Ethical Considerations When Representing Nonprofit And Tax-Exempt Organizations

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The client's good works won't shield counsel who violates the ethics rules.

RECENTLY, BOTH CONGRESS AND STATE LAWMAKERS have increased their focus on correcting misdoings, real or perceived, in the nonprofit sector. The Pension Protection Act of 2006 includes many provisions aimed at addressing perceived abuses in the nonprofit sector. California has enacted legislation that imposes certain requirements on nonprofits that are modeled after provisions of the Sarbanes-Oxley Act of 2002. Similar legislation has been proposed in New York and in other states. Although these laws do not implicate counsel expressly, they highlight the need for counsel to be wary of improper and inappropriate conduct in the arena of tax-exempt organizations, and for counsel to be

conscious of their own ethical duties and obligations when representing nonprofits.

In many respects, the ethical considerations that arise when representing a nonprofit, tax-exempt organization are no different from those that arise when representing a for-profit, taxable entity. Certain issues, however, such as conflicts of interest, may be more prevalent in the case of tax-exempt organizations. For example, an inherent conflict of interest exists within the excess benefit excise tax regime under section 4958 of the Internal Revenue Code (the "Code"), which is structured so as to permit (in most cases) an organization to preserve its tax-exempt status in exchange for the imposition of excise taxes on so-called disqualified persons who have engaged in less-than-fair-market-value transactions with the organization. It may be in the interest of such disqualified persons to contest the imposition of section 4958 excess benefit taxes long after it is apparent that it is in the organization's best interest to argue that the imposition of such taxes is the appropriate sanction in lieu of revocation. And in the case of many tax-exempt organizations, the disqualified persons who run the organization may be under the mistaken impression that outside counsel represents them individually in addition to the organization.

The sections that follow provide both legal and practical information that will help counsel navigate the ethical issues that can arise in the context of representing a tax-exempt organization. Consideration is given to both the state-level rules of professional conduct and the federal regulations that govern practice before the Internal Revenue Service (IRS).

ETHICAL CONSIDERATIONS FOR EO COUNSEL • The rules of professional conduct promulgated by each state (and the District of Columbia) contain provisions that discuss a lawyer's duties to his or her clients. Although state rules of professional conduct do not themselves establish a cause of action for legal malpractice, they help define the standard of care that a lawyer owes a client. Thus, a violation of these rules can help support a finding that the lawyer violated the applicable standard of care, making the lawyer liable in a malpractice action. The discussion herein of a lawyer's duties to his or her clients is based on the ABA Model Rules of Professional Conduct (2003) (hereinafter the "ABA Model Rules"). It is critical, however, that you review and understand the specific ethical rules that govern attorney conduct in your jurisdiction. If you are involved in a matter that potentially involves your practicing in more than one state, make sure to review the ethical rules of all relevant jurisdictions.

Organization As Client And Conflicts Of Interest

ABA Model Rule 1.13(a) makes it clear that "a lawyer employed or retained by an organization represents the *organization* acting through its duly authorized constituents" (emphasis added). In the context of a tax-exempt organization, this may prove important if the IRS challenges the tax-exempt status of an organization based on the wrongdoing of its officers or directors. For example, as discussed above, it may be in the best interests of the organization to argue that the proper sanction is not for the IRS to revoke the organization's tax-exempt status, but to impose "intermediate sanctions" personally on the wrongdoers.

A lawyer representing an organization may also represent any of its officers, directors, employees, members, or other constituents—subject, however, to the provisions of ABA Model Rule 1.7. ABA Model Rule 1.13(g). As a general rule, ABA Model Rule 1.7(a) prohibits a lawyer from representing a client if the representation involves a "concurrent conflict of interest," unless the conflict is "consentable." A "concurrent conflict of interest" exists where: (1) representation of one client will be "di-

rectly adverse" to representation of another; or (2) a significant risk exists that "the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer." ABA Model Rule 1.7(a). Notwithstanding a concurrent conflict of interest, a lawyer may represent another client if:

(1) The lawyer reasonably believes he or she can provide competent and diligent representation to each client (discussed below);

(2) The representation is not prohibited by law;

(3) The representation does not involve the assertion of a claim by one client against another in the same litigation or other proceeding before a tribunal; and

(4) Each affected client gives informed, written consent. *Id*.

If the organization's consent to common representation is required, the consent must be given by an appropriate official of the organization other than the individual who is to be represented. ABA Model Rule 1.13(g) (2002).

Informed consent requires a lawyer to communicate adequate information to the client about the material risks of, and reasonably available alternatives to, the common representation. ABA Model Rule 1.0(e). The lawyer must make each client aware of the material and reasonably foreseeable ways in which the conflict could have an adverse impact on the client's interest—including possible effects on issues of loyalty, confidentiality, and the attorney-client privilege. ABA Model Rule 1.7 cmt. [18]. For example, where the attorney-client privilege is concerned, the privilege may not attach for communications involving the lawyer and the commonly represented clients. Similarly, the lawyer owes an equal duty of loyalty to each client, and must share with each client anything bearing on the representation that might affect that client's interest. *See* ABA Model Rule 1.4. Consequently, for there to be informed consent, the lawyer must make each client aware that, if one client asks the lawyer to withhold information from the other client that could be used to the other client's benefit, the lawyer will have to withdraw from the common representation.

Bear in mind that even when common representation may be possible at the outset of a matter, common representation will fail when potentially adverse interests cannot be reconciled. ABA Model Rule 1.7 cmt. [29]. In some situations, the risk of failure will be so great that multiple representation is clearly impossible, such as when contentious litigation or negotiations between the clients are imminent or contemplated, or when the lawyer cannot maintain impartiality between the clients. *Id*.

