

**CIRCULAR 230 OPINION STANDARDS, LEGAL ETHICS AND FIRST AMENDMENT LIMITATIONS ON THE  
REGULATION OF PROFESSIONAL SPEECH BY LAWYERS**

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# CIRCULAR 230 OPINION STANDARDS, LEGAL ETHICS AND FIRST AMENDMENT LIMITATIONS ON THE REGULATION OF PROFESSIONAL SPEECH BY LAWYERS

## INTRODUCTION

The regulation of professional speech is one of the least developed areas of First Amendment doctrine. The few judicial decisions that have addressed limitations on professional speech have failed to provide a comprehensive analytical framework for defining the limits on such regulation.<sup>2</sup> Moreover, there is little consensus in the academic literature regarding the proper approach to the issue.<sup>3</sup>

This article examines the First Amendment limitations on the regulation of professional speech in the context of recent “Circular 230” regulations, which govern the content and presentation of opinions and other written tax advice (“tax opinions”) concerning transactions that have a significant or principal

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<sup>2</sup> See *Lowe v. Securities and Exchange Commission*, 472 U.S. 181 (1985); *Gentile v. State Bar of Nevada*, 501 U.S. 1030 (1991); *Planned Parenthood of Southeastern Pennsylvania v. Casey*, 505 U.S. 833 (1992); *Legal Services Corp. v. Velazquez*, 531 U.S. 533 (2001); *Conant v. Walters*, 309 F.3d 629 (2002), *cert. denied*, 540 U.S. 946 (2003).

<sup>3</sup> See Paula E. Berg, *Lost in a Doctrinal Wasteland: The Exceptionalism of Doctor-Patient Speech within the Rehnquist Court's First Amendment Jurisprudence*, 8 Health Matrix 153 (1998); Daniel Halberstam, *Commercial Speech, Professional Speech and the Constitutional Status of Social Institutions*, 147 U. Pa. L. Rev. 771, 792-828 (1999); Robert Kry, *The “Watchman for Truth”: Professional Licensing and the First Amendment*, 23 Seattle U. L. Rev. 885, 957-63 (2000); W. Bradley Wendel, *Free Speech for Lawyers*, 28 Hastings Const. L.Q. 305, 404-23 (2001); Kathy S. Pomerantz, Note, “*Silence is a Fence Around Wisdom: How Conant v. Walters Broke Down the Fence by Securing Physicians’ First Amendment Right to Recommend Medical Marijuana to their Patients*,” 37, Loy. L.A. L. Rev. 1771 (2004); Jessica Russak Sharpe, Recent Developments, *Legal Services Corp. v. Velazquez: Tightening the Noose on Patients’ Rights*, 81 N.C. L. Rev. 1312 (2003); Marla Brooke Tusk, Note, *No-Citation Rules as a Prior Restraint on Attorney Speech*, 103 Colum. L. Rev. 1202 (2003). The professional speech doctrine can be viewed as one variant of a more generalized “hearer-centered” First Amendment theory that includes the doctrines of commercial speech. See, e.g., Dale Carpenter, *The Antipaternalism Principle in the First Amendment*, 37 Creighton L. Rev. 579 (2004); Burt Neuborne, *The First Amendment and Government Regulation of Capital Markets*, 55 Brook. L. Rev. 5 (1989); Robert Post, *The Constitutional Status of Commercial Speech*, 48 UCLA L. Rev. 1, 53 (2000); Eugene Volokh, *Speech as Conduct: Generally Applicable Laws, Illegal Courses of Conduct, “Situation-Altering Utterances,” and the Uncharted Zones*, 90 Cornell L. Rev. 1277, 1304 (2005). There has been a considerable amount of scholarship applying such principles to the regulation of speech in the capital markets. See Lillian R. Bevier, *A Comment on Professor Wolfson’s “The First Amendment and the SEC,”* 20 Conn. L. Rev. 325 (1988); Michael P. Dooley, *The First Amendment and the SEC: A Comment*, 20 Conn. L. Rev. 335 (1988); Arthur R. Pinto, *The Nature of the Capital Markets Allows a Greater Role for the Government*, 55 Brook. L. Rev. 77 (1989); Michael E. Schoeman, *The First Amendment and Restrictions on Advertising of Securities under the Securities Act of 1933*, 41 Bus. Law. 377 (1986); Nicholas Wolfson, *The First Amendment and the SEC*, 20 Conn. L. Rev. 265 (1988); Allen D. Boyer, *Free Speech, Free Markets, and Foolish Consistency*, 92 Colum. L. Rev. 474 (1992) (reviewing NICHOLAS WOLFSON, CORPORATE FIRST AMENDMENT RIGHTS AND THE SEC (1990)).

purpose of avoiding Federal taxes or are otherwise deemed to be tax avoidance transactions.<sup>4</sup> Although these regulations apply broadly to “practitioners” before the Internal Revenue Service (“IRS”),<sup>5</sup> this article focuses on the application of the regulations to lawyers.

The Circular 230 requirements are intended to address the significant policy and budgetary issue of practitioners’ involvement in the development, marketing and encouragement of abusive tax shelters. Professionals connected with such shelters certainly have acted inappropriately in some cases.<sup>6</sup> But the Circular 230 requirements are in many respects an inappropriate response to these problems. The framework and prohibitions they impose prevent a lawyer from giving taxpayers a complete, informed assessment of their rights. In certain circumstances the rules create significant ethical conflicts and deny the public legal advice. In general, they distort the lawyer’s role and erode the principles underlying legal ethics rules. The restriction of information and distortion of a lawyer’s role make the rules vulnerable to a First Amendment challenge under the doctrines of professional speech and, in the case of opinions used to market tax shelters to third parties, under a general “hearer-centered” First Amendment theory.

The Circular 230 regulations require a tax opinion to meet a strict set of requirements: The opinion must identify and evaluate all facts relevant to the transaction.<sup>7</sup> It must relate all applicable law to the facts.<sup>8</sup> It generally must identify and evaluate each “significant Federal tax issue,” meaning a Federal tax issue that meets a materiality threshold and to which the IRS has a “reasonable basis” for a successful challenge.<sup>9</sup>

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<sup>4</sup> 31 C.F.R. §§ 10.35, 10.37. The regulations fall within Treasury Dept. Circular No. 230, 31 C.F.R. Subtitle A, Part 10 (hereinafter, “Circular 230”).

<sup>5</sup> Practitioners are defined for this purpose to include attorneys, certified public accountants, “enrolled agents” and “enrolled actuaries.” Circular 230 § 10.2.

<sup>6</sup> For criticism of practitioner conduct relating to tax shelters, *see, e.g.*, James M. Delaney, *Where Ethics Merge with Substantive Law – An Analysis of Tax Motivated Transactions*, 38 Ind. L. Rev. 295 (2005); Richard Lavoie, *Deputizing the Gunslingers: Co-Opting the Tax Bar into Dissuading Corporate Tax Shelters*, 21 Va. Tax Rev. 43 (2001); Sheldon D. Pollack & Jay A. Soled, *Tax Professionals Behaving Badly*, 105 Tax Notes 201 (Oct. 11, 2004); Jay A. Soled, *Third-Party Civil Tax Penalties and Professional Standards*, 2004 Wis. L. Rev. 1611, 1650-53 (2004). For a more balanced view, *see* Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 Tax Notes 1775 (June 21, 1999).

<sup>7</sup> Circular 230 § 10.35(c)(1).

<sup>8</sup> *Id.* § 10.35(c)(2).

<sup>9</sup> *Id.* § 10.35(c)(3).

The opinion may not contain internally inconsistent legal analyses or conclusions,<sup>10</sup> nor may it take into account the possibilities that the IRS may not audit a tax return or raise an issue on audit or that the issue will be resolved by settlement if raised.<sup>11</sup> The opinion must conclude whether the overall tax treatment of the transaction is proper.<sup>12</sup> If someone other than the practitioner will use or refer to the opinion to promote, market or recommend (collectively, “to market”) a transaction (a “marketed opinion”), the opinion must conclude that the taxpayer will prevail on each significant Federal tax issue affecting the transaction, and that the overall tax treatment is proper, at a confidence level of at least “more likely than not.”<sup>13</sup> Any non-marketed opinion that doesn’t express this level of confidence with respect to an issue must prominently disclose that the writer did not intend or write it to be used to avoid tax penalties, and that the taxpayer may not use it for this purpose (a “no reliance” legend).<sup>14</sup> A marketed opinion must prominently disclose that the opinion was written to support the promotion or marketing of the transaction and that the taxpayer should seek advice, based on the taxpayer’s particular circumstances, from an independent tax advisor (a “consumer protection” legend).<sup>15</sup> The tax opinion must disclose any compensation arrangement the practitioner has with a third party for marketing the transaction, and any referral agreement with a third party who markets such a transaction.<sup>16</sup> The rules prohibit a practitioner from providing advice that is contrary to or inconsistent with a required disclosure.<sup>17</sup>

The Circular 230 regulations allow tax opinions that meet certain conditions to avoid these requirements, generally or as to specific issues, by including a “no reliance” legend.<sup>18</sup> Certain marketed opinions can avoid these requirements by including both a “no reliance” legend and a “consumer protection” legend.<sup>19</sup> However, only limited categories of tax opinions can benefit from such exceptions. A practitioner cannot

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<sup>10</sup> *Id.* § 10.35(c)(2)(iii).

<sup>11</sup> *Id.* § 10.35(c)(3)(iii).

<sup>12</sup> *Id.* § 10.35(c)(4).

<sup>13</sup> *Id.* §§ 10.35(c)(3)(ii); 10.35(c)(4)(ii).

<sup>14</sup> *Id.* § 10.35(e)(4).

<sup>15</sup> *Id.* § 10.35(e)(2).

<sup>16</sup> *Id.* § 10.35(e)(1).

<sup>17</sup> *Id.* § 10.35(e)(5).

<sup>18</sup> *Id.* §§ 10.35(b)(4)(ii); 10.35(c)(3)(v).

<sup>19</sup> *Id.* § 10.35(b)(5)(ii).

use the “no reliance” legend to avoid the Circular 230 requirements if an opinion addresses a so-called “listed transaction”<sup>20</sup> or a transaction having as its principal purpose to avoid or evade taxes, or if it is a marketed opinion or is subject to certain “conditions of confidentiality” or “contractual protection” for the taxpayer. Even opinions that are excepted from these rules must satisfy certain requirements regarding factual due diligence and may not take into account the possibility that the IRS won’t audit a tax return or raise an issue on audit or will resolve the issue through settlement if it’s raised.<sup>21</sup>

Part I of this article discusses the background to the Circular 230 rules and the scope and requirements of the rules. Part II discusses the ethical rules applicable to tax opinions and compares these rules to the Circular 230 opinion standards, concluding that the Circular 230 standards impose substantially greater requirements on practitioners than do the ethical rules and in certain respects conflict with the ethical rules.

Part III of the article discusses First Amendment case law and commentary regarding professional speech, and proposes that professional speech regulations be analyzed by means of a model that defines permissible regulation of professional speech largely by reference to the role of the profession in society and to accepted professional norms. Part III also discusses the professional speech doctrine in the context of a more general “hearer-centered” First Amendment theory, which is particularly relevant to evaluating the restrictions on professional opinions used to market tax shelters to third parties.

Part IV of the article applies the professional speech model and the “hearer-centered” theory to the Circular 230 tax opinion requirements. It concludes that the “viewpoint-neutral” standards imposed by Circular 230, while they may be seen as furthering the legitimate government purpose of ensuring that taxpayers not enter into tax-motivated transactions without a full understanding of the risks, are not narrowly tailored to their purpose and distort the normal functioning of the profession based on accepted usage. Part IV also concludes that the “viewpoint-based” standards imposed by Circular 230 are less

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<sup>20</sup> Listed transactions are discussed in more detail below at notes [41] to [43].

justified in terms of furthering a legitimate government purpose and more seriously distort the role of a lawyer and interfere with the exercise of professional judgment.

Part IV, finally, considers what requirements the government could impose on tax opinions under both the “professional speech” model and, in the case of opinions used to market tax shelters, under the “hearer-centered” theory.

## **I. CIRCULAR 230 OPINION RULES**

### **A. History of the Circular 230 Opinion Standards**

The Treasury Department (“Treasury”) has regulated lawyers and others practicing before the Department and its bureaus since before the modern income tax.<sup>22</sup> Although Circular 230 has regulated aspects of tax advice for many years, Treasury’s authority to regulate the content of tax advice had been questioned. That question was addressed by the American Jobs Creation Act of 2004,<sup>23</sup> which amended the current authorizing statute, 31 U.S.C. Section 330, to include the following:

Nothing in this section or in any other provision of law shall be construed to limit the authority of the Secretary of the Treasury to impose standards applicable to the rendering of written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement, which is of a type which the Secretary determines as having a potential for tax avoidance or evasion.<sup>24</sup>

Treasury first adopted rules regulating the content and presentation of tax shelter opinions in 1984, in former Section 10.33 of Circular 230.<sup>25</sup> Former Section 10.33 was directed primarily to the problem of heavily qualified, hypothetical, inconclusive or incorrect opinions which promoters used to market tax shelters. The preamble to the 1984 rules described the problem as follows:

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<sup>21</sup> Circular 230 § 10.37.

<sup>22</sup> Act of July 7, 1884, ch. 334 Sec. 3, 23 Stat. 22.

<sup>23</sup> Pub. L. 108-357 (118 Stat. 1418), Sec. 822.



The theory of the tax shelter promoter appears to be that the tax opinion, even if qualified or simply incorrect, may provided [sic] the investor with assurance that penalties will not be assessed .... Moreover, promoters also appear to hope that investors will view the practitioner's willingness to provide an opinion, even when the opinion is frankly pessimistic ... or simply does not purport to address key tax aspects, as an endorsement of the tax shelter.<sup>26</sup>

The 1984 rules generally defined a "tax shelter" as an investment having specific Federal income or excise tax savings attributes as a significant and intended feature. A "tax shelter opinion" was defined as "advice by a practitioner concerning the Federal tax aspects of a tax shelter either appearing or referred to in the offering materials, or used or referred to in connection with sales promotion efforts, and directed to persons other than the client who engaged the practitioner to give the advice." Accordingly, a tax shelter opinion did not include "rendering advice solely to the offeror ..., so long as neither the name of the practitioner, nor the fact that a practitioner has rendered advice ... is referred to in the offering materials or in connection with the sales promotion efforts."

The 1984 rules required a practitioner who provided a tax shelter opinion to (i) identify, describe and analyze relevant facts, (ii) relate the law to the facts, (iii) identify and assess material tax issues, and (iv) provide an overall evaluation whether an investor will realize the material tax benefits.

In the preamble to the proposed former rules, Treasury emphasized that the rules would not "affect or regulate the practitioner's relationship with individual clients" and that it was "the use of a tax shelter opinion that the proposed rule would regulate, not the rendering of an opinion by a lawyer to his client."<sup>27</sup>

The preamble also stated that the proposed rules were consistent with a 1982 American Bar Association

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<sup>24</sup> 31 U.S.C. § 330(d).

<sup>25</sup> 49 Fed. Reg. 6,719 (Feb. 23, 1984). Treasury considered such rules to be authorized by 31 U.S.C. § 330 as then in effect, as well as other statutory provisions. *Id.* at 6720, 6721.

<sup>26</sup> 45 Fed. Reg. 58,594, 58,595 (Sept. 4, 1980) (footnote omitted).

<sup>27</sup> *Id.* at 56146 (footnote omitted).

opinion concerning tax shelter opinions, Formal Opinion 346.<sup>28</sup> Indeed, after final publication of Formal Opinion 346, the regulations were revised to conform more closely to the ABA opinion.<sup>29</sup> “The legal profession,” as Treasury described the relationship, “has, by publication of ABA Opinion 346, recognized that attorneys have unique ethical responsibilities when they render tax shelter opinions to persons who are not their clients. This action by the ABA reinforces Treasury’s belief that tax practitioners must meet minimum standards of conduct with respect to tax shelter opinions.”<sup>30</sup>

On May 5, 2000, Treasury published an advance notice of proposed rulemaking that requested comments about the standards for providing tax advice and, in particular, whether the standards for tax shelter opinions should be extended to opinions not used to market tax shelters, including those used to establish a “reasonable cause and good faith” exception to accuracy-related penalties. The notice stated that practitioners and professional organizations had recommended a revision of Circular 230 to raise the standards for such advice.<sup>31</sup> On January 12, 2001, after receiving public comments, Treasury proposed revisions to the rules for marketed tax shelters and new rules for all tax shelter opinions, including opinions rendered to clients, that conclude that an issue will be resolved in favor of a taxpayer at a level of confidence of “more likely than not” or higher.<sup>32</sup> Many of the present Circular 230 opinion standards appeared in some form in the 2001 proposed rules and the proposed revisions that followed in 2003.

The 2001 proposed rules revised the definition of a “tax shelter” to incorporate the definition then found in Section 6662(d)(2)(C)(3) of the Internal Revenue Code (the “Code”):<sup>33</sup>

For purposes of this subparagraph, the term “tax shelter” means –

(I) a partnership or other entity,

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<sup>28</sup> Formal Opinion 346 was originally issued on June 1, 1981. After criticism by tax practitioners, it was withdrawn and reissued in revised form on January 29, 1982.

<sup>29</sup> The revised regulations were issued on December 15, 1982.

<sup>30</sup> 49 Fed. Reg. 6,719-20.

<sup>31</sup> 65 Fed. Reg. 30,375 (May 5, 2000)

<sup>32</sup> 66 Fed. Reg. 3,276 (Jan. 12, 2001). On December 30, 2003, Treasury withdrew the 2001 proposed rules and issued new proposed rules, as well as setting forth “best practices” for providing advice or assisting clients in the preparation of submissions to the IRS. 68 Fed. Reg. 75,186 (Dec. 30, 2003).

(II) any investment plan or arrangement, or

(III) any other plan or arrangement,

if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.<sup>34</sup>

As discussed in greater detail below, this technical definition of a “tax shelter” covers far more than what is typically thought of as a tax shelter.<sup>35</sup>

On December 20, 2004, Treasury published final rules that address, among other things, best practices for tax advisors, requirements for “covered opinions,” requirements for other written advice, and procedures to ensure compliance.<sup>36</sup> It published corrections to the final rules on April 14, 2005,<sup>37</sup> and further revisions on May 19, 2005.<sup>38</sup> Also on December 20, 2004, it published proposed rules applying the Circular 230 opinion standards to state and local bond opinions, which are excluded from the general requirements;<sup>39</sup> and on June 7, 2005, the IRS issued interim guidance regarding the definition of a state or local bond opinion.<sup>40</sup>

## **B. The Current Circular 230 Opinion Standards**

There are four significant components to the current rules: (1) a definition of “covered opinions” that are subject to specific standards, (2) the specific standards, including due diligence, analysis and presentation

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<sup>33</sup> Currently, I.R.C. § 6662(d)(2)(C)(ii).

<sup>34</sup> The 2003 proposed rules also adopted a definition of “tax shelter” similar to the definition in I.R.C. § 6662(d)(2) but expanded the definition to cover all taxes imposed by the Internal Revenue Code, not just the Federal income tax.

<sup>35</sup> As pointed out by numerous commentators, the “significant purpose” definition covers almost any transaction that results in tax savings, including many common business transactions and well-accepted tax planning strategies. *See, e.g.,* Michael L. Schler, *Effects of Anti-Tax-Shelter Rules on Nonshelter Tax Practice*, 109 Tax Notes 915, 918 (Nov. 14, 2005).

<sup>36</sup> 69 Fed. Reg. 75,839 (Dec. 20, 2004).

<sup>37</sup> 70 Fed. Reg. 19,892 (Apr. 14, 2005).

<sup>38</sup> 70 Fed. Reg. 28,824 (May 19, 2005).

<sup>39</sup> 69 Fed. Reg. 75,887 (Dec. 20, 2004).

<sup>40</sup> I.R.S. Notice 2005-47, 2005-26 I.R.B. 1.

requirements for different categories of covered opinions, (3) disclosures required to accompany covered opinions, and (4) due diligence and analysis standards for written advice other than covered opinions.

