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TAX PRACTICE IN A CIRCULAR REVOLUTION: A REVIEW OF PLI'S *CIRCULAR 230 DESKBOOK*

Bridget J. Crawford*

WORKING PAPER DATED 10/12/06
SUBJECT TO FURTHER REVISIONS

The Practising Law Institute's *Circular 230 Deskbook*¹ by Jonathan G. Blattmachr, Mitchell M. Gans and Damien Ríos is more than just a deskbook. It is a masterful analysis and an important guide to the Internal Revenue Service's labyrinthine rules and regulations governing tax penalties, reportable transactions and the conduct of attorneys, accountants and others who "practice" before the IRS.⁴ Most practitioners have reacted to the recent changes to Circular 230⁵ by appending banner notices to all written communications.⁶ Without fully understanding the underlying

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¹ JONATHAN G. BLATTMACHR ET AL., *CIRCULAR 230 DESKBOOK* (2006) (hereinafter "CIRCULAR 230 DESKBOOK").

⁴ On what constitutes "practice" before the IRS, see *CIRCULAR 230 DESKBOOK* at §4:5.

⁵ In 2004, Congress authorized the Treasury Department, among other things, to impose financial penalties on practitioners who violate any provision of Circular 230 and to issue standards for written advice relating to any matter that may be tax "avoidance" or "evasion." The American Jobs Creation Act of 2004 (P.L. 108-357), 31 U.S.C. 330.

⁶ See, e.g., Northern Trust Corporation, *What Is Circular 230?*, http://www.northerntrust.com/pws/jsp/display2.jsp?XML=pages/nt/0508/91847367_3976.xml&hp=feature_08082005_2 (last visited Sept. 28, 2006). As this institution explains on its website:

The new [Circular 230] rules in effect require us to add certain standard language to many of our letters, memos, e-mails, and other correspondence concerning federal tax matters. You have probably already seen similar language on written communications from your own professional legal or tax advisers. Although the specific wording may vary depending on the circumstances, you can expect to see notices similar to the following:

rules, however, a practitioner cannot be sure that a banner alone will guarantee compliance with Circular 230's requirements. If Sir Walter Raleigh claimed that there is nothing new in the human experience because the world "hath ever been in a circular revolution,"⁷ tax practice in the twenty-first century surely must be an exception. The complex rules of Circular 230 have transformed the very nature tax practice and likely will continue to govern it for the foreseeable future. For that reason, every tax professional must become fully conversant with the details of Circular 230, or else risk public censure, suspension, fines or even the end of one's professional career.⁸

The PLI *Circular 230 Deskbook* provides a comprehensive, complete and analytical examination of the topic.⁹ Chapter 1 is a thorough and scholarly review of the Supreme Court's administrative law jurisprudence. Building on Professor Gans' earlier work,¹⁰ the authors

IRS CIRCULAR 230 NOTICE: To the extent that this message or any attachment concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law.

Id.

⁷ SIR WALTER RALEIGH, *A Collection of Political Observations, in THE WORKS OF SIR WALTER RALEIGH*, vol. 1 (repr. 1751) ("Whoso desireth to know what will be hereafter, let him think of what is past, for the world hath ever been in a circular revolution; whatsoever is now, was heretofore; and things past or present, are no other than such as shall be again: Redit orbis in orbem.").

⁸ See CIRCULAR 230 DESKBOOK at §4:18

⁹ Circular 230 has received much attention from scholars and practitioners alike. See, e.g., HOWARD M. ZARITSKY, *PRACTICAL ESTATE PLANNING UNDER CIRCULAR 230* (2005); Bruce D. Pingree, *Circular 230 and Tax Shelter Issues in Benefits*, SM046 ALI-ABA 1059 (2006); Edward M. Manigault & Steve R. Akers, *Circular 230 – How it Changed our Lives (or at Least our Practices)*, 20 PROB. & PROP. 32 (2006); Richard M. Lipton et al., *The World Changes: Broad Sweep of New Tax Shelter Rules in AJCA and Circular 230 Affect Everyone*, 707 PLI/Tax 115 (2006); Linda Z. Swartz & Jean Marie Bertrand, *Circular 230 and Tax Shelters in 2006*, 706 PLI/Tax 831 (2006); Susan T. Edlavitch & Brian S. Masterson, *Circular 230 "Best Practices" and Written Advice Standards*, SL054 ALI-ABA 743 (2005); Dan W. Holbrook, *Imagine the Worst the U.S. Treasury Could Do to Us – They've Done It, Revenge of the IRS: Circular 230 Changes Law Practice*, 41 Tenn. Bar J. 28 (Aug. 2005); Jonathan G. Blattmachr et al., *The Application of Circular 230 in Estate Planning (This Article May Not Be Relied on for Penalty Protection)*, 107 TAX NOTES 61 (2005); and Jonathan G. Blattmachr et al., *Circular 230 Redux: Questions of Validity and Compliance Strategies*, 107 TAX NOTES 1533 (2005). However, the *Circular 230 Deskbook* is uniquely comprehensive.