ABA Model Rule 1.8 enumerates a number of specific prohibited transactions involving conflicts of interest. For example, you may not accept from another person or entity compensation for representing a client unless: "(1) the client gives informed consent; (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and (3) information relating to the representation of a client is protected as required by Rule 1.6 [pertaining to the duty to maintain client confidences]." ABA Model Rule 1.8(f). Special conflicts of interest rules apply in the case of former and current government officers and employees. *See* ABA Model Rule 1.11.

Accordingly, it would be prudent for you to delineate clearly at the outset of the representation, both orally and in writing (in the engagement letter), that you represent the organization, and not any of the organization's officers, directors, or employees in their individual capacities. If it becomes apparent during the course of the representation that the interests of the organization may be in conflict with the individual interests of the organization's officers, directors, or employees, you should convey this information to the potentially affected individuals at the earliest opportunity.

If you determine that the issues presented by the representation permit common representation

of the organization and its officers and directors, scrupulously follow the requirements for written, informed consent and be prepared to withdraw from representation of one or the other or both clients if a nonconsentable conflict arises. Again, you should delineate clearly at the outset of the representation, both orally and in writing (in the engagement letter), what will happen if an actual conflict does arise; furthermore, make sure that all clients understand the effects of such a conflict on your ability to continue to represent each client. In all cases, it would be prudent for you to suggest that each client obtain independent advice of counsel as to whether it is in each client's best interests to agree to the common representation; in many cases, you would be wise to insist on it.

If the organization is planning to cover the costs of representing its officers and directors with respect to their potential personal liability, you should be aware of the provisions of the organization's directors and officers liability policy and be wary of the potential for the payment of such fees to constitute an excess benefit transaction under section 4958 of the Code (in the case of a public charity) or self-dealing under section 4941 of the Code (in the case of a private foundation).

General Obligations In Representing Any Client

Lawyers face basic obligations in representing any client. The ABA Model Rules set out these obligations, which have been incorporated in some form into most state rules of professional conduct. In addition to being aware of the following duties, when representing tax-exempt organizations you should have added sensitivity to issues such as cost, avoidance of duplicative work, and ensuring that the work done is in the organization's best interest.

Duties To The Client

Duty To Provide Competent And Diligent Representation. At the most basic level, a lawyer has a duty to provide competent representation, which requires "the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation." ABA Model Rule 1.1. The ABA Model Rules further elaborate that a lawyer must act with "reasonable diligence and promptness" when representing a client. ABA Model Rule 1.3. The duty of diligence requires a lawyer to:

(1) "[P]ursue a matter on behalf of a client despite opposition, obstruction or personal inconvenience to the lawyer";

(2) "[T]ake whatever lawful and ethical measures are required to vindicate a client's cause or endeavor"; and

(3) "[A]ct with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf." ABA Model Rule 1.3 cmt. [1].

Competent representation depends on keeping the client reasonably informed and complying with reasonable requests for information. Because decisions ultimately rest with the client, you must explain matters to the client "to the extent reasonably necessary to permit the client to make informed decisions regarding the representation." ABA Model Rule 1.4(b).

In general, as a lawyer you are not required to give advice unless asked to do so by the client. You can, however, be held liable for failing to advise the client on matters within the scope of representation. The commentary to the ABA Model Rules explains that a lawyer is not expected to give advice until asked by the client. Nevertheless, when you know that the client proposes a course of action that is likely to result in substantial adverse legal consequences to the client, ABA Model Rule 1.4 may obligate you to act "if the client's course of action is related to the representation." ABA Model Rule 2.1 cmt. [5].

Duty To Exercise Independent Judgment And Render Candid Advice. Given the limitations and prohibitions the tax laws place on certain transactions and activities by public charities and private founda-

tions, the prospect of having to give a client unpalatable advice is very real. However, at all times, you must exercise independent professional judgment and render candid advice. The commentary to ABA Model Rule 2.1 explains that a "client is entitled to straightforward advice expressing the lawyer's honest assessment" and that "a lawyer should not be deterred from giving candid advice by the prospect that the advice will be unpalatable to the client." ABA Model Rule 2.1, cmt. [1]. In rendering advice, "a lawyer may refer not only to law, but to other considerations, such as moral, economic, social, and political factors, that may be relevant to the client's situation." ABA Model Rule 2.1. Where nonprofit organizations are concerned, such factors often play a significant role of which you should be mindful. For example, a course of action that may be permitted as a legal matter may have significant downsides from a community-relations or fund-raising perspective.

Duty To Maintain Client Confidences. It is universally recognized that lawyers have a general duty to maintain client confidences. ABA Model Rule 1.6(a) provides that a "lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation," or one of the exceptions to the general duty to maintain client confidences set out in ABA Model Rule 1.6(b) applies. *See* the discussion of Reporting Wrongdoing — Externally, *infra*.

Crime/Fraud Prohibition On Counsel Or Assistance. Notwithstanding confidentiality and the general duty to advise the client, you must not counsel or assist criminal or fraudulent conduct. Of course, it is perfectly acceptable—indeed, expected—to discuss the legal consequences of any proposed course of conduct with a client. Your role as an advocate demands that, in appropriate circumstances, you "assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law." ABA Model Rule 1.2(d). The commentary to ABA Model Rule 1.2 indicates that the rule "does not preclude the lawyer from giving an honest opinion about the actual consequences that appear likely to result from a client's conduct." ABA Model Rule 1.2 cmt. [9].

Duties To Others

Despite your allegiances to the client, you have an overriding duty of honesty and candor when dealing with third parties, particularly courts. The ABA Model Rules make clear that you must not "knowingly" make false statements of material fact or law to the tribunal or offer evidence you know to be false. ABA Model Rule 3.3. The commentary specifies that "an assertion purporting to be on the lawyer's own knowledge...may properly be made only when the lawyer knows the assertion is true or believes it to be true on the basis of a reasonably diligent inquiry." ABA Model Rule 3.3 cmt. [3]. Courts apply an objective reasonableness standard to determine whether the lawyer believed the representations were true. *See, e.g.*, *Office of Disciplinary Counsel v. Price*, 732 A.2d 599, 604 (Pa. 1999). The same duty of honesty applies to third persons generally as it does when dealing with tribunals. *See* ABA Model Rule 4.1.

