College of Tax Counsel Seeks Changes to Proposed Circular 230 Regs

MAY 30, 2006

Citations: 31 U.S.C. section 330

SUMMARY BY TAX ANALYSTS

Frederic Ballard, Jr. of the American College of Tax Counsel, Washington, has urged the withdrawal of provisions under proposed Circular 230 regulations (REG-122380-02) that expand the scope of practice before the IRS, conflicts of interest rules, and publicity of proceedings and provisions that limit certain contingent fees.

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Honorable Eric Solomon
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Honorable Donald L. Korb
Chief Counsel
Internal Revenue Service
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RE: Proposed Amendments to Regulations Governing Practice Before the Internal Revenue Service.

Dear Acting Assistant Secretary Solomon and Chief Counsel Korb:

I am pleased to submit the comments of the American College of Tax Counsel ("ACTC") with respect to the Notice of Proposed Rulemaking that was published in the Federal Register on February 8, 2006, 71 Fed. Reg. 6421-6437 (the "Notice"), proposing amendments (the "Proposed Amendments") to the regulations governing practice before the Internal Revenue Service, 31 C.F.R. Part 10 (the "Regulations"). The ACTC is a professional association consisting of approximately 650 of the leading tax lawyers in the country who are selected on the basis of their professional reputations as well as demonstrated achievement in the areas of lecturing, writing, teaching and bar activities in the tax field. The College and its members have been in the forefront of efforts over the past twenty-five years to increase the professionalism of the tax bar, both the private and the public sectors. We believe those efforts are most likely to succeed when they involve state and local bar associations, professional organizations, and the Government, each acting within its area of particular competence.

These comments were drafted by our Committee on Professionalism and approved by our Board. Our comments are principally directed at four specific areas of the Proposed Amendments:

1. Expansion of the scope of "practice before the Internal Revenue Service;"

2. Contingent Fees;

3. Conflict of Interest;

4. Publicity of Proceedings;

Expansion of Scope of "Practice before the Internal Revenue Service"

For over twenty years, Circular 230 has contained provisions pursuant to which the Director of Practice has been authorized to impose discipline for disreputable conduct relating to the issuance of "tax shelter opinions." Since not all such opinions were prepared for delivery to the Internal Revenue Service and because of constitutional concerns, the exercise of regulatory authority rested on the Treasury Department's authority to sanction individuals who practice before the Internal Revenue Service who engage in disreputable conduct by issuing opinions that fail to meet the standards prescribed by the Treasury for reputable conduct—not by asserting that all such opinions were "practice before the Internal Revenue Service."

There were two constitutional concerns that factored into the approach toward "tax shelter opinions" that was adopted in 1984: encroachment on regulatory power constitutionally vested in the States; and pre-emption of State laws, including ethics rules. As discussed below, we believe the proposed amendments to Circular 230, Section 10.2(a)(4) and proposed addition of Section 10.27(c)(2) elevate those concerns to new levels, and do so unnecessarily and improperly.

The proposed amendment of Section 10.2(d) (proposed as redesignated Section 10.02(a)(4)) would expand "practice before the Internal Revenue Service" to all forms of written tax advice, including emails, whether or not the author or the taxpayer ever intended to deliver or file a copy with the Internal Revenue Service or the copy is voluntarily filed with the Internal Revenue Service on some reasonably contemporaneous basis. Thus, it proposes to make an activity that has no direct presence before the Internal Revenue Service "practice before the Internal Revenue Service."

The proposed new Section 10.27(c)(2) definition of "matter before the Internal Revenue Service" for purposes of the unconscionable fee prohibition and contingent fee limitation provisions of Section 10.27 would expressly expand the scope of that rule to all "tax planning and advice," without regard to whether or not the planning or advice is acted upon by the taxpayer, results in taxpayer inaction, rather than taxpayer action, or the advice is written advice. As such, it clearly goes beyond the scope of the

proposed amendment to the definition of "practice before the Internal Revenue Service" in Section 10.2.

