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LAWYER LIABILITY FOR ASSISTING IN BREACH OF FIDUCIARY DUTY: PRIVILEGE OR PERIL?

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On September 8, the Oregon Supreme Court issued its opinion in *Reynolds v. Schrock*, 341 Or 338, 142 P3d 1062, 2006 WL 2578330 (SC S52503 Sept. 8, 2006), a major lawyer liability case for anyone who advises fiduciaries—whether they are in formal roles such as trustees or informal ones such as joint venture partners. In *Reynolds*, the Supreme Court reversed the Court of Appeals (197 Or App 564, 107 P3d 52 (2005)), which held that a lawyer could be liable for assisting in a client's breach of fiduciary duty by giving the client legal advice on evading a fiduciary duty and then helping the client implement that advice. The Supreme Court recognized a privilege for lawyers who give clients otherwise lawful advice and assistance that exempts them from liability in this situation.

In doing so, however, the Supreme Court also reaffirmed its own earlier decision in *Granewich v. Harding*, 329 Or 47, 985 P2d 788 (1999), where the Supreme Court upheld the more general proposition that a lawyer could be held liable for assisting in breaching a fiduciary duty to a third party if the lawyer was acting outside the scope of advising the lawyer's client. *Granewich*, in turn, drew on Section 876 of the Restatement (Second) of Torts (1979), which deals with tortiously acting in concert with another resulting in injury to a third person. The central facet of the Supreme Court's *Reynolds* decision offers an important shield for lawyers who advise fiduciaries. At the same time, the Supreme Court's reaffirmation of *Granewich* means that lawyers must still proceed with caution in many circumstances in which they may be drawn out of the protective confines of the attorney-client relationship.

In this article, we'll look at five aspects of lawyer liability for assisting in a breach of fiduciary duty. First, we'll first briefly review Section 876. Second, we'll examine the *Granewich* decision. Third, we'll look at the Court of Appeals' decision in *Reynolds*. Fourth, we'll contrast that with the Supreme Court's decision in *Reynolds*. Finally, we'll discuss what lawyers can do to protect themselves from liability under *Granewich*.

Section 876

Section 876 isn't aimed at lawyers. Rather, it sets out three broad categories where someone acting in concert with another can be liable for resulting harm to a third person:

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"For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he

(a) does a tortious act in concert with the other or pursuant to a common design with him, or

(b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or

(c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person."

The Supreme Court in *Granewich* found that prior Oregon case law recognized each element of Section 876 and noted that "to state that this court recognizes section 876 as reflecting the common law of Oregon breaks no new ground."[1] The Supreme Court went on to "conclude that persons acting in concert may be liable jointly for one another's torts under any one of the three theories identified in *Restatement* section 876."[2]

Depending on the circumstances, subsections (a) and (c) can create risks for lawyers. But, subsection (b) poses the greatest practical risk to lawyers because it potentially creates liability to a *nonclient* for advice and other legal work. *Granewich* and *Reynolds* both focused on subsection (b).

Granewich

Granewich involved a "minority squeeze out." Granewich and two business associates, Harding and Alexander-Hergert, formed a closely held financial corporation in 1992. All three were directors, officers and employees of the company and each owned one-third of its shares. About a year later, Harding and Alexander-Hergert had a falling out with Granewich and began planning to remove him from the company. At that point, they hired a law firm to represent the company. The complaint alleged, however, that the law firm soon exceeded this neutral role as corporate counsel and began to advise and assist Harding and Alexander-Hergert individually in their efforts to oust Granewich by amending the company's bylaws and calling special meetings that resulted in Granewich's removal.

After he was forced out, Granewich sued his fellow owners, the corporation and the lawyers. The two other owners and the corporation settled, leaving only the lawyers. The charge against them was that they allegedly assisted in the two majority owner-directors in breaching *their* fiduciary duties to Granewich. The trial court dismissed on the pleadings and the Court of Appeals affirmed, holding that if the lawyers had no direct fiduciary duty to Granewich they could not be vicariously liable for the majority owner-directors' asserted breach. The Supreme Court reversed.