In-House Versus Outside Counsel

In-house counsel generally have the same obligations as outside counsel. In-house counsel, however, have a broader scope of representation, and therefore are responsible for advising the client on a broader range of issues. Whereas outside counsel is typically hired for specific tasks, in-house counsel is charged with an organization's day-to-day legal affairs. In addition to responsibilities that all lawyers owe their clients, in-house counsel often also are bound by employee handbooks and the like, which set forth responsibilities for all employees of the organization.

Reporting Wrongdoing

Reporting wrongdoing can be one of the most difficult tasks you can face as an attorney.

Reporting Wrongdoing—Externally

Like most rules, the duty of confidentiality is not absolute. The ABA Model Rules provide that a lawyer may disclose client confidences to the extent the lawyer reasonably believes necessary:

- To prevent reasonably certain death or substantial bodily harm;
- To establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client;
- To establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved; or
- To respond to allegations in any proceeding concerning the lawyer's representation of the client. ABA Model Rule 1.6(b).

ABA Model Rule 8.3(a) requires you to inform the appropriate professional authority if you know of any violation of the Rules of Professional Conduct by another lawyer that raises a substantial question regarding that other lawyer's honesty, trustworthiness, or fitness as a lawyer in other respects. Whether a non-criminal violation raises a "substantial question" as to honesty, trustworthiness, or fitness, requires a "measure of judgment," and you may opt not to report if you are uncertain on this point. ABA Standing Comm. on Ethics and Prof'l Responsibility, Formal Op. 04-433 (2004).

The duty of confidentiality trumps this duty to report. You may not disclose information relating to a client's representation when reporting the misconduct of another lawyer, unless you obtain the client's informed consent. ABA Model Rule 8.3(c). "However, a lawyer should encourage a client to consent to disclosure where prosecution would not substantially prejudice the client's interests." ABA Model Rule 8.3 cmt. [2]. The decision will ultimately be up to the client, however, and your desire to report the wrongdoing of another lawyer may be effectively precluded from disclosure by the client's "wishes or even whims." ABA Formal Opinion 04-433 (2004), *supra*.

Reporting Wrongdoing—Internally

ABA Model Rule 1.13(b) offers guidance to lawyers who represent organizations and other entities when faced with wrongdoing or potential wrongdoing:

> If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization.

In determining how to proceed, you can consider factors such as the seriousness of the violation, the apparent motivation underlying the conduct, the involved person's responsibility within the organization, the lawyer's scope of representation, the organization's policies, and any other relevant matters. ABA Model Rule 1.13 and cmt. 4 suggest appropriate action including: asking the client to reconsider; advising of the need for a separate legal opinion; and referring the matter to the highest authority that can act on the organization's behalf. If you report a potential violation of law that is likely to result in substantial injury to the organization to the highest authority within the organization, but the highest authority insists on taking an action (or engaging in a failure to act) in violation of law, you may resign in accordance with ABA Model Rule 1.16 (discussed below).

Withdrawing From Representation

ABA Model Rule 1.16 requires a lawyer to withdraw if the representation will result in a violation of the rules of professional conduct or other

law. ABA Model Rule 1.16(a)(1). If a lawyer has not been appointed by a tribunal to represent a client (as typically would be the case where a lawyer represents a tax-exempt organization), ABA Model Rule 1.16 permits, but does not require, a lawyer to withdraw from representing a client if, *inter alia*:

- The client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal or fraudulent;
- The client insists on taking action that the lawyer considers repugnant or with which the lawyer has a fundamental disagreement; or
- The client fails to abide by the terms of the fee agreement with the lawyer, and the lawyer has given the client reasonable warning that the lawyer will withdraw unless the obligation is fulfilled. ABA Model Rule 1.16(b).

Your duty of confidentiality, however, will survive your withdrawal from representation (unless the confidential information must be disclosed to prevent reasonably certain death or substantial bodily harm, or one of the other exceptions to nondisclosure in ABA Model Rule 1.6(b) applies). ABA Model Rule 1.16(b). You may, however, give notice of the fact of withdrawal and withdraw or disaffirm any opinion, document, affirmation, or the like. ABA Model Rule 1.6, cmt. [14].

Application Of The Above Principles To The Trust Context

So how do these principles apply in the trust context?

Who Is The Client?

In the trust context, it is especially important to understand precisely whom you represent. Your attorney-client relationship is a bond with the trustees, who act collectively to represent the trust. A trust is not a recognized entity under the law, but instead is a relationship of obligation imposed on the trustees for the benefit of the beneficiaries. Trustees act on the trust's behalf. In their official capacity, trustees are empowered to employ outside counsel and other service providers. Thus, outside counsel and other providers servicing the trust have as a client the trustees, in their collective and representative capacity as trustees.

Make no mistake: the client is not the beneficiaries. But you may nevertheless owe a limited duty to the beneficiaries. Although a trust lawyer has an attorney-client relationship only with the fiduciary trustees and not the beneficiaries, as the trust lawyer you might be obliged to notify the beneficiaries of trustee misconduct that threatens the beneficiaries' interest in the trust. The Hawaii Probate Rules, for example, state that a lawyer representing a trust "shall owe a duty to notify such beneficiaries...of activities of the fiduciary actually known by the attorney to be illegal that threaten the security of the assets under administration or the interests of the beneficiaries." Haw. Prob.R. 42(b). When the beneficiaries are an open-ended class of individuals, this may require a lawyer to report wrongdoing to the State Attorney General.

