (that is, a greater than 50 percent likelihood) that one or more *significant* Federal tax issues would be resolved in the taxpayer's favor.

A Federal tax issue is significant if the IRS has a reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse under any reasonably foreseeable circumstance, on the overall Federal tax treatment of the transaction(s)

or matter(s) addressed in the writing. It is appropriate to note that the IRS does not need a winning hand with respect to the issue but only has a reasonable basis for a successful challenge. No guidance is provided as to how a practitioner makes that determination. And the "cost" of violating the Circular, apparently even if the lawyer has acted in good faith, may be severe, as mentioned above.

An exception enabling the practitioner to fall outside of the Reliance Opinion category is where the "practitioner prominently discloses in the written advice that it was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer." That "disclaimer" may be used by many practitioners. But client reaction may not be positive. Why would a client want written advice unless he or she believes it could be relied upon it for penalty protection?

Prominently disclosed, which is required in several cases under the Circular, means bolded typeface that is larger than any other typeface used in the written advice.

The Nature of Estate Planning

Estate planning usually encompasses a very broad array of steps and purposes. Traditional estate planning certainly covers the transmission of property at death but deals with much more, including choice of guardians for minor children, selection of other fiduciaries, planning for successive management of a closely-held business, burial instructions, marital arrangements and retirement planning. Almost always, for individuals of significant means, it includes planning to reduce gift, estate and generation-skipping transfer taxation. Indeed, everyday decisions, such as providing for the education or health care of descendants, involve tax considerations, such as deciding between establishing educational accounts under Code Sec. 529 or paying tuition directly to an educational institution so as to fall under the non-taxable transfer rule of Code Sec. 2503(e) to avoid gift tax. The timing and form of a gift of $11,000 to each descendant or other loved one in any calendar may be motivated by a wish to have each transfer fall under the protection of the gift tax (and, if applicable, generation-skipping transfer tax) annual exclusion. Structuring of Wills and trusts often is dictated primarily by tax considerations, such a having a trust contain terms so it may qualify for the marital deduction or making a bequest to use exactly the taxpayer's remaining estate tax exemption and in a manner so that the bequest will not be included in the gross estate for Federal estate tax purposes of the taxpayer's surviving spouse or any descendant of his or hers.

Is tax avoidance the principal purpose, within the meaning of the Circular, of all such gift/estate/generation-skipping transfer tax related arrangements? The Circular does not seem to provide any guidance as to how to answer that question. One might, it seems, reasonably argue that tax avoidance is certainly secondary to the paramount purpose of such actions as (i) opening a Section 529 plan, (ii) paying tuition directly to the educational institution for a loved one, (iii) making annual gifts (that fall under the protection of the annual exclusion) and (iv) structuring a Will so the trust for the spouse will qualify for the marital deduction. It is certainly arguable that the principal purpose is to pay tuition, transmit wealth, etc. in such cases. But, perhaps, that argument might be more difficult to maintain where an arrangement that is specifically designed to avoid tax, such as a grantor retained annuity trust (GRAT) or a qualified personal residence trust (QPRT), is employed. In any case, because the consequences of not complying with the Circular may be viewed as severe, it probably will be prudent to assume that if a transaction is specifically structured to avoid a Federal tax, then its principal purpose is tax avoidance. Therefore, the practitioner may be well advised to comply with the Covered Opinion rules with respect to such an arrangement. Even if that compliance initially seems inviting, compliance almost certainly will complicate and increase the cost of advising clients about such

a transaction, as will be manifested as the discussion of section 10.35 of the Circular continues below.

4. Marketed Opinions

Written advice is a Marketed Opinion, and therefore a Covered Opinion, if it relates to an arrangement a significant purpose of which is tax avoidance or evasion and if the practitioner knows or has reason to know that it will be used or referred to by a person other than the practitioner (or someone affiliated with his or her firm) in promoting, marketing or recommending an arrangement to one or more taxpayers. A writing is not a Marketed Opinion, unless it relates to a listed transaction or to an arrangement, the principal purpose of which is tax avoidance, if it prominently discloses in the written advice that (1) the advice was not intended or written by the practitioner to be used, and that it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer, (2) the advice was written to support the promotion or marketing of the transaction(s) or matter(s) addressed in the written advice, and (3) the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor. In other words, if it is known that others will refer to or use the opinion in promoting an arrangement, it is a Market Opinion if it relates to a Listed Transaction or its principal purpose is tax avoidance even if it contains the "you cannot rely" statements.

