2006

Amendments to Circular 230 and PCAOB Proposed Rules on Ethics and Independence: The Recent Attack on Abusive Tax Shelters from Two Different Angles

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Amendments to Circular 230 and PCAOB Proposed Rules on Ethics and Independence: The Recent Attack on Abusive Tax Shelters from Two Different Angles

I. INTRODUCTION

Improving ethical standards and curbing abusive tax avoidance transactions are two of the most prominent and controversial tax topics currently being discussed in the professional community. In the past few years, several questionable transactions and business decisions among companies and their respective executives have attracted scrutiny by the Internal Revenue Service (IRS) and the Securities and Exchange Commission (SEC). One such incident involved the top two executives of Sprint Corporation.

In 2000, Ernst & Young, one of the “Big Four” accounting firms, was Sprint Corporation’s independent auditor. This firm also provided tax services for William T. Esrey (former CEO) and Ronald LeMay (former President), who were required by Sprint to use Ernst & Young to prepare their tax returns. Following the firm’s advice, Esrey and LeMay participated in a tax shelter designed by Ernst & Young.1 The tax shelter, called Equity Compensation Strategy, or E.C.S., gave Esrey and LeMay the opportunity to postpone taxes for 30 years on a total of almost $200 million in stock-option gains in 2000.2 The IRS began an investigation of this tax shelter, while Esrey, LeMay, and Ernst & Young all maintained their positions that it was legitimate.3 In further support of the legitimacy of the transaction, Esrey had a legal opinion written by an outside law firm that the IRS should agree that his tax position was legitimate.4 When Esrey and LeMay came under investigation by the IRS, the scandal caused Sprint to fire the top executives.

The Sprint executives are not the only ones engaging in these questionable tax shelter transactions. Other top executives who...

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2. Id.
3. Id.
4. Id.
have found themselves in similar situations include Tyco's Dennis Kozlowski and Global Crossing's Gary Winnick. These situations raise serious questions concerning the existence of abusive tax shelter transactions and auditor independence. Are the tax shelters used by top executives cheating the government and public out of tax revenue? Is a serious conflict of interest created when a company's auditor also serves as a tax planner for the company's top executives, thus compromising independence?

Though no evidence exists that the above situation involving the Sprint executives was an abusive tax shelter or that it jeopardized auditor independence, the Treasury Department, the IRS, the Public Company Accounting Oversight Board (PCAOB), and the SEC have opened their eyes to these types of transactions that have the potential to harm investors and impede the proper collection of tax revenue.

II. THE RECENT ATTACK ON ABUSIVE TAX SHELTERS

Though Congress addressed abusive tax shelters as early as the 1970s, the existence of tax shelters has only recently become the most common topic of discussion among the Treasury Department, IRS, SEC, PCAOB, and tax professionals. In October 2002, the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs investigated the development, marketing, and implementation of abusive tax shelters by accountants, lawyers, financial advisors, and bankers. The investigation revealed that the United States tax shelter industry had grown immensely because professionals had begun to use generic tax products and to target multiple clients, rather than focusing on individualized tax advice. The investigation also exposed questionable tax products created and used by members of the country's largest accounting firms, law firms, investment advisory firms, and banks. These groups were involved in the development, marketing, and implementation of tax products that fell into the category of abusive tax shelters, i.e., the main objective of the tax products was tax avoidance or evasion.


6. Id.

7. Id.

8. Id.
Currently, there is not a single standard that defines an abusive tax shelter. A taxpayer may reduce his tax liability by using a legitimate tax shelter to offset income from one source with losses from another source, so long as the shelter is not abusive. A tax shelter is legitimate if it “often produces income and involves a risk of loss proportionate to the expected tax benefit.” However, it is abusive if it “generates little or no income, and exists solely to reduce taxes unreasonably for tax avoidance or evasion.”

Due to the growing popularity and exposure of abusive tax shelters, the IRS has made it a top priority to identify and deter promoters of abusive tax transactions. The IRS has also stated that its goals are to keep the public advised, encourage disclosure by promoters and marketers, and develop and implement alternative methods for resolving abusive transactions. In order to reach these goals, the Treasury Department and IRS have undertaken to create new rules and improve upon old ones.

While the Treasury Department and IRS have intensified their fight against abusive tax shelters in order to prevent the loss of millions of dollars in tax revenues, the PCAOB has also joined the war to protect investors. The PCAOB was created by the Sarbanes-Oxley Act of 2002 to create ethical and independence standards for public accounting firms engaged in audits of companies registered with the SEC. The attack from all angles to protect several different interests makes it clear that abusive tax shelters will not be tolerated for long. But how are the Treasury Department and the PCAOB going to bring a halt to the growing popularity of using abusive transactions to avoid or postpone taxes?