Relying on Section 876, the Supreme Court found that the complaint stated a claim against the lawyers:

"There is no Oregon law directly addressing whether someone can be held liable for another's breach of fiduciary duty. Legal authorities, however, virtually are unanimous in expressing the proposition that one who knowingly aids another in the breach of a fiduciary duty is liable to the one harmed thereby. **That principle readily extends to lawyers**."

329 Or at 57 (emphasis added; footnotes omitted).

Reynolds at the Court of Appeals

Reynolds was painted against the backdrop of a real estate joint venture. Reynolds and Schrock purchased two parcels—one was commercial timber and the other was recreational. They had a falling-out and later entered into a settlement agreement to wind-up the joint venture. Under the settlement, Reynolds conveyed his interest in the recreational parcel to Schrock and, in return, Reynolds was to receive all proceeds from the sale of the timber. Reynolds had invested $500,000 in the joint venture by that point. To make Reynolds whole, the settlement provided that if the timber sale did not net him at least $500,000, Schrock would pay Reynolds any deficiency and Reynolds would have a lien on the recreational parcel to secure the deficiency.

After Reynolds had deeded his interest in the recreational parcel to Schrock, Schrock asked her lawyer if the settlement agreement required her to keep the recreational property pending the timber sale. Schrock's lawyer concluded that the settlement agreement contained no such obligation and advised Schrock accordingly. Schrock then sold the recreational parcel with the lawyer's assistance. Schrock later prevented the timber sale—leaving Reynolds without either his interest in the recreational property or his share of the timber sale proceeds.

Reynolds sued Schrock. Reynolds framed the primary claim against Schrock as breach of fiduciary duty. He argued that Schrock had a fiduciary duty to wind-up the joint venture as contemplated by the settlement agreement and that her failure to do so—notwithstanding the apparent loop-hole in the settlement agreement allowing the sale of recreational property—constituted a breach of that duty. Reynolds also sued Schrock's lawyer. Reynolds did not contend that Schrock's lawyer had an independent fiduciary duty to him. Rather, he argued that the lawyer was jointly liable with Schrock for the breach of Schrock's fiduciary duty to Reynolds by providing the advice and assistance in implementing that advice to Schrock. Schrock settled with Reynolds. Her lawyer moved for summary judgment, which the trial court granted. The Court of Appeals reversed.

Relying principally on Section 876 and *Granewich*, the Court of Appeals concluded that a lawyer advising a client to act contrary to a fiduciary duty may be liable to a nonclient to whom that duty is owed *even if* the act would otherwise be permitted by an associated contract: "[I]f the attorney knows that the fiduciary relationship imposes a higher standard of conduct than the agreement, then the attorney who advises the client that he or she may do an act that the contract permits but that is incompatible with the fiduciary relationship may be liable for the breach of fiduciary duty."[3]

Reynolds at the Supreme Court

In reversing the Court of Appeals, the Supreme Court wove together three primary threads.

First, the Supreme Court distinguished *Granewich* by noting that the law firm there had exceeded its role as corporate counsel and began offering its advice and assistance to the two majority shareholders who were not its clients.

Second, the Supreme Court recognized a privilege against joint liability for a lawyer assisting in a client's breach of fiduciary duty. The Supreme Court found that both Restatement Section 890 ("One who otherwise would be liable for a tort is not liable if he acts in pursuance of and within the limits of a privilege[.]") and prior Oregon case law suggested that in some narrow circumstances a shield from joint liability should be recognized to vindicate important public policy goals. It then found that protection of the lawyer-client relationship was one such goal. In particular, the Supreme Court stressed the importance of having a lawyer's advice unhindered by the specter that the lawyer might be sued by a nonclient for rendering that advice to the lawyer's client. Therefore, the Supreme Court created a limited shield against liability in this circumstance:

"We extend those well-recognized principles to a context that we have not previously considered and hold that a lawyer acting on behalf of a client and within the scope of the lawyer-client relationship is protected by such a privilege and is not liable for assisting the client in conduct that breaches the client's fiduciary duty to a third party. Accordingly, for a third party to hold a lawyer liable for substantially assisting in a client's breach of fiduciary duty, the third party must prove that the lawyer acted outside the scope of the lawyer-client relationship." 2006 WL 2578330 at *7.