1. Covered Opinions

Opinions on certain types of transactions are *per se* covered opinions, with limited exceptions. These transactions include so-called “listed transactions” and transactions whose principal purpose is to avoid or evade tax (“principal purpose transactions”). In contrast, opinions on transactions in which avoiding or evading tax is merely a significant purpose (“significant purpose” transactions), are covered opinions only if they do not fit within an exception and (a) involve such conditions as confidentiality or contractual protection which suggest that the underlying transactions are tax shelters, (b) are marketed opinions, or (c) express a conclusion at a confidence level of “more likely than not” or higher (a “reliance” opinion).

Within these broad categories are numerous specific definitions and exceptions:

a. Opinions on Listed and Principal Purpose Transactions. Listed transaction opinions concern any Federal tax issue arising from (i) a transaction that the IRS has identified in published guidance (*i.e.*, listed) as a tax avoidance transaction, or (ii) a transaction substantially similar to a listed transaction.<sup>41</sup> A listed transaction is *per se* a “reportable transaction.” That is, participants in the transaction are subject to tax shelter reporting obligations,<sup>42</sup> and “material advisors” to the transaction are subject to reporting and record-keeping (so-called “list maintenance”) obligations.<sup>43</sup> The IRS views a “listed transaction” as a hard-core abusive tax shelter.

However, can be difficult to identify a listed transaction. The definition of a listed transaction includes “substantially similar” transactions to those the IRS has listed. The tax shelter reporting

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<sup>41</sup> Circular 230 § 10.35(b)(2)(A).

<sup>42</sup> Treas. Reg. § 1.6011-4(b)(2).

<sup>43</sup> I.R.C. §§ 6111, 6112.

rules add only that a transaction is “substantially similar” to an identified listed transaction if the two are factually similar or based on the same or similar tax strategies and are expected to have the same or similar tax consequences.<sup>44</sup> There is no further guidance on the required degree of similarity; commentators have noted the difficulty of making this assessment.<sup>45</sup>

An opinion on a principal purpose transaction is written advice concerning any Federal tax issue arising from an entity, plan, or arrangement, whose principal purpose of which is the avoidance or evasion of any tax the Code imposes.<sup>46</sup> In this context, a purpose is “principal” if it is more important than any other purpose.<sup>47</sup> “Avoidance” and “evasion” are not defined. Treasury apparently intended that the terms be interpreted consistently with their use in the “tax shelter” definition in Code Section 6662(d)(2)(C). However, neither Section 6662(d)(2)(C) nor the associated regulations define the terms. Federal tax rules generally define “evasion” as reduction of taxes through unlawful means and “avoidance” as reduction of taxes through lawful (or arguably lawful) means.<sup>48</sup> Thus, the IRS may consider even lawful planning or activities to minimize taxes as “avoidance.”<sup>49</sup>

The definition of a principal purpose transaction contains an exception for an entity, plan or arrangement whose principal purpose is to claim benefits “in a manner consistent with the statute and Congressional purpose.”<sup>50</sup> However, there are no clear standards for determining when a claim of tax benefits is consistent with the statute and Congressional purpose, though the

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<sup>44</sup> Treas. Reg. § 1.6011-4(c)(4). *See also* Treas. Reg. § 1.6112-1(d)(2) (adopting the same definition for purposes of the material advisor document maintenance rules).

<sup>45</sup> *See, e.g.,* American Bar Association Section of Taxation, *Comments Concerning Notice 2004-80 (Interim Guidance Under I.R.C. §§ 6111, 6112 and 6708)*, reprinted in *Tax Notes Today* (Feb. 7, 2005).

<sup>46</sup> Circular 230 § 10.35(b)(2)(B).

<sup>47</sup> Circular 230, § 10.35(b)(10).

<sup>48</sup> *See* BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* (1999) ¶ 4.3.2.

<sup>49</sup> *But see* BERNARD WOLFMAN, JAMES P. HOLDEN & KENNETH L. HARRIS, *STANDARDS OF TAX PRACTICE* (6<sup>th</sup> Ed. 2004) § 208.2 (arguing, on the basis of legislative history of Taxpayer Relief Act of 1977 and purpose of tax shelter definition under Code Section 6662, that not every corporate decision involving reduction of tax liability is avoidance).

<sup>50</sup> Circular 230, § 10.35(b)(10).

exception does not appear to apply where there is any meaningful uncertainty that the tax benefits in question are available.<sup>51</sup> Finally, weighing the relative importance of the tax and non-tax purposes of a transaction to determine whether the principal purpose is avoidance of tax can be difficult, especially where the facts are not fully known.<sup>52</sup>

The covered opinion standards of Section 10.35 apply with special rigor to opinions on listed and principal purpose transactions. The standards apply whether an opinion is used in marketing and regardless of the level of confidence it expresses.<sup>53</sup> Section 10.35 provides no opportunity to exclude such an opinion from coverage by adding a “no reliance” legend (“legending out”).

The justification for this rigor cannot be to regulate opinions used for marketing purposes, as was the case with former Section 10.33, because the present Section 10.35 covers more than marketed opinions. Nor can the justification be to regulate opinions used to avoid penalties. A “no reliance” legend could satisfy such needs, but the rule does not allow “legending out.” Further, the rule covers opinions that could not be, or in fact are not, used for penalty protection purposes. Treasury apparently is of the view that listed and principal purpose transactions threaten the tax system, and therefore should be subject to strictures similar to those for marketed opinions.

It is true that taxpayers have used many listed and principal purpose transactions to avoid taxes improperly or evade taxes. The propagation of such transactions undoubtedly threatens the tax system by creating false justifications for taxpayers that wish to misreport their tax liabilities. However, the mere fact that a transaction is a listed or principal purpose transaction does not necessarily mean that it reduces taxes improperly. Few court cases have adjudicated the merits of listed transactions; but the courts have upheld any number of transactions that would most likely

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<sup>51</sup> See Jonathan G. Blattmachr, Mitchell M. Gans, Diana S.C. Zeydel & Tracy L. Bentley, *Circular 230 Redux: Questions of Validity and Compliance*, Tax Notes, June 20, 2005, 1533, 1539-40.

<sup>52</sup> In this regard, the covered opinion rules differ from the penalty and tax shelter reporting and document retention rules. For the latter purpose, the determination of whether a tax return position falls within the rules generally is made after the transaction has been completed.

qualify as principal purpose transactions.<sup>54</sup> If the courts rule that a transaction provides valid tax savings, it's hard to call it a threat to the tax system. If Congress and Treasury conclude otherwise, they have authority to change the applicable statutes and regulations.

Even if no court has ruled yet on the validity of a given listed or principal purpose transaction, all listed transactions and many principal purpose transactions are so-called "reportable transactions," which must be reported to the IRS. If the IRS successfully challenges a transaction, it can impose penalties under Code Section 6662A unless the taxpayer can show, under very stringent standards, reasonable cause for the position and good faith. True, challenging such transactions places administrative burdens on the IRS and subjects the agency to litigation risks; but those are the costs of regulating a complex Federal system, which is subject to the ultimate interpretive authority of the courts.<sup>55</sup>

Even assuming, *arguendo*, that listed and principal purpose transactions are an inherent threat to the tax system, it is not obvious that the threat justifies requiring a comprehensive opinion in every case. A practitioner normally will have a duty to alert a client that such transactions have risks, including a fight with the IRS, but they can be identified without a comprehensive opinion.

Applying the covered opinion standards to every piece of written advice on a listed or principal purpose transaction will increase the cost of the practitioner's advice. Also, some practitioners may be reluctant to any written advice, for fear of inadvertently violating the requirements. Treasury may view such consequences as salutary means of discouraging listed and principal purpose transactions. However, discouraging lawyers' advice is not an appropriate way to discourage such transactions, whose validity depends on the facts of each case.

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<sup>53</sup> As discussed below, there is an exception for "negative advice," but it applies only where the opinion does not reach a conclusion favorable to the taxpayer at any confidence level.

<sup>54</sup> *See, e.g.,* Cottage Savings Ass'n v. Comm'r, 499 U.S. 554 (1991); Compaq Computer Corp. v. Comm'r, 277 F.3d 778 (5<sup>th</sup> Cir. 2001).

c. Opinions on Significant Purpose Transactions. Opinions on significant purpose transactions are written advice concerning any Federal tax issue arising from an entity, plan or arrangement a significant purpose of which is the avoidance or evasion of any tax imposed by the Code, if the written advice is (i) a “reliance opinion,” (ii) a “marketed opinion,” (iii) subject to “conditions of confidentiality,” or (iv) subject to “contractual protection.”<sup>56</sup> The rules do not provide standards for determining whether a significant purpose transaction exists. However, the history, drafting, and purpose of the rules clearly indicate that they incorporate the standards used in Code Section 6662(d)(2)(C) to define a tax shelter.<sup>57</sup>

i. Opinions Subject to “Conditions of Confidentiality” or “Contractual Protection”. In general, an opinion is considered subject to conditions of confidentiality if the practitioner seeks to impose restrictions on the disclosure of the tax treatment or tax structure of the transaction for the purpose of maintaining the confidentiality of the practitioner’s tax strategies. An opinion is considered subject to contractual protection if the taxpayer is entitled to a refund of fees if all or part of the intended tax consequences addressed in the opinion are not sustained, or if the fees are contingent on the taxpayer’s realization of tax benefits from the transaction.<sup>58</sup>

Opinions on significant purpose transactions that are given under these circumstances are *per se* treated as tax shelter opinions and subject to the opinion standards in Section 10.35, regardless of whether they are used in marketing and regardless of their level of confidence. Presumably, the rationale for such rigorous application of the rule is that the tax practitioner should be viewed under these circumstances as promoting the significant

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<sup>55</sup> “It is emphatically the province and duty of the judicial department to say what the law is.” *Marbury v. Madison*, 1 Cranch 137, 177 (1803).

<sup>56</sup> Circular 230 § 10.35(b)(2)(C).

<sup>57</sup> 68 Fed. Reg. 75,186, 75,188 (Dec. 30, 2003). Section 10.35 as proposed in 2003 used the term “tax shelter opinions” and defined “tax shelter” by reference to significant purpose transactions.

<sup>58</sup> *See also* Treas. Reg. §§ 1.6011-4(b)(3), (b)(4), with substantially identical language.



purpose transaction, just as with a marketed opinion. However, the types of opinions do not receive fully parallel treatment. “Legending out” is allowed for marketed opinions but not for “confidentiality” and “contractual protection” opinions; a limited scope opinion, discussed below, is allowed for “confidentiality” and “contractual protection” opinions but not for marketed opinions. The reason for these differences is not obvious.

- ii. Marketed Opinions. An opinion is a marketed opinion if the practitioner knows or has reason to know that the written advice will be used or referred to by a person other than the practitioner (or a person associated with the practitioner’s firm) in marketing an entity, plan or arrangement to one or more taxpayers. A practitioner is permitted to exclude an opinion (other than a listed transaction or principal purpose opinion) from this category by including a “no reliance” legend and a “consumer protection” legend. A marketed opinion that is not excluded nevertheless must include a “consumer protection” legend.

One problem with the rules lies in the lack of specific guidance on what constitutes the marketing of an entity, plan or arrangement. The 2001 proposed rules included the statement that it is irrelevant whether such activities are conducted publicly or privately. However, there has been no guidance on, for example, whether a person may be viewed as a promoter even if not acting in the customary role of a shelter promoter. In many situations, a client engages one practitioner to provide advice regarding the tax treatment of a significant purpose transaction and another professional advisor for other aspects of the transaction. If the tax practitioner knows that the client is sharing the practitioner’s opinion with the other advisor, and the other advisor refers to the tax opinion in recommending that the client engage in the transaction, the tax opinion could be treated as a marketed opinion that must include the legend for marketed opinions. Yet, in this circumstance, the part of the legend stating that the opinion was written to support the

marketing of the transaction will not be correct;<sup>59</sup> the statement that the taxpayer should seek advice from an independent tax advisor makes no sense; and the statement that the client may not rely on the opinion to avoid penalties may not be correct, particularly if the opinion reaches conclusions at a “more likely than not” level of confidence.

These illogical results strongly suggest that the definition of a marketed opinion should be limited to opinions (or parts of opinions) that address the tax treatment of a person other than the practitioner’s client. The absence of such a limitation may reflect a concern that the limitation would allow practitioners working with promoters to avoid the rules by rendering opinions to the promoter’s clients and claiming that such persons are clients of the practitioner. However, even assuming that a valid attorney-client relationship exists,<sup>60</sup> this concern could have been addressed more narrowly, by defining a marketed opinion to include an opinion on a transaction rendered by a practitioner to a client for the purpose of facilitating the marketing of the transaction by a third party.

Another problem with the rules lies in the ambiguous definition of a marketed transaction. Consider the common situation in which a client is negotiating an acquisition and asks a practitioner for written advice regarding the tax treatment of the transaction to the client’s counterparty. If the practitioner knows or has reason to know that the client will use or refer to the advice in connection with the negotiation, the opinion would appear to constitute a marketed opinion, unless there is an election to “legend out” the opinion.

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<sup>59</sup> See Model Code of Professional Responsibility (the “Model Code”) DR 5-104(A) (1980) (a “lawyer shall not enter into a business transaction with a client if they have differing interests therein and if the client expects the lawyer to exercise his professional judgment therein for the protection of the client, unless the client has consented after full disclosure”); Model Rules of Professional Conduct (the “Model Rules”) R. 1.8(a) (1983).

<sup>60</sup> See, e.g., *John Doe #1 v. Wachovia Corp.*, 268 F.Supp.2d 627, 634 (W.D.N.C. 2003).

One could avoid such situations by distinguishing opinions directed only to the client and not used in marketing materials from opinions directed to a third party or incorporated in marketing materials provided to the third party. It is difficult to see why the former should be treated as a marketed opinion.<sup>61</sup>

Presumably, Treasury had two reasons for not creating such an exception. First, there may have been a concern, even where advice is addressed to a client, that the client may show the practitioner's written advice to a third party and encourage the third party to rely on it. However, this concern could have been addressed by requiring a prominent disclosure on the advice to the effect that it may not be relied upon by any third party. Second, there may have been a concern about situations where a practitioner's advice is used to develop a marketed transaction even if the practitioner's opinion was not shown or described to the third party, the practitioner was not directly involved in preparing the marketing materials, and the marketing materials actually furnished to potential purchasers describe the tax strategy and expected tax consequences only in very general terms and counsel the recipient to seek the advice of an independent tax advisor.

In this case, the practitioner's opinion is covered by the Circular 230 standards (absent a "legending out") not because the opinion may be relied upon by any third party taxpayer but rather as a mechanism for regulating the development and marketing of tax shelters. The Treasury rules use professional standards in effect to create an obligation on the part of a practitioner not to participate in the development of tax shelters unless the practitioner can comply with the requirements for marketed opinions.

iii. Reliance Opinions. An opinion is a "reliance opinion" if it concludes at a confidence level of "more likely than not" (a greater-than-50-percent likelihood) that one

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<sup>61</sup> See Jonathan G. Blattmachr, Mitchell M. Gans & Tracy L. Bentley, *The Application of Circular 230 in*

or more significant Federal tax issues would be resolved in the taxpayer's favor. A practitioner can exclude such an opinion (on other than a listed or principal purpose transaction) by including a "no reliance" legend. A Federal tax issue is "significant" if the IRS has a reasonable basis for a successful challenge and the resolution of the issue could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall Federal tax treatment of the transactions or matters addressed in the opinion.<sup>62</sup>

The "more likely than not" standard of Section 10.35 is based on the standards in Code Section 6664 for opinions that may be relied upon to establish reasonable cause and good faith for avoiding the accuracy-related penalties with respect to corporate tax shelters. However, there are circumstances when a taxpayer cannot rely upon an opinion for that purpose, even if it reaches a level of confidence of more likely than not. For example, a taxpayer cannot rely on it to avoid penalties for reportable transactions under Code Section 6662A for reportable transactions if the practitioner rendering the opinion is a "disqualified tax advisor." In those circumstances, the opinion should not have to meet the standards for a reliance opinion.

A practitioner may "legend out" a reliance opinion by including a "no reliance" legend. However, that legend is inaccurate in a number of ways. Treasury stated in the 2004 preamble to Section 10.35, that it would amend Treasury Regulations Section 1.6664-4 to clarify that taxpayers may not rely on opinions with such a legend to establish reasonable cause and good faith. However, no such amendment has been promulgated,<sup>63</sup> and accordingly, no regulation prevents a client from relying on an opinion for this purpose,

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*Estate Planning*, Tax Notes, April 4, 2005, 61, 68.  
Circular 230 § 10.35(b)(3).

even if it contains a “no reliance” legend. Even if an opinion does not meet the standards for avoiding penalties under Code Section 6664, a taxpayer may be able to reply on it as a defense against other penalties, for example, the penalty under Section 6662(b)(1) for negligence or disregard of rules or regulations<sup>64</sup> or the penalty under Section 6663 for fraud.<sup>65</sup>

Section 10.35 contains exceptions for opinions that otherwise would be defined as covered opinions under the foregoing rules. They include (i) preliminary advice if the practitioner is reasonably expected to later provide written advice satisfying the requirements of Section 10.35, (ii) opinions on retirement plan qualification, state or local bond opinions, and opinions required to be filed with the Securities and Exchange Commission,<sup>66</sup> provided the opinion does not concern a listed or principal purpose transaction, (iii) opinions given after a tax return is filed reflecting the tax benefits of a transaction, (iv) so-called “negative advice” concluding that a taxpayer will not prevail on an issue, at any level of confidence, and (v) opinions rendered by a practitioner to his or her employer about the employer’s tax liabilities. The preliminary advice exception has little value to a practitioner providing initial planning advice, and who cannot predict whether the planned transaction will proceed, whether the client will continue to retain the practitioner, and what subsequent advice the client ultimately will request.

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<sup>63</sup> The absence of an amended regulation may reflect the fact that, because the Section 10.35 standards are much more detailed than those of Code Section 6664 and Treas. Reg. Section 1.6664-4(c), an opinion could meet the general standards of Section 6664 but not meet certain requirements of Section 10.35.

<sup>64</sup> For this purpose, “negligence” includes any failure to make a reasonable attempt to comply with the tax rules, and “disregard” means disregard that is careless, reckless or intentional. *See* Treas. Reg. § 1.6662-3. *See also* Wolfman *et al.*, *supra* note [49], § 203.3.1.1, *citing* United Title Ins. Co. v. Comm’r, 55 T.C.M. (CCH) 34, 53 (1988) (“an incorrect decision regarding an unsettled question of law does not constitute negligence, provided the taxpayer’s interpretation is not clearly untenable and is held in good faith”).

<sup>65</sup> Wolfman *et al.*, *supra* note [49], § 203.3.2, *citing* Jemison v. Comm’r, 45 F.2d 4 (5<sup>th</sup> Cir. 1930); Whyte v. Comm’r, 52 T.C.M. (CCH) 677, *aff’d*, 852 F.2d 306 (7<sup>th</sup> Cir. 1988); Noël B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 Va. Tax Rev. 1, 30 (2004).

<sup>66</sup> Treasury has issued proposed regulations regarding State and local bond opinions, and the IRS issued interim guidance regarding the definition of a State or local bond opinion for this purpose. *See supra* notes [39] to [40].

## 2. Standards for Covered Opinions

The current covered opinion standards, like the prior rules, require due diligence, relating the law to the facts, analysis of relevant tax issues, and an overall conclusion. However, the covered opinion requirements differ from the prior rules in other respects, including required scope and level of confidence, limitations on the content of the analysis and advice, and required disclosures.

- a. Due Diligence Standards. Section 10.35 requires a practitioner to use reasonable efforts to determine relevant present and future facts and events and prohibits reliance on unreasonable assumptions or representations. A factual representation is unreasonable if, among other things, the practitioner knows or should know that it is incorrect or incomplete. Section 10.37 applies similar standards to non-covered written advice. Section 10.35 also requires a practitioner to identify and consider all facts identified as relevant and to identify in separate sections all factual assumptions and all factual representations, statements or findings relied upon by the practitioner.

Section 10.35 specifically addresses assumptions and representations regarding the business purpose of a transaction: It is unreasonable for a practitioner to assume that a transaction has a business purpose or has the potential for nontax profits. The practitioner may not rely on a business purpose representation unless it specifically describes the purpose, or if the practitioner knows or should know that it is incorrect or incomplete. This requirement addresses strategies that fit within the literal terms of the Code and regulations but would not succeed without a valid business purpose.