III. THE AMENDMENTS TO TREASURY DEPARTMENT CIRCULAR 230

The Treasury Department has recently released final regulations amending Title 31, Part 10, of the Code of Federal Regulations, which set forth rules governing practice before the IRS by

10. Id.
11. Id.
13. Id.
attorneys, certified public accountants, enrolled agents, and enrolled actuaries. Collectively, these regulations are more commonly known as Treasury Department Circular 230 (hereinafter "Circular 230"). Circular 230 addresses the duties and restrictions relating to practice before the IRS, the sanctions for violating the regulations, and the rules applicable to disciplinary proceedings. \(^{15}\) Practicing before the IRS occurs when making "presentation[s] to the IRS concerning a client's rights, privileges or liabilities under federal tax law." \(^{16}\) It does not include "preparing a tax return, furnishing information at the request of the IRS, or appearing as a witness for the taxpayer." \(^{17}\)

As part of the goals to improve ethical standards and curb abusive tax shelters, proposed amendments were issued to Circular 230 in January 2001, and later replaced with new proposed regulations in December 2003. Finally, on December 17, 2004, final regulations amending Circular 230 were released. The regulations, which include Sections 10.33, 10.35, 10.36, 10.37, 10.38, and 10.52 of 31 C.F.R. pt. 10, became effective for written advice rendered after June 20, 2005.

A. **Best Practices for Tax Advisors**

Section 10.33 of the final regulations sets forth guidelines concerning best practices for tax advisors. \(^{18}\) This section suggests that tax advisors should follow best practices when providing advice on federal tax issues and when assisting clients with submissions to the IRS. \(^{19}\) As the preamble to the final regulations makes clear, the best practices are only aspirational. \(^{20}\) While the regulations will not subject tax advisors to discipline merely because they fail to engage in best practices, "tax professionals are expected to observe these practices to preserve public confidence in the tax system." \(^{21}\)

The "best practices" standard includes four basic principles. First, tax advisors should communicate the terms of the engagement clearly in order to clarify the purpose, form, and scope of the

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16. *Id.* § 10.2(d).
18. 31 C.F.R. § 10.33(a).
19. *Id.*
21. *Id.*
tax advisor's advice or assistance. Second, tax advisors should use the appropriate law and facts to arrive at a conclusion. Third, tax advisors should inform clients of the significance of any conclusions. Fourth, when practicing before the IRS, tax advisors should be fair and act with integrity.

In addition to describing best practices, Section 10.33 sets forth procedures to apply best practices to tax advisors. Tax advisors responsible for the supervision of their firm's federal tax advice practice or the assistance of clients with submissions to the IRS are expected to incorporate the best practices into their firm's procedures.

B. Requirements for Covered Opinions

1. Written Advice That Qualifies as a Covered Opinion

The next new section of the regulations articulates the requirements for covered opinions. Section 10.35 requires that practitioners must follow the rules of the section when they give a covered opinion concerning a federal tax issue. Before practitioners are subject to the requirements of Section 10.35, the practitioners' advice must be a covered opinion, which is written advice concerning one of the three following situations.

The first situation occurs when a practitioner provides advice on a tax issue that developed from a transaction which the IRS has deemed a tax avoidance transaction and has published as a listed

22. 31 C.F.R. § 10.33(a)(1).
23. Id. § 10.33(a)(2). To accomplish this, tax advisors must determine and establish the relevancy of all facts, make reasonable assumptions, and apply the law to the relevant facts. Id.
24. Id. § 10.33(a)(3). For example, tax advisors should communicate to clients whether they may use the advice to avoid accuracy-related penalties under the Internal Revenue Code. Id.
25. Id. § 10.33(a)(4).
26. Id. § 10.33(b).
27. 31 C.F.R. § 10.33(b). Similar to the aspirational best practices, ensuring that tax advisors' firms incorporate best practices into their procedures is encouraged, but not required. See 31 C.F.R. pt. 10.
28. Practitioners include attorneys, certified public accountants, enrolled agents, and enrolled actuaries. See 31 C.F.R. § 10.2(e).
29. Id. § 10.35(a). "A Federal tax issue is a question concerning the Federal tax treatment of an item of income, gain, loss, deduction, or credit, the existence or absence of a taxable transfer of property, or the value of property for Federal tax purposes." Id. § 10.35(b)(3).
30. Id. § 10.35(b)(2)(i). Written advice includes electronic communications. Id.
transaction. A listed transaction is defined as “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.”

The second situation occurs when a tax issue results from partnerships, other entities, investment plans, or any other plans or arrangements that are created with the principal purpose of avoiding or evading taxes.

Similar to the second situation, the third situation also occurs when a tax issue results from partnerships, other entities, investment plans, or any other plans or arrangements. However, the plans must only have a significant, rather than a principal, purpose of avoiding or evading taxes if the written advice is a reliance opinion, a marketed opinion, subject to conditions of confidentiality, or subject to contractual protection.

a. Reliance Opinions

The regulations thoroughly define the four types of written advice listed in the third situation that result in a covered opinion. Section 10.35 defines a reliance opinion as written advice that provides that a taxpayer has a more likely than not chance of having a favorable outcome of a significant federal tax issue. Practitioners can prevent written advice from being treated as reliance opinions, however, by prominently disclosing in writing that the taxpayer may not use the advice to avoid penalties. That said, practitioners may not use such a disclosure to prevent a reliance opinion when the advice concerns listed transactions or entities created with the principal purpose of avoiding or evading taxes.