Third, the Supreme Court outlined several exceptions to the shield. In doing so, it focused on situations where the lawyer is acting outside the lawyer-client relationship, is acting contrary to the client's interests or is otherwise advising the client on future unlawful or fraudulent conduct:

"[T]he rule protects lawyers only for actions of the kind that permissibly may be taken by lawyers in the course of representing their clients. It does not protect lawyer conduct that is unrelated to the representation of a client, even if the conduct involves a person who is a client. Because such unrelated conduct is, by definition, outside the scope of the lawyer-client relationship, no important public interest would be served by extending the qualified privilege to cover it. . . For the same reason, the rule does not protect lawyers who are representing clients but who act only in their own self-interest and contrary to their clients' interest. Similarly, this court would consider actions by a lawyer that fall within the 'crime or fraud' exception to the lawyer-client privilege, OEC 503(4)(a), and Rule of Professional Conduct 1.6(b)(1), to be outside the lawyer-client relationship when evaluating whether a lawyer's conduct is protected." *Id.* (Citation omitted.)[4]

Lessening the Continued Risks Under Granewich

Although the Supreme Court's decision in *Reynolds* creates a shield when advising fiduciaries, the Supreme Court's reliance on *Granewich* underscores that the risks identified in that more common situation remain. Lawyers advising closely held corporations, family groups, partnerships and other joint ventures are often put in situations which invite them to step beyond their role as lawyers for the entities involved to give advice to individual shareholders, family members or partners as was the case in *Granewich*. Under *Reynolds*, they would not have the protective shield of privilege for advice beyond their clients.

Granewich and *Reynolds* heighten the importance of clearly spelling out in an engagement letter who the lawyer is representing and then acting in conformance with that agreement. In situations like *Granewich*, if a law firm confines its role to entity counsel only it will lessen the risk of being accused later of having "taken sides" and, in doing so, assisting one camp in an internal dispute in breaching fiduciary duties to the other.[5]

Summing Up

Reynolds is a very important decision for lawyers and law firms. In taking comfort from *Reynolds*,

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FAMOUS FOOLISH BLUNDERS – IGNORING THE EVOLUTION OF CIRCULAR 230

While not as foolish as getting involved in a land war in Asia, woe betide the unwary tax practitioner.[1]

By Larry J. Brant and Scott M. Schiefelbein[2]

Section 330 of Title 31 of the United States Code authorizes the Secretary of the Treasury to adopt regulations to govern practice before the Treasury Department ("Treasury"), including the Internal Revenue Service ("Service"). The bulk of these regulations are contained in Circular 230 ("C230").[3]

In response to numerous recent public scandals involving unscrupulous tax and accounting practices (such as Enron, Global Crossing, ImClone, WorldCom, Qwest, Tyco, Lucent, HealthSouth, Adelphia, and the collapse of Arthur Andersen),[4] Treasury made significant broad-reaching revisions to the regulations governing practice before the Service when it published final regulations in 2004 ("Final Regulations"). The Final Regulations were published in December 2004,[5] and amended in May 2005.[6] In addition, in February 2006, Treasury attempted to further overhaul C230 when it published proposed regulations ("Proposed Regulations").[7] The Final Regulations and the Proposed Regulations are aimed at strengthening Treasury's authority to govern practice before the Service and restore the public's trust in our taxation system, which has been undoubtedly tarnished by these public scandals. Most commentators, however, believe the regulations go way beyond these goals.

Tax advisors need to be thoroughly familiar with these changes to C230 and understand how they may impact their practices. While this Article contains a brief discussion of the Final Regulations, the focus is the amendments contained in the Proposed Regulations.

A. CIRCULAR 230 AND THE FINAL REGULATIONS.

C230 defines "practice before the Service" and provides:

PRACTICE BEFORE THE INTERNAL REVENUE SERVICE COMPREHENDS ALL MATTERS CONNECTED WITH 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. 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.[8]

C230 applies to attorneys, certified public accountants, enrolled agents, enrolled actuaries, and all other persons representing taxpayers before the Service (collectively "Advisors").[9] It is broad in scope and generally covers: (1) rules relating to who may practice before the Service; (2) duties and restrictions relating to practice before the Service; (3) sanctions for rule violations; and (4) discipline of Advisors.[10]

