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Circular No. 230: Rules Regulating Practice before the IRS

Last fall, the United States Treasury Department proposed significant changes to its Circular No. 230 which contains rules regulating practice before the Internal Revenue Service ("IRS").[1] When made final, many of the changes will fundamentally alter the way written client communications are negotiated, prepared and delivered. They will also change the manner by which internal risk management by tax practitioners in firms of all sizes–from 1 to +1,000–will be established and managed. Described in greater detail below are a select group of the September 2012 Proposals.[2] Our focus herein is on the following: (i) the elimination of the "covered opinion" standards in current section 10.35 and the expansion (both in scope and degree) of prevailing standards for all written Federal tax advice, including opinions and other substantive communications; (ii) the addition of new standards for practitioner competence; and (iii) the expansion of compliance-driven procedures in section 10.36 to all rules governing practitioners.

SUMMARY

For the first time in a generation, after the finalization of the September 2012 Proposals Circular 230 will eschew proscriptive rules, including the form of delivery, for written Federal tax advice (incl., actual or potential tax shelter opinions). When a client requests written tax advice, the practitioner will be required to use reasoned judgment to determine the nature and scope of the advice and the appropriate path to take from initiation of the service to delivery of the work product, taking into account all facts and circumstances. Practitioners would no longer be entitled to rely on one or more of the now prevalent standardized legends in order to reduce the duty of care and diligence otherwise seemingly required in delivering written advice—including infamous Circular 230 disclosures which legend nearly every advisor email, letter, information bulletin and other written communication. Practice oversight by firm tax practice leaders would be required to go beyond the existing scope of opinion and tax return review to include all practitioner responsibilities governed by Circular 230, including oversight with respect to the new minimum competency requirements (or "table stakes").

Firms which offer tax services will be required to review existing internal controls and governance practices against the new paradigm presented by revised Circular 230. From such a review, a renewed emphasis on practitioner development and oversight, client communication and risk management should arise. Hopefully, firms will see the developments which result from the finalization of the September 2012 Proposals as silver linings that permit them to readjust internal management roles over tax advisory and opinion practices. Additionally, the finalization of the September 2012 Proposals will likely present an opportunity—and an obligation—for firms to communicate with clients about the effect those revisions will have on each other.

[1] REG-138367-06, 77 (Sept. 17, 2012) (the "September 2012 Proposals"). All section references are to Circular No. 230 ("Circular 230").

[2] Tax practitioners are encouraged to review all of the September 2012 Proposals.

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DISCUSSION

1. Written Tax Advice (Including Opinions).

    a. Description of Proposals.

The September 2012 Proposals would eliminate substantially all of the covered opinion rules in current section 10.35. They also would withdraw proposed rules concerning state or local bond opinions (see prior proposed section 10.39). In their stead the September 2012 Proposals provide principal-based guidance, a logical and perhaps necessary extension of the "due diligence" rules of section 10.22, which would apply to the provision of all written tax advice (see proposed section 10.37). Generally, a practitioner would be required to base any written advice on reasonable factual and legal assumptions, reasonably consider all relevant facts the practitioner knows or should know, use reasonable efforts to identify and ascertain all relevant facts, not rely on input from the taxpayer or any other person if such reliance would be unreasonable and, in evaluating a Federal tax matter, not take the likelihood of an audit into account.

Unlike the current section 10.35's rules, the guidance set forth in proposed section 10.37 does not mandate a particular form of written advice. Rather, the proposed rules would adopt a facts and circumstances approach that should take into account the type of tax advice the client requests and practitioner agrees to provide, the practitioner's knowledge of the client's affairs, the complexity of the underlying facts or hypothetical situation to be considered and the appropriateness of assumptions to be used. In determining the appropriate choice of format of the written communication, the nature and complexity of the issues presented and other material terms of the engagement also would need to be considered by the practitioner and discussed with the client.

The September 2012 Proposals would carry over a rule applicable to marketed tax shelter opinions, demonstrating a reluctance to completely resort to principle-based guidance. Current section 10.37 judges a practitioner's compliance based on a "heightened standard of care" in the case of a tax shelter opinion prepared by a practitioner knowing or with reason to know it will be used or referred to by another in promoting, marketing or recommending a transaction to one or more taxpayers. The proposal would modify this sub-rule by changing "heightened standard of care" to a "heightened standard of review." Though no explanation is offered, this change may be intended to maintain an elevated standard of review for purposes of IRS administrative enforcement.

    b. Impact of the Proposals.