31. Id. § 10.35(b)(2)(i)(A). Currently, the IRS has identified thirty transactions as listed transactions. See I.R.S. Notice 2004-67.
33. 31 C.F.R. § 10.35(b)(2)(i)(B).
34. Id. § 10.35(b)(2)(i)(C).
35. Id.
36. Id. § 10.35(b)(4)(i). The phrase “more likely than not” means that there is a greater than 50 percent likelihood. Id. “[A] Federal tax issue is significant if the Internal Revenue Service has a reasonable basis for a successful challenge and its resolution could have a significant impact . . . on the overall Federal tax treatment of the transaction(s) or matter(s) addressed in the opinion.” Id. § 10.35(b)(3).
37. 31 C.F.R. § 10.35(b)(4)(ii).
38. See 26 C.F.R. § 1.6011-4(b)(2).
b. Marketed Opinions

A marketed opinion is another type of written advice that is treated as a covered opinion. A practitioner provides a marketed opinion when he gives written advice and knows or has reason to know that another person will use the advice to promote or market entities or investment arrangements to taxpayers. Similar to reliance opinions, practitioners can prevent written advice from being treated as marketed opinions by prominently disclosing in writing that taxpayers may not use the advice to avoid penalties and should discuss their particular situations with independent tax professionals. Additionally, practitioners should set forth that they wrote such opinion “to support the promotion or marketing of the transaction(s) or matter(s) addressed by the written advice.” As with reliance opinions, such a disclosure will not prevent written advice from being a marketed opinion when the advice concerns listed transactions or entities created with the principal purpose of avoiding or evading taxes.

c. Conditions of Confidentiality

Written advice is also a covered opinion if it is subject to conditions of confidentiality. This occurs when practitioners protect the confidentiality of their tax strategies by limiting the taxpayer’s power to disclose the structure of the transaction or its planned tax treatment. Even when practitioners describe transactions as “proprietary or exclusive,” that claim is not a limitation on disclosure. Thus, advice given under that rubric is not subject to conditions of confidentiality, provided taxpayers are informed of their power to disclose the tax treatment or structure of the transaction.

40. 31 C.F.R. § 10.35(b)(5)(i).
41. Id. § 10.35(b)(5)(ii)(A) and (C).
42. Id. § 10.35(b)(5)(ii)(B).
43. See 26 C.F.R. § 1.6011-4(b)(2).
44. See descriptions in 31 C.F.R. § 10.35(b)(2)(i)(B).
45. 31 C.F.R. § 10.35(b)(6).
46. Id. The disclosure limitation does not have to be legally binding for the written advice to be considered subject to conditions of confidentiality. Id.
47. Id.
48. Id.
d. Contractual Protection

The last type of written advice treated as a covered opinion is advice subject to contractual protection.49 Practitioners give advice subject to contractual protection when they receive fees contingent on the taxpayer receiving benefits represented as forthcoming from the transaction, or when the taxpayer may receive a full or partial refund if the actual results of the transaction do not coincide with the advice given.50

2. Written Advice That Does Not Qualify as a Covered Opinion

Though it seems as if the definition of a covered opinion is rather extensive, some written advice is not within its purview. For example, practitioners are not subject to the Section 10.35 rules when they give advice to taxpayers during an engagement, and the taxpayers reasonably expect the practitioners to give them additional written advice that complies with the requirements of Section 10.35.51 Also, written advice is not a covered opinion if it concerns the qualification of a qualified plan, is a state or local bond opinion, or is included in required Securities and Exchange Commission documents.52 However, if the three types of written advice just mentioned qualify as a listed transaction or have tax avoidance or evasion as their principal purpose, then the advice falls within the definition of a covered opinion.53

49. Id. § 10.35(b)(7).
50. 31 C.F.R. § 10.35(b)(7).
51. Id. § 10.35(b)(2)(ii)(A).
52. Id. § 10.35(b)(2)(ii)(B)(1), (2), and (3).
A State or local bond opinion is written advice with respect to a Federal tax issue included in any materials delivered to a purchaser of a State or local bond in connection with the issuance of the bond in a public or private offering, including an official statement (if one is prepared), that concerns only the excludability of interest on a State or local bond from gross income under section 103 of the Internal Revenue Code, the application of section 55 of the Internal Revenue Code to a State or local bond, the status of a State or local bond as a qualified tax-exempt obligation under section 265(b)(3) of the Internal Revenue Code, the status of a State or local bond as a qualified zone academy bond under section 1397E of the Internal Revenue Code, or any combination of the above.
Id. § 10.35(b)(9).
53. Id. § 10.35(b)(2)(ii)(B).
3. **Four Requirements When Providing Covered Opinions**

Once practitioners determine that they are providing a covered opinion to their clients, they must comply with the four requirements of Section 10.35 concerning the following: factual matters, the relation of laws to facts, the evaluation of significant federal tax issues, and the overall conclusion.