- b. Standards of Legal Analysis. Section 10.35 generally requires a covered opinion to (i) relate the applicable law (including judicial doctrines) to the relevant facts, (ii) consider all significant Federal tax issues, (iii) provide a conclusion as to the likelihood that the taxpayer will prevail on each issue, and the facts and analysis supporting the conclusion, and (iv) provide an overall conclusion as to the likelihood that the Federal tax treatment of the transaction is proper, and the

reasons for that conclusion. If the practitioner cannot reach either an overall conclusion or a conclusion on one or more issues, the opinion must state so and include the reasons.

- i. Scope of Issues that Must be Addressed. Unless a covered opinion qualifies under an exception for limited scope opinions or opinions that rely on the opinion of another practitioner, it must address all “significant Federal tax issues.” It may not assume that a significant Federal tax issue will be resolved in the taxpayer’s favor, rather it must provide a conclusion whether the taxpayer will prevail on each significant Federal tax issue. A Federal tax issue is significant for this purpose if it meets a materiality threshold, the IRS has a reasonable basis for a successful challenge, and the resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall Federal tax treatment of the transaction.

The reasonable basis standard in Section 10.35 clearly is intended to reflect the standard in Code Section 6662(d)(2)(B)(ii), which permits a taxpayer to avoid a substantial underpayment penalty if the taxpayer has a reasonable basis for a position that is not associated with a tax shelter, and the taxpayer discloses the position on its tax return. Under the applicable Treasury Regulations, “reasonable basis” is a relatively high standard of tax reporting, significantly higher than “not frivolous” or “not patently improper.” The reasonable basis standard is not satisfied by a merely arguable return position or a merely colorable claim.<sup>67</sup> In contrast, former Section 10.33 required a practitioner to consider only material Federal tax issues involving a “reasonable possibility of a challenge by the IRS.” This standard allowed a practitioner to exercise

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<sup>67</sup> Treas. Reg. § 1.6662-3(b)(3). *See also* H.R. Rep. 103-213 at 669 (1993) (Conf. Rep.) (“The conferees intend that ‘reasonable basis’ be a relatively high standard of tax reporting, that is, significantly higher than ‘not patently improper.’ This standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim”); H.R. Rep. No. 103-111 at 754 (1993) (similar).

professional judgment to distinguish between those issues that raise such a possibility of challenge, and thus require discussion, and those that do not.

In contrast, the reasonable basis standard of Section 10.35 does not allow for such judgment. The standard is reasonably workable for defining the minimum plausibility of a disclosed tax return position to avoid penalties. However, applying the standard to define the entire range of issues to be considered in an opinion requires the practitioner to identify not merely the positions that the IRS would most probably raise but rather all positions that the IRS might take that are more than merely arguable, colorable, frivolous or patently improper. The practitioner must do so even if the position has a low likelihood of success or the IRS is unlikely to raise the issue for policy or other reasons.

The preambles to the new rules do not discuss why “reasonable basis” replaced “reasonable possibility of challenge.” Treasury may have thought that practitioners unduly discount the strength of IRS positions or rely too heavily on the chances that an issue will not be raised on audit or will be settled. However, it is hard to see why the goal of informing investors about important issues is furthered by requiring that they also be informed about unimportant ones.

Alternatively, Treasury may have chosen the “reasonable basis” standard simply to discourage tax shelters, by requiring practitioners to present potential investors with a “parade of horrors” or by increasing the cost of tax shelter opinions. Such an approach assumes that tax shelters are *per se* illegitimate, and should be discouraged. However, the definition of a covered opinion for purposes of Section 10.35 depends not on the merits of the relevant transaction but on whether the transaction and the opinion fall within formal criteria indicating the existence of a tax shelter. Finally, Treasury may have feared that a practitioner would render a favorable conclusion on certain issues,



leading investors to think they can rely on the opinion to avoid penalties, while failing altogether to address issues that the IRS might in fact raise. However, such a concern could have been addressed by requiring opinions to state that the taxpayers may not rely on them to avoid penalties in respect of issues that are not addressed in such opinions.

ii. Exceptions for Reliance on Opinions of Others and Limited Scope Opinions.

Section 10.35 contains two exceptions to the general rule that a covered opinion must address all significant Federal tax issues. The first exception is for an opinion in which the practitioner relies on the opinion of another practitioner with respect to a significant Federal tax issue. The relying practitioner's opinion must identify the other opinion and set forth its conclusions and the practitioner must conclude that the combined analysis and any overall conclusions of the opinions, taken as a whole, satisfy the requirements of Section 10.35. This exception merely allows different practitioners to split the responsibility for preparing opinions that together satisfy the requirements of Section 10.35. Although the exception may be useful in practice, it has little importance in analyzing the framework of the rules.

The second exception, for limited scope opinions that address less than all significant Federal tax issues in transactions, has greater significance. Such opinions are permitted, provided that (i) the practitioner and the taxpayer agree that the scope of the opinion, and the taxpayer's reliance on it for penalty purposes, are limited to the issues addressed in the opinion; (ii) the opinion does not relate to a listed or principal purpose transaction and is not a marketed opinion; and (iii) the opinion discloses that it (A) is limited to the Federal tax issues addressed, (B) expresses no opinion on other issues that could affect the tax treatment of the transaction, and (C) may not be used by the taxpayer to avoid penalties with respect to such other issues. The practitioner is not required to identify the Federal tax issues that the opinion does not address.

Former Section 10.33 addressed only opinions used to market tax shelters to third parties. It was thus reasonable to require disclosure and analysis of all important Federal tax issues associated with the transaction. Accordingly, the former rule contained no provision for limited scope opinions. In contrast, present Section 10.35 also applies to advice that is addressed to a client concerning the client's tax treatment. There is no obvious reason in this circumstance for prohibiting a limited scope opinion. Yet, Section 10.35 will not allow such an opinion if it concerns a listed or principal purpose transaction, even if the opinion is not used for marketing to third parties and even with a "no reliance" legend. Similarly, Section 10.35 will not allow such an opinion, even if addressed only to the practitioner's client concerning the client's tax treatment, if the opinion is referred to by a third party in marketing, promoting or recommending the transaction, and thus falls within the technical definition of a marketed opinion. There is no clear reason why any of these limitations should apply.

The limited scope opinion also raises issues stemming from the fact that the practitioner and the taxpayer must agree to limits on the taxpayer's reliance on the opinion for penalty purposes. It is not clear that such an agreement is binding on the taxpayer in its dealings with the IRS. If it is, the practitioner is placed in the position of negotiating directly with the client over the scope of the client's rights.<sup>68</sup>

- iii. Required Level of Confidence Regarding Conclusions. If a covered opinion is not a marketed opinion, Section 10.35 does not require conclusions on specific issues or on the overall treatment of the transaction at a minimum level of confidence. However, if an opinion fails to reach a favorable conclusion on one or more significant Federal tax issues at a "more likely than not" level, it must include a "no reliance" legend with respect to

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<sup>68</sup> If the reason for requiring such an agreement was to ensure that the taxpayer has given "informed consent" to the limited availability of the opinion for penalty purposes, that could have been achieved more directly.

those issues. Also, even if the opinion is not subject to the foregoing requirements, it may remain subject to other requirements of Circular 230, including those of Section 10.34, which imposes standards for advice on tax return positions. Under Section 10.34, a practitioner may not advise a client to take a position on a tax return unless either (i) the practitioner determines that the position has a realistic possibility of being sustained on the merits, or (ii) the position is not frivolous and the practitioner advises the client of any opportunity to avoid penalties through disclosure.<sup>69</sup> A position is considered to have a realistic possibility of being sustained on its merits if the position has approximately a one-in-three, or greater, likelihood of being sustained on its merits.

In contrast, if a covered opinion is a marketed opinion, it must conclude that the taxpayer will prevail on each significant Federal tax issue, and that the Federal tax treatment of the transaction is proper, at a confidence level of at least “more likely than not.” A practitioner who is unable to reach such conclusions may not provide the marketed opinion. However, the practitioner may provide written advice under the “legending out” exception by including a “no reliance” legend and a “consumer protection” legend. The “legending out” exception does not apply to written advice regarding listed or principal purpose transactions.

The requirement that a marketed opinion reach “more likely than not” conclusions reflects Treasury’s view that the “reasonable basis” tax shelter opinions permitted under former Section 10.33 were of questionable legitimacy. However, the requirement does not merely prohibit favorable opinions where the practitioner in fact believes that tax benefits are unlikely to be available. A practitioner may be unable to provide a “more likely than not” opinion concerning a position because of the absence of published

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<sup>69</sup> A position is frivolous if it is “patently improper.” Circular 230 § 10.34(d)(2).

guidance; yet, even if the position is as likely as any other to succeed, Section 10.35 would prevent the practitioner from rendering a marketed opinion.

Alternatively, a practitioner may be able to reach a “more likely than not” conclusion regarding the primary tax benefits of a transaction but not regarding some lesser benefit. If the secondary benefit would have a “significant” impact on the overall tax treatment of the transaction, the practitioner may not render a marketed opinion unless the practitioner concludes that the benefit would not be allowable at any confidence level (*i.e.*, even at a “not frivolous” level). If the practitioner concludes that the secondary benefit probably is not allowable but that the taxpayer would have a more than frivolous case for claiming it, the practitioner would not qualify for the “negative advice” exception.

In the case of a significant purpose transaction, the opinion may qualify for the “legending out” exception. However, the “legending out” exception is not available for a listed or principal purpose transactions. If the purpose of the “more likely than not” rules is to prevent practitioners from encouraging positions that they believe unlikely to be allowable, there is little reason to treat listed and principal purpose transactions differently from significant purpose transactions. The absence of a “legending out” exception for listed and principal purpose transactions may reflect a view that such transactions simply should not be marketed if there is substantial uncertainty about the tax benefits. Prohibiting practitioners from rendering marketed opinions about such transactions will certainly make it difficult, if not impossible, to market them. However, this motivation raises the question of the purpose of the Circular 230 opinion requirements: Are they meant to be professional standards, or are they being used as a tool for the regulation of otherwise permissible tax shelter activity?

iv. Limitations on Content of Analysis and Advice. A covered opinion must not contain internally inconsistent legal analyses or conclusions. Further, the practitioner may not provide advice to any person that is contrary to or inconsistent with a disclosure required under Section 10.35. The rules do not define “internally inconsistent” analyses or conclusions.” Presumably, the term describes taking an analytical position to reach a favorable conclusion on one issue and a contrary analytical position to reach a favorable conclusion on another issue. In many circumstances, however, there is a question whether different provisions of the Code and regulations embody the same concept. For example, the practitioner may conclude that the same term should be defined differently for purposes of different provisions. If it ultimately is determined that the same definition is used in provisions, does the opinion violate the requirements of Section 10.35?<sup>70</sup>

An opinion will often adopt alternative analyses, usually because a particular point cannot be resolved with a sufficient level of certainty. If the outcome of one alternative analysis as opposed to another could have a significant impact on the overall tax treatment of the transaction, the issue will be a significant Federal tax issue. If pursuing the alternative analyses leads the opinion to differing conclusions, are those analyses and conclusions “internally inconsistent?”<sup>71</sup>

The prohibition against a practitioner’s providing any advice inconsistent with a required disclosure raises similar issues. Consider the “no reliance” legend: A practitioner would appear to be prohibited from advising the client that this legend is not relevant to the

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<sup>70</sup> See, e.g., *Black & Decker Corp. v. United States*, \_\_\_ F.3d \_\_\_, \_\_\_ 2006 WL 241073 (4<sup>th</sup> Cir., Feb. 2, 2006) (concluding that the term “money received” has a different meaning in Code Section 358(a)(1) from its meaning in Code Section 357(b)(1)).

<sup>71</sup> Alternative analyses also present problems for the requirement that a marketed opinion reach a favorable conclusion at a confidence level of at least “more likely than not”. At most, the opinion can conclude that only one of the alternative analyses and resulting positions will “more likely than not” be the correct

penalty for negligence or fraud, even if such is in fact the case. Or, in the case of a marketed opinion addressed to a client, what is the practitioner to say if the client expresses puzzlement about the disclosures that the opinion was written to support the promotion or marketing of the relevant transaction and that the client should seek advice based on the client's particular circumstances from an independent tax advisor?

One of the most serious limitations on the content of a covered opinion or other written advice is that the practitioner must not take 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. The first two parts of the requirement were intended to prevent practitioners from relying on the "audit lottery" in reaching conclusions about the tax treatment of transactions. Such a prohibition is clearly sound and congruent with the duties of the practitioner to the client and the tax system.

However, once an issue is identified in an audit, a practitioner should be permitted to analyze the likelihood that the IRS will pursue the issue, or that the issue will be settled if raised. An essential role of a tax advisor is to identify those issues that are most likely to be raised and to assess the various ways that such issues may be resolved. This is especially true in complex transactions: The IRS might hypothetically raise a large number of tax issues, whereas, in practice, only the strongest challenges would emerge in any IRS audit or court proceeding.

The IRS frequently issues revenue procedures stating that it will not challenge positions taken by taxpayers under specific circumstances.<sup>72</sup> There are many other cases in which the IRS reaches conclusions in unsettled areas. In some such areas there may be no

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resolution. Is analysis of the other alternatives prohibited in a marketed opinion? Must a covered opinion that is not a marketed opinion contain a "no reliance" disclosure if it analyses other alternatives?

authority other than published, private, or internal rulings or other IRS pronouncements. In other areas, there are applicable court decisions but the IRS has stated that it will not follow such decisions. Under the Circular 230 rules, a practitioner may not rely on such statements in assessing the merits of a position. The practitioner would instead be required to assume that the IRS will challenge the position and assess whether a court would uphold the revenue procedure or other administrative pronouncement as a correct statement of the tax law or find the pronouncement binding on the IRS. Although such analysis may on occasion be appropriate, requiring it in all circumstances eliminates the certainty and simplicity that such revenue procedures and other IRS guidance are intended to create.

## **II. ETHICAL RULES REGARDING TAX SHELTER OPINIONS**

One of the most striking features of the Circular 230 covered opinion standards is their divergence from, and in certain respects their conflict with, the rules of legal ethics and pronouncements regarding tax opinions.<sup>73</sup> While former Section 10.33 closely followed the standards in ABA Formal Opinion 346 regarding opinions on tax shelter offerings, the substantially more stringent standards of Section 10.35 reflect a fundamental change in Treasury's view of a lawyer's professional responsibilities.

### **A. Ethical Guidance Regarding Marketed Tax Shelter Opinions**

ABA Formal Opinion 346 provides guidance regarding tax opinions used to market tax shelters to third parties. That opinion sets forth "disciplinary standards" and "ethical considerations." The disciplinary standards are as follows:

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<sup>72</sup> See, e.g., I.R.S. Rev. Proc. 2000-37, 2000-2 C.B. 308 (qualification of certain property for like-kind exchange treatment if property is held under arrangements meeting certain requirements).

<sup>73</sup> The following discussion is based largely on the Model Code, the Model Rules and formal opinions of the ABA Standing Committee on Ethics and Professional Responsibility. Though nearly all States have adopted some version of the Model Code, and many have adopted some version of the Model Rules, neither codification sets forth binding ethical standards. The ethical standards of the relevant jurisdiction

- A lawyer shall not give a false opinion, including one that is intentionally or recklessly misleading.
- A false opinion includes accepting facts provided by the promoter, when the lawyer should know that the facts are untrue. The standard under Rule 10b-5 under the Securities Act of 1933 applies for this purpose.
- A lawyer shall not act with gross incompetence, indifference, inadequate preparation under the circumstances or consistently fail to perform obligations to the client, when rendering an opinion.

The “ethical considerations” in Formal Opinion 346, which reflect a “body of principles” but do not “constitut[e] absolute requirements, the violation of which may result in sanctions,” are as follows:

- A lawyer should obtain from the client offering the tax shelter investment a full disclosure of the structure and intended operations of the venture and complete access to all relevant information.
- A lawyer should inquire as to the relevant facts and be satisfied that the material facts are accurately and completely stated in the offering materials, and that the representations as to intended future activities are clearly identified, reasonable and complete.
- A lawyer should relate the law to the facts and identify what facts are assumed.
- A lawyer should ascertain that legal issues have been addressed, other than those to be addressed in the tax shelter opinion.
- A lawyer should ensure that all material Federal tax issues have been considered and that the offering materials address all issues involving the reasonable possibility of challenge by the IRS.

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must also be consulted. *See* Wolfman *et al, supra* note [49],. § 103. Likewise, ethics opinions represent a source of interpretive guidance but are generally not binding on the courts. *Id.* § 103.1.2.



- A lawyer should, where possible, provide an opinion on the likely outcome of the material tax issues addressed in the offering materials.
- A lawyer should, where possible, provide an overall evaluation whether the tax benefits in the aggregate are likely to be realized.
- A lawyer should ensure that the offering materials correctly describe the tax shelter opinion.

Formal Opinion 346 contains a narrow definition of a “tax shelter,” but reasonably should apply to any marketed investment, plan or arrangement designed to reduce Federal taxes.”<sup>74</sup> The Opinion limits the definition of “tax shelter opinion” to broadly marketed opinions and tax in marketing materials.<sup>75</sup>

Accordingly, it excludes the following types of advice:

- Rendering advice solely to the offeror, so long as neither the name of the lawyer nor the fact that a lawyer has rendered tax advice referred to in the offering materials or in sales promotion efforts;
- Cases where a small group of investors negotiates the transaction directly with the offeror of securities and depends solely on other advisors for tax advice.

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<sup>74</sup> Formal Opinion 346 defines a tax shelter as an investment which has as a significant feature for Federal income or excise tax purposes either or both of the following attributes: (1) deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, and (2) credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from any other sources in that year. Excluded from the term are investments such as, but not limited to, municipal bonds; annuities; family trusts; qualified retirement plans; individual retirement accounts; stock option plans; securities issued in a corporate reorganization; mineral development ventures whose only tax benefit would be percentage depletion; and real estate, if deductions are unlikely to exceed gross income from the investment in any year and tax credits are unlikely to exceed the tax on the income from that source in any year.

<sup>75</sup> Formal Opinion 346 generally defines a tax shelter opinion as advice by a lawyer concerning the federal tax law applicable to a tax shelter if the advice is referred to either in offering materials or in connection with sales promotion efforts directed to persons other than the client that engages the lawyer to give the advice. The definition includes the tax aspects portion of the offering materials prepared by the lawyer, whether or not a separate opinion letter is issued.

Apart from the differences in the definitions of tax shelter and tax shelter opinion, the principal differences between Formal Opinion 346 and Section 10.35 concern the scope of the issues that a tax shelter opinion must address and the level of confidence that the opinion must reach.

Under Formal Opinion 346, a lawyer should consider all “material tax issues” or ensure that they are considered by another competent professional. The opinion should address each material tax issue having a reasonable possibility of an IRS challenge. For this purpose, a “material” tax issue is an issue having a significant effect in sheltering from taxes.

Formal Opinion 346 requires a tax shelter opinion, where possible, to state the probable outcome of each material tax issue. Also, the tax disclosure in the offering materials should include an overall evaluation whether the aggregate tax benefits are likely to be realized. The lawyer should state whether the benefits probably will or probably will not be realized or whether the probabilities are evenly divided. If such a judgment is impossible, the lawyer should explain why, and assure full disclosure in the offering materials of the assumptions and risks. Formal Opinion 346 does not set forth a minimum level of confidence for a tax shelter opinion.<sup>76</sup> However, if it reaches a negative conclusion, that must be clearly and prominently noted in the offering materials.<sup>77</sup> Thus, Formal Opinion 346 stands in contrast to the requirement in Section 10.35 that a marketed covered opinion provide “more likely than not” conclusions on each significant Federal tax issue and the overall tax treatment of the transaction.

## **B. Ethical Guidance Regarding Opinions on Tax Return Positions**

ABA Formal Opinion 85-352 sets forth standards for advice regarding uncertain tax return positions. It provides that a lawyer may recommend positions favorable to a client if the lawyer has a good faith belief

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<sup>76</sup> See also Wolfman *et al.*, *supra* note [49], § 503.4.2.6 (“it would be difficult to conclude that a practitioner who provides an adequately disclosed negative opinion violated a professional standard”).