Prior to 1966, attorneys desiring to practice before the Internal Revenue Service had to apply for admission and obtain a "Treasury card," and certified public accountants had to go through special enrollment procedures, similar in many respects to the procedures that persons who desire to become "enrolled agents" must pursue today. Congress believed that agency admission practice unnecessarily intruded into a client's ability to seek representation of the client's own choosing and that the state licensure process ensured that persons licensed and in good standing possessed satisfactory moral character to represent clients before federal agencies, including the Treasury Department and the Internal Revenue Service. Consequently, over the objections of the Treasury Department, Congress enacted the Act of November 8, 1965, commonly known as the Agency Practice Act of 1965, Pub. L. No. 89-332, 89th Cong., 1st sess., 79 Stat. 1281, currently codified in 5 U.S.C. §500, requiring Treasury to rely in the first instance on state licensure as the authorization to practice, unless and until Treasury suspended or terminated that right for incompetence or disreputable conduct by the practitioner.

The House Report on the Agency Practice Act of 1965 illustrates Congress's sensitivity to the impact of federal legislation upon state laws and regulation of professionals. Two years earlier, the Supreme Court had held, in *Sperry v. Florida,* 373 U.S. 379 (1963) that federal agency regulations authorizing individuals to practice before the agency pre-empted state laws that would otherwise restrict or prohibit such practice. Congress was concerned that the Act might be perceived by some as broadening the scope of practice before the Internal Revenue Service that would be encompassed by *Sperry* pre-emption. Thus, for example, in H.R. Rep. No. 1141, 89th Cong., 1st sess. (1965) reprinted at [1965] US Code & Cong. Ad. News 4170, 4171, the House Committee acknowledged that the Agency Practice Act would abolish the special enrollment procedures for certified public accountants desiring to represent clients in "accounting matters before the Internal Revenue Service," and then added "but it is not intended to change the scope of service performed by certified public accountants in practice before that agency." Thus, the 89th Congress sought to preserve state laws and ethics rules from pre-emption by declaring that the practice rights provisions did not expand the scope of practice before the Internal Revenue Service.

The United States Court of Appeals for the District of Columbia Circuit most recently observed:

> It is undisputed that the regulation of the practice of law is traditionally the province of the states. Federal law "may not be interpreted to reach into areas of State sovereignty unless the language of the law compels the intrusion." *City of Abilene v. FCC*, 164 F.3d

> 49, 52 (D.C. Cir. 1999). Otherwise put, "if Congress intends to alter the 'usual constitutional balance between the States and the Federal Government,' it must make its intention to do so 'unmistakably clear in the language of the statute.'" *Will v. Michigan Dep't of State Police*, 491 U.S. 58, 65 (1989) (quoting *Atascadero State Hospital v. Scanlon*, 473 U.S. 234, (1985)). By now it should be abundantly plain that Congress has not made an intention to regulate the practice of law "unmistakably clear" in the language of the GLBA. In *Gregory v. Ashcroft*, 501 U.S. 452 (1991), citing, *inter alia*, *Will* and *Atascadero State Hospital*, the Supreme Court held that [t]his plain statement rule is nothing more than an acknowledgment that the States retain substantial sovereign powers under our constitutional scheme, powers with which Congress does not readily interfere.

American Bar Assoc. v. Federal Trade Comm'n, 430 F.3d 457, 471-472 (D.C. Cir. 2005).

The view of the D.C. Circuit is particularly germane to these issues because disciplinary proceedings under Circular 230 are matters that could reach that appellate court. The Supplementary Information in the Notice of Proposed Rulemaking gives no indication that the Treasury Department or the Internal Revenue Service gave any consideration to these constitutional constraints on their rulemaking authority.

Given the 89th Congress's concern and the absence of any contrary indication in the legislative history of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, it seems reasonable to conclude that the 108th Congress did not intend for the Jobs Act to authorize Treasury to expand the scope of "practice before the Internal Revenue Service" and pre-empt state laws with respect to tax planning and tax advice. The modification of 31 U.S.C. §330 made by Section 822(b) of the Jobs Act does not require or clearly authorize such a sweeping realignment of the "usual constitutional balance." Indeed, that provision can fairly be read as merely affirming that the approach taken in 1984 was a valid way to address imposing sanctions for "disreputable conduct" in the issuance of "tax shelter opinions."