**a. Factual Matters**

First, Section 10.35 requires practitioners to identify and reasonably consider all facts relevant to the transaction involved, and those facts must be included in the opinion. In the same vein, practitioners may not use unreasonable factual assumptions or representations as the basis for their opinions. A factual assumption or representation is unreasonable if "the practitioner knows or should know it is incorrect or incomplete." For example, the reliance on a projection, financial forecast, or appraisal to develop an opinion is a factual assumption. Thus, if a practitioner knows or should know that he relied on a projection, financial forecast, or appraisal that was incorrect or incomplete, then that factual assumption is unreasonable and he may not use it as a basis for his opinion. An unreasonable factual representation occurs, for instance, when a practitioner relies on a representation that the transaction has a business purpose although "the representation does not include a specific description of the business purpose or the practitioner knows or should know that the representation is incorrect or incomplete." Practitioners must include all factual assumptions and representations used in developing their advice in a separate section of the opinion.

**b. Relation of Laws to Facts**

When providing covered opinions, Section 10.35 further requires that practitioners "relate the applicable law . . . to the relevant

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54. Id. § 10.35(c)(1)(i).
55. 31 C.F.R. § 10.35(c)(1)(ii) and (iii).
56. Id. Examples of unreasonable assumptions include assuming that "a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits." Id.
57. Id. § 10.35(c)(1)(ii).
58. Id.
59. Id. § 10.35(c)(1)(iii).
60. 31 C.F.R. § 10.35(c)(1)(ii) and (iii).
facts."\textsuperscript{61} When doing this, practitioners must be careful not to include any inconsistent legal analyses or conclusions in their opinions.\textsuperscript{62} They must also avoid using unreasonable legal assumptions, representations, or conclusions as a basis for their advice.\textsuperscript{63} Additionally, Section 10.35 prohibits practitioners from assuming that a significant federal tax issue will have an outcome favorable to a taxpayer.\textsuperscript{64}

c. Evaluation of Significant Federal Tax Issues

A third requirement when practitioners provide a covered opinion is that they address all significant federal tax issues in the opinion.\textsuperscript{65} For each significant federal tax issue, practitioners must include in their opinion an explanation of whether the taxpayer will prevail on the merits, without taking "into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised."\textsuperscript{66} Practitioners must also disclose if they are unable to reach a conclusion.\textsuperscript{67} The explanations should include all the facts and analyses that enabled the practitioner to reach (or not reach) a conclusion.\textsuperscript{68} If practitioners do not conclude that the outcome is "more likely than not," however, then they must include in the opinion appropriate disclosures as described in paragraph (e) of Section 10.35.\textsuperscript{69}

This third requirement also addresses marketed opinions and limited scope opinions.\textsuperscript{70} When practitioners provide a marketed opinion, they must conclude for each significant federal tax issue that the taxpayer will "more likely than not" prevail on the merits.\textsuperscript{71} If practitioners cannot make conclusions on a more-likely-than-not confidence level, then they may not provide the marketed

\textsuperscript{61} Id. § 10.35(c)(2)(i). The applicable law includes any applicable judicial doctrines.
\textsuperscript{62} Id. § 10.35(c)(2)(iii).
\textsuperscript{63} Id. § 10.35(c)(2)(ii).
\textsuperscript{64} Id.
\textsuperscript{65} 31 C.F.R. § 10.35(c)(3)(i).
\textsuperscript{66} Id. § 10.35(c)(3)(ii) and (iii).
\textsuperscript{67} Id. § 10.35(c)(3)(ii).
\textsuperscript{68} Id.
\textsuperscript{69} Id. The disclosures described in paragraph (e) of Section 10.35 are discussed hereafter.
\textsuperscript{70} 31 C.F.R. § 10.35(c)(3)(iv) and (v).
\textsuperscript{71} Id. § 10.35(c)(3)(iv).
opinion. Alternatively, they may still provide the written advice if they include appropriate disclosures in the opinion.

Practitioners may give limited scope opinions, which enable them to address less than all of the significant federal tax issues. A limited scope opinion may include reasonable assumptions concerning the favorable outcomes of federal tax issues, though practitioners must identify the assumptions in a separate section of the opinion. In order for practitioners to provide limited scope opinions, it must be agreed that the taxpayer will rely on the opinion solely to avoid federal tax penalties concerning issues included in the opinion. Also, practitioners must include appropriate disclosures in any limited scope opinion, as required under paragraph (e) of Section 10.35. However, if the advice is a listed transaction, a transaction that has the principal purpose of tax avoidance or evasion, or a marketed opinion, then it cannot qualify as a limited scope opinion.

d. Overall Conclusion

Finally, the fourth requirement of Section 10.35 calls upon practitioners to include an overall conclusion in their opinions. Practitioners must also provide an explanation if they are unable to reach a conclusion. The conclusion should set forth the likelihood that the opinion expresses the proper treatment of each issue. With respect to any marketed opinion, the practitioner must be able to conclude that the opinion "more likely than not" expresses the proper treatment of the issue.

