Circular 230: Legitimate Regulation or Unconstitutional Intrusion into the Attorney-Client Relationship?

By Megan L. Brackney

Megan Brackney discusses the new Circular 230, outlining First Amendment Free Speech concerns that have been raised and discussing the federal government's previous attempts to regulate professional advice.

By now, most tax practitioners are aware that they have to think twice, or even three times, before they send an e-mail or write a short letter to a client and that they have to carefully negotiate with clients over the scope, cost and utility of any written tax advice. This is a result of the new standards for written advice contained in Circular 230. As part of its war on tax shelters, the Treasury has undertaken to regulate and prohibit certain types of written communications between tax practitioners and their clients. In certain cases, it is likely that these regulations intrude too far into the relationship between the attorney and client and constitute an improper restriction on the attorney's constitutionally protected speech.

Circular 230's Restrictions on Professional Advice

Circular 230 heavily regulates written advice from tax practitioners to clients. For the most part, Circular 230 imposes affirmative obligations on tax practitioners, telling them what must be included in written advice and what types of legends and disclaimers must be included in written advice. However, other provisions of Circular 230 limit what practitioners can put in writing to their clients.

Most importantly, practitioners are not permitted to reduce to writing any short-form tax advice regarding listed transactions or transactions that have as a principal purpose the avoidance or evasion of tax. Similarly, Circular 230 prohibits practitioners from dispensing written advice based on assumptions as to certain future events, including the possibility that a 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.[1] In addition, for covered opinions, with limited exceptions,[2] the tax practitioner cannot assume the favorable resolution of any significant federal tax issue.[3]

Of course, practitioners are still free to have oral discussions with their clients regarding listed transactions, principal purpose transactions, and whether and how the government may settle an issue. Nevertheless, in an area as complex as the tax law, such oral discussions will often be insufficient, and the prohibition against putting certain things in writing will only lead to confusion, mistakes and, in some cases, lack of compliance. It certainly does not seem that the government's interest in promoting compliance with the tax law and in limiting the proliferation of illegal tax shelters and in promoting compliance justifies, or is even served by, some of the limitations on written advice contained in Circular 230.

Megan L. Brackney is an Associate with Kostelanetz & Fink, LLP, in New York City.

Circular 230's Restrictions on Speech Implicate First Amendment Concerns

There is no question that a state may require a person to comply with certain conditions before he or she can practice a profession.[4] Historically, states have regulated the admission and practice of law,[5] and some of those regulations have had the incidental effect of abridging attorneys' freedom of speech.[6] However, regulations, and other rules governing the standards of practice, are subject to constitutional limitations.[7] As observed by the Supreme Court, attorneys' speech on matters of legal representation is entitled to "the strongest protection our Constitution has to offer."[8]

For example, in *Legal Services Corp. v. Velazquez,*[9] the Supreme Court held unconstitutional, a restriction on Legal Services' lawyers that prevented them from arguing to a court that a statute was unconstitutional. The *Velazquez* case involved Legal Services Corporation (LSC),[10] an entity created by Congress for the purpose of providing

grants to local organizations to hire and supervise lawyers to provide free legal assistance to indigent clients.[11] Congress, however, prohibited legal representation funded by LSC if the representation involved an effort to amend or challenge existing welfare law, including presenting an argument to a court that a state statute conflicts with a federal statute or that a state or federal statute is unconstitutional.[12] The Supreme Court held that this restriction violated the First Amendment.[13] The Court explained that "attorneys should present all the reasonable and well-grounded arguments necessary for proper resolution of the case," and that limiting or restricting the analysis of certain legal issues, "prohibits speech and expression upon which courts must depend for the proper exercise of judicial power."[14]

Failed Attempts to Regulate Professional Advice

Outside of the various codes of professional responsibility, there have been almost no legislative or regulatory attempts to closely regulate attorneys' advice to clients, much less one as elaborate and comprehensive as the new Circular 230. One such attempt, however, ended in failure. In 1997, Congress enacted a law which criminalized the transfer of assets to become eligible for Medicaid. Due to the political fallout from what became known as the "Granny Goes to Jail Law," Congress repealed this provision and replaced it with one aimed at attorneys. The amended law made it a crime to counsel or to assist an individual to make certain asset transfers. The amended statute provided that whoever