The proposed amendment of Section 10.02(a) goes beyond tax shelter opinions or advice. It literally would expand "practice before the Internal Revenue Service" to all forms of written advice. Any doubts about this analysis seem to be dispelled by the explicitly broad sweep of the proposed definition of "matters before the Internal Revenue Service" in proposed Section 10.27(c)(2). Taken together, these provisions would collectively pre-empt all state laws regulating the qualification and manner of providing "tax planning and tax advice." In other words, the Treasury Department would effectively determine how all federal tax work was done and what the terms of engagement would be between practitioners and their clients, with both state licensed lawyers and certified public accountants being fully authorized, per se, to perform all such services. The states would be left powerless to regulate the conduct of lawyers

and CPAs in the fields of federal tax planning and tax advice. As the D.C. Circuit observed, "[I]t is not reasonable for an agency to decide that Congress has chosen such a course of action in language that is, even charitably viewed, at most ambiguous." *American Bar Assoc., supra,* 430 F.3d at 472.

We therefore urge the Treasury Department and the Internal Revenue Service not to implement either the proposed amendment to present Section 10.2(d) or the proposed addition of Section 10.27(c)(2).

Contingent Fees

As the preceding discussion states, we strongly urge the Treasury Department and the Internal Revenue Service not to implement the proposed addition of Section 10.27(c). If the Treasury Department and the Internal Revenue Service believe that "matters before the Internal Revenue Service" in present Section 10.27(a) is an ambiguous term, it could simply be changed to "practice before the Internal Revenue Service." Alternatively, it could be defined with reference to the definition of "practice before the Internal Revenue Service" in Section 10.2. For the reasons previously stated, we believe adoption of proposed Section 10.27(c) would seriously alter the balance between federal and state regulation of attorneys.

The Supplementary Information in the Notice of Proposed Rulemaking, states, at 71 Fed. Reg. 6424, "Additionally a broader prohibition against contingent fee arrangements is appropriate in light of concerns regarding attorney and auditor independence. The recent shift toward even greater independence, including rules adopted by the Securities and Exchange Commission [SEC] and Public Company Accounting Oversight Board, also support expanding the prohibition on contingent fees with respect to Federal tax matters." Whatever the validity of this rationale may be with respect to auditors of publicly-held firms, it is has absolutely no credence in the case of attorneys.

Attorneys and accountants are different professions with different roles in society and different ethical duties toward their clients. As the Supreme Court observed in *United States v. Arthur Young & Co.,* 465 U.S. 805, 817-18 (1984),

> The *Hickman* work-product doctrine was founded upon the private attorney's role as the client's confidential adviser and advocate, a loyal representative whose duty it is to present the client's case in the most favorable possible light. An independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporations financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant

> performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.

Attorneys are not "independent" from their clients in the sense that auditors must be "independent" of the clients whose financial statements they audit. Indeed, seeking to compel an attorney to be "independent" from the client would totally destroy the foundation of the attorney-client relationship: the client's trust that the attorney will represent the client's interests with warm zeal. As stated in the ABA Model Rules of Professional Conduct Preface [11], "independence" for lawyers relates in large part to independence from government domination. "An independent legal profession is an important force in preserving government under law, for abuse of legal authority is more readily challenged by a profession whose members are not dependent on government for the right to practice." *Id.* A prohibition against contingent fees for representing clients before governmental bodies actually impairs the independence of the legal profession.

Section 10.27 already prohibits the charging of an "unconscionable fee." A contingent fee is not always appropriate and can be "unconscionable" if it is inappropriate, or the amount of the contingent fee is excessive under the facts and circumstances. Most state legal ethics rules that permit contingent fees recognize these general principles. Thus, it seems inappropriate for the Treasury Department and the Internal Revenue Service to intrude into the attorney-client relationship that is already regulated by state laws, effectively pre-empting those laws.

The proposed additional restrictions on contingent fees are also contrary to the legislative intent behind the Agency Practice Act of 1965, *supra*. In those circumstances in which a contingent fee is appropriate, and is the only basis upon which a taxpayer can engage legal counsel to represent the taxpayer, prohibiting the attorney and client from reaching agreement on a fair and appropriate contingent fee effectively deprives the client of the right to be represented before the Internal Revenue Service by the attorney of the client's own choice. H.R. Rep. No. 1141, *supra*. Treasury should not, through prohibition of contingent fees, do what Congress determined Treasury should not do by an application process. The effect on the attorney-client relationship is the same, and these proposed new restrictions should therefore not be adopted with respect to attorneys.