72. Id.
73. Id. The appropriate disclosures include prominently disclosing in writing that taxpayers may not use the advice to avoid penalties and should discuss their particular situations with independent tax professionals. Id. § 10.35(b)(5)(ii)(A) and (C). Practitioners should also set forth that they wrote the opinion "to support the promotion or marketing of the transaction(s) or matter(s) addressed by the written advice." Id. § 10.35(b)(5)(ii)(B).
74. Id. § 10.35(c)(3)(v)(A).
75. 31 C.F.R. § 10.35(c)(3)(v)(B).
76. Id. § 10.35(c)(3)(v)(A)(1).
77. Id. § 10.35(c)(3)(v)(A)(3). The disclosures described in paragraph (e) of Section 10.35 are discussed hereafter.
78. Id. § 10.35(c)(3)(v)(A)(2).
79. Id. § 10.35(c)(4)(i).
80. 31 C.F.R. § 10.35(c)(4)(i).
81. Id.
82. Id. § 10.35(c)(4)(ii).
4. **Practitioner Competency**

In addition to the above-mentioned requirements for covered opinions, practitioners must be competent to provide the opinion. Practitioner competency entails being "knowledgeable in all of the aspects of Federal tax law relevant to the opinion being rendered.

A practitioner who is not knowledgeable in a certain area of tax law may still be competent if he is relying on the opinion of another practitioner, so long as there is no reason to believe that the other practitioner should not be relied upon. Ultimately, "[t]he practitioner must be satisfied that the combined analysis of the opinions, taken as a whole, and the overall conclusion (if any), satisfy the requirements of [Section 10.35]."

5. **Disclosures**

Section 10.35 further requires practitioners to include certain disclosures, if applicable, in all covered opinions. Practitioners must disclose whether they have compensation arrangements or referral agreements with someone other than the taxpayer concerning the promotion, marketing, or recommendation of the transaction discussed in the opinion. If the advice is a marketed opinion, practitioners must indicate that taxpayer-clients should discuss their particular situations with independent tax professionals and that "[t]he opinion was written to support the promotion or marketing of the transaction(s) or matter(s) addressed in the opinion." When providing a limited scope opinion, practitioners must disclose that the opinion does not address all of the significant federal tax issues that could affect the transaction and warn the taxpayer that the opinion cannot be used to avoid penalties concerning issues not addressed. Similarly, practitioners must disclose if they do not reach a "more likely than not" conclu-
sion and warn taxpayers that they may not use the opinion to avoid penalties.\(^9\)

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C. Procedures to Ensure Compliance  

Once it is determined that the rules for covered opinions in Section 10.35 apply to a transaction, Section 10.36 provides procedures to ensure compliance.\(^9\) Practitioners who are responsible for the supervision of their firm’s federal tax advice practice are required to “take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees for purposes of complying with § 10.35.”\(^9\) If they do not follow this requirement, supervising practitioners will be subject to discipline if one of the two following situations exists. First, they will be subject to discipline if, through willfulness, recklessness, or gross incompetence, they do not take reasonable steps to ensure compliance with the requirements for covered opinions, and someone in their firm fails to comply with Section 10.35.\(^9\) Second, supervising practitioners will be subject to discipline if they know or should know that someone in their firm is not in compliance with Section 10.35, and they, “through willfulness, recklessness, or gross incompetence, [fail] to take prompt action to correct the noncompliance.”\(^9\)

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D. Requirements for Other Written Advice  

If written advice does not qualify as a covered opinion under Section 10.35, then practitioners must follow the requirements for other written advice under Section 10.37. When providing written advice on federal tax issues, practitioners must base their advice on all relevant facts that they know or should know, and they must not base their advice on unreasonable factual or legal assumptions.\(^9\) Practitioners must also not rely upon representations, statements, findings, or agreements of others unless it is reasonable to do so.\(^9\) Additionally, Section 10.37 prohibits practitioners from taking “into account the possibility that a tax return

\(^9\) Id. § 10.35(e)(4)(i) and (ii).  
\(^9\) Id. § 10.36.  
\(^9\) Id.  
\(^9\) Id. § 10.36(a)(1).  
\(^9\) 31 C.F.R. § 10.36(a)(2).  
\(^9\) Id. § 10.37(a). Written advice includes electronic communications. Id.  
\(^9\) Id.
E. Establishment of Advisory Committees

To promote and maintain the public’s confidence in tax practitioners, Section 10.38 provides authorization to the Director of the Office of Professional Responsibility to create advisory committees and prescribe procedures for them to follow. The main responsibilities of the advisory committees are to “review and make general recommendations regarding professional standards or best practices for tax advisors, including whether hypothetical conduct would give rise to a violation of §§ 10.35 or 10.36.” The committees must include at least five practitioners and be balanced among attorneys, accountants, and enrolled agents.

