U.S. Treasury Releases Final Rules On Tax Practitioner Written Advice, Competency and Risk Management

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Introduction

On June 12, 2014, the United States Treasury Department published long-awaited regulatory changes to Circular No. 230 regarding several key aspects of practice before the Internal Revenue Service ("IRS").[1] Effective immediately, many of the June 14 rules fundamentally alter the way written client communications should be negotiated, prepared and delivered. They also change the manner in which federal tax practitioners in firms of all sizes (from 1 to 1,000+) should establish and implement internal risk management. Some of the changes are described in greater detail below, including:

- The elimination of the "covered opinion" standards in former section 10.35 and the expansion (both in scope and degree) of principal-based standards for all written federal tax advice, including opinions and other substantive communications.
- The expansion of the standards for practitioner competence.
- The extension of compliance-driven procedures in section 10.36 to all of the substantive rules within Circular 230 that govern practitioners.

Summary

For the first time in a generation, Circular 230 eschews proscriptive rules for written federal tax advice, including the form of delivery. When a client requests written tax advice, the practitioner will be required to use reasoned judgment to determine the nature and scope of the advice and the appropriate path to take from initiation of the service to delivery of the work product, keeping in mind all facts and circumstances. A practitioner may no longer rely on one or more of the now prevalent standardized legends in order to reduce the duty of care and diligence otherwise appropriately required in delivering written advice, including the infamous Circular 230 disclosures that legend nearly every advisor email, letter, information bulletin and other written communication.

Tax practice leader(s) in professional services firms are required to go beyond the scope of opinion and tax return review to all practitioner responsibilities governed by Circular 230, including oversight with respect to the new minimum competency requirements (or "table stakes"). Firms that offer federal tax services are now required to review existing internal controls and governance practices against the new paradigm presented by the June 2014 rules. From such a review, a renewed emphasis on practitioner development and oversight,

[1] Treas. Dec. 9668 (the "June 2014 Rules"), adopting substantially as proposed rules first released in REG-138367-06, 77 (Sept. 17, 2012) (the "September 2012 Proposals"). All section references are to Circular No. 230 ("Circular 230").

client communication and risk management will likely emerge. Hopefully, firms will see those developments as silver linings, permitting them to readjust internal management roles over tax advisory and opinion practices. The June 2014 rules also present an opportunity—and an obligation—for firms to communicate with clients about the impact the revised rules will have on firms and clients alike.

Discussion

1. Written Tax Advice (Including Opinions).

a. Descriptions.

As expected, the June 2014 Rules eliminate the covered opinion rules in former section 10.35 and withdraw proposed rules concerning state or local bond opinions (prior proposed section 10.39). In their stead, revised section 10.37 provides principal-based guidance which applies to the provision of all written tax advice, a logical extension of the "due diligence" rules of section 10.22. Generally, a practitioner is required to base any written advice concerning one or more Federal tax matters on reasonable factual and legal assumptions, reasonably consider all relevant facts the practitioner knows or should know, use reasonable efforts to identify and ascertain all relevant facts, not rely on input from the taxpayer or any other person if such reliance would be unreasonable and, in evaluating a Federal tax matter, not take the likelihood of an audit into account.

Unlike the former rules, the guidance set forth in section 10.37 does not mandate a particular form of written advice. It does include electronic communications within its scope, an appropriate measure in light of today's reliance on e-mail and messaging. The June 2014 Rules adopt a facts and circumstances approach which in application should take into account the type of tax advice the client requests and practitioner agrees to provide, the practitioner's knowledge of the client's affairs, the complexity of the underlying facts or hypothetical situation to be considered, and the appropriateness of assumptions to be used. In determining the appropriate choice of format of the written communication, the nature and complexity of the issues presented and other material terms of the engagement should also be considered by the practitioner and discussed with the client.

The June 2014 Rules contain several refinements to section 10.37 since its re-proposal. First, "Federal tax matter" is defined expansively to reflect "the broad nature of advice rendered … in today's [federal tax] practice environment."[2] Second, two forms of written communication are carved-out from section 10.37 – submissions to a governmental body or agency on matters of general policy; and continuing education presentations provided solely for the purpose of enhancing the audience's professional knowledge of one or more Federal tax matters.[3]

[2] Preamble to the June 2014 Rules. For purposes of section 10.37, a Federal tax matter is any matter concerning the application or interpretation of (1) a revenue provision as defined in IRC section 6110(i)(1)(B), (2) any provision of law impacting a person's obligations under the internal revenue laws and regulations, including but not limited to the person's liability to pay tax or obligation to file returns, or (3) any other law or regulation administered by the IRS.

[3] Although exempt from the written advice rules, CLE/CPE materials would continue to be regulated under the due diligence and competency standards of Sections 10.22 and 10.35. Preamble to the June 2014 Rules.

The June 2014 Rules address several open items presented by the September 2012 Proposals concerning reliance by a practitioner on others in her written advice, as set forth in section 10.37(b). As a general matter, the third-party advice must be reasonable and the practitioner must rely in good faith (considering all facts and circumstances). As an initial modification, the June 2014 Rules clarify the advice may come from any other person, including appraisers and other individuals not subject to Circular 230. In addition, reliance on another is not reasonable if one "knows or reasonably should have known" the other person's opinion should not be relied on, the other person is not competent to provide the advice, or the other person has a conflict of interest. The Preamble clearly states the practitioner has an affirmative duty to inquire into the skills and experience of the other person absent his prior knowledge of the other person's background.