<sup>77</sup> Formal Opinion 346 also notes that a tax shelter opinion may question the validity of a revenue ruling or the reasoning in a lower court opinion. However, there must be a complete explanation of such questioning, including an assessment of what position the IRS is likely to take on the issue and, if applicable, a summary of why this position is wrong, and a statement of the risks of an adversarial proceeding.

that the positions are warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law. Good faith requires that there be some realistic possibility of success if the position is litigated, but may exist even if the lawyer believes the client's position probably will not prevail. Formal Opinion 85-352 also states a number of duties of a lawyer in rendering tax advice:

- The lawyer should counsel the client whether a court is likely to sustain the position.
- The lawyer should counsel the client regarding the potential penalties and other legal consequences, including a judgment whether the position has sufficient merit to avoid penalties with or without disclosure.
- A lawyer must not mislead the IRS deliberately, either by misstatements or by silence or by permitting the client to mislead.

A Special Task Force established by the ABA Tax Section issued a report (the "Special Task Force Report") concluding that Formal Opinion 85-352 applies both to advice rendered in the preparation of a tax return and to other advice involving tax return positions, including tax advice rendered while structuring transactions or preparing transaction documents.<sup>78</sup> The Special Task Force Report states that a position has a realistic possibility of success if the likelihood of success before a court closely approaches one-third, or if the position is supported by "substantial authority." A position with a realistic possibility of success may be asserted to obtain a concession in settlement negotiations.

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<sup>78</sup> The Special Task Force Report was approved by the Council of the Section of Taxation of the ABA but not reviewed or approved by the ABA Standing Committee on Ethics and Professional Responsibility, which had originally issued Formal Opinion 85-352. Accordingly, the authoritative effect of the Special Task Force Report is not clear. Wolfman *et al.*, *supra* note [49] § 204.1.

### C. Proposed ABA Tax Opinion Standards

The Committee on Standards of Tax Practice of the ABA Section of Taxation prepared a draft Statement of Standards of Tax Practice 2000-2 setting forth standards for written Federal tax opinions (the “Draft Statement”).<sup>79</sup> Although the Draft Statement has not been finalized or reviewed, it addresses many of the same topics addressed in the covered opinion standards of Section 10.35.

The Draft Statement is limited to tax opinions addressing specific factual circumstances and providing a legal conclusion. Accordingly, it does not apply to advice that is abstract, tentative or preliminary. The standards include the following:

- A tax opinion should state the purposes for which it was prepared and how it may be relied upon, where appropriate to avoid a risk of misunderstanding.
- A tax opinion should clearly identify the material factual circumstances. An attorney need not audit such facts but must make further inquiry if they are materially incomplete, inconsistent, or otherwise implausible and may not issue an opinion on the basis of representations known to be false. An opinion addressed to a third party should describe the relevant due diligence and assumptions and may not ignore relevant facts.
- A tax opinion should relate the applicable legal authorities to the facts.
- A tax opinion should identify all material tax issues for which no opinion is being rendered, where appropriate to avoid a misunderstanding.
- A tax opinion should express the author’s degree of confidence and, if appropriate, discuss whether the position has sufficient merit to avoid penalties. An opinion may be given for the stated purpose of

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<sup>79</sup> Standards of Tax Practice Committee, American Bar Association, *Draft Statement of Standards of Tax Practice 2000-2* (Sept. 13, 2000), reprinted in *Tax Notes Today* (Oct. 23, 2000).

penalty protection only if the author concludes that the required level of probability exists as of the relevant date.

- A lawyer should advise a client regarding penalties that may be imposed because of a tax return position recommended by the lawyer.

The Draft Statement (i) does not define material tax issues, (ii) permits limited scope opinions, and (iii) does not impose a minimum level of confidence.

The greater flexibility of the Draft Statement reflects a view that the duties of a lawyer rendering a tax opinion should be defined by reference to the purpose of the opinion and the legal and ethical standards that apply to the lawyer and the recipient of the opinion. Implicit in the Draft Statement is a lawyer's obligation to ascertain those standards and conform the opinion to them.

#### **D. General Ethical Principles Applicable to Tax Shelter Opinions**

Underlying the foregoing guidance is the broader question of how to balance a lawyer's duties to a client against his or her duties to the tax system .

##### **1. General Duties of a Lawyer to Clients and to the Tax System**

The ethical rules governing a lawyer's duties to the client and to the tax system are contained in Canons 7 and 8 of the Model Code. Canon 7 provides that a lawyer should represent a client zealously within the bounds of the law. Canon 8 provides that a lawyer should assist in improving the legal system. The Model Code does not view these duties as conflicting; to the extent that a conflict arises, it generally should be resolved in favor of the client. For a lawyer serving as advocate, Ethical Consideration 7-19 states more directly that "[t]he duty of a lawyer to his client and his duty to the legal system are the same: to represent his client zealously within

the bounds of the law.” By contrast, the obligations of lawyers to assist in improving the legal system largely arise outside the context of a specific client representation.<sup>80</sup>

Notwithstanding the client-centered position of the Model Code, most commentators express the view that, when providing tax advice to a client, the lawyer’s duty to promote the interests of the client is limited by a duty to the tax system as a whole.<sup>81</sup> Such duty generally is justified by the self-assessment nature of the Federal income tax system and the inability of the IRS to audit a meaningful percentage of returns filed.<sup>82</sup> A number of commentators argue, on various theories, that a lawyer has a duty to the tax system regardless of whether a particular transaction is likely to be audited.<sup>83</sup> The basis and scope of this duty to the system are not clear; beyond basic principles, the views regarding the fundamental sources of a lawyer’s duties to the tax system are all over the map.<sup>84</sup>

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<sup>80</sup> See, e.g., Model Code EC 8-1.

<sup>81</sup> See, e.g., Wolfman *et al.*, *supra* note [49] § 101.2 (the “practitioner’s obligation to the client, however, is not unrestricted. The practitioner also owes a duty, albeit less well-defined, to the tax system as a whole”); Michael C. Durst, *The Tax Lawyer’s Professional Responsibility*, 39 U. Fla. L. Rev. 1027 (1987); Theodore C. Falk, *Tax Ethics, Legal Ethics and Real Ethics: A Critique of ABA Formal Opinion 85-352*, 39 Tax Law. 634 (1986); Myron C. Grauer, *What’s Wrong with this Picture?: The Tension between Analytical Premises and Appropriate Standards for Tax Practitioners*, 20 Cap. U. L. Rev. 353 (1991); Gwen Thayer Handelman, Reply, *Counseling Ordered Liberty*, 9 Va. Tax Rev. 781 (1990); Gwen Thayer Handelman, *Constraining Aggressive Return Advice*, 9 Va Tax Rev. 77 (1989); James P. Holden, *Practitioners’ Standard of Practice and the Taxpayer’s Reporting Position*, 20 Cap. U. L. Rev. 327 (1991); James P. Holden, Commentary, *Constraining Aggressive Return Advice*, 9 Va. Tax Rev. 771 (1990); Loren D. Prescott, Jr., *Challenging the Adversarial Approach to Taxpayer Representation*, 30 Loy. L.A. L. Rev. 693 (1997); Camilla E. Watson, *Tax Lawyers, Ethical Obligations, and the Duty to the System*, 47 U. Kan. L. Rev. 847 (1999); Linda Galler, *The Tax Lawyer’s Duty to the System*, 16 Va. Tax Rev. 681 (1997) (reviewing BERNARD WOLFMAN, JAMES P. HOLDEN & DEBORAH H. SCHENK, *ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE* (1995)); Deborah H. Schenk, *Tax Ethics*, 95 Harv. L. Rev. 1995, 2004-05 (1982) (reviewing BERNARD WOLFMAN & JAMES P. HOLDEN, *ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE* (1981));

<sup>82</sup> Wolfman *et al.*, *supra* note [49], § 201.2; Galler, *supra* note [82], at 694-695.

<sup>83</sup> The theories include the notion that tax returns are a collective obligation of citizenship, see Wolfman *et al.*, *supra* note [49], § 201.2; Falk, *supra* note [82], at 648 (footnote omitted), that the duties of tax lawyers should be aligned with the client’s obligations, see Wolfman *et al.*, *supra* note [49], § 101.2; Durst, *supra* note [82], at 1047-48, that taxpayers should duly assert positions having legitimate authoritative support, see Handelman, *Counseling*, *supra* note [82], at 784, and that the flexibility taxpayers and advisers have to structure affairs to minimize taxes creates obligations to the tax system, see Wolfman *et al.*, *supra* note [49], § 503.1.

<sup>84</sup> See, e.g., Durst, *supra* note [82], at 1059-1064 (distinguishing between rules imposing imposing normative obligations and those meant to discourage specific activity); Falk, *supra* note [82], at 663 (“[t]ax shelters

This lack of consensus extends to the question of what a lawyer should do when a client does not accept the lawyer's duty to the system. Under the Model Code, a lawyer "may continue the representation of his client even though his client has elected to pursue a course of conduct contrary to the advice of the lawyer so long as he does not thereby knowingly assist the client to engage in illegal conduct or to take a frivolous legal position."<sup>85</sup> Likewise, under Formal Opinion 85-352, a lawyer has no duty to withdraw merely because a client refuses to disclose a position on a tax return that could subject the client to penalties. By contrast, the Special Task Force Report concludes that a lawyer must withdraw from representing a client that insists on asserting a tax return position that does not have a realistic possibility of success if litigated.<sup>86</sup>

## 2. Due Diligence Standards

Neither the Model Code nor the Model Rules imposes specific standards of factual inquiry. However, a lawyer's duty to make appropriate inquiry can be derived from more general requirements, especially the duty of competent<sup>87</sup> and zealous representation within the bounds of the law,<sup>88</sup> and duties in communicating with third parties.<sup>89</sup> When advising a client, a lawyer's duty of inquiry is based upon the circumstances and is subject to reasonable agreement between the lawyer and the client.<sup>90</sup> The Model Rules also permit a client to limit the scope of a lawyer's investigation when preparing an evaluation for use by a third party. However, the limitation must be disclosed to the third party, and the lawyer must not knowingly make a false statement of

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raise distinctive problems that justify unique ethical rules for tax shelter advice"); Grauer, *supra* note [82], at 358 (duty of lawyer derives from taxpayer's duty to file true and correct tax return); Handelman, *Counseling*, *supra* note [82], at 782-786 (lawyer's reporting position duties derive from the client's duties to comply with Code as can be best determined); Holden, *Practitioners' Standard*, *supra* note [82], at 327 (source of professional standards "generally not the tax law itself" but "authority that has the power to regulate professional practice within the tax field").

<sup>85</sup> Model Code EC 7-5.

<sup>86</sup> See, e.g., Wolfman et al., *supra* note [49], § 204.2.4.1.

<sup>87</sup> Model Code Canon 6; Model Rules R. 1.1.

<sup>88</sup> Model Code Canon 7; Model Rules R. 1.3; R. 2.1; R. 3.1.

<sup>89</sup> Model Rules R. 2.3(a); R. 4.1.

<sup>90</sup> Model Rules R. 1.1, 1.2(c).

material law or fact.<sup>91</sup> Under some circumstances, the terms of the evaluation may be limited: For example, certain issues or sources may be categorically excluded, or the scope of the search may be limited by time constraints or the non-cooperation of persons having relevant information. The Model Rules state, “Any such limitations that are material to the evaluation should be described . . . .”<sup>92</sup>

Formal Opinion 346 and the Draft Statement impose more explicit duties to inquire into the relevant facts. Formal Opinion 346 ignores a client’s right to limit the scope of a lawyer’s investigation. Other relevant authorities, including the regulations regarding return preparer penalties and Section 10.34 of Circular 230, governing advice with respect to tax return positions, adopt similar standards.<sup>93</sup>

### 3. Scope of Issues that Must be Addressed

The Model Code and Model Rules provide only general guidelines regarding the issues that must be addressed by a lawyer when advising a client. Both codifications recognize the tension between the lawyer’s duty of competence and the client’s right to limit the scope of the lawyer’s work, and seek to resolve the tension through a process of informed consent.<sup>94</sup> Though Canon 6 and Disciplinary Rule 6-101(A)(2) of the Model Code and Model Rule 1.1 state that competent representation requires certain levels of knowledge and preparation, the comment to Model Rule 1.1 recognizes that “[a]n agreement between the lawyer and the client regarding the scope of the representation may limit the matters for which the lawyer is responsible.”<sup>95</sup>

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<sup>91</sup> As noted above, Formal Opinion 85-352 likewise provides that a lawyer is under a duty not to mislead the IRS deliberately, either by misstatements or by silence or by permitting the client to mislead.

<sup>92</sup> Model Rules R. 2.3 cmt.

<sup>93</sup> Treas. Reg. § 1.6694-1(e). *See also* Circular 230 § 10.22 (due diligence standard for practitioners); Wolfman *et al.*, *supra* note [49], § 502.1.1.

<sup>94</sup> *See* Paul J. Sax, *When World Collide: Ethics v. Economics*, 20 Cap. U. L. Rev. 365 (1991). *See also* Wolfman *et al.*, *supra* note [49], § 502.1.2 (discussing ABA Section of Taxation draft informal opinion addressing question of whether a lawyer may reduce research on behalf of client if the client so requests).

<sup>95</sup> *See also* Model Rules R. 1.2(a), (c), (d); R. 1.4(a), (b); Model Code EC 7-8.



Formal Opinion 346 is the most detailed ethical guideline regarding the required scope of issues that must be addressed in a tax shelter opinion. It requires a lawyer rendering a marketed opinion to address each material issue raising the reasonable possibility of an IRS challenge. However, Formal Opinion 346, like the other guidance, relies on the lawyer's judgment to identify the material issues likely to be raised by the IRS and to assess the level of analysis required by each such issue. The Draft Statement also takes the lawyer's judgment as the point of reference, relying on the lawyer's assessment of the potential for misunderstanding if an issue is not addressed in an opinion.

4. Required Level of Confidence Regarding Conclusions

The views on the level of confidence required before a lawyer can recommend a tax position to a client are as diverse as the views regarding the nature of the lawyer's duties to the system. At one pole is Model Rule 1.2(d), which provides that a lawyer shall not counsel a client to engage in conduct the lawyer knows is criminal or fraudulent, but may discuss the legal consequences of any proposed course of conduct and counsel a client in a good faith effort to determine the validity, scope, meaning or application of the law. The comment to Model Rule 1.2(d) notes that determining such validity "may require a course of action involving disobedience." Formal Opinion 85-352 uses the standard of the lawyer's good faith belief in "some realistic possibility of success if the matter is litigated." The Special Task Force Report states that this standard should be met if the likelihood approaches one-third or the position is based on "substantial authority. The "realistic possibility of success" standard has been adopted in the context of return preparer penalties and in Section 10.34.<sup>96</sup>

Commentators differ regarding the proper interpretation of these standards. A principal difference concerns the extent to which the standard should be subjective or objectively

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<sup>96</sup> See I.R.C. § 6694(a)(1); Treas. Reg. §§ 1.6662-4(d)(3)(ii), (iii), 1.6694-2(b)(1), (2).

verifiable. Many commentators view a percentage-based standard as both unacceptably subjective and unadministrable.<sup>97</sup> However, there is little consensus on how to frame a more objective standard, including questions of whether the standard should be based on the reasonableness of the position<sup>98</sup> or specifically tied to available tax authorities.<sup>99</sup> Another principle difference concerns the approach that a lawyer should take to uncertain issues, including positions that have some realistic possibility of success but probably will not succeed. Several commentators advocate a minimal standard for litigating a position in Tax Court, on the ground that a taxpayer's right to pursue a position in Tax Court would be meaningless without the right to take such position on the tax return.<sup>100</sup> Some would impose a higher standard, at least for undisclosed positions, on the ground that the self-assessment system presumes that tax returns are correct without the need for an audit.<sup>101</sup> However, commentators generally have not proposed a

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<sup>97</sup> See Wolfman *et al.*, *supra* note [49], at § 302.3.1.1; Falk, *supra* note [82], at 657; Handleman, *Constraining*, *supra* note [82], at 97; J. Timothy Philipps, Michael M. Mumbach & Morgan W. Alley, *What Part of RPOS Don't You Understand? An Update and Survey of Standards for Tax Return Positions*, 51 Wash. & Lee L. Rev. 1163 (1994).

<sup>98</sup> See, e.g., Special Task Force Report; Durst, *supra* note [82], at 1074; Holden, *Practitioners' Standard*, *supra* note [82], at 333-34.

<sup>99</sup> See, e.g., Gwen Thayer Handleman, *Law and Order Comes to "Dodge City": Treasury's New Return Preparer and IRS Practice Standards*, 50 Wash. & Lee L. Rev. 631, 637 (1993). Cf. Holden, *Constraining*, *supra* note [82], at 774; Philipps *et al.*, *supra* note [97], at 1173; Lin M. Trucksess, *Painting the Gray Zone Grayer: Why Substantial Authority Fails as a Replacement for the Reasonable Basis Standard in Assessing Practitioner Conduct Under Circular 230*, 8 Va. Tax Rev. 743, 758 (1989).

<sup>100</sup> Such right was well articulated by Franklin Green: "Under our system, a taxpayer is permitted to take a position with a substantially less than 50 percent likelihood of success if that position nevertheless has a sufficient degree of merit. It is then incumbent on the government to raise questions on audit and to seek deficiencies in tax from the taxpayer who has the right not to pay the disputed amount until the matter has been litigated. ... [I]t has been a fundamental role of tax practitioners to identify for taxpayers those tax return positions that may be attempted and those that are beyond the pale. ... In a real sense, the tax adviser is a gatekeeper who regulates the flow of issues into the system. Franklin L. Green, *Exercising Judgment in the Wonderland Gymnasium*, 90 Tax Notes 1691, 1692 (Mar. 19, 2001). See also Durst, *supra* note [82], at 1071-73; Holden, *Commentary*, *supra* note [82], at 774; Holden, *Practitioners' Standard*, *supra* note [82], at 334; Philipps *et al.*, *supra* note [97] at 1184-86; J. Timothy Philipps, *It's Not Easy Being Easy: Advising Tax Return Positions*, 50 Wash. & Lee L. Rev. 589, 597 (1993); Trucksess, *supra* note [99], at 757 (the "primary allocation of responsibility rests with the taxpayer who makes the decisions with regard to his return").

<sup>101</sup> See, e.g., Handleman, *Constraining*, *supra* note [82], at 91. The notion of setting a higher standard for professionals than for taxpayers has been criticized because of the tension such discrepancy would create in the lawyer-client relationship. See, e.g., Durst, *supra* note [82], at 1043; Holden, *Practitioners' Standard*, *supra* note [82], at 341. Cf., *Grauer*, *supra* note [82], at 357 n. 21.

standard requiring that the position be “more likely than not” to succeed, because such a standard would unduly limit taxpayer’s access to Tax Court on uncertain positions.<sup>102</sup>

##### 5. Limitations on Content of Analysis and Advice

The ethical rules do not expressly limit the method of analyzing a legal problem beyond requiring competence, action within the bounds of law, and the application of generally accepted methods of legal analysis. Commentators generally agree with such standards, though noting the difficulty of applying them.<sup>103</sup> The return preparer penalties and Section 10.34 require that an undisclosed position have a realistic possibility of success. Both the preparer penalty regulations and Section 10.34 incorporate the standards for determining whether “substantial authority” exists for a tax return position for purposes of the substantial understatement penalties.<sup>104</sup> However, those standards do not prescribe a comprehensive method of legal analysis but simply identify the types of authorities that may support a position and the weight to be given those authorities.

Once it is assumed that a position has been raised on audit, the Model Code and the Model Rules clearly permit a lawyer to consider the likelihood that the IRS would challenge the position or agree to a settlement. Less clear is whether Formal Opinion 85-352 permits a lawyer to take the expected behavior of the IRS into account in determining whether the position has a realistic possibility of success. The Special Task Force Report states that a position asserted in a return as

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<sup>102</sup> See, e.g., Wolfman *et al.*, *supra* note [49], at § 202.2; Durst, *supra* note [82], at 1071-72; William A. Falik, *Standards for Professionals Providing Tax Opinions in Tax Shelter Offerings*, 37 *Tax Law.* 701, 713 (1984); Handleman, *Constraining*, *supra* note [82], at 98; Philipps *et al.*, *supra* note [97], at 1185. *But see* Pollack & Soled, *supra* note [6], at 211-12; Soled, *supra* note [6], at 1650-53; Mortimer Caplin, *The Tax Lawyer’s Role in the Way the American Tax System Works*, Lecture Before the American College of Tax Counsel (Jan. 22, 2005), in 24 *Va. Tax Rev.* 969, 977 (2005); Ann Southward, Note, *Redefining the Attorney’s Role in Abusive Tax Shelters*, 37 *Stan. L. Rev.* 889, 916-17 (1985).