It is uncertain whether a writing constitutes a Marketed Opinion if the lawyer merely prepares text that the client will put in its brochure with no attribution that it was prepared by the attorney. For example, a lawyer prepares text for a client that is a charitable organization so it can prepare a brochure to be sent to current and prospective donors about various forms of deferred giving (such as a charitable remainder trust, gift annuity or pooled income fund). Even if the charity does not refer to or attribute the text it uses to the lawyer who prepared it, it is not certain whether the writing constitutes a Marketed Opinion.

It is possible that a Marketed Opinion even covers an article written about Federal tax issues that is to be published in a commercial publication (such as Tax Notes) or distributed at a seminar sponsored by someone other than the practitioner (or his or her firm) attended by other tax practitioners. Although there seems to be an exception for the distributions of written advice by the practitioner (and his or her firm), there is none, it appears, for anyone else. Therefore, such an article written by a practitioner and will be published in a commercial publication or distributed at a conference may be a Covered Opinion unless it contains the prominently disclosed "disclaimers" and "warnings" discussed above, and does not address Listed Transactions or an arrangement the principal purpose of which is tax avoidance or evasion.

5. Conditions of Confidentiality

Written advice with respect to one or more Federal tax issues involving an arrangement, a significant purpose of which is tax avoidance or evasion, that is subject to conditions of confidentiality is a Covered Opinion. Such a condition of confidentiality will be present is the practitioner imposes on one or more recipients of the written advice a limitation on disclosure of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of the practitioner's tax strategies, regardless of whether the limitation is legally binding. A claim that a transaction is proprietary or exclusive is not a limitation if the practitioner confirms to all recipients of the written advice that there is no limitation on disclosure of the tax treatment or tax structure of the transaction that is the subject of the written advice.

6. Contractual Protection

Written advice with respect to an arrangement, a significant purpose of which is tax avoidance or evasion, is subject to Contractual Protection is a Covered Opinion. Contractual Protection means the taxpayer has the right to a full or partial refund of fees paid to the practitioner if all or part of the intended tax consequences from the matters addressed are not sustained, or if the fees are contingent on the taxpayer's realization of tax benefits from the transaction. The Circular indicates that "any agreement to provide services without reasonable compensation" constitutes contractual protection, although it seems this would be the case only if the intended tax consequences are not sustained. An agreement to defend the intended tax consequences without additional compensation does not appear to be contractual protection within the meaning of the Circular. Similarly, a contingent fee arrangement in seeking a refund does not appear to be contractual protection. Nevertheless, the Treasury has indicated that it will soon address contingent fee matters.

Requirements for Covered Opinions

The Circular specifies four requirements with which a Covered Opinion must comply. Each has subparts. And other rules are also specified. So realistically, the practitioner probably will have to deal with a dozen or so requirements for each Covered Opinion.

1. Factual Matters

A practitioner must use reasonable efforts to identify and ascertain the facts, which may relate to future events if a transaction is prospective or proposed, and to determine which of the facts are relevant. Apparently, the test of whether the practitioner did or did not use reasonable efforts is an objective one. In other words, the fact that the practitioner honestly and, perhaps, even reasonably believed he or she had made reasonable efforts to identify and ascertain the facts may not be found to be compliance if it turns out the efforts were not reasonable. All of the facts upon which the practitioner relies must be in a separate section of the written advice.

The practitioner must not base the opinion on any unreasonable factual assumption (including any with respect to future events) or unreasonable representation of another. An unreasonable factual assumption is one that the practitioner knows or should know is incorrect or incomplete. As an illustration, the Circular states that it is unreasonable to assume that a transaction has a business purpose or is potentially profitable apart from tax benefits. On the other hand, the Circular states that it is not unreasonable to rely on a projection, financial forecast or appraisal unless if the practitioner knows or should know it is incorrect, incomplete or prepared by a person lacking the skills of qualifications necessary to complete it

2. Relating the Law to the Facts

The practitioner, in rendering a Covered Opinion, must relate the applicable law to the facts. Applicable law includes "potentially applicable judicial doctrines". Although not specified, these may include the substance over form doctrine, the business purpose doctrine, the economic substance doctrine, the step transaction doctrine, the reciprocal trust or reciprocal transfer doctrines. Perhaps, there are others. Unfortunately, these judicial or court developed doctrines are not codified and, therefore, are uncertain in scope and content. It seems, to be on the "safe" side, that each Covered Opinion should discuss each doctrine. For example, although it does not seem that the business purpose doctrine is generally applicable to steps taken to reduce gift tax, a discussion that the doctrine should not apply (and specifying why that is so) probably should be contained in the advice.