> for a fee knowingly and willfully counsels or assists an individual to dispose of assets in order for the individual to become eligible for medial assistance under a State plan under Title XIX, if disposing of the assets results in the imposition of a period of ineligibility for such assistance under section 1917(c), shall . . . (ii) in the case of such a statement, representation, concealment, failure to disclose, conversation or provision of counsel or assistance by any other person, be guilty of a misdemeanor and upon conviction thereof fined not more than $10,000 or imprisoned for not more than one year or both.[15]

Thus, the amended law made it a crime for attorneys to discuss transferring assets with their clients, even though the asset transfers themselves were not illegal. Attorney General Janet Reno refused to enforce this provision[16] because she believed it violated the First Amendment. In a letter to Congress, Attorney General Reno explained that Sec. 1128B(a)(6) would prohibit attorneys and other professional advisors from counseling their clients about a lawful estate planning.[17] Attorney General Reno concluded that "[u]nder these unique circumstances, and in light of the fact that, pursuant to this provision, professional advisors such as attorneys would be prohibited from providing truthful, non-misleading advice to their clients about lawful behavior, we are unable to identify a governmental interest that would justify this restriction on protected speech."[18]

Although it considered restrictions on communications between a physician and a patient, the Ninth Circuit's decision in *Conant v. Walters*,[19] is also instructive. There, a federal policy declared that a physician's license could be revoked if he or she recommended marijuana to patient.[20] The court recognized the First Amendment value of the physician-patient relationship, comparing that relationship with the attorney-client relationship.[21] The court also observed that the policy punished physicians because of the content of their communications with patients, and emphasized that "[w]hen the government targets not subject matter but particular views taken by speakers on a subject, the violation of the First Amendment is all the more blatant."[22] Applying a strict scrutiny analysis, the court found that the

policy was not narrowly tailored to serve the interest identified by the government—that physicians' recommendation of marijuana may encourage illegal conduct—because the government was not able to formulate a definition of "recommend" that would not also restrict speech relating to legal conduct.[23]

Circular 230 Cannot Survive Strict Scrutiny

Like the "Granny Goes to Jail Law" and the federal policy in *Conant*, the new Circular 230 regulations cannot survive strict scrutiny because they impermissibly limit an attorney's ability to provide truthful, nonmisleading advice to his or her clients about lawful behavior.

For example, the new Circular 230's prohibition on written advice relating to principal purpose transactions in any form other than a full-blown covered opinion may impermissibly limit or restrict the tax practitioner's analysis of legal issues, and, as a result, limit tax practitioners' ability to provide written advice to their clients. The covered opinion requirements are so burdensome[24] as to make it impossible for a tax practitioner to quickly communicate with their clients in writing in situations that require prompt attention. In addition, if the client cannot afford to pay a tax practitioner to draft a full-blown covered opinion, the practitioner's only option is to communicate orally, which may be insufficient in many circumstances. The recent amendment to Circular 230, which provides that a transaction is not a "principal purpose transaction" if the claimed tax benefits are "consistent with the Code and Congressional purpose,"[25] does not save the regulation. As observed by one court, "[i]t is, of course, commonplace to note that the Internal Revenue Code is remarkably complicated."[26] This complexity makes it difficult, if not impossible, in certain cases, to determine whether a transaction is consistent with Congressional purpose and therefore, whether it is necessary to draft a covered opinion in numerous situations; such uncertainty may chill tax practitioners' speech by discouraging them from providing written advice to their clients.

> [T]he burdensome requirements for covered opinions may inhibit the quality of attorney counseling, which runs counter to he purported goals of the new Circular 230.

Another example of Circular 230's impermissible interference with attorney speech is the prohibition on dispensing written advice discussing or even taking 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 resolved through settlement if raised.[27] In addition, for covered opinions, with limited exceptions,[28] the tax practitioner cannot assume the favorable resolution of any significant federal tax issue.[29] Advice regarding these issues is not untruthful or misleading, but represents the attorneys' judgment, based on his or her experience and understanding of the tax law, of the potential outcomes of certain conduct. Moreover, this advice does not counsel or encourage clients to commit unlawful behavior; rather, it presents a full picture of the consequences of certain conduct.