Trust-Specific Standards

In addition to the usual rules governing all lawyers, trust law imposes several special rules and obligations. Fundamentally, a lawyer representing a trust cannot give legal advice if the work can in no way benefit the trust. Still, as in most other contexts, you need not question the client's (*i.e.*, the trustee's) decisions. In short, you may assume that trustee decisions are proper, unless you know them to be illegal, they are based on your own negligent advice, or they are completely adverse to the trust's interest and lacking any legitimate justification. (In-house counsel may have an additional obligation as an employee to more closely monitor the decisions of trustees.)

You similarly are not obligated to second-guess the trustees' request for legal advice. The trustees ask for advice in order to make decisions on the appropriate course of action. You therefore should

provide advice, even when the advice is that a specific action cannot be taken. Bear in mind, however, the usual caveat: you cannot give legal advice when the work requested can in no way benefit the trust.

Reporting Fiduciary Wrongdoing

In some jurisdictions, provisions of the governing probate rules may mandate reporting of fiduciary wrongdoing. Hawaii Probate Rule 42 is one example. That rule allows lawyers for a trust to disclose trustee wrongdoing to the beneficiaries, when the activity is "actually known by the attorney to be illegal" and threatens "the security of the assets under administration or the interests of the beneficiaries." Haw. Prob. R. 42(b).

Hawaii Probate Rule 42(c) also provides that a lawyer for a trust:

> is an officer of the court and shall assist the court in securing the efficient and effective management of the estate. The attorney has an obligation to monitor the status of the estate and to ensure that required actions such as accountings and closing a probate estate are performed timely. The attorney, after prior notice to the fiduciary, shall have an obligation to bring to the attention of the court the nonfeasance of the fiduciary.

This disclosure requirement, however, appears to be limited to administrative matters, and is not all encompassing.

ETHICAL CONSIDERATIONS IN REPRESENTING TAX-EXEMPT CLIENTS BEFORE THE IRS • For decades, tax practitioners have been subject to the rules governing practice before the IRS contained in what is referred to as "Circular 230." *See generally* 31 C.F.R. pt.10 (2005). The IRS from time to time revisits and revises these standards of practice, and has done so recently in connection with its efforts to battle abusive tax-avoidance transactions. The IRS promulgated final regulations at the end of 2004 that amended Circular 230 to: (1) include best practices for tax advisors providing advice to taxpayers relating to federal tax issues or submissions to the IRS; and (2) revise the standards for providing opinions and other written advice. *See* T.D. 9165, 69 Fed. Reg. 75839 (Dec. 20, 2004). In May of 2005, the IRS promulgated additional final regulations to clarify certain aspects of the December 20, 2004, rules. *See* T.D. 9201, 70 Fed. Reg. 28824 (May 19, 2005). The IRS issued proposed regulations in early 2006 (the "2006 Proposed Regulations"), *see* 71 Fed. Reg. 6421 (Feb. 8, 2006). If finalized, these proposed regulations would update other provisions of Circular 230. Many of these revisions and proposals are discussed below, along with other relevant provisions of Circular 230.

General Scope Of Circular 230 Standards

The Secretary of the Treasury is authorized to regulate the practice of practitioners (*e.g*., attorneys and certified public accountants) before the Department of Treasury, including the Internal Revenue Service. 31 U.S.C. §330(a)(1). Practice before the IRS includes "all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service." 31 C.F.R. §10.2(d). "Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the Internal Revenue Service, and representing a client at conferences, hearings, and meetings." *Id*. To this list of what constitutes practice before the IRS, the 2006 Proposed Regulations add "rendering written advice with respect to any entity, transaction plan, or arrangement...having a potential for tax avoidance or evasion."

The Circular 230 regulations are limited to practice before the IRS and do not supplant other ethical standards (*e.g.*, state ethics rules) that may apply to practitioners. Like state ethical standards, Circular 230 standards could be used in a profes-

sional malpractice action involving a tax practitioner to determine the applicable standard of care.

Best Practices For Tax Advisors

"To restore, promote, and maintain the public's confidence" in individuals and firms providing tax advice, Circular 230 includes "best practices" for all tax advisors providing advice to taxpayers relating to federal tax matters or submissions to the IRS. 69 Fed. Reg. 75839, 75840 (Dec. 20, 2004). These best practices are merely "aspirational"; therefore, a practitioner who fails to comply with them cannot be subject to discipline unless the violation is contrary to another provision of Circular 230. *Id*.

Best practices when providing advice to clients or in preparing submissions to the IRS include the following:

- Communicating clearly with the client regarding the terms of the engagement. For example, the advisor should determine the client's expected purpose for and use of the advice and should have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.
- Establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts.
- Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice.
- Acting fairly and with integrity in practice before the Internal Revenue Service. 31 C.F.R. §10.33(a) (2005).

In the case of law and accounting firms, Circular 230 urges those charged with overseeing the firm's tax practice to take reasonable steps to ensure that the firm's procedures for all members, associates, and employees are consistent with these best practices. *Id*. §10.33(b).

Duties Of Disclosure And Due Diligence

Circular 230 has its own disclosure and due diligence duties that it imposes on those practicing before the IRS.

Obligation To Furnish Information To IRS

You must promptly submit records or information requested by the IRS unless you reasonably believe, in good faith, that the records or information sought are privileged or that the request is of doubtful legality. 31 C.F.R. §10.20(a)(1). If the requested information or records are not in your or the client's possession or control, you must promptly notify the IRS of the identity of any person who you believe has possession or control of the requested information or documents. *Id*. §10.20(a)(2). You "must make reasonable inquiry of [your] client" to ascertain who may have possession or control of the requested information or records, but you are not required to make an inquiry of any other third parties or independently verify what your client tells you in response to your reasonable inquiry. *Id*.