Until recently, C230 was not a major influence on the daily practice of tax law. As a likely result of the aforementioned tax and accounting scandals, and the continued proliferation of abusive tax shelters,[11] Treasury adopted Final Regulations to strengthen C230. The most significant provisions of the Final Regulations (as amended): (1) create aspirational "Best Practices" standards for Advisors; (2) set forth stringent requirements for "Covered Opinions" and other "Written Advice" given by Advisors; (3) attempt to deter taxpayers from engaging in abusive transactions by limiting or eliminating their ability to avoid penalties via inappropriate reliance on advice of Advisors; and (4) curb the ability of promoters to market abusive transactions and tax products to a large number of customers based upon an opinion of an Advisor that fails to adequately consider all the relevant facts or law.

Many of these provisions are controversial and received immediate comment from the tax community. The most controversial provisions, which are contained in Section 10.35 of C230, relate to "Covered Opinions" (a subset of "Written Advice"). Advisors criticized these rules for being difficult to apply and for extending to written communications the government did not really intend to regulate.[12] In fact, soon after Cono Namorato, the immediate past Director of the Office of Professional Responsibility ("OPR"), left the Service, he publicly stated, "My personal opinion today is that we don't need Section 10.35 in Circular 230. This is a conclusion I came to halfway through my tenure as OPR director. It is so complicated as to be almost unenforceable from an OPR point of view."[13] OPR current acting Director Stephen Whitlock recently stated that the Service is still considering whether a change is necessary: "We have said a number of times that we recognized there are a lot of concerns being expressed and we understand what those are. The question is, can you address those [concerns] and still adhere to the core of the rule and the underlying objectives of what we're trying to get at with [Section] 10.35."[14]

A complete discussion of the Final Regulations is beyond the scope of this Article. These regulations, however, significantly impact tax practices. Consequently, a good understanding of the Final Regulations is necessary for all Advisors.[15]

Advisors also need to be well-versed with these rules because the Service is increasing its investigations of Advisors. According to Edward Karl, Director of the Tax Division of the American Institute of Certified Public Accountants ("AICPA"), the OPR, which was formed in 2003 and charged with enforcing C230,[16] is currently in a "hiring frenzy" and is adding more attorneys in order to increase the office's investigations and enforcement of C230.[17] This activity will likely continue.

B. THE PROPOSED REGULATIONS.

In February 2006, Treasury published Proposed Regulations to C230.[18] The Proposed Regulations are not binding, and may or may not be adopted by Treasury in their current form. They are, however, a strong indication of Treasury's current thinking and, as such, should be taken seriously. In addition, the Proposed Regulations, in current or amended form, are likely to be finalized in the future.

Advisors anticipated the Proposed Regulations would bring clarity to Section 10.35. Unfortunately, the anticipated clarification failed to materialize. Rather, the Proposed Regulations focus on other provisions of C230.

The Proposed Regulations have sparked considerable comment from practitioners and academics, mostly highly critical. For example, Thomas J. Purcell III, Chair of the Tax Executive Committee of the AICPA, wrote in a May 9, 2006 cover letter accompanying the AICPA's formal comments to the Proposed Regulations that "many of the proposed [C230] revisions appear to reflect a lack of balance that may undercut both the goal of enhanced standards and compromise fundamental fairness. The proposed regulations also create additional grounds for sanction without any explanation of why the additional provisions are necessary or when they might be satisfied in a particular case. The net effect of these changes, if adopted without elaboration or examples, unfortunately may be to unnecessarily subject practitioners to discipline and sanction."

Following is a summary of the major provisions contained in the Proposed Regulations and a critical analysis of their potential application.

Amendment 1: Monetary Sanctions.

Section 10.50 of C230 currently empowers Treasury to suspend or disbar an Advisor from practice before the Service if the Advisor: (1) is incompetent or disreputable; (2) fails to comply with C230; or (3) with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client.

The OPR is charged with enforcing C230, including Section 10.50. While the OPR has a sizable case load, it has historically issued sanctions only in a minority of cases. In 2006, the OPR completed 783 cases. Of these cases, 473 cases (approximately 60.4%) resulted in no sanctions, 205 cases (approximately 26.2%) resulted in expedited suspensions due to violations of state licensing actions (these cases trigger "pretty much automatic" sanctions, according to OPR acting Director Stephen Whitlock), and 105 cases (approximately 13.4%) resulted in sanctions.[19] The vast majority of the cases in which sanctions were issued were resolved by agreement. The OPR's formal hearing process was used in only six cases last year.[20]

Under the Proposed Regulations, Section 10.50(a) would empower Treasury to *censure*, suspend, or disbar from practice before the Service an Advisor who: (1) is incompetent or disreputable; (2) fails to comply with C230; or (3) with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client.