¹⁰ Mitchell M. Gans, *Deference and the End of Tax Practice*, 36 REAL PROP. PROB. & TR. J. 731 (2002).

untangle the complex factors that inform when (and how much) courts will defer to an administrative agency's interpretation of the law. The authors lay out four standards of deference that a court may give to an agency's interpretation: (1) in the case of *legislative regulations*, a court will uphold an agency's interpretation unless its interpretation is "arbitrary and capricious;" (2) in the case of an *ambiguous statute*, a court will defer to an agency's interpretation that reasonably resolves the ambiguity (this is known as *Chevron*¹¹ deference¹²); (3) in cases where Congress did not intent to give the administrative agency the ability to interpret conclusively the law, the court will defer to the agency's interpretation if it is persuasive, taking into account a variety of factors¹³ (this is known as *Skidmore*¹⁴ deference); and (4) in cases where an agency's *interpretation of a statute* (but not the statute itself) is ambiguous, the court will defer to the agency's interpretation if the agency's proposed resolution of the ambiguity is not abusive or clearly inappropriate (this is known as *Auer*¹⁵ deference).

Chapter 1 will be of great interest scholars and students of administrative law, and practitioners should heed the chapter's principal conclusion: in interpreting the Internal Revenue Code ("IRC") and related Treasury Regulations, courts will grant wide berth to the positions taken by Internal Revenue Service ("IRS" or "Service"). As the authors explain, "given its enhanced quasi-legislative function under *Chevron*, the government is no ordinary adversary in that it can rewrite the rules in many cases rather than litigate the meaning of the rules as originally written."¹⁶ Perhaps most surprising is the ability of the Service to make retroactive its interpretation of a regulation, provided that such interpretation is not "abusive or clearly inappropriate."¹⁷ The authors explain that over the last twenty years, interpretive power gradually has shifted away from the courts to administrative agencies. This creates an atmosphere in which taxpayers and their advisors will find it difficult to make reliable, *ex ante* determinations about the tax consequences of any particular transaction that

¹¹ *Chevron USA, Inc. v. Nat'l Res. Def. Council*, 467 U.S. 837 (1984).

¹² The authors discuss the Tax Court's recent decision in *Swallows Holding*, 126 T.C. 96 (2006), which, in their view, erroneously suggests that *Chevron* may not apply to interpretive regulations issued under the authority of IRC § 7805.

¹³ See CIRCULAR 230 DESKBOOK at § 1:3.

¹⁴ *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944).

¹⁵ *Auer v. Robbins*, 519 U.S. 4452 (1997).

¹⁶ CIRCULAR 230 DESKBOOK at § 1:2.

¹⁷ CIRCULAR 230 DESKBOOK at § 1:4.

is not expressly permitted by statute.¹⁸

In Chapter 2, the authors first discuss the accuracy-related penalties under IRC § 6662 and then explore the main defenses to those penalties. The defenses are: (1) that the taxpayer's position has a reasonable basis and disclosure is made;¹⁹ (2) that the taxpayer's position has substantial authority;²⁰ and (3) that the taxpayer had reasonable cause for any underpayment and acted in good faith with respect to it.²¹ In a well-organized treatment of the Treasury Regulations, case law, IRS notices and announcements, Blattmachr, Gans and Ríos detail the complexity of each defense. Because a taxpayer's (or her advisor's) understanding of "good faith" or "full disclosure," for example, may not necessarily comport with judicial and agency interpretations, the *Circular 230 Deskbook* is an important resource for any taxpayer who finds herself defending against the imposition of penalties. Similarly, for taxpayers who wish to appeal a penalty determination, the *Circular 230 Deskbook* will be a helpful guide, as there does not appear to be any other comprehensive resource that addresses the waiver of penalties. This chapter strikes an important warning for practitioners: a lawyer's (or accountant's) opinion will not necessarily protect a taxpayer from penalties. To provide adequate protection, the opinion must be crafted carefully by someone with the necessary knowledge and expertise. Furthermore the advisor may not necessarily be able to rely on statements or representations by his client. An "opinion" for penalty-protection purposes is much more complicated than it might seem at first.