In connection with a disciplinary proceeding conducted by the Director of Practice, you must provide the Director with any information lawfully and properly requested, and testify regarding such information as part of the disciplinary proceeding, unless you have a good faith and reasonable belief that the information is privileged. *Id*. §10.20(b). Moreover, absent a good faith and reasonable belief that the information or record is privileged, you "may not interfere, or attempt to interfere, with any proper and lawful effort by the Internal Revenue Service, its officers or employees, or the Director of Practice, or his or her employees, to obtain any record or information." *Id*. §10.20(c).

Obligation To Notify A Client Of Noncompliance, Errors, Or Omissions

If you are representing a client with respect to any matter administered by the IRS, you must notify promptly your client of the fact of: (1) any noncompliance with the revenue laws of the United States; and (2) any error or omission from any return, document, affidavit, or other paper that the client submitted or executed under the revenue laws of the United States. *Id*. §10.21. You are also required to advise your client "of the consequences as provided under the Code and regulations of such noncompliance, error, or omission." *Id*. The current standards of practice do not, however, obligate you to advise the client how to correct errors or omissions (although you presumably would do so at a client's request).

Due Diligence Requirements

With respect to a matter before the IRS, you must exercise due diligence in: (1) preparing (or assisting in the preparation of), approving, and filing documents relating to an IRS matter; and (2) determining the correctness of oral or written representations the practitioner makes to the Treasury Department or to his or her clients concerning the matter. *Id*. §10.22(a). If you rely on the work product of others, you must use reasonable care in engaging, supervising, training, and evaluating those persons. Reasonable care depends on the expertise and qualifications of the person on whom you are relying. *Id*. §10.22(b). For example, you would need to exercise greater supervision over a paralegal than another attorney hired for his or her special legal expertise in regard to a particular matter.

You may not "unreasonably delay" the prompt disposition of a matter before the IRS. *Id*. §10.23.

Limitations On Assistance From Certain Persons

You are prohibited from knowingly accepting assistance from, or providing assistance to, any person who is under disbarment or suspension from practice before the IRS if the assistance relates to a matter or matters constituting practice before the IRS. *Id*. §10.24. This prohibition applies to both direct or indirect assistance. *Id*. Circular 230 also provides rules limiting the ability of former government employees, their partners, and their associates from representing clients before the IRS. *Id*. §10.25.

Fees

You are prohibited from charging "an unconscionable fee" for representing a client in a matter before the IRS. *Id*. §10.27(a).

You may not charge a contingent fee for "advice rendered in connection with a position taken or to be taken on an original tax return." *Id*. §10.27(b)(2). You may charge a contingent fee, however, for advice in connection with an amended return or a claim for refund (other than a claim for refund made on an original return), but only if you reasonably anticipate that the IRS will substantively review the amended return or claim. *Id*. §10.27(b)(3).

The 2006 Proposed Regulations, *see* 71 Fed. Reg. 6421 (Feb. 8, 2006), revise these rules somewhat to provide that you may not charge a contingent fee "for services rendered in connection with any matter before the Internal Revenue Service," except for services rendered in connection with any judicial proceeding under the Internal Revenue Code, or for services rendered in connection with the IRS's examination of, or challenge to (1) an original tax return, or (2) an amended return or claim for refund or credit filed before the taxpayer received written notice of the examination of, or a written challenge to, the original tax return.

A contingent fee for purposes of section 10.27 of Circular 230 is a fee based, in whole or in part, on whether or not a position taken on a tax return or other filing either avoids challenge by the IRS, or is sustained by the IRS or by a court. *Id*. §10.27(b)(1). A contingent fee includes any fee arrangement that requires you to reimburse the client for all or a por-

tion of the client's fee if a position taken on a tax return or other filing is challenged by the IRS or is not sustained (*e.g.*, pursuant to an indemnity agreement, a guarantee, rescission rights, or any other arrangement with a similar effect). *Id*.

Conflicts Of Interest

You cannot represent a client before the IRS if the representation involves a conflict of interest, unless:

(1) You reasonably believe that you will be able to provide competent and diligent representation to each affected client;

(2) The representation is not prohibited by law; and

(3) Each affected client gives informed consent, confirmed in writing. *Id*. §10.29(b).

A conflict of interest exists for purposes of Circular 230 if: (1) the representation of one client will be directly adverse to another client; or (2) a significant risk exists that the representation of one or more clients will be materially limited by your responsibilities to another client, a former client, or a third person, or by your personal interest. *Id*. §10.29(b).

Note that the Circular 230 rules governing conflicts of interest essentially mirror ABA Model Rule 1.7(a), discussed *supra*. Circular 230, however, imposes the added requirement that you maintain copies of any written consents for at least 36 months from the date of the conclusion of the representation of the affected clients and provide the IRS copies of the written consents on request. *Id*. §10.29(c).

Standards For Providing Oral And Written Advice To Clients

Advice, of course, is what your clients seek from you. In the special circumstances of tax advice, Circular 230 provides certain standards for how you impart it.

Advice With Respect To Tax-Return Positions And Documents Submitted To The IRS

You may not advise a client to take a tax-return position unless: (1) the position meets the "realistic possibility standard"; or (2) the position is "not frivolous." *Id*. §10.34(a). A position meets the "realistic possibility" standard "if a reasonable and well informed analysis of the law and the facts by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits." *Id*. §10.34(d)(1). A position is frivolous if it is "patently improper." *Id*. §10.34(d)(2).

The 2006 Proposed Regulations extend the proscriptions applicable to tax returns to other documents, and would prohibit you from advising a client to take a position on any document, affidavit, or other paper to the IRS, unless the position is not frivolous. In addition, the 2006 Proposed Regulations would prohibit you from advising a client to submit a document, affidavit, or other paper to the IRS:

(1) The purpose of which is to delay or impede the administration of the federal tax laws;

(2) That is frivolous or groundless; or

(3) That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation.