While there are disciplinary rules prohibiting a lawyer from counseling a client to engage in conduct that the lawyer knows is criminal or fraudulent, traditionally, lawyers have not been prohibited from discussing the legal consequences of a proposed course of conduct with a client.[30] Indeed, the prohibition on a lawyer knowingly counseling or assisting a client to commit a crime or fraud "does not preclude the lawyer from giving an honest opinion about the actual consequences that appear likely to result from a client's conduct. . . . There is a critical distinction between presenting an analysis of legal aspects of questionable conduct and recommending the means by which a crime or fraud might be committed with impunity."[31] The new Circular 230 blurs this distinction by prohibiting attorneys from giving meaningful written advice concerning whether particular conduct would be viewed by the IRS as inconsistent with the tax law or whether the tax law, or the IRS' interpretation of it, is vulnerable to challenge, or whether an issue would be audited or resolved through settlement.

The drafters of the new Circular 230 describe its purpose as restoring, promoting and maintaining the public's confidence in the honesty and integrity of tax practitioners.[32] The restriction on written advice contemplating a favorable interpretation of federal tax law, however, actually may run counter to other governmental interests. As the Supreme Court explained in *Velazquez*, restrict-

ing the analysis of certain legal issues, "prohibits speech and expression upon which courts must depend for the proper exercise of judicial power."[33]

Although the written advice regulated by the new Circular 230 is not prepared for presentation to the courts, limiting the content of this advice may, in turn, limit the arguments that are made to the courts. For instance, if a tax practitioner is not able to present to a client a meaningful, written explanation of why a particular tax law may be unconstitutional, in conflict with another federal statute or how it may have been misinterpreted by the IRS, it is less likely that the client will challenge that tax law or test the IRS's interpretation of the tax law, in court.

Moreover, the burdensome requirements for covered opinions may inhibit the quality of attorney counseling, which runs counter to the purported goals of the new Circular 230. Clients of tax practitioners frequently need quick, informal advice to make informed decisions. Because the regulations apply with equal force to e-mails as to written memos, tax practitioners will only be able to provide this type of advice orally. The complexity of certain tax issues, however, makes it difficult to meaningfully advise a client orally. As a result, Circular 230 impairs attorneys' ability to advise clients about the potential consequences of their conduct, and to successfully challenge the IRS's interpretation of a federal tax law.[34]

Conclusion

The new Circular 230 restrictions profoundly limit an attorney's ability to counsel his or her client about all possible consequences of particular conduct and apply to categories of speech much broader than necessary to achieve goal of restoring, promoting and maintaining public confidence in the honesty and integrity of tax professionals. Thus, it is likely that Circular 230 violates tax practitioners' First Amendment right to communicate freely with their clients.

Endnotes

1 31 CFR §§10.35(c)(3)(iii); 10.37(a).

2 31 CFR §10.35(c)(2)(ii) (covered opinion must not assume the favorable resolution of any significant federal tax issue except as provided in paragraphs (c)(3)(v) and (d)).

3 31 CFR §10.35(c)(2)(ii).

4 *Dent v. West Virginia*, SCt, 129 US 114, 121-22, 9 SCt 231 (1889).

5 *See Gentile v. State Bar of Nevada*, SCt, 501 US 1030, 1066, 111 SCt 2720 (1991) ("'Membership in the bar is a privilege burdened with conditions'") (quoting *In re Rouss*, N.Y. CtApp, 221 NY 81, 84, 116 NE 782, 783 (1917) (Cardozo, J.))); *Ohralik v. Ohio State Bar Ass'n*, SCt, 436 US 447, 460, 98 SCt 1912 (1978) (state has special responsibility for maintaining standards among members of licensed professions).

6 *See American Motors Corp. v. Huffstutler*, Ohio SCt, 61 OhioSt3d 343, 575 N.E.2d 116, 120 (1991) (by practicing law an attorney surrenders a portion of his or her right to free speech under First Amendment); *cf. Schware v. Board of Bar Exam'rs*, SCt, 353 US 232, 239, 77 SCt 752 (1957) (attorney regulations upheld if they "have a rational connection with the applicant's fitness or capacity to practice").

7 *See Gentile*, 501 US at 1038 (disciplinary rules may not be applied to such a broad scope of speech that they impinge on an attorney's legitimate exercise of his or her First Amendment rights); *NAACP v. Button*, SCt, 371 US 415, 439, 83 SCt 328 (1963) (holding that the State of Virginia could not prohibit NAACP from advising individuals of legal rights and referring them to lawyers, and observing that attorneys have rights to speak freely subject only to government regulating with "narrow specificity.").