F. Violations of Regulations

The last section of the regulations, amending Section 10.52 of Circular 230, concerns violations. Section 10.52 now provides that if practitioners willfully violate any of the regulations, except for Section 10.33 best practices, they may be censured, suspended, or disbarred from practice before the IRS. Practitioners may also be censured, suspended, or disbarred if they violate Sections 10.34, 10.35, 10.36, or 10.37 through recklessness or gross incompetence.

G. Revisions to the Final Circular 230 Regulations

After publication of the final regulations in December 2004, many practitioners voiced concern that the IRS should clarify certain language of the regulations in order for them to be interpreted and enforced within the IRS’s intent. In response, the

98. Id. Note that the requirements under Section 10.37 for other written advice resemble some of the procedures required under Section 10.35 concerning covered opinions.
99. Id. § 10.38(a). “The Office of Professional Responsibility investigates allegations of misconduct or negligence against tax practitioners and enforces the standards of practice for those who represent taxpayers before the IRS, as detailed in Circular 230. The office also licenses ‘enrolled agents,’ who are tax professionals meeting certain testing or experience requirements.” I.R.S. News Release IR-2003-148 (Dec. 29, 2003).
100. 31 C.F.R. § 10.38(a). Section 10.35 sets forth requirements for covered opinions, and Section 10.36 sets forth procedures to ensure compliance with Section 10.35.
101. 31 C.F.R. § 10.38(a).
102. Id. § 10.52(a)(1).
103. Id. § 10.52(a)(2).
Treasury Department and IRS released revisions to the final Circular 230 regulations, effective May 19, 2005. These revisions include additional types of written advice that are outside (or “beyond”) the definition of a covered opinion.

Practitioners are therefore not subject to the rules under Section 10.35 when they provide advice under the following three situations. First, written advice provided by practitioners after the taxpayer has filed a return for the transaction will not constitute a covered opinion. Also, advice provided by in-house counsel will not be a covered opinion if the practitioner acts in an employee capacity and provides the advice to determine his employer’s tax liability. However, in-house counsel must still follow the requirements for providing other written advice under Section 10.37. Finally, negative advice, which concludes that a federal tax issue will not be resolved in the taxpayer’s favor, is excluded from the covered opinion definition. However, if a favorable conclusion is also reached concerning the same issue, the advice may constitute a covered opinion.

The recent revisions also amend the definitions of “prominently disclosed” and “principal purpose.” For an item to be prominently disclosed, it must at least be written in a separate section in a typeface that is, at a minimum, the same size as the typeface of the discussion of the facts or law. Additionally, the facts and circumstances must indicate that the item is readily apparent to a person who reads the advice. The revisions define principal purpose as a purpose that exceeds any other purpose. The avoidance or evasion of tax is not the principal purpose if a “partnership, entity, plan or arrangement has as its purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose.”

105. Id.
106. Id.
107. Id.
108. Id.
109. See 2005-23 I.R.B. 1153, T.D. 9201 (2005). Examples of confidence levels that may indicate a favorable conclusion include not frivolous, realistic possibility of success, reasonable basis or substantial authority. Id.
110. Id. An item is not prominently disclosed if it is included in a footnote. Id.
111. Id.
112. Id.
113. Id.
IV. REACTION TO THE AMENDMENTS TO CIRCULAR 230

Many tax professionals have greeted the Circular 230 amendments with apprehension. The regulations are perceived as vague and overly broad; by the IRS seeking "to prevent a small group of tax shelter advisors and promoters from acting badly, all are effectively punished . . . ." Since the new regulations are significantly different from the previous rules, practitioners are having a difficult time deciphering the meaning and consequences of the new tax shelter rules.

One of the main complaints among practitioners is that the definition of a covered opinion includes more than just traditional tax shelter situations. Thus, when practitioners want to give any written advice, they must follow the requirements of the new Circular 230. In effect, practitioners have three options when giving written tax advice. However, each option carries with it risks and unknown consequences.

First, practitioners could comply with all of the new regulations and give complete opinions for all tax advice. However, if the tax advice is routine, informal, or minor, this option would be extremely costly yet provide little benefit to the client. Second, practitioners could "conclude that the IRS has no reasonable basis for challenging the issue(s) and not offer any disclaimer to the client." This is risky because it provides no protection for practitioners. Third, practitioners could include disclaimers stating that the taxpayer cannot rely on the advice to avoid IRS penalties. While this third option is the most convenient and provides the most protection for practitioners, it could discourage clients from seeking and relying on advice because they obtain no protection.