Similar to the penalty rules, the final Treasury Regulations concerning so-called "Reportable Transactions" and tax-shelter list-keeping²² are designed to make it easier for the IRS to collect revenue (this time, by keeping track of certain transactions). Chapter 3 is a straightforward reference work that addresses what types of transactions are reportable,²³ what rules are applicable to shareholders of foreign corporations,²⁴ how and in what manner disclosure must be made,²⁵ what

¹⁸ E.g., IRC § 2503(b) (annual exclusion gifts).

¹⁹ IRC § 6662(d)(2)(B).

²⁰ *Id.*

²¹ IRC § 6664(c); CIRCULAR 230 DESKBOOK at § 2:3.2. *But see* the Pension Protection Act of 2006, Pub. L. No. 109-280 § 1219, 120 Stat 780 (2006) (eliminating the reasonable cause exception in the case of gross valuation misstatements).

²² Treas. Reg. § 1.6011-4(a).

²³ CIRCULAR 230 DESKBOOK at § 3:2.1[A].

²⁴ *Id.* at § 3:2.1[B].

penalties can arise when reporting requirements are not followed,²⁶ and when “material advisors” of reportable transactions must maintain lists about those whom they advise.²⁷ The authors are generally critical of the rules, especially those that require a material advisor, among other things, to keep information that the advisee is not necessarily required to provide to the advisor.²⁸ This is just one example of the seemingly endless opportunities to run afoul inadvertently of the Service’s reporting and record-keeping requirements. For that reason, the *Circular 230 Deskbook* is a worthy *vade mecum* of both the newest law school graduate and most seasoned tax practitioner.

The authors’ discussion of the penalty provisions and reportable transactions sets the stage for their treatment of Circular 230 itself in Chapter 4. Like the penalty provisions, Circular 230, at least in part, “is aimed at limiting the ability of taxpayers to avoid penalties by relying on the advice of practitioners.”²⁹ In imposing duties on practitioners in §§ 10.34, 10.35 and 10.37, Circular 230 borrows from the penalty provisions in IRC §§ 6662 and 6694 and the interpretative regulations. But this borrowing is not whole-cloth. The authors point out, for example, that the scope of Treas. Reg. § 1.6011-4(b)(3) is broader than its Circular 230 counterpart, and that understanding one will not lead to sufficient understanding of the other.³⁰ Practitioners need to be conversant with all of the penalty provisions, the reportable transaction rules, Circular 230, and the important variations among them.

Blattmachr, Gans and Ríos are critical of Circular 230’s rules as overly complex and interfering with the attorney-client relationship. The authors acknowledge the government’s rationale of protecting taxpayers from being misled by practitioners,³¹ but suggest that the Treasury Department has exceeded its authority in several ways. The authors find fault with mandatory disclosure rules, for example, pointing out that “while a taxpayer may rely [under the Regulations] on professional advice that there is a reasonable basis for the claimed position to avoid a penalty, the

²⁵ *Id.* at § 3:2.1[C].

²⁶ *Id.* at § 3:3 to 3:8.

²⁷ *Id.* at § 3:9.

²⁸ *Id.* at § 3:9.2[J].

²⁹ CIRCULAR 230 DESKBOOK at § 4:7.1

³⁰ *Id.* at 4:16.1.

³¹ *Id.* (referring to the government’s “concern about preventing taxpayers from being misled”).

Circular prevents the Practitioner from issuing such an opinion unless it contains an advisory that reliance is not permitted.”³² Blattmachr and Gans have previously suggested that such mandatory disclosure rules may violate the First Amendment.³³ Other commentators and scholars agree with their analysis.³⁴ The *Circular 230 Deskbook* book includes an intriguing discussion of this issue. More extensive analysis is not necessary from a practical standpoint because, as the authors point out, courts seek to avoid constitutional questions where possible.³⁵ Any challenge to Circular 230 likely will rest on the Treasury Department's authority to promulgate certain provisions of the Circular, especially when Congress has demonstrated no intent “to authorize the Treasury to use the Circular as a vehicle to override the Code.”³⁶ The authors anticipate that Circular 230 may be at some point challenged, either by a practitioner who is accused of violating it, or by a professional association seeking a declaration of facial invalidity.³⁷ Professional associations have commented publicly on the provisions of Circular 230,³⁸ but this reviewer is unaware of any proposed legal challenge to the rules. The roadmap of *Circular 230 Deskbook* will be helpful if any individual or group does take up this task.