The notice of proposed rulemaking proposes additional changes in the existing contingent fee rules concerning refund claims. In this regard, it is important to remember that refund claims are required, jurisdictional documents. Under section 6511 of the Internal Revenue Code of 1986, as amended (the "Code") failure to timely file a claim for refund of an overpayment bars recovery of the overpayment. Under section 7422 of the Code no judicial action for refund of an overpayment of tax can be commenced unless the taxpayer has first timely filed a claim for refund. Further, under the "variance doctrine" of *United States v. Felt & Tarrant Mfg. Co.*, 238 U.S. 269 (1931), no judicial action for refund can be brought or maintained on grounds other than those stated in a timely filed claim for refund.

Refund claims thus frame the legal rights of taxpayers to recovery of overpayments. As such they have a different function and effect than an original tax return. Whereas the assistance of a lawyer may not be necessary or advisable in filing most, if not all, federal tax returns, the assistance of a lawyer is absolutely advisable in the preparation of a claim for refund, particularly a claim for refund filed as the first jurisdictional element of a civil action to seek a refund of taxes paid as a consequence of adjustments made by the Internal Revenue Service to the taxpayer's tax liability.

We recognize the Internal Revenue Service has been having difficulty with refund claim fraud by prisoners in federal penal institutions for over 30 years. However, we are not aware that any of those refund claims have been prepared by an attorney whose license is in good standing on a contingent fee basis. The simple truth is that the Internal Revenue Service can examine any refund claim carefully before making a refund and only a final judgment of a court of competent jurisdiction that the taxpayer is entitled to a refund can compel the Internal Revenue Service to make a refund.

There are also existing statutory penalties for improper refund claim preparation that have been in the Code for almost 30 years. Throughout most of the history of those penalties, practitioners whose conduct has lead to the assessment of one of those penalties have been referred to the Director of Practice for consideration of discipline under Circular 230. Thus, it is not unreasonable to question why additional Circular 230 provisions regulating preparation of refund claims are even necessary at this time.

Most importantly, the existing provisions of Section 10.27 improperly limit contingent fees for refund claims. Congress has recognized that some refund claims are purely jurisdictional and that they pose no threat of abuse of the tax system. Thus, refund claims described in Code section 7701(a)(36)(B) are not even subject to the income tax return preparer penalty regime. *A fortiori,* those refund claims should not be subject to contingent fee regulation under Circular 230, and we urge the Treasury

Department and Internal Revenue Service to amend Section 10.27 to exclude such refund claims from any per se prohibition against contingent fees.

It is unclear whether proposed new Section 10.27 would prohibit a practitioner from agreeing to represent a taxpayer before the Internal Revenue Service on an arrangement that a minimal fee would be charged pending the outcome and that, if the taxpayer prevailed, the taxpayer would then seek recovery of additional fees under section 7430 of the Code, which, if recovered, would be paid to the practitioner. This type of arrangement is clearly authorized by Code section 7430(c)(3)(B) and extends to administrative proceedings as well as judicial proceedings. Since it is expressly authorized by law, Circular 230 cannot properly prohibit it. Thus, we urge the Treasury Department and the Internal Revenue Service to amend section 10.27 to make it clear that Circular 230 does not prohibit fee arrangements that are predicated upon fees awarded to prevailing parties pursuant to Code section 7430.

Indeed, proposed new Section 10.27(b)(2)(ii) is too narrow. It should permit contingent fees for preparation of amended returns that are claims for refund and for the handling of all examinations by the Internal Revenue Service, including examinations of claims for refund filed after notice of an examination or conclusion of an initial examination. Any notions that an Internal Revenue Service examination is not an adversarial process no longer hold true in the present enforcement environment.