The opinion must not contain internally inconsistent legal analyses or conclusions. For example, a conclusion that the actuarial value of the remainder interest in a charitable remainder unitrust is less than ten percent seems inconsistent with a conclusion that the value of the remainder is deductible for income and gift tax purposes. See Code Sec. 664(d)(2)(D). It is not specified that such inconsistency must relate solely to Federal tax issues. Thus, a conclusion that the taxpayer's husband is not a citizen of the United States would seem inconsistent with a conclusion that a lifetime gift to the husband qualifies for the marital deduction. This is true even though the former conclusion is not one directly involving a tax issue–because no gift tax marital deduction is allowed for gifts to one's spouse if the spouse is not a U.S. citizen.

3. Evaluation of the Significant Federal Tax Issues
The opinion must consider all *significant* Federal tax issues except as provided with respect to limited scope opinions (discussed below) or with respect to opinions that may and do rely on the opinion of another practitioner.

In any event, with respect to each significant Federal tax issue, the opinion must provide a conclusion as to the likelihood that the taxpayer will prevail on the merits on each such issue considered in the opinion. If the practitioner is unable to reach a conclusion as to one of more of those issues, the opinion must so state. The opinion must describe the reasons for the conclusions, including the facts and analysis, or describe the reasons the practitioner is unable to reach a conclusion as to one or more issues.

If the practitioner cannot reach a more-likely-than-not level of confidence with respect to one or more significant Federal tax issues considered, the opinion must disclose that and must prominently disclose that "the opinion was not written and cannot be used by the taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer."

4. Overall Conclusion
The opinion must provide the practitioner's overall conclusion as to the likelihood that the stated Federal tax treatment of the arrangement is the proper treatment and the reasons for that conclusion. In the case of a Marketed Opinion, the opinion must provide the practitioner's overall conclusion at a level of at least more-likely-than-not. If the practitioner cannot reach that level of confidence with respect to what would be a Marketed Opinion, it seems that the opinion may not be issued without violating the Circular.

5. Competency to Render the Opinion
The practitioner must be knowledgeable in all of the aspects of Federal tax law relevant to the opinion rendered, except the practitioner may rely on another's opinion with respect to one of more significant Federal tax issues, unless he or she knows or should know that the opinion of the other should not be relied upon. The opinion of another upon which the practitioner relies must identify the other opinion and set for the conclusions it reaches.

Limited Scope Opinions

The Circular provides that a practitioner may provide an opinion that considers less than all of the significant Federal tax issues if (1) the practitioner and the taxpayer agree that the scope of the opinion and the taxpayer's potential reliance on the opinion for avoiding penalties that may be imposed are limited to the Federal tax issues that are address in the writing, (2) the opinion does not involve a Listed Transaction or an arrangement the principal purpose of which is tax avoidance, and is not a Marketed Opinion, and (3) the opinion includes certain Required Disclosures (discussed below).

The practitioner, in issuing a limited scope opinion, may make reasonable assumptions about the favorable resolution of a Federal tax issue but must identify, in a separate section of the opinion, all issues for which the practitioner assumed a favorable resolution. It probably would be appropriate for the opinion to contain a heading for such part of the writing stating something like "Assumptions about Favorable Resolution of Certain Federal Tax Issues." It is important to note that limited scope opinions are not permitted for arrangements the principal purpose of which is tax avoidance. As discussed above, there is a chance that many estate planning strategies will be held to be such arrangements, thereby foreclosing the use of limited scope opinions with respect to them.

Required Disclosure with Respect to Promoter Relationship

Each Covered Opinion must prominently disclose (that is, specify in bolded typeface larger than any other typeface used in the writing) any compensation arrangement (such as a referral fee or fee-sharing) or referral agreement between the practitioner (or the practitioner's firm) and any person (other than the client for whom the opinion is prepared) engaged in promoting, marketing or recommending the arrangement (or a substantially similar one) that is the subject of the opinion.

The scope of the promoter relationship rule is uncertain. For example, consider the situation in which an attorney occasionally refers individuals to an insurance sales representative who, in turn, typically recommends that the customer engage that attorney to draft an irrevocable trust to acquire the policy. The sales representative occasionally refers other customers who are acquiring policies to that same attorney if the representative concludes that the customer should seek legal advice in structuring the acquisition of a life policy and is not otherwise adequately represented on legal matters. If the attorney prepares a Covered Opinion with respect to a Federal tax matter with respect to the trust and/or the policy of insurance, must the lawyer include the required disclosure with respect to the sales representative because it is a promoter-practitioner relationship that Circular 230 covers? The answer is not certain. But prudence again may suggest that the fact that the attorney and the life agent make referrals to each other might well be mentioned. It seems also appropriate to mention that there is no fee sharing between them (assuming that is correct). Similar disclosure probably should be made with respect to other "referral" arrangements, even if not formal, such as with an accounting firm, bank or trust company, where the attorney (or his or her law firm) has, even if only occasionally, referred clients to the entity and the entity has, again even if only occasionally, referred customers to the attorney (or his of her law firm).