In addition to the main text, the Appendix to the *Circular 230 Deskbook* has many useful resources including, for example, a sample framework for covered opinions and a sample memorandum of written advice that is not a covered opinion. Especially helpful are five charts in the Appendix that are also reprinted as colored, glossy, single-reference sheets that can be removed from the book. The first of these is a “Decision

³² *Id.*

³³ Jonathan G. Blattmachr et al., *The Application of Circular 230 in Estate Planning (This Article May Not Be Relied on for Penalty Protection)*, *supra* note 9, and Jonathan G. Blattmachr et al., *Circular 230 Redux: Questions of Validity and Compliance Strategies*, *supra* note 9..

³⁴ *E.g.*, Holbrook, *supra* note 9, at 30 (“Circular 230 will drive a wedge between taxpayer and professional advisor It may even be unconstitutional as a violation of the First Amendment right of free speech.”).

³⁵ *Id.* (citing *INS v. St. Cyr*, 533 U.S. 289 (2001)(resolving statutory ambiguity instead of reaching constitutional question)).

³⁶ *Id.*

³⁷ CIRCULAR 230 DESKBOOK at 4:16.1

³⁸ *E.g.*, Association of the Bar of the City of New York, Comments on Circular 230 Regulations (May 10, 2005), available at <http://www.nycbar.org/Publications/reports/index.php?type=subject&alpha=T>.

Tree for Potential Application of Circular 230, § 10.35.”³⁹ It is a flowchart that allows a practitioner to answer a series of yes or no questions to determine whether her proposed advice will be subject to § 10.35, the most onerous of the rules. The chart assists a practitioner in answering the important threshold question of whether the proposed advice will constitute a “Covered Opinion,” a determination that is the source of much debate and anxiety among practitioners. The second chart, “The Chart for Compliance with Circular 230, § 10.35,”⁴⁰ lists the types of “Covered Opinions,” all possible exceptions to that status, and – in three succinct columns – the requirements for covered opinions. The third chart, a “Circular 230 Flowchart,”⁴¹ compactly lists the affirmative duties and restrictions placed on practitioners as well as conduct by them that is prohibited expressly. The “Chart of Reportable Transactions”⁴² poses a series of yes/no questions that helps determine whether Form 8886 must be filed. In the “Checklist for Covered Opinions and Other Written Advice About Federal Tax Issues,”⁴³ the authors recommend answering 27 yes/no questions before providing any written advice (including e-mail) with respect to any federal tax issue. Depending on the particular question, the applicable “yes” or “no” checkbox may be red. The authors caution that when a red box is checked, further study and inquiry may be necessary to avoid running afoul of the requirements of Circular 230. At that point, a practitioner would then refer to the explanation in the corresponding section of the main text.

With the *Circular 230 Deskbook*, Blattmachr, Gans and Ríos have created a single-volume reference book that helps interpret some of the most complex and confusing rules facing tax practitioners today. In the coming months, the authors will issue a supplement that covers the decreased thresholds for the imposition of accuracy-related penalties enacted as part of the Pension Protection Act of 2006,⁴⁴ as well as any guidance on Circular 230 that the Service may issue in accordance with the Treasury Department’s 2006-2007 Priority Guidance Plan.⁴⁵ In any event,

³⁹ Appendix D.

⁴⁰ Appendix E.

⁴¹ Appendix F.

⁴² Appendix G.

⁴³ Appendix H.

⁴⁴ Pub. L. No. 109-280 § 1219, 120 Stat 780 (2006).

⁴⁵ Department of the Treasury, 2006-2007 Priority Guidance Plan (Aug. 15, 2006), available at <http://www.irs.gov/pub/irs-uti/2006-2007pgp.pdf#search=%222006-2007%20priority%20guidance%20plan%22>.

this particular regulatory field likely will become more complicated before it is simplified, and tax professionals will find the *Circular 230 Deskbook* to be a useful resource.