In any case, if you are advising a client to take a position on a tax return, you must inform the client of the penalties reasonably likely to apply, including the section 6662 accuracy-related penalty, and of any opportunity to avoid such penalties by adequately disclosing the position. *Id*. §10.34(a) & (b). You must also inform the client of the requirements for adequate disclosure (if relevant). *Id*. The 2006 Proposed Regulations would require you similarly to advise the client of potential penalty exposure and potential actions the client could take to avoid such penalty exposure in the case of the submission of any document, affidavit, or other paper to the IRS.

If you are advising a client to take a position on a tax return, you generally may rely in good faith without verification on information furnished by the client. You may not, however, ignore the implications of information furnished to, or actually known by, yourself, and you must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete. *Id*. §10.34(c).

Written Tax Advice

All written advice, including electronic communications such as emails and faxes, rendered after June 20, 2005, must comply with the following requirements.

- You may not base written advice on unreasonable factual or legal assumptions (including assumptions as to future events).
- Written advice may not unreasonably rely on representations, statements, findings, or agreements of the taxpayer or any other person.
- Written advice must consider all relevant facts that you know or should know.
- In evaluating a Federal tax issue, the written advice may 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. *Id*. §10.37(a).

The IRS will consider all facts and circumstances, including the scope of the engagement and the type and specificity of the advice sought by the client, in determining whether you have failed to comply with these requirements for written tax advice. *Id*.

Reliance Opinions

Certain written advice that meets the definition of a "covered opinion," including a so-called reliance opinion, is subject to additional requirements. *Id*. §10.35(a).

Definition Of Covered Opinion

A "covered opinion" is defined as written advice (including electronic communications) by a practitioner concerning one or more Federal tax issues arising from:

- A transaction that is the same or substantially similar to a *listed transaction*;
- Any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, the *principal purpose* of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code;
- Any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a *significant purpose* of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code, if the written advice is: (1) a *reliance opinion*, (2) a marketed opinion, (3) subject to conditions of confidentiality, or (4) subject to contractual protection. (Written advice that concerns the qualification of a qualified plan, is a state or local bond opinion, or is included in documents to be filed with the SEC, is excluded from this "significant purpose" category of covered opinion. *Id*. §10.35(b)(2)(ii)(B).) *Id*. §10.35(b)(2)(i) (emphasis added).

In your day-to-day representation of tax-exempt organizations, you are most likely to be faced with the issue of whether the written advice you are providing meets the definition of a *reliance opinion*. Accordingly, this article focuses only on the requirements for reliance opinions and does not discuss the other definitions of covered opinions (*e.g.*, listed transaction opinions, tax shelter opinions, or other marketed opinions). Be mindful, however, of any transactions that could fall under any of these other definitions of a "covered opinion." *See id*. §10.35(b)(2) for these other definitions.

Exclusions From Definition Of Covered Opinion

There are several notable exceptions to the definition of a covered opinion. Written advice that meets one of the following exceptions will not have to comply with the additional requirements discussed below that apply to a covered opinion.

Subsequent Written Advice Exception. Written advice provided to a client during the course of an engagement is excluded from the definition of a reliance opinion if you are reasonably expected to provide subsequent written advice to the client that satisfies the section 10.35 requirements for a covered opinion. *Id*. §10.35(b)(2)(ii)(A).

Post-Filing Advice Exception. Written advice prepared for and provided to a taxpayer, solely for the use by that taxpayer, after the taxpayer has filed a tax return with the IRS reflecting the tax benefits of the transaction is excluded from the definition of a reliance opinion. The post-filing exception does not apply, however, if you know or have reason to know that the written advice will be relied upon by the taxpayer to take a position on a tax return (including an amended return that claims tax benefits not reported on a previously filed return) filed after the date on which the advice is provided to the taxpayer. *Id*. §10.35(b)(2)(ii)(C).

In-House Advice Exception. Written advice is excluded from the definition of a reliance opinion if it is "provided to an employer by a practitioner in that practitioner's capacity as an employee of that employer solely for purposes of determining the tax liability of the employer." *Id*. §10.35(b)(2)(ii)(D).

Negative Advice Exception. Written advice that does not resolve a federal tax issue in a taxpayer's favor at any confidence level is excluded from the definition of a reliance opinion. *Id*. §10.35(b)(2)(ii)(E).

Definition Of Reliance Opinion

As noted above, a reliance opinion must concern one or more Federal tax issues arising from a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement, "a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code." *Id*. §10.35(b)(2)(i)(C). A "significant purpose" of tax avoidance or evasion is not defined in Circular 230, and authorities from other areas of the tax law do not provide any other meaningful guidance as to the application of this term. Thus, whenever tax planning is involved, the prudent tax practitioner should assume that the IRS, for purposes of determining whether the covered-opinion rules apply, will take the position that a significant purpose of the plan or arrangement under consideration is tax avoidance.

In addition, for written advice to meet the definition of a "reliance opinion," the written advice must conclude "at a confidence level of at least more likely than not (a greater than 50% likelihood) that one or more significant Federal tax issues would be resolved in the taxpayer's favor." *Id*. §10.35(b)(4)(i). Thus, a reasonable basis opinion is not a reliance opinion, because it does not reach a confidence level of at least more likely than not. (A reasonable basis opinion could, however, meet one of the other definitions of a covered opinion not discussed herein.)

A "Federal tax issue" is defined as a "question concerning the Federal tax treatment of an item of income, gain, loss, deduction, or credit, the existence or absence of a taxable transfer of property, or the value of property for Federal tax purposes." *Id*. §10.35(b)(3). A "significant" Federal tax issue is one for which 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 transaction(s) or matter(s) addressed in the opinion." *Id*.

Requirements For Reliance Opinions That Do Not Contain a Disclaimer

You can opt out of the rules that apply to a reliance opinion by using an appropriate disclaimer. Written advice is not treated as a reliance opinion "if the practitioner *prominently discloses* in the written advice that it was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer." *Id.* §10.35(b)(4)(ii) (emphasis added). To be prominently disclosed within the meaning of section 10.35, this disclaimer must be "readily apparent to a reader of the written advice." At a minimum, the disclaimer "must be set forth in a separate section (and not in a footnote) in a typeface that is the same size or larger than the typeface of any discussion of the facts or law in the written advice." *Id.* §10.35(b)(8).