<sup>103</sup> See, e.g., Model Rules R. 1.1 cmt; Handleman, *Law and Order*, *supra* note [82], at 639-642; Handleman, *Constraining*, *supra* note [82], at 96-98; Philipps *et al.*, *supra* note [97], at 1173-74; Caplin, *supra* note [102] at 976-79. There is debate concerning issues such as the extent to which a well-reasoned construction of a statute will suffice. See, e.g., Handleman, *Law and Order*, *supra* note [82], at 639-642; Philipps *et al.*, *supra* note [97], at 1173-74.

a bargaining position would not meet its standards unless the position had a realistic possibility of success if litigated. Further, the Report states that the determination whether the position has a realistic possibility of success “assumes that the issue is in court and to be decided.”

As discussed above, requiring a lawyer to ignore the discretion exercised by the IRS prevents a lawyer from performing one of the essential functions of tax advice. In addition, requiring a lawyer to assume that a matter is before a court ignores the role of the IRS as an interpreter of the tax law. The degree to which IRS positions affect court decisions is beyond the scope of this article.<sup>105</sup> However, in broad terms, a court may treat the position of the IRS as (1) binding, on either the IRS or both the IRS and the taxpayer, (2) meriting deference, (3) meriting no stronger weight than the position of the taxpayer, or (4) meriting no weight, for example, because it intentionally conflicts with the Code. Even in the cases in which a court accords the IRS position no deference, the agency acts in an interpretive role, if for no other reason than the fact that the position will be publicly articulated, and, consequently, taken into account by taxpayers.

Because of the importance of the substantive role of the IRS, in addition to the *de facto* role of the agency as a wielder of administrative discretion, a lawyer, in reaching a conclusion about the substantive merits of a taxpayer’s position, should be permitted to take into account the likely position of the IRS, whether in published guidance or otherwise. A contrary rule would involve compromise of a lawyer’s duty to a client.<sup>106</sup> Consider, for example, a revenue procedure that expressly permits a taxpayer’s position but is inconsistent with the tax law and would not be

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<sup>104</sup> Treas. Reg. §§ 1.6694-2(b)(1), (b)(2) (incorporating Treas. Reg. §§ 1.6662-4(d)(3)(ii), (d)(3)(iii)). Oddly, Section 10.34 does not incorporate the standards in the regulations for weighing the persuasiveness of those authorities. See Philipps *et al.*, *supra* note [97], at 1168, n. 27.

<sup>105</sup> See, e.g., Paul L. Caron, *Tax Myopia Meets Tax Hyperopia: The Unproven Case of Increased Judicial Deference to Revenue Rulings*, 57 Ohio St. L.J. 637 (1996); Benjamin J. Cohen & Catherine A. Harrington, *Is the IRS Bound by its own Regulations and Rulings?*, 51 Tax Law. 675 (1998); John F. Coverdale, *Court Review of Tax Regulations and Revenue Rulings in the Chevron Era*, 64 Geo. Wash. L. Rev. 35 (1995); Linda Galler, *Judicial Deference to Revenue Rulings: Reconciling Divergent Standards*, 56 Ohio St. L.J. 1037 (1995); Linda Galler, *Emerging Standards for Judicial Review of IRS Revenue Rulings*, 72 B.U. L. Rev. 841 (1992).

binding on the IRS in litigation. A taxpayer would have a right to file a tax return based on the revenue procedure, subject to the risk that the IRS might later seek to take a contrary position,<sup>107</sup> but the lawyer would be prevented from advising a client to do so.<sup>108</sup> If a taxpayer would have the right to file a tax return on that basis, it cannot be unethical for a lawyer to advise a client on the same basis.

Under the regulations specifying the “permissible authorities” that may be taken into account when determining whether “substantial authority” exists for a tax return position,<sup>109</sup> administrative pronouncements of the IRS are treated as “authority,” including pronouncements such as private letter rulings that do not have precedential value and would be given little or no deference by a court.<sup>110</sup> The weight given to an authority depends not only on its persuasiveness but also the type of the administrative pronouncement, the level of formal agency review, and the extent to which the pronouncement is intended as a general statement of the position of the IRS. Thus, for example, a revenue ruling will be given greater weight than a private letter ruling, and certain older authorities will be given less weight than more recent ones.<sup>111</sup> A lawyer should not be treated as unethical for applying the same principles.

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<sup>106</sup> See Wolfman *et al.*, *supra* note[49], § 202.3.1.2 (adviser who ignored nonbinding IRS pronouncements “likely breached his duty of competence to the client”).

<sup>107</sup> The extent to which a court would hold the IRS to a position expressed in a revenue procedure that is contrary to the tax law is not entirely clear. See *Capitol Federal Savings & Loan v. Comm’r*, 96 T.C. 204 (1991) (revenue procedures generally not binding on the IRS unless failure to follow would constitute abuse of discretion).

<sup>108</sup> See, e.g., Lee A. Sheppard, News Analysis, *Wall Street Rules: Feline Prides get IRS Imprimatur*, Tax Notes, Aug. 1, 2003 (revenue procedures are “declarations of how the IRS will administer the law, even if the result contravenes it”). Cf. Terrence Floyd Cuff, *Real Estate and the Deferred Exchange Regulations*, 562 PLI/Tax 457 at 856 (2003) (if “[Rev. Proc. 2000-37] is inconsistent with the law, then it is not a legitimate approach to law enforcement”).

<sup>109</sup> Treas. Reg. § 1.6662-4(d)(3)(iii)

<sup>110</sup> I.R.C. § 6110(k)(3). In general, a court gives weight to a private letter ruling only as evidence that the IRS has taken the positions stated therein. See, e.g., *Rowan Cos. v. U.S.*, 452 U.S. 247, 261 n. 17 (1981); *True Oil Co. v. Comm’r*, 170 F.3d. 1294, 1302 (10<sup>th</sup> Cir. 1999); *Snap-On Tools, Inc. v. U.S.*, 26 Cl. Ct. 1045, 1060 (1992); *Vons Companies, Inc. v. U.S.*, 51 Fed. Cl. 1, 8-11 (2001).

<sup>111</sup> Treas. Reg. § 1.6662-4(d)(3)(ii). A revenue ruling is more likely to be given binding effect or deference by a court. However, the “substantial authority” standards do not require a determination whether a court would give weight to a particular pronouncement because it represents the position of the IRS. Instead they give weight to the pronouncement because it is the outcome of a deliberative process by the IRS.

## 6. Required Disclosures

The ethical rules do not contain any specific disclosure requirement corresponding to the “no reliance” and “consumer protection” legends of Circular 230. Formal Opinion 85-352 and the Draft Statement require a lawyer to counsel the client regarding penalties, but neither document requires every tax opinion to state the permissible extent of reliance on the opinion itself as a defense against penalties. The Draft Statement provides merely that, if an opinion has been prepared for the specific purpose of penalty protection, the author must comply in good faith with the standards for penalty protection opinions and include a specific representation to that effect in the opinion.

In contrast, the general effect of Section 10.35 is to require that all tax opinions include a “no reliance” legend unless the advice complies with the covered opinion rules and expresses conclusions at a confidence level of at least “more likely than not.” As discussed above, the legend is not accurate in a number of respects. Requiring a lawyer to include a “no reliance” legend if the advice could in fact be relied upon by the taxpayer conflicts with a lawyer’s ethical duties to provide competent advice and to exercise independent judgement.<sup>112</sup> The prohibition in Section 10.35 against a lawyer’s providing advice inconsistent with such a disclosure prevents the lawyer from correcting the misstatement.<sup>113</sup> There are circumstances in which a lawyer faced with this situation may feel required to withdraw from a representation.<sup>114</sup> Further, the same the

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<sup>112</sup> See J. Matthew Miller, Note, *Balancing the Budget on the Backs of America’s Elderly – Section 4734 of the Balanced Budget Act: Criminalization of the Attorney’s Role as Advisor and Counselor*, 29 U. Mem. L. Rev. 165, 210-213 (1998) (chilling effect of overbroad prohibitions on lawyer speech).

<sup>113</sup> See Burgess J.W. Raby & William L. Raby, *Practitioner Advice as a Defense Against Penalties*, Tax Notes Today, Oct. 13, 2005 (“it doesn’t seem professionally responsible to tell the client in any and all written-advice situations that advice cannot be relied on for penalty protection when, absent that disclaimer, the practitioner believes that the law, regulation, and cases would allow that reliance”).

<sup>114</sup> See Model Rules R. 1.7(b). Cf. ABA Section of Taxation Committee on Standards of Tax Practice, Statement of Standards of Tax Practice 2000-1, *reprinted in* 54 Tax Law. 185 (2000) (conflicts between the penalty rules for taxpayers and professional rules for lawyers providing advice on tax return positions); Green, *supra* note [100], at 1703, 1709 (disparity between rules applicable to taxpayers and rules applicable to practitioners advising tax return positions creates conflicts of interest).

ethical issues that forced the lawyer's withdrawal would keep the client from procuring alternative legal advice regarding the tax treatment of the transaction.

Finally, the "consumer protection" requirement in Section 10.35 for both marketed opinions and opinions that are not marketed opinions because they are "legended out," raises issues of professional ethics similar to those raised by the "no reliance" legend. Where an opinion is rendered by a lawyer to a client in a true lawyer-client relationship concerning the client's tax treatment, the required disclosures that the opinion was written to support the promotion or marketing of the relevant transaction, and that the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor, are patently incorrect and undermine the confidence that a client is entitled to place in a lawyer. Under the ethical rules, the lawyer is required to exercise independent professional judgment on behalf of the client free of the interests of third parties.<sup>115</sup> Where a lawyer is acting in a manner consistent with his or her ethical obligations, there is no reason to require the lawyer to make statements suggesting otherwise.

### **III. FIRST AMENDMENT LIMITS ON THE REGULATION OF PROFESSIONAL SPEECH**

Though the Circular 230 opinion standards impose substantially greater requirements on practitioners than the corresponding requirements of the ethical rules, Treasury has clear statutory authorization to impose such requirements. It is less clear that the requirements are permitted by the First Amendment.

The U.S. Supreme Court addressed the tension between freedom of speech and the state's authority to regulate the professions in the 1985 case *Lowe v. Securities and Exchange Commission*.<sup>116</sup> The case arose from an attempt by the SEC under the Investment Advisors Act of 1940 to enjoin a former investment advisor, whose registration had been revoked because of criminal activity, from publishing investment

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<sup>115</sup> See, e.g., Model Code EC 5-1; Model Rules R. 5.4(c).

<sup>116</sup> 472 U.S. 181.

newsletters and a chart service.<sup>117</sup> The court held that the publishing activity could not be enjoined because it fell within the Act's exemption for "the publisher of any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation."<sup>118</sup> In so holding, the Court distinguished between the provision of personalized advice, based on a fiduciary relationship, to a specific client and the publication of generic and impersonal advice or information:

. . . [T]he petitioner's publications do not fit within the central purpose of the Act because they do not offer individualized advice attuned to any specific portfolio or to any client's particular needs. On the contrary, they circulate for sale to the public at large in a free, open market – a public forum in which typically anyone may express his views.<sup>119</sup>

Justice White's concurrence concluded that the statute permitted regulation of the activity and considered whether the regulation violated the First Amendment. The concurrence took a broad view of government's power to regulate professions, opining that such power "is not lost whenever the practice of a profession entails speech."<sup>120</sup> However, the concurrence stated, government's authority to restrict entry into professions through licensing "has never been extended to encompass the licensing of speech *per se* or of the press. . . . At some point, a measure is no longer a regulation of a profession but a regulation of speech or of the press; beyond that point, the statute must survive the level of scrutiny demanded by the First Amendment."<sup>121</sup> The concurrence, like the majority opinion, based the limits of permissible regulation on the distinction between whether a professional offers personal advice and purports to exercise judgment on the client's behalf in light of the client's individual circumstances.<sup>122</sup>

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<sup>117</sup> The newsletters included commentary about the markets, reviews of market indicators and investment strategies, and specific recommendations for buying, selling, or holding specific investments, and advertised a hotline for current information.

<sup>118</sup> 15 U.S.C. § 80b-2(a)(11)(D).

<sup>119</sup> *Lowe*, 472 U.S. at 207-08 (footnote omitted).

<sup>120</sup> *Id.* at 228.

<sup>121</sup> *Id.* at 229-30.

<sup>122</sup> *Id.*



Applying this distinction, the concurrence, like the majority opinion, concluded that “[t]he application of the Act’s enforcement provisions to prevent unregistered persons from engaging in the business of publishing investment advice for the benefit of any who would purchase their publications ... is a direct restraint on freedom of speech and of the press subject to the searching scrutiny called for by the First Amendment.”<sup>123</sup>

Though both the majority opinion and the concurrence based the standard for permissible governmental regulation of professional speech on whether the communication was personalized and given within a fiduciary-like relationship, neither opinion sought to define this standard further. It happened that one of the first cases to attempt such further definition, *Joslin v. Secretary of the Department of the Treasury*,<sup>124</sup> arose in connection with former Section 10.33. The plaintiff tax lawyer in *Joslin* challenged former Section 10.33 on the grounds that it limited his ability to give legal advice and opinions regarding taxation and his ability to communicate advice to the public. The taxpayer argued that, because the rules applied to opinions directed to third parties, they could not be justified as professional regulation under the standard articulated in *Lowe*.

The court observed that former Section 10.33 followed the professional guidelines of Formal Opinion 346 and noted the general power of the state to impose restrictions on professions even if the incidental effect was to abridge freedom of speech.<sup>125</sup> It followed Justice White’s concurrence in finding the relevant distinction whether there was a “personal nexus between professional and client.”<sup>126</sup> The court next concluded that, although former Section 10.33 applied only to tax shelter opinions addressed to third

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<sup>123</sup> *Id.* The concurrence concluded that, even if the newsletters were treated as having only the lesser protection of commercial speech, the injunction would be found overbroad; thus, it was not necessary to determine whether the newsletters had full First Amendment protection or only commercial speech protection. *Id.* at 234-35.

<sup>124</sup> 616 F.Supp. 1023 (1985), *vacated*, 832 F.2d 132 (10<sup>th</sup> Cir. 1987).

<sup>125</sup> 616 F.Supp. at 1026, *citing* *Giboney v. Empire Storage & Ice Co.*, 336 U.S. 490, 502 (1949); *Dent v. West Virginia*, 129 U.S. 114, 121-22 (1889).

<sup>126</sup> *Joslin*, 616 F. Supp. at 1026 (*citing* *Lowe*, 472 U.S. at 181).

parties, there was nevertheless a personal nexus between the attorney and the promoter for whom the opinion was prepared.<sup>127</sup>

The attorney is charged with making factual determinations about a tax scheme. In order to do so the attorney must develop a personal relationship with his client. The tax shelter opinion purports to be the judgment of a practitioner exercised on behalf of a particular individual or corporation with whom he is directly acquainted.

The *Joslin* court further held that, even if the rendering of tax shelter opinions constituted speech, it was commercial speech; thus, the regulations were required to satisfy only the Constitutional guidelines for the restriction of false and misleading commercial speech.<sup>128</sup> Applying these standards, the court concluded that “the regulations contained in Sections 10.33 ... are not abridgements of constitutionally protected speech but are regulations governing the standard of practice of professionals.” The court implied that, if the regulation of professional speech satisfies the minimum Constitutional standards for the State’s exercise of its police powers, any such regulation is permissible. *Joslin* thereby went substantially beyond the Supreme Court’s decision in *Lowe*. Further, because the District Court’s decision was vacated on appeal for lack of jurisdiction,<sup>129</sup> *Joslin* has no precedential value. However, the analysis in *Joslin* reflects one pole in the debate over First Amendment restrictions on the regulation of professional speech.

The Supreme Court has returned to the issue of regulation of professional speech a number of times since *Lowe*. The plaintiff criminal defense attorney in *Gentile v. State Bar of Nevada*<sup>130</sup> had given a press conference, shortly after his client’s indictment for alleged theft, asserting, among other things, that his client was innocent and that a police detective expected to be a prosecution witness had in fact had in fact committed the theft. The state bar subsequently disciplined the lawyer under a professional rule that

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<sup>127</sup> *Id.* at 1027.

<sup>128</sup> The application of the commercial speech doctrine to marketed tax shelter opinions is discussed below.

<sup>129</sup> 832 F.2d 132.

prohibits a lawyer from making a public statement about a pending case if the lawyer knows or reasonably should know that the statement will have a substantial likelihood of materially prejudicing a court proceeding.<sup>131</sup> The lawyer challenged the imposition of discipline on First Amendment grounds. In a fragmented decision, the Court held that, though the particular rule under which the lawyer was disciplined was unconstitutionally vague, the First Amendment generally permits courts to impose such restrictions on lawyers' statements concerning pending cases. The Court declined to subject such restrictions to the more demanding standards for restrictions on media statements, which may not be restricted by a court absent a clear and present danger of causing a malfunction in the criminal justice system.<sup>132</sup>

In so holding, the Court emphasized the lawyer's role, even outside the courtroom, as an "essential part of the justice system."<sup>133</sup> Because of this role, a range of restrictions had been permitted on lawyers' speech, including limitations on advertising and solicitation.<sup>134</sup> In each case, the Court had "engaged in a balancing process, weighing the State's interest in the regulation of a specialized profession against a lawyer's First Amendment interest in the kind of speech that was at issue."<sup>135</sup> The "substantial likelihood of material prejudice" standard was Constitutional for attorneys because "it is designed to protect the integrity and fairness of a State's judicial system, and it imposes only narrow and necessary limitations on lawyers' speech."<sup>136</sup>

*Gentile* could be viewed narrowly as establishing guidelines for the regulation by courts of lawyers appearing before them in pending cases. However, the decision also may be viewed as a template for the regulation of speech by professionals that participate in crucial public functions. Under the court's analysis, the mere fact that a professional participates in an important public function is not sufficient to

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<sup>130</sup> 501 U.S. 1030.

<sup>131</sup> The rule was based on Model Rules R. 3.6.

<sup>132</sup> 501 U.S. at 1069-71.

<sup>133</sup> *Id.* at 1071.

<sup>134</sup> *Id. citing* Peel v. Attorney Registration and Disciplinary Comm'n of Ill., 496 U.S. 91 (1990); *Ohralik v. Ohio State Bar Ass'n.*, 436 U.S. 447 (1978); *Bates v. State Bar of Ariz.*, 433, U.S. 350 (1977).

permit limitations on the professional’s speech. Rather, the speech must present a clearly defined and realistic threat to the functioning of the system. Moreover, any restriction on the speech must be designed to address the threat and be narrowly tailored to limit only such speech.

These considerations arose in *Planned Parenthood of Southeastern Pennsylvania v. Casey*,<sup>137</sup> in which the Court considered state restrictions on the provision of abortions, including a requirement that, at least 24 hours before performing a non-emergency abortion, a physician inform a patient of the nature of the procedure, the health risks of abortion and childbirth, and the probable gestational age of the unborn child. The physician or a qualified nonphysician also was required to inform the woman of the availability of printed materials published by the state describing the fetus and providing information about medical assistance for childbirth, obtaining child support from the father, and agencies which provide adoption and other services as alternatives to abortion. No abortion could be performed unless the woman certified in writing that she had been informed of the availability of the printed materials and had been provided with them if she so chose.

In a fragmented decision, the Court upheld the state information requirements, though none of the opinions was supported by a majority of the Justices, and only one of the opinions, by Justice O’Connor, joined by Justices Kennedy and Souter, considered the First Amendment. Justice O’Connor’s opinion, overruling certain prior decisions,<sup>138</sup> concluded that the information requirements did not unduly burden the right to obtain an abortion, in light of the state’s substantial and legitimate interests in protecting the physical and psychological health of the mother and the life of the unborn child: The information to be provided was truthful and designed to further the state’s interests by allowing a patient to make a fully informed decision.<sup>139</sup> The opinion noted that a physician was not required to comply if the physician

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<sup>135</sup> Gentile, 501 U.S. at 1071.

<sup>136</sup> *Id.* At 1075.

<sup>137</sup> 505 U.S. 833.

