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We perceive that the Internal Revenue Service is using three primary methods to increase compliance by taxpayers with the federal tax system. One method is to increase the number of and circumstances under which federal tax penalties may be imposed. Although, as a general rule, new penalties may be imposed only by the enactment of a new law (such as an amendment to the Internal Revenue Code), the Treasury Department has broad discretion to issue regulations by which it may expand the practical impact of such penalties. As discussed in this book, it has attempted to do so by denying taxpayers the right to rely on certain written advice where the level of confidence is less than “more likely than not” even though that advice would otherwise be adequate under the Code to avoid certain penalties. In addition, Congress has shown increased willingness to enact new penalties requested by the Treasury.

The second method is a Treasury Department regulation issued under section 6011 of the Code. That regulation requires each taxpayer to file a special return advising the IRS that the taxpayer has engaged in what are called “Reportable Transactions.” Of significant importance is that the IRS may label virtually any arrangement that has a tax effect a “Listed Transaction,” which is one that the IRS views as potentially abusive of the tax system. A Listed Transaction is a Reportable Transaction. Filing the Reportable Transaction return invites special and heightened inquiry of the taxpayer by the IRS. Such special and heightened inquiry is especially likely as a result of special new penalties that may, and in some cases must, be imposed if the taxpayer has not promptly filed the Reportable Transaction return. Also, if the Reportable Transaction is found to be abusive, the risk of other penalties being imposed increases.

The third method used by the IRS is the recent expansion of Circular 230. This is also a Treasury Department regulation. The Circular was first enacted in 1921. It sets forth the conduct that Tax Practitioners (called “Practitioners” in this book) must follow or be faced with disciplinary action. Becoming a Practitioner is voluntary and, in general, occurs by filing a written statement with the IRS; once filed, apparently, the statement cannot be withdrawn. Discipline for violating the Circular may include the imposition of monetary penalties, a public censure, or suspension or disbarment from practice before the IRS. The recent changes made to the Circular, primarily
relating to written tax advice, were claimed to have been enacted to enhance the public’s confidence in Practitioners. It is unlikely that this has been the effect. Instead, the consequence of the new rules has been to inhibit Practitioners from providing written tax advice, which may protect taxpayers from penalties and to steep all written communications in disclaimers. The new rules relating to written tax advice are so onerous that, in many cases, written advice will not be provided. Interestingly, under current law, oral advice will protect a taxpayer from penalties to the same degree that written advice would. However, oral advice suffers from the problem of proving later on that the advice was given and what the advice was. It seems that neither the IRS nor taxpayers are as well served by oral advice, especially with respect to complex federal tax issues. Taxpayers are less likely to understand or apply oral advice in most cases. We do not believe it was the intention of the IRS to increase taxpayer errors by forcing them to rely on oral advice and thereby increase the likelihood of penalties being imposed. In any case, as stated, the changes have not, in our view, increased the public’s confidence in Practitioners but have only increased the probability of a penalty being imposed by denying taxpayers the opportunity to avoid penalties by demonstrating reliance on professional advice.

It will be noted that all three methods (penalties, Reportable Transactions, and inhibitions on providing written tax advice) are based, in large measure, on Treasury Department regulations. Such regulations, unlike other types of authority, are entitled to special deference by the federal courts, including construction consistent with the IRS’s, and not the taxpayer’s, interpretation. Because of its importance, the first chapter of this book deals with deference.

Although the principal focus of the book is on Circular 230, the second and third chapters deal, respectively, with selected tax penalties and with Reportable Transactions. As indicated, penalties and the Circular are intertwined to a significant degree. Indeed, many parts of the Circular mirror in significant part penalty-type provisions of the Internal Revenue Code. Reportable Transactions and the Circular also are intertwined. In fact, some of the most onerous rules relating to written federal tax advice relate to Listed Transactions, one of the six types of Reportable Transactions.

Although this book may be read cover to cover, it is designed primarily to be a reference book. To enhance understanding of the organization and application of Circular 230, there are five special charts that provide certain overviews. One is the Circular 230 Flowchart. It sets forth in summary fashion what we perceive to be the affirmative duties and prohibited activities that apply to Practitioners. Another is the Circular 230 Decision Tree. It provides a guide for the Practitioner to determine whether written advice must comply with either section 10.35 or 10.37 of the Circular, both
of which deal with written advice about a federal tax issue. The third is a section 10.35 chart that sets forth whether the particular type of Covered Opinion (for example, Marketed Opinion) is subject to exceptions or special rules. In addition, the book contains a Checklist for Written Advice, which we hope will be of assistance to Practitioners. A fifth chart, a flowchart for Reportable Transactions, is also included. We recommend spending some time going through the charts to provide an overview before reading the part to which it pertains. For example, we think studying the Reportable Transactions flowchart will aid in understanding the structure of the regulations under section 6011 of the Code.

Parts of the Circular, including certain proposed regulations and portions applicable to enrolled agents, are reserved. They will be added in future supplements.

We thank our colleague Tracy L. Bentley, Esq., an associate at Milbank, Tweed, Hadley & McCloy LLP, in its New York office, for her permission to reproduce the Circular 230 § 10.35 Decision Tree and Circular 230 § 10.35 Chart, which can be found in the Appendices, and to use materials from the article she co-authored. We thank Paula Prudenti of the Milbank Tweed library for her able help in providing us with materials and other assistance. We also acknowledge, with great appreciation, the excellent work performed by our research assistants Melody Morgan, enrolled in the NYU Master’s in Tax program, and Asif Ranginwala, who has just graduated from Hofstra University School of Law.

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