The amendment gives the Service the right to censure Advisors who violate C230. Censure, which is the lowest form of sanction that may be issued by the Service under Section 10.50, should not cause ethical and reputable Advisors too much concern.

The Proposed Regulations would add new Subsection 10.50(c). This new provision proposes to extend the imposition of penalties to a sanctionable Advisor's firm. It provides that Treasury may impose monetary penalties on any Advisor who engages in conduct subject to sanctions and the Advisor's "employer or any firm or other entity in connection with the conduct giving rise to the penalty . . . if it knew, or reasonably should have known, of such conduct."[21] The penalty "shall not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty."[22]

These monetary sanctions have been criticized on various grounds, including: (1) there is no requirement that the penalty bear a reasonable relationship to the conduct subject to the sanction; (2) it is unclear whether any remedial action or adhering to C230's "Best Practices" standards may eliminate or reduce liability; (3) the phrase "to be derived" in Section 10.50(c)(1)(ii) is vague and overly broad; (4) it appears Treasury may be allowed to speculate what the Advisor will "derive from" the act giving rise to the penalty; and (5) no objective standard exists for setting the precise amount of the penalty in relation to the bad conduct.[23]

OPR acting Director Whitlock has stated that the Service will use this new authority to impose monetary sanctions only in extraordinary instances: "What we need to look at is striking the appropriate balance in the kind of penalty we seek. I think the right answer here is that you use the monetary penalty sparingly in situations where traditional sanctions don't work, because it is important not to allow a professional to buy his or her way out of an ethical lapse."[24]

We believe that Section 10.50, as amended, is too broad. Whitlock's statement that the Service will use this provision sparingly is not adequate. We urge Advisors to provide Treasury with comments and request that changes be made to this provision.

We believe it is unlikely that the penalty extension to employers and firms will be eliminated. A major component of Treasury's campaign to restore integrity to our tax system is aimed at eliminating organization-wide cultures that permit or enable wrongdoing. In our opinion, the power to impose penalties against employers or firms whose personnel violate C230 will likely continue to be a vital part of the OPR's arsenal.

On April 23, 2007, the very day this Article was sent to the publisher, the Service issued Notice 2007-39.[25] This Notice provides Advisors with additional guidance relative to monetary sanctions in two specific areas, namely the amount of the penalty (or penalties) which may be imposed, and the imposition of the penalty (or penalties) on the Advisor's firm.

Separate penalties may be imposed against an Advisor and the Advisor's firm for the Advisor's sanctionable conduct. Each separate penalty, however, may not exceed the gross income derived or to be derived by the penalty recipient. Likewise, the collective penalty (or penalties) imposed on an Advisor and the Advisor's firm may not exceed the aggregate gross income derived or to be derived by the Advisor and the Advisor's firm from the sanctionable conduct. The Service has discretion, however, to impose a lesser penalty.

In determining whether a lesser penalty is warranted, the Service will consider the level of culpability of the Advisor and the Advisor's firm; whether the Advisor or the Advisor's firm violated a duty owed to a client or a prospective client; the actual or potential injury caused by the sanctionable conduct; and the existence of any aggravating or mitigating factors. While the Notice is silent on what constitutes an aggravating factor, it provides that mitigating factors include whether the Advisor or the Advisor's firm took prompt remedial action immediately upon discovery; ceased the conduct upon discovery; attempted to remedy any harm; or undertook measures to ensure the conduct will not reoccur.

The Notice also provides that the Service will not impose a monetary penalty for "minor technical violations" of C230. In such cases, however, to avoid the imposition of a penalty, there must be little or no injury to a client, the public or tax administration, and there must be little likelihood of repeated similar conduct.

The Notice provides that an Advisor's firm may only be subject to a monetary penalty (or penalties) for the Advisor's sanctionable conduct if two tests are met. First, the Advisor must have acted "on behalf" of the firm. Second, the firm must have known or reasonably should have known of the conduct.