When finalized, the approach taken by proposed section 10.37 (together with the contemplated removal of current section 10.35 and proposed section 10.39) would establish a more comprehensive, yet flexible, standard for the establishment (and evaluation) of written Federal tax advice. Factors for consideration here would be (i) the nature of the issues to be addressed; (ii) the client's internal tax risk management

resources and level of informed participation in tax issue resolution; (iii) the practitioner's prior knowledge of the client and the completeness of the fact pattern conveyed to the practitioner; and (iv) the medium of the suggested written communication (email, separate tax communication, combined tax and non-tax legal advisory communication, marketing tax shelter opinion, etc.).

One would expect with the elimination of current section 10.35, in particular its "opt-out" provision for communications not intended to meet the covered opinion definition, tax advisors will see little utility in the use of standardized Circular 230 "legends" on general communications to non-firm recipients. More importantly, all practitioners should review any standardized disclaimer after the adoption of the final changes in order to ensure the accuracy of the statement made. Based on a review of correspondence received recently, many practitioners currently fail to fairly describe the opt-out rationale provided by the existing rules. To continue to use such language after could perhaps be interpreted as a violation of the general "due diligence" requirement of section 10.22.

2. "Table Stakes" Competency Requirement.

   a. Description of Proposal.

When finalized, the September 2012 Proposals will convert section 10.35—the current covered opinion rules—into an affirmative obligation by each practitioner to possess the level of competence required to practice before the IRS. Specifically, proposed section 10.35 would provide that a practitioner must possess the necessary competence to engage in such practice before the Service, including required knowledge, skill, thoroughness of analysis and preparation necessary for the particular client matter.

   b. Impact of Proposal.

The determination of competency which rewritten section 10.35 would require will turn on the specific facts and circumstances of the proposed engagement. Traditional training and mentored experience, as well as periodic participation in formal continuing legal or other professional education, appear to be implicit obligations of a practitioner, regardless of their broad or narrow field of practice. One would also imagine the competency requirement could necessitate an internal evaluation of a particular practitioner's skills, knowledge and availability to address the issues presented by the client's case or fact pattern. Where on assessment competency is not immediately present, a case can be made for reasonable reliance on other tax practitioners or on individuals outside of the contracting firm. Clear and unambiguous descriptions of the scope of the engagement for tax services, including the nature and extent of the effort by the practitioner, the participation in the engagement by the client and the type of work product the parties expect to be delivered will aide in bringing focus to the underlying required competencies. Nevertheless, such an aspirational and subjective standard may leave some firms feeling uncertain about when they could be subject to disciplinary action.

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3. Risk Management – To Apply to All Practitioner Duties.

    a. Description of Proposal.

Currently, the leadership of tax practices within a firm are required to plan for, adopt and execute procedures to ensure firm compliance with current section 10.35 (covered opinions) and in connection with preparation of returns or other submissions to the IRS. (Section 10.36.) The September 2012 Proposals seek to expand the risk management responsibilities currently in force to all applicable provisions of the practice standards found in Subpart B of Circular 230. As proposed, revised section 10.36 would subject practice leaders with oversight responsibility to disciplinary actions by the IRS for certain failures to ensure that adequate procedures are in place.

    b. Impact of Proposal.

The tax department leaders in a multi-member firm will need to ensure that Circular 230 risk management responsibilities are established and monitored by individuals who possess competencies to do so. This may require tax leadership in multi-disciplinary firms to educate their members as to the importance of complying with Circular 230.

If adopted, this change could greatly increase the need for review of advice prepared or to be provided junior professionals by a qualified partner or principal and thereby influence the client expense associated with such advice. These efforts could perhaps be hindered by the fact the September 2012 Proposals lack detail on the types of oversight responsibilities which the US Treasury Department has in mind. Would it include tax-leadership oversight related to client acceptance (including conflict review), engagement letter negotiation, staffing determinations, or merely the provision of substantive advice? The sparse language of the September 2012 Proposals also raises the question of what would be the outcome if internal controls over tax matters existed but are not followed? We believe is likely tax practice leaders will need to reassess all facets of their practice and stewardship over firm matters in order to demonstrate compliance with the section 10.36 obligations as proposed.