8 *Florida Bar v. Went For It, Inc.*, SCt, 515 US 618, 634-35, 115 SCt 2371 (1995); *see also Button*, 371 US at 439 (attorneys' speech on behalf of their clients is afforded constitutional protection which the government may not ignore "under the guise of prohibiting professional misconduct.").

9 *Legal Services Corp. v. Velazquez,* 531 US 533, 121 SCt 1043 (2001).

10 *Velazquez*, 531 US at 436.

11 *Id.*

12 *Id.* at 537.

13 *Id.* at 548-49.

14 *Id.* at 545.

15 42 USC §1320a-7b(a)(6) (1997).

16 Social Security Act Sec. 1128B(a)(6), codified at 42 USC §1320a-7b(a)(6) (1997).

17 Letter dated Mar. 11, 1998, from Attorney General Janet Reno to Speaker of the House Newt Gingrich, *available at www.virtual-lawoffice.com/ALERT.html*.

18 *Id.* Attorneys filed suit challenging 42 USC §1320a-7b(a)(6), but before those cases were decided, the Attorney General issued her letter advising Congress that the Department of Justice would not enforce the law. *See Magee v. U.S.*, DC R.I., 93 F Supp2d 161, 164-65 (2000) (dismissing challenge for lack of jurisdiction because no case or controversy after Attorney General announced that law would not be enforced); *New York State Bar Assoc. v. Reno*, DC N.Y., 999 FSupp710, 715-16 (1998) (enjoining enforcement of Act Sec. 4734 of the Balanced Budget Act of 1997 (P.L. 105-33) because there were no assurances that attorneys would not be prosecuted in future).

19 *Conant v. Walters*, CA-9, 309 F3d 629 (2002).

20 *Id.* at 632.

21 *Id.* at 637.

22 *Id.* (quoting *Rosenberger v. Rector*, SCt, 515 US 819, 829, 115 SCt 2510 (1995)).

23 *Id.* at 638-39.

24 The requirements for covered opinions are outlined in 31 CFR §10.35(c), and include that the tax practitioner must identify and consider all of the relevant facts, set forth the applicable law to the relevant facts, consider all significant federal tax issues, provide the practitioner's conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each significant federal tax issue, or indicate that the practitioner is unable to reach a conclusion with respect to one or more issues, and describe the reasons for the conclusions.

25 *Id.*

26 *D.A. Koss,* CA-3, 95-2 USTC ¶50,599, 69 F3d 705, 712 ; see also *J.B. Laing,* SCt, 76-1 USTC ¶9164, 423 US 161, , 188, 96 SCt 473 ("Every experienced tax practitioner also knows that our Internal Revenue Code is a structured and complicated instrument perhaps too complex . . ."); *In re Hudson Oil Co., Inc.,* BC-DC-Kan, 88-2 USTC ¶9554; 91 BR 932, 944 ("It has been opinionized by some that the Internal Revenue Code is one of the most complicated documents ever written.").

27 31 CFR §§10.35(c)(3)(iii); 10.37(a).

ENDNOTES

[28] 31 CFR §10.35(c)(2)(ii) (covered opinion must not assume the favorable resolution of any significant federal tax issue except as provided in paragraphs (c)(3)(v), (d)).
[29] 31 CFR §10.35(c)(2)(ii).
[30] Model Rules of Prof'l Conduct, R. 1.2(d).
[31] Model Rules of Prof'l Conduct, R. 1.2 cmt.
[32] 69 FR 75839 (Dec. 20, 2004).
[33] 531 US at 545.
[34] The only decision on this subject related to the former version of Circular 230. In *G. J. Joslin* DC Utah, 85-2 USTC ¶9547, 616 FSupp 1023 , *rev'd on other grounds*, CA-10, 87-2 USTC ¶9584, 832 F2d 132, a tax attorney challenged the former Circular 230 regulations on the ground that they unduly restricted his ability to communicate tax advice to the public. *Id.* at 1025. The court rejected this challenge for two reasons: first, the court held that the prior version of Circular 230 did not actually limit speech, but merely governed the standard of practice of attorneys; and, second, the court held that if the regulations did restrict speech, they only impacted false or misleading commercial speech not entitled to constitutional protection. *Id.* at 1027. The *Joslin* decision is not an obstacle to a First Amendment challenge to the new Circular 230 because the court erred in failing to recognize that a standard of practice could be a restriction on speech, and, in any event, the new Circular 230 reaches far beyond false or misleading commercial speech.