If a reliance opinion does not contain this disclaimer, then you must comply with the following requirements. (The following discussion assumes that the reliance opinion does not include an opinion that covers a listed transaction, a "principal purpose" tax shelter, a marketed transaction, or a transaction for which there exists a confidentiality agreement or contractual protection. *See id.* §10.35(b) for the relevant definitions of these transactions and terms.)

Requirements Pertaining To Factual Matters. You must use reasonable efforts to identify and ascertain the facts, which may relate to future events if a transaction is prospective or proposed, and to determine which facts are relevant. The opinion must identify and consider all facts that you determine to be relevant. *Id.* §10.35(c)(1)(i).

You cannot base a reliance opinion on any unreasonable factual assumptions (including assumptions as to future events). An unreasonable factual assumption includes a factual assumption that you know or should know is incorrect or incomplete. For example, it is unreasonable to assume that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits. A factual assumption includes reliance on a projection, financial forecast, or appraisal. It is unreasonable to rely on a projection, financial forecast, or appraisal if you know or should know that the projection, financial forecast, or appraisal is incorrect or incomplete or was prepared by a person lacking the skills or qualifications necessary to prepare such projection, financial forecast, or appraisal. The opinion must identify in a separate section all factual assumptions you relied upon. *Id.* §10.35(c)(1)(ii).

You must not base the opinion on any unreasonable factual representations, statements, or findings of the taxpayer or any other person. An unreasonable factual representation includes a factual representation that you know or should know is incorrect or incomplete. For example, you may not rely on a factual representation that a transaction has a business purpose if the representation does not include a specific description of the business purpose or you know or should know that the representation is incorrect or incomplete. The opinion must identify in a separate section all factual representations, statements, or findings of the taxpayer relied upon by the practitioner. *Id.* §10.35(c)(1)(iii).

Requirements Pertaining To Legal Analysis. A reliance opinion must relate the applicable law (including potentially applicable judicial doctrines such as the requirements of business purpose and/or economic substance) to the relevant facts. *Id.* §10.35(c)(2)(i). The opinion must not contain internally inconsistent legal analyses or conclusions. *Id.* §10.35(c)(2)(iii). You must not assume the favorable resolution of any significant Federal tax issue, and the opinion must consider all significant Federal tax issues, unless you rely on the opinion of another practitioner with respect to one or more significant Federal tax issues, or the opinion is a so-called limited scope opinion (discussed *infra*). *Id.* §§10.35(c)(2)(ii), 10.35(c)(3)(i). You must not otherwise base an opinion on any unreasonable legal assumptions, representations, or conclusions. *Id.*

§10.35(c)(2)(ii). In evaluating the significant Federal tax issues addressed in the opinion, you 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. *Id.* §10.35(c)(3)(iii).

Reliance On Opinions Of Others. In general, you must be knowledgeable in all of the aspects of Federal tax law relevant to the opinion being rendered. You may, however, rely on the opinion of another practitioner with respect to one or more significant Federal tax issues, unless you know or should know that you should not rely on the opinion of the other practitioner. If you rely on the opinion of another practitioner, the practitioner's opinion must identify the other opinion on which you are relying and set forth the conclusions reached in the other opinion. *Id.* §10.35(d)(1). You must be satisfied that the combined analysis of the opinions, taken as a whole, and the overall conclusion, if any, otherwise satisfy the requirements for a reliance opinion.

Limited Scope Opinion. A reliance opinion does not have to consider all of the significant Federal tax issues if it meets the requirements for a limited scope opinion. *Id.* §10.35(c)(3)(v). First, you and your client the taxpayer must agree that the scope of the opinion and the taxpayer's potential reliance on the opinion for purposes of avoiding penalties that may be imposed on the taxpayer will be limited to the Federal tax issue(s) addressed in the opinion. *Id.* §10.35(c)(3)(v)(A)(1). Second, the opinion must prominently disclose that:

- The opinion is limited to the one or more Federal tax issues addressed in the opinion;
- Additional issues may exist that could affect the Federal tax treatment of the transaction or matter that is the subject of the opinion and the opinion does not consider or provide a conclusion with respect to any additional issues; and
- With respect to any significant Federal tax issues outside the limited scope of the opinion, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer. *Id.* §§10.35(c)(3)(v)(A)(3), 10.35(e)(3).

In other words, a limited scope opinion must contain a prominent disclaimer that the taxpayer cannot rely on the opinion for penalty protection with respect to any significant Federal tax issue not considered in the opinion.

Unlike in the case of a non-limited-scope opinion, you may make reasonable assumptions regarding the favorable resolution of a Federal tax issue (an assumed issue) for purposes of providing a limited scope opinion. *Id.* §10.35(c)(3)(v). The limited scope opinion must, however, identify in a separate section all issues for which you assumed a favorable resolution. *Id.*

Additional Requirements For Non-Limited Scope Reliance Opinions. If the reliance opinion is not a limited scope opinion, the opinion must satisfy additional requirements.

The opinion must provide your conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each significant Federal tax issue considered in the opinion (unless you are relying on the opinion of another with respect to that issue). If you are unable to reach a conclusion with respect to one or more of those issues, the opinion must state that you are unable to reach a conclusion with respect to those issues. The opinion must describe the reasons for the conclusions, including the facts and analysis supporting the conclusions, or describe the reasons that you are unable to reach a conclusion as to one or more issues. *Id.* §10.35(c)(3)(ii).

If you fail to reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant Federal tax issues considered, the opinion must prominently disclose that:

- The opinion does not reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant Federal tax issues addressed by the opinion; and
- With respect to those significant Federal tax issues, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer. *Id.* §§10.35(c)(3)(ii), 10.35(e)(4).