Conflict of Interest

The tenuous constitutional basis and undesirability of expansion of "practice before the Internal Revenue Service" are also manifested when the effect of that expansion is considered in light of Section 10.29 of Circular 230. Is the appropriate division of responsibility between the federal and the state government that conflicts of interest in any legal representation that touches upon tax planning or tax advice is exclusively regulated by the Office of Professional Responsibility? We think not.

Few, if any, transactional matters or disputes that require legal representation are totally devoid of tax implications. As the professional staff of the Office of Professional Responsibility fully appreciate, every state has rules of legal ethics that deal with the conduct of lawyers confronted with clients with conflicting interests. Expansion of the scope of "practice before the Internal Revenue Service" to encompass all forms of tax planning or tax advice is nothing more than removing, through pre-emption, regulation of conflict of interest ethics rules for lawyers from the states to the Office of Professional Responsibility. There is nothing in the Jobs Act or its legislative history that remotely suggests Congress intended to alter the balance between state and federal regulation of the legal profession in this broad manner.

Thus, the unwarranted effect under Section 10.29 is yet another reason the proposed expansion of "practice before the Internal Revenue Service" should not be adopted.

As the Supplementary Information in the Notice of Proposed Rulemaking observes, Section 10.29 of Circular 230 draws heavily on Model Rule 1.7 of the ABA Model Rules of Professional Conduct. To the extent that it does so and its scope is properly limited to matters that involve actual representation of a client before the Internal Revenue Service, it is not objectionable. However, when it deviates from that Model Rule it raises concerns.

In Scope [20] of the ABA Model Rules of Professional Conduct, concerns about subversion of the purpose of the Rules are addressed as follows: "Furthermore, the purpose of the Rules can be subverted when they are invoked by opposing parties as procedural weapons. The fact that a Rule is a just basis for a lawyer's self-assessment, or for sanctioning a lawyer under the administration of a disciplinary authority, does not imply that an antagonist in a collateral proceeding or transaction has standing to seek enforcement of the Rule."

The requirement, in Section 10.29(c) that client consents be furnished to "any officer or employee of the Internal Revenue Service on request" is troubling and contrary to the philosophy set forth with respect to the ABA Model Rule on which it is premised. If a real-time consent verification process is deemed necessary by the Office of Professional Responsibility, then Section 10.29(c) should be amended to provide that the practitioner is obligated to supply a copy of the client consent to the Office of Professional Responsibility upon the request of any officer or employee of the Internal Revenue Service, and that the consent will not be disclosed to any other Internal Revenue Service personnel. That permits the attorney and the clients to have the sharing of information necessary to have an appropriate consent and precludes the Internal Revenue Service from employing a rule of conduct as a strategic device to vitiate the attorney-client privilege. We urge Treasury and the Internal Revenue Service to revise Section 10.29(c) accordingly.

The proposed amendment to Section 10.29(b)(3) goes beyond ABA Model Rule 1.7 and most state legal ethics rules by requiring the client to "waive the conflict of interest." All the ABA Model Rule and most state legal ethics rules require is a consent to the "concurrent representation of a client with an interest that conflicts." Such consents do not always have to be in writing. Section 10.29 should not go further, and this proposed amendment to Section 10.29(b)(3) should not be adopted.

The proposed further expansion of Section 10.29(b)(3) adding the phrase "at the time the existence of the conflict of interest is known by the practitioner," similarly seems unnecessary. It adds a potential area of dispute about what it means, and whether an otherwise proper consent is "ethically sufficient." If the purpose of the

rule is to assure that the client has consented to representation of conflicting interests, the existence of that consent is what is significant; when the practitioner first knew of the conflict and the timing of the consent in that context seem relatively insignificant. Thus, we urge the Treasury Department and the Internal Revenue Service not to adopt this proposed expansion of Section 10.29(b)(3) of Circular 230.

Proposed Amendments to Section 10.34

The Proposed Amendments would expand the standards of Section 10.34 to documents, affidavits, and other papers submitted to the Internal Revenue Service. We have no objection to the proposed amendment that proscribes advising a client to submit a frivolous or groundless document. However, we respectfully submit that proposed addition of Section 10.34(b)(2)(iii), proscribing advice regarding a document that demonstrates an intentional disregard of a rule or regulation, is overly broad. Proposed Section 10.34(b)(2)(iii) should be clarified so that it clearly permits advising clients with respect to IRS Forms 8275, 8275-R, and 8886, and other documentation to manifest and demonstrate a good faith challenge to a rule or regulation. Circular 230 should not preclude a lawyer from advising a client on such matters since they are either required or permitted by the Code and Treasury Regulations.