An Advisor is deemed to have acted on behalf of a firm if: (1) there is an agency relationship (e.g., partner/partnership or employee/employer); (2) the purpose of the relationship is to provide services in connection with practice before the Service; and (3) the sanctionable conduct arises in connection with the agency relationship.

A firm is deemed to know of sanctionable conduct if: (1) one or more members of the firm's management actually knows or has information from which a person with similar "experience and background" would reasonably know of the sanctionable conduct; or (2) the firm did not take reasonable steps to comply with C230 and the conduct harmed a client, the public, or tax administration, or a pattern of noncompliance otherwise exists.

As provided in the Notice, the Service desires comments from Advisors regarding monetary penalties. We strongly recommend that Advisors provide input on this issue.[26]

Amendment 2: Contingent Fees.

Section 10.27 of C230 currently provides that an Advisor may charge contingent fees except in specific instances.[27] By contrast, in an effort to reduce such practices as "playing the audit lottery," the Proposed Regulations reverse this approach and contain a sweeping prohibition against the charging of contingent fees with limited specific exceptions. The newly proposed provision provides that, except as otherwise provided, "a practitioner may not charge a contingent fee for services rendered in connection with any matter" before the Service. An Advisor may charge a contingent fee only: (1) for services rendered in connection with the Service's examination of, or challenge to, an original tax return or an amended return or claim for refund or credit filed *prior* to the taxpayer receiving a written notice of the examination of, or a written challenge to the original tax return; or (2) for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.

This expanded proposed prohibition has been criticized on at least three grounds. First, the Chair of the Tax Executive Committee of the AICPA has noted that certain taxpayers must rely on contingent fees to afford the assistance of Advisors in pre-filing matters such as private letter ruling requests.[28] We agree with Mr. Purcell that pre-filing assistance from qualified Advisors likely enhances disclosure and transparency of taxpayer filing positions, which is one of the Service's goals in its fight to reduce the "tax gap" and restore integrity to our tax system. Unfortunately, restricting the ability of Advisors to offer contingent fee arrangements will only serve to limit the number of taxpayers who will be able to obtain pre-filing assistance.

Second, the preamble to the Proposed Regulations states that the prohibition against contingent fees is intended to promote "attorney and auditor independence."[29] In many instances, as noted by Dennis Drapkin of the American Bar Association ("ABA") Section on Taxation, the Advisor should *not* be independent, but should be a zealous *advocate* of the taxpayer.[30]

Third, C230 does not apply to judicial proceedings.[31] Consequently, as noted by Mr. Drapkin, the judicial proceeding exception to Treasury's broad-brush prohibition against contingent fees is likely beyond its authority.[32]

The definition of "contingent fees" has also been expanded. C230 currently defines a contingent fee as "any fee that is based, in whole or in part, on whether or not a position taken on a tax return or other filing avoids challenge by the [Service] or is sustained either by the [Service] or in litigation . . . ."[33] The Proposed Regulations add: "A contingent fee includes a fee that is based on a percentage of the refund reported on a return, that is based on a percentage of the taxes saved, or that otherwise depends on the specific result attained."[34] Mr. Drapkin of the ABA Tax Section criticized the phrase, "that otherwise depends on the specific result attained" as overly broad, arguing that this portion of the definition could improperly intrude into fee arrangements for tax services. Such arrangements often take into account multiple factors, only one of which is the specific result achieved: "We do not believe that every fee arrangement that takes into account, among other factors, the result attained should be classified as a contingent fee. . . Consequently, we recommend that the quoted phrase in proposed [S]ection 10.27(c)(1) should be revised to read as follows: 'a fee . . . that depends in material part upon the specific tax result attained.'"[35]

Amendment 3: Publicity of Disciplinary Hearings.

Section 10.71(b) of C230 currently provides that disciplinary proceedings against an Advisor are private unless otherwise requested by the Advisor. The requests for publicity may be granted by the Administrative Law Judge ("ALJ").