Finally, the opinion must provide your *overall conclusion* as to the likelihood that the Federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment and the reasons for that conclusion. If you are unable to reach an overall conclusion, the opinion must state that you are unable to do so and describe the reasons therefor. *Id.* §10.35(c)(4).

Other Considerations. A reliance opinion that meets these requirements satisfies your responsibilities under section 10.35 of Circular 230, but the IRS will continue to evaluate the persuasiveness of the opinion with regard to the tax issues in question and the taxpayer's good faith reliance on the opinion under applicable provisions of the law and regulations. *Id.* §10.35(f).

Consequences For Violating Circular 230 Standards

After notice and an opportunity to be heard, the IRS may suspend or disbar from practice before the IRS practitioners who are incompetent or disreputable, who fail to comply with the standards set forth in Circular 230, or with intent to defraud, willfully and knowingly mislead or threaten a client or prospective client. 31 U.S.C. §330; 31 C.F.R. §10.50(a). Circular 230 also provides for censure (defined simply as a "public reprimand") as an alternative to suspension or disbarment. 31 C.F.R. §10.50(a). Incompetent or disreputable conduct includes, *inter alia*: conviction of a criminal offense under the tax laws or one involving dishonesty or a breach of trust; knowingly giving false or misleading information to an officer or employee of the Treasury Department; and use of abusive language or other "contemptuous conduct" in connection with practice before the IRS. *Id.* §10.51.

Only "willful" violations of the Circular 230 regulations can result in censure, suspension, or disbarment from practice before the IRS, with the exception of the standards set out in sections 10.34 (covering standards for advising with respect to tax return positions), 10.35 (setting out requirements for covered opinions, including reliance opinions), 10.36 (covering compliance with section 10.35 by firms), and 10.37 (setting out requirements for all written advice). *Id.* §10.52. You may be censured, suspended, or disbarred from practice before the IRS, if you "[r]ecklessly or through gross incompetence" violate any of these provisions. *Id.* Reckless conduct is defined as "a highly unreasonable omission or misrepresentation involving an extreme departure from the standards of ordinary care that a practitioner should observe under the circumstances." *Id.* §10.51(l). Moreover, in determining whether you acted recklessly or through gross incompetence, the existence of a pattern of conduct will be taken into account. *Id.* Gross incompetence "includes conduct that reflects gross indifference, preparation which is grossly inadequate under the circumstances, and a consistent failure to perform obligations to the client." *Id.*

In addition to, or in lieu of, censure, suspension, or disbarment, the 2006 Proposed Regulations would permit the IRS to impose a monetary penalty, in an amount not to exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty, on any practitioner who engages in any of the above conduct in violation of section 10.50. In addition, if you were acting on behalf of an employer or any firm or other entity in connection with the conduct giving rise to the conduct, the 2006 Proposed Regulations would permit the IRS to impose a monetary penalty on such employer, firm, or other entity if it knew, or

reasonably should have known, of such conduct. This employer-level penalty may be in addition to the penalty imposed on you. The Preamble to the 2006 Proposed Regulations states that the Treasury and the IRS will issue procedures relating to the imposition of this monetary penalty through separate published guidance.

Procedures Governing Circular 230 Proceedings

The Director of the Office of Professional Responsibility ("OPR") in the IRS investigates violations of the standards of practice and institutes and conducts disciplinary proceedings. *Id*. §10.1(b). Circular 230 provides procedures that govern such proceedings, and provides for an evidentiary hearing and review by an Administrative Law Judge of any complaint filed by the Director of OPR for the censure, suspension, or disbarment of a practitioner. *Id*. §§10.60-10.78.

A practitioner who has been disbarred from practice before the IRS may petition the Director of OPR for reinstatement after five years. *Id*. §10.81. The petition will not be granted unless the Director of OPR is satisfied that the petitioner, thereafter, is not likely to conduct himself or herself contrary to the requirements of Circular 230, and that granting reinstatement would not be contrary to the public interest. *Id*. Were you to be suspended from practice before the IRS, or censured, your future ability to represent clients before the IRS may be subject to certain conditions "designed to promote high standards of conduct." *Id*. §10.79. The period of time during which such conditions apply will depend on the gravity of the violations. *Id*. For example, when a practitioner is censured because he or she failed to advise his or her clients about a potential conflict of interest or failed to obtain the clients' written consents, the Director of OPR may require the practitioner to obtain, and to provide the IRS with a copy of, client consents for an appropriate period following censure. *Id*.

CONCLUSION • Whether representing a nonprofit organization in front of the IRS, in court, or in general, you should bear in mind the general and particular ethics rules that apply to such representation. A working knowledge of such rules could help you to avoid not just potential malpractice liability, but also disbarment, censure, and the personal embarrassment that is attendant to such outcomes.

PRACTICE CHECKLIST FOR
Ethical Considerations When Representing Nonprofit And Tax-Exempt Organizations

It's crucial to have an understanding of the ethical principles governing your work for nonprofit and tax-exempt organizations. Among them are the following:

__ Who is the client? Usually the organization.
__ But if the organization, can conflicts arise in your dealings with individuals within the organization?
__ Are the potential conflicts "consentable", or outright prohibited?
__ Are you competent to handle the particular matter?
__ Can you exercise independent judgment and render candid advice?
__ Can you maintain client confidences—or are there some exceptions that permit/require you to disclose certain facts?
__ Can you satisfy your duties to others besides your client?
__ How and when can you withdraw from the representation?

__ Can you meet your disclosure obligations under Circular 230?
__ Are there errors or omissions in tax-related matters you must disclose to the client?
__ What due diligence must you do in representing a client before the IRS?
__ Are you cognizant of the standards that apply for providing oral and written advice to clients in tax matters?

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