Traditionally, most firms followed the third option listed above, taking the route of trying to avoid the stringent requirements. In order to protect themselves against the harsh punishments for violating the regulations, many firms have included disclaimers,
referred to as "legends," with all or most of the written communications sent outside the firm. 121

Before the amendments to Circular 230 were put into effect, many taxpayers invested in tax shelters recommended by accounting firms. To protect themselves from possible penalties, the taxpayers would get opinion letters from law firms that essentially assured the validity of the tax shelter and protected the tax shelter participants from possible penalties should the IRS rule the shelters were illegal. The IRS usually waived penalties when a taxpayer relied on professional advice that the IRS regarded as reasonable and given in good faith.

However, the amendments to Circular 230 now make it more difficult and costly for taxpayers to obtain the level of protection that would make them comfortable enough to engage in the tax shelter transaction. Since most firms have added disclosure language to almost all of their communications indicating that their advice cannot be used as protection from IRS penalties, the only way that taxpayers will get the coveted protection is by paying a hefty sum of money. In order for the firms to give advice regarding tax shelter transactions, Circular 230 requires that they engage in a thorough analysis of all the relevant facts. A great amount of time and resources would have to be expended to reach this level of research and planning to achieve a result that taxpayers could have previously gotten simply by obtaining an opinion letter from a professional. Thus, if taxpayers want penalty protection, they will have to pay a significant amount of money to get it.

Firms are also informing their clients about the new regulations to explain why their communications concerning tax advice will now have disclaimers. 122 It is important for practitioners to communicate to their clients that the disclaimers do not mean that the advice being received is incorrect or inadequate. 123 Of course, one must remember that disclaimers are ineffective under the new regulations if the advice concerns a transaction that has tax evasion or avoidance as its principal purpose. 124

121. Id.
122. Id.
123. Id.
124. See 31 C.F.R. § 10.35(b)(2)(i).
V. PCAOB PROPOSED RULES ON ETHICS AND INDEPENDENCE

While the Treasury Department has addressed the abusive tax shelter problem by amending Circular 230, the Public Company Accounting Oversight Board (PCAOB) has approached the problem by proposing ethics and independence rules concerning tax services and contingent fees. Overall, the proposed rules were created to meet four main objectives.

A. Ethical Principles

First, the rules codify an ethical principle. Rule 3502 prohibits a person associated with a registered public accounting firm from causing that firm to violate the Sarbanes-Oxley Act, the PCAOB rules, or the securities rules pertaining to audit reports. A person causes a violation if "an act or omission the person knew, or was reckless in not knowing, would directly and substantially contribute to such violation.

B. Independence

The second objective of the rules is to "introduce a foundation for the independence component of the [PCAOB]'s ethics rules." Rule 3520 requires that, throughout an audit, a registered public accounting firm must be independent of its audit client. Various rules regarding independence are set forth by the PCAOB rules and standards and by the SEC under the federal securities laws.

C. Impaired Independence

Third, the proposed rules describe three situations in which the auditor's independence may be impaired. Under Rule 3521, if a registered public accounting firm enters into a contingent fee ar-

125. The rules were proposed on July 26, 2005. However, the SEC must approve the proposed rules before they come into effect.
127. Id.
128. Id. at Rule 3502, Page A-5-Rule.
129. Id.
130. Id. at Page 8.
132. Id.
133. Id.
rangement with an audit client, the firm is not independent.\textsuperscript{134} Also, Rule 3523 provides that a firm is not independent if it provides "any tax service to a person in a financial reporting oversight role at the audit client."\textsuperscript{135}

Additionally, the auditor’s independence may be impaired under Rule 3522 when a registered public accounting firm "provides any non-audit service to the audit client related to marketing, planning, or opining in favor of the tax treatment of, a transaction . . . that was initially recommended, directly or indirectly, by the registered public accounting firm and a significant purpose of which is tax avoidance."\textsuperscript{136} However, the firm is independent if the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws.\textsuperscript{137}

D. Non-prohibited Tax Services

The final objective of the proposed rules is to require registered public accounting firms seeking pre-approval to engage in non-prohibited tax services for the audit client to provide certain information.\textsuperscript{138} Rule 3524 provides that before a firm can provide permissible tax services for an audit client, the firm must seek pre-approval by describing in writing the following: the scope of the service, the fee structure for the engagement, any side letter or other amendment to the engagement letter, and any compensa-

\textsuperscript{134} Id. at Rule 3521, Page A-6-Rule.

\textsuperscript{135} Id. at Rule 3523, Page A-7-Rule. This rule does not apply if "the person is in a financial reporting oversight role at the audit client only because he or she serves as a member of the board of directors or similar management or governing body of the audit client." Id. It also does not apply if

the person is in a financial reporting oversight role at the audit client only because of the person's relationship to an affiliate of the entity being audited whose financial statements are not material to the consolidated financial statements of the entity being audited and whose financial statements are audited by an auditor other than the firm or an associated person of the firm.


\textsuperscript{137} Id.