Finally, a new performance benchmark has been added - section 10.37(c)'s "standard of review." For practitioner disciplinary matters, in determining whether specific advice adheres to section 10.37 the IRS will apply a reasonable practitioner standard, considering all facts and circumstances, including the scope of the engagement and the type and specificity of the advice the client sought. The Preamble makes clear the totality of the facts before the practitioner, and not a rigid adherence to each requirement for written advice, will be the touchstone for post-advice evaluation by the IRS. Further, for marketed tax advice, section 10.37(c)(2) notes emphasis will be paid to how the practitioner avoided additional risk otherwise caused by her failure to obtain knowledge of the actual taxpayer's particular facts and circumstances.[4]

b. Impact of the Proposals.

The approach now taken by section 10.37 (together with new section 10.39 and revised section 10.35) establishes a more comprehensive, yet flexible, standard for the establishment (and evaluation) of written Federal tax advice. Factors for consideration here are (i) the nature of the issues to be addressed; (ii) the client's internal tax risk management resources and level of informed participation in tax issue resolution; (iii) the practitioner's prior knowledge of the client and the completeness of the fact pattern conveyed to the practitioner; and (iv) the medium of the suggested written communication (email, separate tax communication, combined tax and non-tax legal advisory communication, marketing tax shelter opinion, etc.).

With the elimination of former section 10.35, practitioners will see little utility in continued use of standardized Circular 230 "legends" on general communications to non-firm recipients. More importantly, all firms should review any standardized disclaimer to ensure the continued accuracy of the statement. The Preamble to the June 2014 Rules states "Treasury and the IRS expect that [the June 2014 Rules] will eliminate the use of a Circular 230 disclosure in e-mail and other writings." Continued use of general disclaimers after a brief transition period could perhaps be interpreted as a violation of the general "due diligence" or competency requirements of sections 10.22 and 10.36.

[4] This new rule of review is in lieu of the "heightened standard of review" test for targeted or marketed tax shelter documents described in the September 2012 Proposals.

2. "Table Stakes" Competency Requirement.

a. Description of Proposal.

The June 2014 Rules convert section 10.35 (formerly the "covered opinion" rules) into an affirmative obligation by each practitioner to possess the level of competence required to practice before the IRS. Specifically, revised section 10.35 mandates that each practitioner have the necessary competence to engage in such practice on a Federal tax matter before the IRS, including required knowledge, skill, thoroughness of analysis and preparation necessary for the particular client matter. Those rules now make clear competence can be gained through legal research as well as consultation with relevant experts, provided the adequacy of obtained competence is established by the facts and circumstances at hand.

b. Impact of Proposal.

The determination of competency which rewritten section 10.35 requires will turn on the specific facts and circumstances of the proposed engagement. Traditional training and mentored experience, as well as periodic participation in formal continuing legal or other professional education, appear to be implicit obligations of a practitioner, regardless of their broad or narrow field of practice. One would also imagine the competency requirement, when coupled with the risk management mandates described below, should necessitate an internal evaluation of a particular practitioner's skills, knowledge and availability to address the issues presented by a particular client's case or fact pattern. Where competency is not immediately present, reasonable reliance on other tax practitioners or on individuals outside of the contracting firm is available to close the gap. Clear and unambiguous descriptions of the scope of the engagement for Federal tax services, including the nature and extent of the effort by the practitioner, the participation in the engagement by the client, and the type of work product the parties expect to be delivered will aide in bringing focus to the underlying required competencies.

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

a. Description of Proposal.

Prior to the release of the June 2014 Rules, the leader of the tax practice in a firm had been required to plan for, adopt and execute procedures to ensure firm compliance with former section 10.35 (i.e., covered opinions) and in connection with preparation of returns or other submissions to the IRS (section 10.36). The new rules expand the risk management responsibilities currently in force to all applicable provisions in Subparts A, B and C of Circular 230. In the event the tax practice leader is not a practitioner under Circular 230, the risk management responsibilities fall on a management team member who is such a practitioner or upon a non-management member of the firm who is a practitioner under Circular 230 (potentially as directed by the IRS). Revised section 10.36 subjects practice leaders who are practitioners under Circular 230 to disciplinary actions for certain

failures to ensure that adequate procedures are in place and implemented.

b. Impact of Proposal.

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

This change should greatly increase the need for review of advice prepared or to be provided junior professionals by a qualified partner or principal. Indeed, revised section 10.22(b) makes this link, and influences the client expense associated with that type of service. These efforts could perhaps be hindered by the fact the June 2014 Rules lack detail on the types of oversight responsibilities which the US Treasury Department has in mind. Would it include tax-leadership oversight related to client acceptance (including conflict review), engagement letter negotiation, staffing determinations, or merely the provision of substantive advice? We believe it is likely tax practice leaders will need to reassess all facets of their practice and stewardship over firm matters in order to demonstrate compliance with the section 10.36 obligations.