Publicity of Disciplinary Proceedings

Section 10.72(d) as amended by the Proposed Amendments would make public all disciplinary proceedings and records once the OPR commences a disciplinary proceeding before an Administrative Law Judge. The Proposed Amendment would expressly authorize the Secretary to publish documents on the IRS website from the moment the complaint is filed. The present practice is that the disciplinary proceeding is confidential unless the practitioner waives confidentiality or the practitioner appeals a disciplinary sanction to the federal district court.

The Notice offers no explanation for the proposed change. In public meetings, OPR representatives have stated the proposed change is warranted to give transparency to the disciplinary process so practitioners and the public are both provided information as a check to assure OPR does its job properly and to inform them about what is and is not permissible. OPR representatives have also pointed to ABA and state bar disciplinary procedural rules under which disciplinary proceedings are open to the public.

The ABA Model Rules for Lawyer Disciplinary Enforcement contain an elaborate division of investigatory, prosecutorial, and adjudicatory responsibilities that are intended to protect the rights of all interested parties in the disciplinary

enforcement process. In particular, those Model Rules provide for independent review of ethical complaints and investigation materials before a disciplinary adjudication proceeding can be commenced. Only when the independent process, with its checks and balances, has been completed to assure that the complaint is meritorious, does the curtain of confidentiality drop away.

The OPR disciplinary process has no such independent review or system of independent checks and balances. Referrals are principally made by IRS field personnel who have had contact with the practitioner, directly or indirectly, to OPR personnel who are IRS employees, who review the referrals and investigate. The OPR investigators and their supervisors determine whether or not to file and prosecute a complaint that will be adjudicated by an Administrative Law Judge employed under contract to the Treasury Department.

Without disparaging the integrity of any of the individuals involved in the process, the simple fact is that the complainants and OPR personnel work for the same agency superior, the Commissioner of Internal Revenue. The process has no independent review, and to suggest that publicity of charges and the negative impact that will have on the accused is beneficial for practitioners or the tax system is indefensible. There is no adequate way to rectify the harm done by adverse publicity, including Internal Revenue Service website notoriety, to a practitioner who is exonerated at the end of the disciplinary process. The potential harm from abuse of the process far outweighs any proffered public benefit from the proposed publicity of the complaint and proceedings.

Maintaining the present confidentiality of the process is the best way to protect against harm from complaints that are not meritorious. It is also the most efficient way to protect the confidentiality of taxpayer and third-party information—something to which the Proposed Amendments are rightfully sensitive, but with which they struggle because of the proposed change in publicity of filings and proceedings.

The Treasury Department and the Internal Revenue Service should withdraw the Proposed Amendment of Section 10.72(d) and consider other means to achieve greater dissemination of information concerning their views of what is or is not permissible conduct under Circular 230. This is not a new suggestion. One time the Director of Practice published synopses of disciplinary actions in the Internal Revenue Bulletin. That did not recur however, and the reasons for that decision are not publicly known. We urge the Treasury Department and the Internal Revenue Service to reconsider publishing such synopses once disciplinary proceedings have become final within the Treasury Department.

Concluding Observations

The past decade has been marked by major restructuring of the Internal Revenue Service, continuous amendment of the Code, and actions of a few within and without the Government that have not necessarily been in the best interests of maintaining public confidence in the integrity and fairness of the tax system. We acknowledge the role the OPR plays in addressing disreputable conduct by tax practitioners. We also appreciate that personnel turnover can impair institutional memory. Thus we have endeavored to focus our comments on historical antecedents relevant to the Proposed Amendments in the hope that background will assist Treasury and the Internal Revenue Service in finding appropriate balance in Circular 230.

Thank you for your consideration of these comments. We would be pleased to discuss any of our comments with you in further detail if that would be helpful to you.

Sincerely,

Frederic L. Ballard, Jr.
Chair

cc: Mr. Stephen A. Whitlock