\textsuperscript{138} Id. at 8-9.
tion arrangement.\textsuperscript{139} Under Rule 3524, the accounting firm is also required to "discuss with the audit committee . . . the potential effects of the services on the independence of the firm and document the substance of its discussion with the audit committee."\textsuperscript{m140}

VI. EFFECT OF THE PCAOB PROPOSED RULES ON ETHICS AND INDEPENDENCE

Unlike the Amendments to Circular 230, the PCAOB proposed rules on ethics and independence have not been greeted with apprehension by the professional community. Rather than perceived as vague and overly broad, the proposed rules are viewed as specific and easy to understand. Most professionals do not believe that the rules will significantly impact their daily practice, except that the rules may prevent tax professionals from continuing to provide certain tax services to audit clients of their firms.

In 2003, the SEC adopted rules that allowed auditors to provide some tax services to clients, while still remaining independent.\textsuperscript{141} The rules listed specific categories of tax services that cannot be provided by auditors, which include: bookkeeping or other services relating to the accounting records or financial statements of the audit client; financial information systems design, implementation, appraisal, or valuation services; fairness opinions or contribution-in-kind reports; actuarial services; internal audit outsourcing services; management functions; human resource services; broker, dealer, investment adviser, or investment banking services; legal services; expert services unrelated to the audit; and any other service that the PCAOB determines, by regulation, is impermissible.\textsuperscript{142} However, other non-audit services may be rendered without impairing independence if the service has been pre-approved by the client's audit committee.\textsuperscript{143}

The SEC rules do not, however, prohibit auditors from setting up tax shelters, issuing tax opinion letters, or doing compensation planning for the audit client or its executives, as long as the audit committee approves the services. This has generated concern among the PCAOB and SEC in light of the recent focus on abusive tax shelter transactions.

\textsuperscript{139} Id. at Rule 3524, Page A-7-Rule - A-8-Rule.
\textsuperscript{140} Id.
\textsuperscript{141} 17 C.F.R. § 210.2-01 (2005).
\textsuperscript{142} Id.
\textsuperscript{143} Id.
The PCAOB proposed the rules to prevent accounting firms from reviewing their own advice and from having their auditing judgments be "compromised by lucrative tax fees." Although not much evidence, if any, exists that proves an auditor's independence is compromised when the auditor also serves as a tax planner for the company's top executives, the PCAOB did not want to take any chances when dealing with the protection of investors. William J. McDonough, former PCAOB chairman, stated the concern when he said, "The appearance that some in the profession assist corporate and other privileged clients to evade the rules . . . threatens the restoration of public confidence."

The proposed rules do not ban auditors from providing all tax services to audit clients. The rules merely add a few more tax services to the SEC's list of tax services that cannot be provided by auditors. Thus, firms may not provide any tax services to a person in a financial reporting oversight role to the audit client or any non-audit services to the client related to marketing, planning, or opining in favor of the tax treatment of a transaction that was initially recommended, directly or indirectly, by the firm and a significant purpose of which is tax avoidance. Firms may still, however, provide routine tax work, such as preparing tax returns for the company or some of its employees, general tax planning and advice, and international assignment tax services.

VII. CONCLUSION

In response to the investigation by the U.S. Senate Permanent Subcommittee, which revealed the immense growth of the tax shelter industry, the Amendments to Circular 230 and the PCAOB proposed rules on ethics and independence both sought to prevent abusive tax shelters and promote ethical behavior among tax practitioners. However, they each attack the problem from a different angle and seek to protect different interests. The new regulations under Circular 230 were created to deter the involvement of promoters, advisors, and investors in abusive transactions, while the PCAOB rules aimed to protect investors by preventing accounting.
firms from compromising their ethics for self-interest by promoting abusive tax shelters. But are these actions taken by the Treasury Department, IRS, PCAOB, and SEC going to effectively bring a halt to the growing popularity of using abusive transactions to avoid or postpone taxes?

One would like to think “yes.” However, with the complexity and purported ambiguity of the new rules, the result may just be tougher standards for professionals to follow with little correction of the problem. The majority of tax professionals do not engage in the abusive transactions that are the subject of all of the new rules. Thus, they are subjected to the strenuous rules that should, in effect, only target the small number of unethical professionals who try to maneuver around the rules to make an extra dollar. No matter what rules are put into effect, these unethical professionals will always be present in the professional community.

Even if the rules may not effectively prevent abusive tax shelters and may burden tax professionals with complex and ambiguous rules, the rules are necessary to restore public confidence in the accounting and legal professions. In light of the several recent corporate scandals, the Treasury Department, IRS, PCAOB, and SEC all needed to do something to show that they would not tolerate abusive transactions and unethical behavior. Thus, new rules and regulations, such as the Amendments to Circular 230 and the PCAOB proposed ethics and independence rules, are imposed upon the professional community. If the intended benefits do not materialize, the rules will more than likely be revised once again. Regardless, tension will remain among the professional community, law-making authority, and taxpayers. The establishment of new rules to protect taxpayers against unethical professionals will persist, while ethical tax professionals will continue to provide advice to taxpayers with the concern of violating ever-changing rules.

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