<sup>138</sup> *Thornburgh v. American College of Obstetricians and Gynecologists*, 476 U.S. 747, 762 (1986); *Akron v. Akron Center for Reproductive Health, Inc.* 462 U.S. 416, 444 (1983).

<sup>139</sup> *Casey*, 505 U.S. at 883.

could demonstrate by a preponderance of the evidence that the physician reasonably believed that furnishing the information would have had a severely adverse effect on the patient’s physical or mental health. Accordingly, the opinion stated, the “statute does not prevent the physician from exercising his or her medical judgment.”<sup>140</sup>

The opinion treated the question of professional speech as secondary to the question of state burdens on abortion. However, the opinion included a consideration of whether a physician has a First Amendment right not to provide information in the manner required by the statute. The opinion concluded that, while “the physician’s First Amendment rights not to speak are implicated,” such rights were implicated “only as part of the practice of medicine, subject to reasonable licensing and regulation by the state.”<sup>141</sup> Accordingly, the opinion found the information requirements constitutional. It should be noted in this regard that *Casey* involved a requirement to provide information, not a prohibition on speech by a doctor. Further, Justice O’Connor’s conclusion was dependent on a finding that the state’s requirements did not prohibit a physician from exercising professional judgment.

The most recent Supreme Court consideration of First Amendment limitations on the regulation of professional speech occurred in *Legal Services Corp. v. Velazquez*.<sup>142</sup> The case arose from a challenge to a federal statute under which lawyers receiving funding from the Legal Services Corporation were prohibited from undertaking any representation that involved an effort to amend or otherwise challenge existing welfare laws.<sup>143</sup> In *Rust v. Sullivan*, the Court had upheld a prohibition, in funding legislation for family planning clinics, on clinic doctors’ discussing abortion with their patients.<sup>144</sup> The *Velazquez* Court distinguished *Rust*, explaining that the federal program in *Rust* had been intended to further a specific government message and that viewpoint-based restrictions were therefore permitted. In contrast, the

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<sup>140</sup> *Id.* at 884. The opinion also held that the requirements did not violate the doctor-patient relationship. *Id.*

<sup>141</sup> *Id.*

<sup>142</sup> 531 U.S. 533.

<sup>143</sup> If the presence of constitutional or statutory challenges became apparent while a lawyer was engaged in a representation, regulations under the statute required the lawyer to withdraw.

<sup>144</sup> 500 U.S. 173 (1991).

Legal Services program was designed to facilitate private speech, not to promote a governmental message.<sup>145</sup> In such circumstance, the Court stated that a restriction on lawyers' speech "distorts the legal system by altering the traditional role of attorneys."<sup>146</sup>

Accordingly, the Court concluded, government "may not design a subsidy to effect this serious and fundamental restriction on advocacy of attorneys and the functioning of the judiciary."<sup>147</sup> By seeking to prohibit the analysis of certain legal issues and to truncate presentation to the courts, the Court stated, the statute "prohibits speech and expression upon which courts must depend for the proper exercise of the judicial power."<sup>148</sup>

The chief contribution of *Velazquez* was to emphasize that a restriction on lawyers' speech may distort the legal system by altering the "traditional role of attorneys." A finding of such distortion of the lawyer's advocacy role was one of the main bases for the Court's holding that the Legal Services restriction was unconstitutional.

In *Conant v. Walters*,<sup>149</sup> the Court of Appeals for the Ninth Circuit upheld, on First Amendment grounds, an injunction against the Federal government's law enforcement actions against California physicians. The controversy arose from California's enactment of legislation that decriminalized the use of marijuana for limited medical purposes and immunized physicians from prosecution under state law for recommending or approving of the use of marijuana for such purposes. In response, the Federal

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<sup>145</sup> "Congress funded LSC grantees to provide attorneys to represent the interests of indigent clients. The attorney defending the decision to deny [welfare] benefits will deliver the government's message in the litigation. The LSC lawyer, however, speaks on the behalf of his or her private, indigent client." *Velazquez*, 531 U.S. at 542.

<sup>146</sup> The Court compared such distortion to restrictions on editorial content and decisions by broadcast networks, *citing* *Ark. Educ. Television Comm'n v. Forbes*, 523 U.S. 666 (1998); *FCC v. League of Women Voters of Cal.*, 468 U.S. 364 (1984); and restrictions on editorial content in student newspapers, *Rosenberger v. Rector and Visitors of Univ. of Va.*, 515 U.S. 819 (1995).

<sup>147</sup> *Velazquez*, 531 U.S. at 544.

<sup>148</sup> *Id.* The Court was particularly concerned with the fact that the prohibition "sifts out cases presenting constitutional challenges in order to insulate the Government's laws from judicial inquiry." *Id.* at 546. The Court did not view the ability of a funded lawyer to withdraw from representation as avoiding an unconstitutional restriction on speech, particularly because the indigent client was unlikely to find other counsel. *Id.* at 547.

government promulgated a policy stating that a doctor’s recommending or prescribing marijuana was not consistent with the public interest within the meaning of the Controlled Substances Act and that, accordingly, such actions would lead to revocation of the physician’s authority to prescribe controlled substances. Various parties challenged the policy on First Amendment grounds and obtained a permanent injunction that prohibited the Federal government from revoking the controlled substances registration of a doctor, or conducting an investigation the might lead to such revocation, solely on the basis of the physician’s recommending, based on sincere medical judgment, that a patient use medical marijuana.

The Ninth Circuit noted that, where a physician actually prescribed marijuana or made a recommendation that the physician intended the patient to use to obtain marijuana, the injunction did not bar the Federal government from prosecuting the physician for aiding and abetting a violation of or a conspiracy to violate Federal law. However, a doctor could not be viewed as aiding and abetting or participating in a conspiracy merely because the doctor anticipated that the patient would respond to the doctor’s recommendation by obtaining marijuana in violation of Federal law.<sup>150</sup>

The court rejected a series of government arguments. The government had argued that restrictions on physicians’ First Amendment rights are permissible because medicine is a regulated profession; the court, rejecting the argument, responded that professional speech “may be entitled to ‘the strongest protection our Constitution has to offer.’”<sup>151</sup> The court also rejected the government’s argument that a doctor-patient discussion about marijuana might lead the patient to make a bad decision, noting that the First Amendment does not permit restrictions on the communication of truthful information because of decisions such information may lead a recipient to make,<sup>152</sup> and court rejected an argument that a doctor’s

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<sup>149</sup> 309 F.3d 629.

<sup>150</sup> *Id.* at 635-36.

<sup>151</sup> *Id.* at 637 (*quoting* Fla. Bar v. Went For It, Inc., 515 U.S. 618 (1995)).

<sup>152</sup> The Conant court cited Thompson v. W. States Med. Ctr., 535 U.S. 357 (2002), in which the Supreme Court, in holding unconstitutional rules that prohibited physicians and pharmacists from advertising compounded drugs, rejected the government’s argument that “people would make bad decisions if given truthful information about compounded drugs.” *Id.* at 374.

recommending marijuana may encourage illegal conduct.<sup>153</sup> The court also concluded that the Federal policy restricted a particular viewpoint – *i.e.*, the view that medical marijuana would likely help a specific patient -- and that such content-based restrictions on speech are “‘presumptively invalid.’”<sup>154</sup> Finally, the court followed *Velazquez* in concluding that the Federal policy “‘alter[s] the traditional role’ of medical professionals by ‘prohibit[ing] speech necessary to the proper functioning of those systems.’”<sup>155</sup>

*Conant* addresses both the relatively narrow issue of viewpoint-based speech, and broader principles. First, the decision sets a basic threshold by affirming the First Amendment protection of speech that does not in itself constitute illegal conduct.<sup>156</sup> The decision also recognizes that communications between a professional and a client are entitled to strong First Amendment protections, notwithstanding that the professions are subject to regulation, and follows *Velazquez* in stating that the scope of the First Amendment protection of professional speech is related to the traditional role and purpose of the profession. Finally, the decision refuses to accept restrictions on truthful professional speech based on the possibility that the recipient may use the information to make bad decisions or engage in illegal conduct.

Though a comprehensive analysis of the philosophical underpinnings of the First Amendment and the function and meaning of professional speech is beyond the scope of this article,<sup>157</sup> the court opinions discussed above suggest a model, supported by commentators, for analyzing the regulation of

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<sup>153</sup> The court noted that a similar justification had been rejected in *Ashcroft v. Free Speech Coal.*, 535 U.S. 234 (2002) (First Amendment prohibited application of Child Pornography Prosecution Act of 1996 to virtual child pornography). 309 F.3d at 638.

<sup>154</sup> *Conant*, 309 F.3d at 637 (*quoting* *R.A.V. v. St. Paul*, 505 U.S. 377, 382 (1992)).

<sup>155</sup> *Id.* at 638 (*quoting* *Velazquez*, 531 U.S. at 544). The court also found the Federal policy impermissible because it was a restriction on speech whose meaning depends upon the meaning attributed to it by the hearer. *Id.*, *citing* *Thomas v. Collins*, 323 U.S. 516 (1945).

<sup>156</sup> *See* *New York State Bar Ass’n v. Reno*, 999 F.Supp. 710 (N.D.N.Y. 1998) (preliminary injunction against enforcement of Section 4734 of Balanced Budget Act of 1997, which made it illegal to counsel or assist an individual to dispose of certain assets to qualify for Medicaid benefits; Federal government did not defend constitutionality of provision). *See also* *Magee v. U.S.*, 93 F.Supp.2d 161 (D.R.I. 2000) (the “United States does not dispute that Section 4734 is ‘plainly unconstitutional’”).

<sup>157</sup> *See* Halberstam, *supra* note [3], at 792-828 (1999) (analyzing professional speech under theories of economics, culture, democracy and liberty, and arguing that professional speech should be evaluated by reference to the social context in which it is expressed); Kry, *supra* note [3], at 957-63 (2000) (analyzing professional speech under the “marketplace of ideas” theory and the “self governance” theory); Wendel,



professional speech. The model identifies professional speech as a personalized communication given in the context of a fiduciary-like relationship between a person who adheres to a shared body of professional knowledge and values, and that person's client.<sup>158</sup> Such speech is entitled to First Amendment protection.<sup>159</sup> This protection differs from the protection given to the press and "street corner" speech, on the one hand, and the protection given to commercial speech, on the other.<sup>160</sup>

The model defines permissible regulation of professional speech largely by reference to the role of the profession in society and accepted professional norms.<sup>161</sup> Professional speech may be prohibited where it involves illegal conduct, presents a clear and realistic threat to the proper functioning of the profession or the institutions with which the profession interacts, or deviates from accepted professional norms.<sup>162</sup> However, any such prohibition must be narrowly tailored to address only the illegal conduct, the specific threat to the system, or the deviation from professional norms. In addition, professional speech may be regulated for the purpose of furthering a legitimate State policy, provided that the regulation does not distort the usual functioning of the profession based on accepted usage or prevent the exercise of professional judgment. Professional speech may not be prohibited merely because the client may use the information to make a bad choice or to engage in illegal conduct, provided that the professional does not participate in or further the illegal conduct. Likewise, a professional may not be required to make statements that are false or misleading.

An obvious question regarding the professional speech model is whether it should apply to professional speech used to market a product to a third party, such as a tax opinion used to market a tax shelter. In

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*supra* note [3], at 404-23 (2001) (analyzing lawyers' speech by reference to the values of discovery of truth, democracy, dissent, and self-fulfillment).

<sup>158</sup> See Halberstam, *supra* note [3], at 839-844; Kry, *supra* note [3], at 907-11.

<sup>159</sup> See Halberstam, *supra* note [3], at 838 ("Justice White's rationality review, as adopted by four members of the Court in *Casey*, fails to give professional speech its due. At a minimum, professional speech should be accorded no less protection than commercial speech"); Wendel, *supra* note [3], at 359 (Gentile does not revive the long-discredited right/privilege distinction .... It merely makes the less controversial constitutional point that in some kinds of state-established forums, speakers' rights may be limited by reasonable government interests"); Berg, *supra* note [3], at 170.

<sup>160</sup> See Berg, *supra* note [3]; Halberstam, *supra* note [3], at 773-76; Wendel, *supra* note [3] at 381-82.

<sup>161</sup> See Halberstam, *supra* note [3], at 834-35; Wendel, *supra* note [3], at 385-86.

addressing the question, it is useful to consider whether a lawyer’s opinion constitutes “commercial speech” and, if so, how the professional speech model interacts with the commercial speech doctrine. Both courts and commentators have noted that the boundaries of commercial speech are unclear.<sup>163</sup> However, even in the broadest formulations, “commercial speech” would apply only to communications made by or on behalf of a seller to a potential purchaser and having some connection to the proposed sale.<sup>164</sup> Thus, in the case of a marketed tax shelter, the commercial speech doctrine would not apply to an opinion given by a lawyer to a client that is a potential purchaser and addressing the client’s tax treatment, because the lawyer is not the seller of the shelter or the seller’s agent.<sup>165</sup> Likewise, the commercial speech doctrine will not apply where the client is the tax shelter promoter and the lawyer provides advice to the promoter regarding the tax treatment of a potential purchaser, if the lawyer’s advice is not addressed to the potential purchaser and not intended by the lawyer to be shown to the potential purchaser or incorporated in marketing materials.

Where the client is the tax shelter promoter and asks the lawyer to prepare advice for a third party investor in the shelter, there is a facial appeal to viewing the shelter as the product and the lawyer’s advice as a form of advertising; in this view, the commercial speech doctrine would apply. However, even in this case, the lawyer’s obligation to exercise independent professional judgment, speak truthfully, and disclose relevant facts distinguishes the lawyer’s advice from typical advertising, which has no such internally imposed obligations.

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<sup>162</sup> See Halberstam, *supra* note [3] at 844-49, 867-68.

<sup>163</sup> See, e.g., *Edenfield v. Fane*, 507 U.S. 761, 765 (1993) (“ambiguities may exist at the margins of the category of commercial speech”); *City of Cincinnati v. Discovery Network, Inc.*, 507 U.S. 410, 419 (1993) (“difficulty of drawing bright lines that will clearly cabin commercial speech in a distinct category”); *Zauderer v. Office of Disciplinary Council*, 471 U.S. 626, 637 (1985) (“precise bounds of the category of ... commercial speech” unclear); Post, *supra* note [3], at 5-25 (2000); Samuel A. Terilli, *Nike v. Kasky and the Running-but-Going-Nowhere Commercial Speech Debate*, 10 Comm. L. & Pol’y 383 (2005); Scott Wellikoff, Note, *Mixed Speech: Inequities that Result from an Ambiguous Doctrine*, 19 St. John’s J. Legal Comment. 159, 174-79 (2004).

<sup>164</sup> See, e.g., *Bolger v. Youngs Drug Products Corp.*, 463 U.S. 60, 67 (1983) (commercial speech generally characterized by advertising format, product reference and commercial motivation); *Kasky v. Nike, Inc.*, 45 P.3d 243, 256 (Cal. 2002) (speech considered to be in advertising format if message is directed to an audience that will be influenced, or likely influenced, to engage in a commercial transaction).

The objective of the commercial speech doctrine is to ensure the free flow of truthful rather than misleading commercial information and permit reasonable consumer protection and similar regulations. If the speech in question is directed to third parties but is professional speech, it may be more appropriate to apply a “hearer-centered” First Amendment theory similar to the theory developed by Burt Neuborne in *The First Amendment and Government Regulation of Capital Markets*.<sup>166</sup> The purpose of such a theory is to ensure that the recipient, in this case of the lawyer’s advice, receives information that enhances the recipient’s ability to make an informed and autonomous choice. Under such a theory, the government would be free to prohibit false or misleading speech or speech that promotes an unlawful choice. Moreover, the government would be free to require the inclusion in communications of information that helps the recipient make an informed choice. However, absent a compelling governmental need and narrowly tailored measures that address such need, the government could not prohibit the communication of truthful, non-misleading information, regardless of the risk that the recipient would use the information to make an undesirable choice, and could not impose inaccurate prophylactic rules branding certain categories of speech as inherently false or misleading.

The “hearer-centered” theory has several elements in common with the professional speech model described above. Both theories aim principally at protecting the recipient’s interest in receiving the advice for the purpose of making an informed and autonomous choice within the scope of the recipient’s rights. Both theories permit the censoring of speech that promotes an illegal objective or is deemed actually or professionally false or misleading, and both permit reasonable compelled disclosures provided that the disclosures are not themselves false or misleading. Under both theories, the possibility that the recipient may use the information to make a bad choice is not a legitimate basis for restricting speech.

However, the professional speech model focuses on the specific societal role of the lawyer, the relevant professional norms, and the exercise of professional judgment. In contrast, the “hearer-centered” theory,

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<sup>165</sup> See Post, *supra* note [3], at 23 (the “doctrine stops short of commercial communications between persons deemed to be involved in relationships of dependence or reliance”).

while regarding the professional and societal context as relevant because it helps define the interests of the recipient of advice, does not protect the professional role, professional institutions, or the exercise of professional judgment as values in themselves.

#### **IV. APPLICATION OF FIRST AMENDMENT PRINCIPLES TO THE CIRCULAR 230 OPINION REQUIREMENTS**

The obligations imposed by Circular 230 on lawyers rendering tax shelter opinions consist of (1) obligations regarding the general structure of the advice and the issues that must be addressed, which generally are neutral as to the viewpoint expressed by the advice (“viewpoint-neutral requirements”), and (2) obligations regarding the method of analysis, the conclusions reached in certain advice, and disclosures that must accompany the advice and that require the expression of specific viewpoints or facts (“viewpoint-based” requirements). Application of the professional speech model described above to these rules raises a number of serious First Amendment concerns.

##### **A. Viewpoint-Neutral Requirements**

As discussed above, both Section 10.35 and Section 10.37 impose due diligence standards; Section 10.35 also requires a practitioner to relate the applicable law to the relevant facts, consider all “significant Federal tax issues,” provide a conclusion as to the likelihood that the taxpayer will prevail with respect to each issue, and provide an overall conclusion as to the tax treatment of the transaction. The significant First Amendment questions are (1) whether the government may prohibit the rendering of written advice that does not reflect one or more of those analyses and (2) to what extent the government may impose standards for conducting the analyses themselves.

The requirements in Section 10.35 are intended to prevent hypothetical, inaccurate or incomplete advice. However, in certain circumstances the advice rendered by a tax lawyer perforce will be objectively

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<sup>166</sup> See Neuborne, *supra* note [3], at 28-40.

inaccurate, hypothetical, or incomplete, because it is based on inaccurate assumptions, or the client asks a hypothetical or limited question. Under the legal ethics rules, the ability of a lawyer to give limited advice depends on the context of the request. Lawyers and clients are given broad latitude to define the scope of the lawyer's advice, subject to standards of reasonableness.

In certain circumstances the rules require more extensive advice. A lawyer advising on a tax return position may not recommend a position without determining relevant facts, placing them in a legal framework, identifying relevant issues, and reaching conclusions on the issues and an overall conclusion that the position has a reasonable possibility of success if litigated.<sup>167</sup> A tax opinion reaching a conclusion on a specific set of facts must identify relevant facts, relate them to applicable law, identify and consider the relevant issues and reach conclusions appropriate to the purpose and expected use of the opinion.<sup>168</sup> A lawyer preparing a tax opinion used to market tax shelters must conduct reasonable factual due diligence, relate the law to the facts, consider all material Federal tax issues, and, where possible, provide specific and general conclusions about separate issues and the overall tax treatment of the transaction.<sup>169</sup>

However, Section 10.35 has a broader scope than the ethical rules. Formal Opinion 346 applies only to "tax shelter opinions," which are limited to broadly marketed opinions or tax disclosure in offering or marketing materials. It does not apply where advice is rendered solely to the offeror, where the involvement of the lawyer is not publicized, or where a tax shelter transaction is directly negotiated by a small group of investors having their own tax counsel. Formal Opinion 85-352 applies to advice regarding a tax return reporting position. It is true, as noted in the Special Task Force Report, that the opinion would also apply to advice regarding tax return positions prior to the actual preparation of the

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<sup>167</sup> Formal Opinion 85-352.

<sup>168</sup> Draft Statement of Standards of Tax Practice 2000-2.

<sup>169</sup> Formal Opinion 346.

return, including advice in structuring transactions.<sup>170</sup> However, Formal Opinion 85-352 does not clearly require a lawyer to approach every planning question, no matter how preliminary or hypothetical, based on the assumption that the lawyer's advice will be reflected in a tax return.

Even where advice is related to a return position, a foreshortened analysis may be permissible. For example, a client may request advice concerning regarding a specific rule that is only one of a number of elements in determining a return reporting position. In these circumstances, the lawyer will have an obligation to identify all the relevant facts regarding the application of the rule and to consider such application in the context of the facts as known by the lawyer. However, the lawyer will not be required by Formal Opinion 85-352 to engage in a full analysis leading to an overall conclusion regarding the tax treatment of the position.

In many situations in which the ethical rules would not require a full-fledged analysis, Section 10.35 would require such an analysis. Where this is the case, the First Amendment professional speech model described above requires consideration of a number of questions. First, does the absence of a full-fledged analysis constitute participation in illegal conduct, present a clear and realistic threat to the tax system, or deviate from accepted professional norms? If so, are the requirements of Section 10.35 narrowly tailored to address the illegality, the threat to the tax system, or the deviation from professional norms? Second, do the requirements of Section 10.35 further a legitimate government policy in a manner that does not distort the usual functioning of the profession based on accepted usage, or prevent the exercise of professional judgment?

1. Harmful Effects of Tax Advice

There is no reason to think that rendering written advice without a full-fledged analysis will in itself constitute participation in illegal conduct. Likewise, based on the ethical rules and practices discussed

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<sup>170</sup> See also Wolfman *et al.*, *supra* note [49], § 502 (“Since advising on return positions is inherent in most tax planning, the application of Opinion 85-352 would appear to apply to tax planning by logical extension”).

above, there is little reason to think that the absence of a full-fledged analysis represents a deviation from accepted professional norms.<sup>171</sup> Arguably, limited-scope written tax advice represents a clear and meaningful threat to the system because it facilitates transactions motivated by tax avoidance, which themselves constitute such a threat. It further is arguable that the covered opinion requirements for a full-fledged opinion are directly related to the goal of discouraging inappropriate tax avoidance by ensuring that the recipient of the advice receives a full analysis of the likelihood that the transaction will or will not have the desired tax objectives.<sup>172</sup>

As discussed above, however, a tax-avoidance motivation for a transaction does not necessarily prevent the transaction from lawfully achieving the desired tax benefits.<sup>173</sup> Therefore, the government must argue either that tax-avoidance transactions are frequently invalid, or that the threat to the system comes from the combination of the transaction's tax-avoidance purpose with the uncertainty over its tax results. Under the First Amendment, it is difficult to justify regulating speech regarding a class of transactions because of the frequency with which invalid transactions occur within that class. If a meaningful amount

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<sup>171</sup> It might be argued that the covered opinion standards of Section 10.35 reflect accepted professional norms because they reflect recommendations of the ABA Section of Taxation. *See* ABA SECTION OF TAXATION, REPORT TO AMEND 31 C.F.R. PART 10, TREASURY DEPARTMENT CIRCULAR 230, TO DEAL WITH “MORE LIKELY THAN NOT” OPINIONS RELATING TO TAX SHELTER ITEMS OF CORPORATIONS, *reprinted in* Tax Notes Today (Nov. 1, 1999); ABA SECTION OF TAXATION, COMMENTS REGARDING “PRE-OPINION OPINIONS” RELATING TO CORPORATE TAX SHELTER ITEMS, *reprinted in* Tax Notes Today (Sept. 15, 2000); ABA SECTION OF TAXATION, ADMINISTRATIVE RECOMMENDATION REGARDING REGULATIONS GOVERNING PRACTICE BEFORE THE IRS, *reprinted in* Tax Notes Today (Aug. 13, 2001); ABA SECTION OF TAXATION, PROPOSED REVISIONS TO CIRCULAR 230 ABA SECTION OF TAXATION RECOMMENDATIONS, *reprinted in* Tax Notes Today (Apr. 24, 2002). However, the ABA Section of Taxation recognized that many of the concepts in its recommendations “are novel and untried.” PROPOSED REVISIONS (Apr. 24, 2002). The ABA Section of Taxation has since concluded that “the regulations are producing undesirable consequences at a level that is disproportionate to the associated benefits to the tax system.” Letter from Dennis B. Drapkin to Mark W. Everson, Donald L. Korb, Eric Solomon, Cono R. Namorato, *reprinted in* Tax Notes Today (Dec. 5, 2005).

<sup>172</sup> *See* PROPOSED REVISION (Apr. 24, 2002) (“Arguably, the goals of Circular 230 concerning [penalty-protection opinions] could be achieved by making Circular 230 applicable to, and only to, opinions offered for purposes of penalty protection. Notwithstanding this, however, the Recommendation makes Circular 230 applicable to any opinion covering a section 10.35 transaction, as defined, regardless of whether the opinion is intended to create penalty protection. This is because . . . [w]e believe that the attractiveness of abusive transactions will be reduced if practitioners are required to disclose all relevant issues and risks to taxpayers. This is appropriate in our current environment despite the fact that some transactions that meet the heightened due diligence procedures contained in section 10.35 are substantively sound under today’s rules”).

of legitimate speech exists within the class, the regulation must fall.<sup>174</sup> It is true that, where the rules are not clear, some taxpayers will interpret the uncertainty in their favor and seek to structure transactions to fall within these uncertain rules; tax advice regarding such transactions will facilitate this behavior.<sup>175</sup> However, the potential for such manipulation has not been held sufficient grounds for regulating a class of speech that includes legitimate speech.

It might be argued, based on *Gentile*, that the test for regulating professional speech does not require certainty that the speech will harm the system. However, the ethical rule considered in *Gentile* specifically targeted statements that “have a substantial likelihood of materially prejudicing an adjudicative proceeding,” and the Court emphasized the specific connection between the lawyer’s speech and a threat to the integrity and fairness of the judicial system.<sup>176</sup> In contrast, Section 10.35 applies indiscriminately to speech regarding valid and invalid transactions. It is doubtful that a court would uphold a regulation of professional speech based on the nonspecific threat that, as a result of such speech, taxpayers and their lawyers may structure transactions to exploit ambiguities in the tax rules.

This justification for regulating speech may not be appropriate even where written tax advice concerns an issue that ultimately is determined in favor of the IRS. Consider, for example, advice that correctly concludes that (i) an issue is uncertain, (ii) there is a realistic possibility that the taxpayer will prevail, but (iii) “more likely than not” the IRS will prevail, and (iv) if the IRS prevails, the taxpayer will incur a substantial understatement penalty. There is little in such advice that could be seen to facilitate the improper tax avoidance. It is true that, by concluding that the taxpayer has a realistic possibility of

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<sup>173</sup> Likewise, the fact that a transaction has been designated by the IRS as a listed transaction does not in itself mean that the transaction is invalid.

<sup>174</sup> See generally RONALD D. ROTUNDA & JOHN E. NOVAK, TREATISE ON CONSTITUTIONAL LAW § 20.8 (3d ed. 1999) (discussing the overbreadth doctrine); Richard H. Fallon, *Making Sense of Overbreadth*, 100 Yale L.J. 853 (1991); Wendel, *supra* note [3], at 382-91 (discussing the application of the overbreadth doctrine to limits on lawyer speech); Miller, *supra* note [112], at 199-201.

<sup>175</sup> See Caplin, *supra* note [102], at 976 (quoting Charles Grassley, R-Iowa as observing that “At the heart of every abusive tax shelter is a tax lawyer or accountant”).

<sup>176</sup> “While supported by the substantial state interest in preventing prejudice to an adjudicative proceeding by those who have a duty to protect its integrity, the Rule is limited on its face to preventing only speech having a substantial likelihood of materially prejudicing that proceeding.” 501 U.S. at 1076.



success, the advice enables the taxpayer to assert the position on a tax return without risk of penalties for fraud, negligence or disregard of rules or regulations. However, until the issue has been resolved, the taxpayer has the right to assert the position. It is difficult to see how the tax system is threatened by advice that correctly assesses the taxpayer's rights.<sup>177</sup>

Even if advice threatens system, for example because it improperly concludes that a structure will provide tax benefits, are the requirements in Section 10.35 for a full-fledged opinion narrowly tailored to address the specific threat? There are two ways in which such a full-fledged opinion might help avoid structured transactions that improperly claim tax benefits. By identifying risks and penalties, could the recipient might be less likely to claim improper benefits. Or, an opinion giving a full description of the factual and legal context of a transaction and identifying its strengths and weaknesses, could, if seen by the IRS, assist the IRS in challenging an improper transaction.

The requirements cannot be justified based on the possibility that an opinion will be seen by the IRS. While opinions sometimes will be disclosed to the IRS, many remain privileged and undisclosed. Accordingly, such requirements would not be narrowly tailored to a specific threat. Even if the requirements were limited to opinions that are discoverable by the IRS, this justification would be doubtful. Requiring a lawyer to prepare an opinion in ways designed to assist the IRS in a future challenge would entail a serious distortion of the lawyer's professional role; and, as a practical matter, taxpayers and lawyers would, absent some specific purpose such as penalty protection, avoid such advice whenever possible.

The requirements also cannot be justified on the grounds that they will discourage taxpayers from taking improper positions. The "ground up" analysis required by Section 10.35 – identification of facts, relation of law to the facts, a reasoned conclusion regarding each significant Federal tax issue, and an overall reasoned conclusion, with separate statements of assumptions relied upon and representations by the

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<sup>177</sup> See Trucksess, *supra* note [99] at 755.

taxpayer, will lead to the preparation of comprehensive opinions. However, such comprehensiveness is not necessary or even desirable if the purpose is to prevent taxpayers from taking improper positions. Arguably, the objective could be better achieved by requiring practitioners to address properly those issues that are relevant to the purpose and expected use of the opinion, including requirements that the practitioner consider all facts relevant to such issues and all relevant legal aspects of each issue, reach correct conclusions regarding the likelihood that each such issue will be resolved in the taxpayer's favor, and address the likelihood that the client will incur penalties if the client's position is not sustained.

## 2. Legitimate Government Policies

Another possible justification of the requirements is that they further legitimate government policies and impose only minor burdens on the lawyer-client relationship. Possible government policies include ensuring that taxpayers not enter into tax-motivated transactions without a full understanding of the risks, and maintaining the public confidence in the honesty and integrity of tax professionals.<sup>178</sup>

These purposes are undoubtedly legitimate. Of greater concern is whether the requirements achieve these ends and whether they improperly distort the role of an attorney based on accepted practices. In one sense, taxpayers will be better informed of the relevant risks by opinions that provide a comprehensive analysis of every potential issue. However, such analysis may not give taxpayers a meaningfully better understanding of the risks.<sup>179</sup> In particular, the low threshold for defining a significant Federal tax issue may require a lawyer to address relatively unimportant issues in ways that dilute the lawyer's message regarding more important issues.<sup>180</sup>

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<sup>178</sup> The preamble to Section 10.35 specifically refers to the goal of restoring, promoting and maintaining the public's confidence in tax practitioners as a purpose for the "best practices" contained in Section 10.33.

<sup>179</sup> A similar issue arises in securities offering disclosures containing extensive discussions of potential risks. Without guidance regarding the relative importance of various risks, the reader may tend to discount the entire discussion.

<sup>180</sup> One response is that Section 10.35 does not prevent the lawyer from highlighting the most important issues. However, the argument that the covered opinion requirements ensure better-informed taxpayers is not supported by a suggestion that the taxpayer need not read the entire opinion.

The requirements that covered opinions address all significant Federal tax issues and include comprehensive analyses of the strengths and weaknesses of the taxpayer's position also significantly alters the role of a lawyer providing advice to a client. Lawyers and clients may agree to limit the scope of written advice for any number of reasons. The client may want the benefit of the lawyer's judgment as to which issues are most important. The client may have an independent knowledge of the tax law and wish advice only on a specialized point. The client may not want all the advice in writing because of a concern that the written advice may lose the protection of the attorney-client privilege. The client may have a limited budget. A transaction may not be sufficiently developed to merit an in-depth analysis. There may be insufficient time to prepare a comprehensive analysis. None of these reasons should deny the client the right to receive advice regarding its legal rights and exposures. For that reason, the ethical rules generally permit lawyers and clients to agree on the scope of legal advice, provided that the client is informed and the limitation does not prevent competent representation.

Even where the lawyer's advice is provided to a third party, the requirements substantially expand the obligations of a lawyer in ways that may prevent such advice from being rendered. That is a particular concern for advice rendered in connection with commercial negotiations between the client and a third party having its own tax counsel. There, the lawyer's role is akin to that of an advocate, since the third party's tax counsel normally will evaluate the lawyer's advice and make a recommendation to the third party whether or not to accept such advice. There are many legitimate reasons why the parties may not wish the lawyer to provide a comprehensive analysis of the third party's tax position.<sup>181</sup> Nor is a comprehensive analysis required under the ethical rules, which merely require that the lawyer disclose to

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<sup>181</sup> The client typically will not wish to undertake this responsibility because of cost and liability concerns, and because the client's relationship with the third party is principally commercial. Even if the client were prepared to have its lawyer provide a comprehensive analysis, the lawyer may not have sufficient information about the third party to permit such an analysis. The third party may request that the lawyer provide advice only regarding the tax treatment of facts that are better known to the client and the lawyer than to the third party. Also, the third party may be reluctant to disclose commercially sensitive or private information to the lawyer, who generally would have an ethical obligation to disclose those facts to the client. Finally, the third party may be reluctant to have the lawyer prepare a comprehensive analysis because such analysis would not be covered by attorney-client privilege.

the third party any limitation on the scope of the lawyer's investigation and that the lawyer not knowingly make a false statement of material law or fact.

Arguably much of the distortion to a lawyer's typical role can be avoided through the various "legending out" exclusions to the covered opinion rules and the possibility, within the covered opinion rules, of providing a limited scope opinion. That is at best an incomplete response. First, the "legending out" and limited scope exceptions are not available in all circumstances: No "legending out" exclusion is available for written advice regarding listed or principal purpose transactions, or opinions regarding significant purpose transactions that are subject to conditions of confidentiality or contractual protection.<sup>182</sup> Likewise, a limited scope opinion may not be provided in the case of a listed or principal purpose transaction or a marketed opinion. The distortion of a lawyer's role is just as likely in these cases as where a "legending out" exception is available.

Also, there are problems with the legends themselves. As discussed above, the legends may be false, overbroad, or inappropriate for the circumstances; practitioners should not be required to make such statements as a condition of avoiding the covered opinion requirements. A lawyer's role also is distorted by the conditions for providing a limited scope opinion, which as discussed above, appear to place the lawyer in the position of negotiating directly with the client over the scope of the client's rights.

Finally, it is not clear that the covered opinion requirements have any meaningful connection to the level of public confidence in tax professionals. It could just as well be argued that the covered opinion requirements erode confidence among the informed public in their ability to obtain legal advice at a reasonable cost and in a manner suited to their legitimate needs.<sup>183</sup>

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<sup>182</sup> Arguably lawyers who offer confidential tax strategies or charge fees contingent on tax benefits have a greater duty to analyze the entire transaction. Assuming that is the case, a better approach would be to limit practitioners' ability to impose confidentiality restrictions or charge contingent fees. Proposed revisions to Circular 230 would do that for contingent fees. 71 Fed. Reg. 6,421 (Feb. 8, 2006)

<sup>183</sup> See, e.g., Green, *supra* note [100], at 1702 ("[r]espect for the system is jeopardized if rules of practice ban advising about positions that in other contexts may be legitimately advocated and that in some cases ... may be attempted by taxpayers without exposure of penalty to them").

## B. Viewpoint-Based Requirements

Circular 230's viewpoint-based requirements include obligations regarding the method of analysis, conclusions that must be reached, and disclosures that must be made. As a general proposition, the First Amendment subjects viewpoint-based restrictions to a heightened level of scrutiny.<sup>184</sup> However, such restrictions are not *per se* invalid under the professional speech model described above.<sup>185</sup> Instead, each viewpoint-based requirement must be evaluated based on the policy goal that the requirement is intended to serve, whether the requirement is narrowly tailored to its objective, and whether the requirement distorts the usual functioning of the legal profession, prevents the exercise of professional judgment, or requires a professional to make false or misleading statements.

### 1. Requirements Regarding Method of Analysis

Section 10.35 imposes two principal restrictions on the analysis in a covered opinion. The first is that the opinion may not contain internally inconsistent legal analyses or conclusions. As discussed above, the principle difficulty with this requirement is the uncertainty regarding its scope,<sup>186</sup> since it is frequently not clear whether two analyses or conclusions are inconsistent. It is difficult to identify the policy goals served by preventing a lawyer from seeking to distinguish the meanings given to the same term in different provisions of the Code, or addressing alternative analyses. Prohibiting such types of analysis would interfere with the practitioner's obligation to provide a client with a complete assessment of the possible outcomes and with a lawyer's fundamental role in interpreting the law.<sup>187</sup>

The second principal restriction is that, in evaluating a tax issue, a practitioner may not take into account the possibilities that the IRS may not audit a tax return or raise an issue, or that the issue will be resolved

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<sup>184</sup> See, e.g., *Rosenberger v. Rector & Visitors of the Univ. of Va.*, 515 U.S. at 829.

<sup>185</sup> See *Casey*, 505 U.S. at 883-84 (upholding required disclosures by physicians providing abortions).

<sup>186</sup> If an opinion contains literally opposite analyses, one is plainly wrong; accordingly, the practitioner is not competent. Section 10.51(l) defines incompetent and disreputable conduct for which a practitioner may be sanctioned as including the giving of a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading.

by settlement if raised. Section 10.37 imposes this second restriction on written advice that is not a covered opinion. As discussed above, prohibiting a lawyer from taking the audit lottery into account is a noncontroversial restatement of existing ethics rules.<sup>188</sup> On the other hand, prohibiting a lawyer from analyzing the likely responses of the IRS to a position identified on audit interferes with a lawyer's role.

The vast majority of tax disputes are resolved at the administrative level, where the identification, evaluation and resolution of issues generally is faster and less expensive, and Congress has expressed a general policy favoring resolution of tax disputes outside the courts.<sup>189</sup> The IRS, through revenue procedures and other pronouncements, regularly provides channels for resolving specific issues outside the courts. In those cases, advice that fails to take into account the expected position of the IRS would be incomplete.<sup>190</sup> Even if there is no specific administrative channel for resolving an issue, administrative pronouncements are treated as authority for purposes of defining acceptable tax return positions, not merely because of the persuasiveness of pronouncement, or the likelihood that a court may give deference to the positions, but precisely because they represent the view of the IRS and are thought to predict the position that the IRS will take in similar cases. Because predictions of IRS positions can be an important element in identifying a taxpayer's rights, a rule that prohibits such predictions in evaluating a tax issue can significantly distort a lawyer's role and prevent the exercise of professional judgment.

## 2. Required Level of Confidence Regarding Conclusions

Unless an opinion is a marketed opinion, Section 10.35 does not impose minimum levels of confidence. However, an opinion that fails to express a favorable conclusion on a significant Federal tax issue at a

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<sup>187</sup> See generally Bruce A. Green, *The Criminal Regulation of Lawyers*, 67 *Fordham L. Rev.* 327 (1998) (discussing conflicts between criminal law and professional role of protecting public's legal rights).

<sup>188</sup> But see Blattmachr *et al.*, *Application of Circular 230*, *supra* note [61], at 75 n.76 (rule prohibiting a practitioner from referring to possibility that return will not be audited may raise constitutional questions because it would preclude practitioners from giving clients accurate information).

<sup>189</sup> See, e.g., I.R.C. § 7123, which provides for non-binding mediation at the request of a taxpayer or the IRS Office of Appeals on any issue unresolved at the conclusion of appeals procedures or unsuccessful attempts to enter into a closing agreement.

confidence level of at least “more likely than not” must include a “no reliance” legend. A marketed opinion must express a favorable conclusion on each significant Federal tax issue, and regarding the overall tax treatment of the transaction, at a confidence level of at least “more likely than not.”

Requiring “more likely than not” conclusions in marketed opinions is meant to prevent a practitioner from providing advice used by third parties to encourage taxpayers to take improper positions. However, as discussed above, the rule prohibits a practitioner from providing an opinion in circumstances where there is little reason to think that taxpayers are being encouraged to take improper positions – for example, where the rules are uncertain or situations involving only secondary issues. The problem of secondary issues does not arise if the practitioner renders “negative advice” that the position will not succeed, and does not indicate a favorable view at any level of confidence. However, other professional standards may treat such advice as incomplete or misleading if it does not appropriately identify the taxpayer’s rights.<sup>191</sup> Also, the broad definition of a marketed tax shelter results in the rule applying in situations where there is no improper inducement, for example where the advice is provided to a client regarding the client’s tax treatment.

Finally, there is a fundamental question whether the “more likely than not” standard is appropriate. The ethical rules generally apply a “realistic possibility of success” standard, which can be satisfied if there is a one-in-three possibility of success. Likewise, the tax return preparer understatement penalty applies a “realistic possibility of success” standard. In the ethics context, most commentators have rejected a “more likely than not” standard because of the inherent subjectivity of a percentage-based standard and because such a standard unduly restricts the positions that a taxpayer may assert on a return.<sup>192</sup>

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<sup>190</sup> A corporate tax shelter opinion that takes into account the possibility of settlement in reaching a “more likely than not” confidence level may not be relied upon as a defense against the penalties of Treas. Reg. § 1.6664-4(f)(2)(B). However, there is no ethical prohibition against a lawyer’s rendering such an opinion.

<sup>191</sup> Formal Opinion 346 specifically requires a lawyer to “fully and fairly address” each relevant material tax issue.

<sup>192</sup> See *supra* notes [97] to [102]. Cf. Wolfman et al., *supra* note [49], § 202.3.1.2 (a “substantial authority standard is more stringent than the professional standard currently governing practitioners in recommending positions that may be taken on the taxpayer’s return”); Green, *supra* note [100], at 1698 (a

The minimum-level-of-confidence standards also interfere in significant ways with a lawyer's role in providing tax advice and the legitimate exercise of a lawyer's judgment. Consider three situations where a lawyer renders tax advice: (1) advice addressed to a client and discussing the tax treatment of the client, (2) advice addressed to a client and discussing the tax treatment of a third party (such as a business counterparty of the client), and (3) advice addressed to a third party and discussing the tax treatment of the third party. In the first situation, assume that the lawyer is rendering tax advice to a client regarding the client's treatment in a tax shelter transaction but that the lawyer knows the advice will be used by a promoter in marketing the transaction to the client – for example, because the client asks the lawyer to send a draft of the advice to the promoter for comments. In this situation, the limits on the lawyer's ability to provide advice should be no greater than the client's right to act on such advice.<sup>193</sup> If the client has the right to file a tax return (subject to any required disclosure) claiming tax benefits from the transaction, it should not be deprived of the lawyer's advice regarding the strength of the position, even if the lawyer does not reach a conclusion at a confidence level of at least "more likely than not."<sup>194</sup> True, the lawyer's inability to reach that level of confidence normally will prevent the client from using it to establish a reasonable cause and good faith defense against penalties. However, the client has a right to assert the position on a tax return pending resolution of the relevant issues; and the penalties will apply only if the client's position ultimately is determined to be incorrect.<sup>195</sup>

The fact that the lawyer's advice is used by the tax shelter promoter should not affect the foregoing analysis. It might be argued that either the promoter or the client may press the lawyer to reach a favorable conclusion on an improper transaction. However, a fundamental tenet of legal ethics is the lawyer's duty to exercise independent professional judgment in the face of such pressure.<sup>196</sup> A rule based

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"more stringent return position standard will result in more meritorious positions being placed beyond the pale of ethical tax advice").

<sup>193</sup> Cf. Casey, 505 U.S. at 884 ("Whatever constitutional status the doctor-patient relation may have as a general matter, in the present context it is derivative of the woman's position").

<sup>194</sup> Cf., Trucksess, *supra* note [99] at 762-63.

<sup>195</sup> See *supra* at notes [100] to [102].

<sup>196</sup> See, e.g., Model Rules R. 2.1; Model Code Canon 5.



on the assumption that a lawyer will not exercise such judgment fundamentally distorts the role of a lawyer by preventing both good and bad lawyering. Another concern may be that the promoter will use the lawyer's advice to encourage the client to take a risky position; that is, the client will make bad choices based on the lawyer's advice. However, this argument suffers from two flaws. First, the lawyer generally will have a duty to explain the risks.<sup>197</sup> Second, any problem that exists is one of bad choices, not of truthful information: "It is precisely this kind of choice, between the dangers of suppressing information, and the dangers of its misuse if it is freely available, that the First Amendment makes for us."<sup>198</sup>

Now consider the second situation, in which the lawyer advises a client about the tax treatment of a third party. Assume that the client is the tax shelter promoter and seeks advice about the treatment of a third party investor in the shelter, and that the lawyer knows the client will use the advice to market the tax shelter to the third party. Further assume, however, that the lawyer's advice is not addressed to the third party and that the client's marketing efforts will not refer to the lawyer's advice. Here again, the limits on the lawyer's ability to provide advice should be no greater than the client's right to act on such advice. The lawyer will have a duty not to knowingly participate in the development of a tax shelter that lacks a realistic possibility of success, and will have a duty to advise the client of its legal obligations in

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<sup>197</sup> See Model Rules R. 1.4(b) (a "lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation"); Model Code EC 7-8 (a "lawyer should exert his best efforts to insure that decisions of his client are made only after the client has been informed of relevant considerations").

<sup>198</sup> *Va. Bd. Of Pharmacy v. Va. Citizens Consumer Council, Inc.*, 425 U.S. 748, 770 (1976). See also *First Nat'l Bank v. Bellotti*, 435 U.S. 765, 791-92 (1978); *Linmark Assocs. v. Twp. of Willingboro*, 431 U.S. 85, 96-97 (1977). The government will frequently seek to justify restrictions on speech by arguing that the speech is not in an individual's or the public's interest. Such justifications are generally referred to in First Amendment theory as "paternalism," and a First Amendment doctrine has developed around the rejection of such justifications. See *Carpenter*, *supra* note [3]. See also *Volokh*, *supra* note [3], at 1304 (the "premise of modern First Amendment law is that the government generally may not (with a few narrow exceptions) punish speech because of a fear, even a justified fear, that the people will make the wrong decisions based on that speech"). Nevertheless, the boundary between speech that falls outside professional norms, and speech that merely reflects a professionally controversial position, often is unclear. Attempts to prohibit marginal professional views raise important First Amendment issues. See, e.g., *Opinion No. 02-12-1* (A.G. Iowa Dec. 10, 2002) (analyzing Dental Board rule prohibiting dentists from recommending removal of restorations from nonallergic patients for alleged purpose of removing toxic substances from body, and concluding that Dental Board had responsibility to monitor scientific support for its position).

marketing the tax shelter, such as any duty to report the tax shelter and to maintain documentation regarding the tax shelter and the marketing efforts. However, if the client is permitted to market the tax shelter, it cannot be deprived of legal advice regarding the tax shelter it is marketing.

Finally, consider the third situation, in which the lawyer gives advice to a third party about the tax treatment of the third party. Assume that the client, the tax shelter promoter, asks the lawyer to prepare advice for a third party investor in the tax shelter regarding the investor's tax treatment. In this case, the effect of restrictions on the lawyer's advice is to restrict the client's marketing activities. Even if other marketing activities are not prohibited, regulating the lawyer's advice may be considered important because of the perceived authority of a lawyer's advice.

This situation is more complex than the others, because it involves First Amendment limits on the regulation of both professional speech and commercial-type speech. The initial question is whether providing legal advice as part of a marketing effort is an accepted part of a lawyer's role. Lawyers representing sellers frequently will be called upon to provide advice to potential purchasers. For example, a lawyer representing a seller of property may be called upon to provide a good-title opinion to the purchaser, or a lawyer for an issuer of securities may be called upon to provide a tax disclosure in a prospectus. Such role is specifically addressed by the ethical rules and other guidance.<sup>199</sup>

The ethical rules nevertheless highlight the tension that arises when a lawyer renders an opinion at the client's request to a third party. In those circumstances, the lawyer assumes responsibilities to the third party as well as to the client. As stated in Formal Opinion 346, "[t]hese third persons have an interest in the integrity of the evaluation." Under Model Rule 3.1, a lawyer may provide such advice if the lawyer reasonably believes that providing the opinion "is compatible with other aspects of the lawyer's relationship with the client." Where providing the opinion is likely to have a material adverse effect on the client's interests, the lawyer must obtain the client's informed consent before providing the opinion.

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<sup>199</sup> See, e.g., Model Rules R. 2.3 cmt.; ABA Formal Opinion 335; ABA Formal Opinion 346.

Under the ethical rules, the lawyer rendering an opinion to a third party has a duty of candor, and must exercise independent professional judgment. Thus, the lawyer must disclose to the third party any limitation on the scope of the opinion or limitation imposed by the client.<sup>200</sup> The lawyer must not knowingly make a false statement of material fact or law in providing the opinion.<sup>201</sup> However, assuming that the client and the third party are otherwise acting within the bounds of the law, the lawyer has no duty to evaluate whether the thing being sold by the client is appropriate for the third party's needs.

A similar analysis should apply for purposes of the First Amendment. If the third party would have the right to file a tax return claiming tax benefits based on the relative strength of the position, the lawyer should not be prevented from providing an otherwise accurate and complete opinion merely because the transaction is uncertain or risky. A rule prohibiting the lawyer from providing the opinion could be justified only on the ground that the third party might be persuaded to take undue tax risk. However, as discussed above, the "bad choices" rationale for restricting truthful speech has been emphatically rejected by the Supreme Court.<sup>202</sup>

### 3. Required Disclosures and Prohibition Against Contrary Advice

Section 10.35 provides for various disclosures on written advice, either as conditions for qualifying under a specific exception from the covered opinion rules or as absolute requirements for covered opinions with certain characteristics. In the first category are the "legending out" disclosures for reliance opinions or marketed opinions and the disclosures for limited scope opinions. In the second category are the required disclosures for covered opinions that are marketed opinions and opinions (other than marketed opinions) that fail to reach a "more likely than not" conclusion. If a disclosure is required under Section 10.35, a practitioner may not provide advice that is contrary to or inconsistent with the required disclosure.

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<sup>200</sup> Model Rules R. 2.3 cmt.

<sup>201</sup> *Id.*

<sup>202</sup> Dale Carpenter has noted that the antipaternalism principle is not limited to the rejection of justifications based on the harm that may be caused to the direct recipient of the speech. Rather, the principle "is hostile

As discussed above, the “no reliance” legend is inaccurate in a number of respects: (i) there currently is no rule prohibiting a taxpayer from relying on a “no reliance” opinion; (ii) in the case of tax shelters that are not reportable transactions, a non-corporate taxpayer may assert reliance on an opinion reaching a lower level of confidence; and (iii) the “no reliance” legend is inconsistent with a taxpayer’s ability to rely on an opinion to avoid the penalties for negligence, disregard of rules or regulations, and fraud. By requiring a lawyer to include a “no reliance” legend in circumstances in which the written advice could in fact be relied upon by the taxpayer, and by prohibiting a lawyer from providing advice contrary to or inconsistent with the “no reliance” legend, Section 10.35 creates a significant conflict with a lawyer’s ethical duties to provide competent advice and exercise independent judgement, and interferes in significant ways with a lawyer’s role. Likewise, the “consumer protection” legend is inaccurate in cases where the opinion is rendered by the lawyer to a client and addresses the client’s tax treatment.

From a First Amendment perspective, there is no sufficiently compelling justification to require a lawyer to make false or misleading statements.<sup>203</sup> Rather, First Amendment case law has permitted required disclosures by professionals only where such disclosures were “truthful and nonmisleading.”<sup>204</sup> Moreover, First Amendment case law has specifically condemned restrictions on legal advocacy that effectively deny a client access to legal advice.<sup>205</sup>

### **C. Covered Opinion Requirements Permitted Under the Professional Speech Model**

Many of the covered opinion standards appear to be derived from the requirements for opinions used to establish a reasonable cause and good faith defense against corporate tax shelter penalties,<sup>206</sup> and an

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to attempts by the government to restrict speech on the grounds that, after receiving speech, citizens will make decisions based on the speech which in the aggregate harm the collective welfare.” Carpenter, *supra* note [3], at 618.

<sup>203</sup> See Blattmachr *et al.*, *Circular 230 Redux*, *supra* note [51], at 1534; Blattmachr *et al.*, *Application of Circular 230*, *supra* note [61], at 74-75 (First Amendment implications of requiring a “no reliance” legend that is inconsistent with the applicable penalty rules).

<sup>204</sup> See Casey, 505 U.S. at 882. See also Eubanks v. Schmidt, 126 F.Supp.2d at 457-60.

<sup>205</sup> See Velasquez, 531 U.S. at 545.

<sup>206</sup> See Treas. Reg. §§ 1.6664-4(c)(1) (factual due diligence obligations), 1.6664-4(f)(2)(B)(2) (relation of the law to the facts, and conclusion at a greater-than 50% confidence level), 1.6664-4(f)(2)(B) (opinion does

apparent purpose of the standards is to make clear to a taxpayer the extent to which it may rely on the advice for penalty defense.<sup>207</sup> However, as discussed above, the standards for penalty-defense opinions are not appropriate over the whole range of clients' needs for tax advice, and imposing those standards across the board significantly distorts a lawyer's role in many circumstances.

The policy objectives could be achieved far more directly by requiring an opinion to state whether it is intended to be relied upon to establish a reasonable cause and good faith defense to penalties. If so, it would be appropriate to require that the opinion comply with the standards for penalty-defense opinions. Other advice would be subject to the general due diligence and competency standards of Section 10.22 and Section 10.51 of Circular 230. Consistent with those general standards, where a practitioner's advice purports to reach a definitive conclusion about the tax treatment of specific facts, the practitioner could be required to (1) identify the scope of the opinion, (2) state the purposes for which it has been prepared, and (3) identify the persons who may rely on the opinion. Likewise, the rules could prohibit opinions that are based on unreasonable factual or legal assumptions, that unreasonably rely upon representations, statements, findings or agreements, or that fail to consider all relevant facts that the practitioner knows or should know. The rules could require such opinions, within the scope of the opinion, to (i) relate the applicable law to the facts, (ii) identify and address the relevant legal issues, (iii) reach conclusions regarding such issues, and (iv) where relevant to the purpose of the opinion, state the extent to which such conclusions affect the recipient's right to report a position on its tax return and the potential penalties if the position is not sustained. Finally, the rules could prohibit a practitioner from taking into account the possibility that a tax return will not be audited, or that a the position will not be discovered in an audit. However, the practitioner could take into account the possibilities that an issue would not be raised once detected by the IRS, or would be resolved at the administrative level.

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not take into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled).

<sup>207</sup> See Wolfman *et al.*, *supra* note [49], § 208.5.3 (discussing the 2003 proposed covered opinion rules).

Special standards would continue to apply to marketed tax shelter opinions, defined as opinions addressed to third parties and used by a tax shelter promoter for marketing purposes (including tax disclosures and materials that will be referred to in marketing efforts). Consistent with Formal Opinion 346 and the consumer protection concerns associated with marketed tax shelter opinions, the rules could require a full-fledged opinion along the lines of the covered opinion requirements of Section 10.35. The principal differences between present Section 10.35 and the suggested revisions relate to the scope of the issues that the opinion must consider, the permissible analytical methods, the required level of confidence for conclusions, and the content of the required disclosures. The rules would require such a marketed opinion to address all Federal tax issues (i) that could have a significant impact on the overall tax treatment of the transaction, and (ii) for which there is a reasonable possibility of challenge by the IRS. The opinion would not have to address every tax issue for which the IRS has a reasonable basis for a successful challenge. The opinion would have to conclude that all the tax benefits being promoted have a realistic possibility of being sustained if challenged by the IRS. However, to the extent that a taxpayer would have a right to assert the benefits on a tax return and the promoter would have a right to market the transaction, the opinion would not have to conclude that the taxpayer is “more likely than not” to succeed if such benefits are challenged. Finally, the opinion would have to (1) address the potential penalties if the benefits are successfully challenged, (2) address the extent to which a taxpayer may rely upon the opinion as a defense against such penalties, (3) state that it was written to support the marketing of the transaction, and that the taxpayer should seek independent tax advice, and (4) disclose the existence of any compensation or referral arrangement between the promoter and the practitioner.

**D. Covered Opinion Requirements for Marketed Tax Shelter Opinions Permitted Under the “Hearer-Centered” Theory**

In certain respects the Circular 230 requirements for tax opinions used to market tax shelters can be compared to the requirements for securities offering materials. Securities offering materials can be seen

as a form of commercial speech, and it may be appropriate to consider tax shelter opinions used for marketing purposes in a similar light.<sup>208</sup>

As discussed above, the purpose of the “hearer-centered” First Amendment theory is to ensure that the recipient of commercial-type speech receives information that enhances his or her ability to make an informed and autonomous choice. Under such a theory, the government can prohibit false or misleading speech, or speech that promotes an unlawful choice, and can require inclusion of information that helps the recipient make an informed choice. However, absent a compelling need and narrowly tailored measures, the government cannot prohibit the communication of truthful, non-misleading information, regardless of the risk that the recipient will use the information to make an undesirable choice, and cannot impose inaccurate prophylactic rules.

Applying the “hearer-centered” theory to the Circular 230 restrictions on marketed tax shelter opinions results in a somewhat different analysis than under the professional speech model. Consider first the requirement that a lawyer address each significant issue for which the IRS has a “reasonable basis” for a successful challenge. Under a “hearer-centered” theory, such a requirement will be evaluated principally based on whether it promotes an informed and autonomous choice by the recipient. That, in turn, depends on whether the use of a “reasonable basis” standard, rather than the “reasonable possibility of challenge” standard under the professional rules, is furthers or hinders the recipient’s informed choice. Because the “reasonable basis” standard is more comprehensive and more objective than the “reasonable possibility of challenge” standard, a court is likely to conclude that the “reasonable basis” standard furthers, or at least does not materially hinder, the recipient’s informed decision making. The burden would be on the challenger to establish that the “reasonable basis” requirement prevents an informed choice, for example, by submerging important risks in speculative ones, by deterring lawyers from providing important advice

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<sup>208</sup> See generally, Bevier, *supra* note [3]; Dooley, *supra* note [3]; Neuborne, *supra* note [3]; Pinto, *supra* note [3]; Schoeman, *supra* note [3]; Wolfson, *supra* note [3]; Boyer, *supra* note [3].

out of a fear of the consequences of failing to identify an issue, or by making legal advice prohibitively expensive.<sup>209</sup>

Second, consider the prohibition against a lawyer's 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. A professional speech model would allow rules prohibiting a lawyer from taking into account the likelihood of detection, but would strike down rules prohibiting a lawyer from taking into account the likely responses of the IRS after the issue has been identified in an audit. Under a "hearer-centered" theory, all of the prohibitions would be problematic for two reasons: First, they prevent the recipient from making an informed choice based on clearly relevant and significant information, and second, they prevent the recipient from choosing to take the risk that the matter will be identified and challenged by the IRS, and will not be resolved at the administrative level.

Third, consider the requirement that the opinion reach a favorable conclusion on each significant tax issue at a confidence level of at least "more likely than not." As discussed above, such requirement prohibits advice reaching a favorable conclusion at a lower level of confidence, regardless of whether the taxpayer has a right to claim the uncertain position on a tax return. The prohibition against advice at a lower level of confidence is a prophylactic rule that treats the lower-confidence-level conclusions as inherently invalid, or as encouraging bad choices. The professional speech theory would find problems with this rule based on a lawyer's duties to a client; a "hearer-centered" theory would not allow the prohibition against lower-confidence-level conclusions, both because the advice may well be correct, and because of the paternalistic effect of the prohibition.

## CONCLUSION

The recent surge in illegitimate tax shelters is undeniably a problem for the tax system. Moreover, the behavior of certain professionals in developing, promoting and executing highly abusive tax shelters is

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<sup>209</sup> See Pinto, *supra* note [3], at 94.



deplorable. However, the Circular 230 requirements for covered opinions are in many respects an inappropriate response to these problems. The requirements effectively impose a framework and prohibitions on advice in ways that prevent a lawyer from giving taxpayers a complete, informed assessment of their rights. In certain circumstances the rules create significant ethical conflicts and deny the public legal advice. More generally, they distort the lawyer's role and erode the principles underlying legal ethics rules. The restriction of information and distortion of a lawyer's role make the rules vulnerable to a First Amendment challenge under the doctrines of professional speech and, in the case of tax opinions used to market tax shelters to third parties, under a general "hearer-centered" First Amendment theory.