Section 10.72(d) of the Proposed Regulations provides that, except as may be determined by the ALJ, virtually the entire disciplinary process shall be public. Treasury argued that the publicity will inform the public as to the types of conduct the Service seeks to punish.[36] Many commentators protest this vigorously, as it will be difficult to "unring the bell" – even if the Advisor is ultimately exonerated – in an industry so reliant upon credibility. The National Association of Tax Professionals put it bluntly in their official comments to the Proposed Regulations: "The damage to one's reputation could be devastating to his practice."[37]

This concern is particularly grave because the Proposed Section 10.72(d) contains no guidelines regarding *when* the information will be made public. The Service could use this negative publicity to coerce Advisors. This is among the most controversial elements of the Proposed Regulations.[38] We urge Advisors to provide Treasury with comments on this proposed provision.

Amendment 4: Conflicting Interests.

Section 10.29 of C230 currently contains provisions regarding conflicts of interest for the Advisor. C230 allows clients to waive conflicts of interest through informed consent that arguably can be confirmed in writing by the Advisor.[39] The Proposed Regulations revise Section 10.29 of C230 to provide that a client may only waive a conflict with informed consent that is confirmed in writing *by the affected client* at the time the existence of the conflict is known by the Advisor.[40]

This amendment has been criticized as "too rigid to fairly address all potential conflict situations," and as

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THE GAUNTLET OF WITHHOLDING ON NONRESIDENT ALIEN BENEFICIARIES OF ESTATES AND TRUSTS

By David C. Streicher, Black Helterline LLP

As society becomes more mobile, estate distributions to nonresident aliens (NRA) become more common. If the distributions carry out distributable net income (DNI) or capital gains, a US withholding tax may apply. Unfortunately, complying with the withholding rules can be tedious or outright overwhelming.

By way of background, a NRA is an individual who is neither a citizen nor resident of the US. Generally, an alien is a US resident if he either has a "green card" evidencing permanent US status or has met the "substantial presence test" in the US. See IRC § 7701(b)(1)[1].

Under the general rule, a fiduciary is required to withhold at the rate of 30% on DNI paid to a NRA – to the extent the DNI consists of "an amount subject to withholding." Treas. Reg. § 1.1441-5(b)(2)(ii) and (iii). Certain categories of income (including most interest income) are not considered "an amount subject to withholding." Treas. Reg. § 1.1441-1(b)(4). Withholding must also be made on DNI required to be distributed (i.e., by the underling will or trust), even if it is accumulated. The fiduciary may make a reasonable estimate of DNI carried out by the distribution and apply the withholding rate to the estimate. If, at the end of the year, the fiduciary determines that tax was underwithheld, the trust or estate (but not the fiduciary personally) is liable for the amount underwithheld. Provided the estimate was reasonable and the underwithheld amount is paid by the following March 15 (with Form 1042), no penalties are imposed. Certain restrictions apply for estates with fiscal years. Treas. Reg. § 1.1441-5(b)(2)(iii).

Amounts withheld must be deposited quarter-monthly, monthly or annually, depending on the amount of tax withheld. Treas. Reg. § 1.6302-2(a)(1).

By negative implication, no withholding is required if there is no DNI. Thus, for example, if a fiduciary is certain that deductions for professional fees and other costs of administration will zero out DNI, there is no need to withhold.

A similar procedure is required when a trust or estate having NRA beneficiaries makes a taxable sale of US real property, except that the withholding rate is 35% of the *gain* on the sale. Treas. Reg. § 1.1445-5(c)(1)(iii)(A). The fiduciary must keep a running balance (known as the US real property account) of all gains and losses realized during the year on dispositions of US real property. To the extent a distribution to a NRA is attributable to a positive balance in the US real property account, 35% must be withheld. Like DNI, the balance in the US real property account is reduced by the amount distributed to beneficiaries (both domestic and foreign) attributable to the account during the taxable year. (Distributions are sourced first to the US real property account, and then to other items.) Any balance in the US real property account at the end of the year is taxed to the trust or estate, and the balance reverts to zero. Id. Thus, at the beginning of each taxable year, the fiduciary starts out with a "clean slate." See also, Rubin and Hudson, 912 T.M. Federal Taxation of Foreign Investment in US Real Estate, at A64.

Looking beyond the theoretical rules, several observations and planning opportunities emerge. First, if there are no gains during the taxable year or if the balance in the US real property account is negative, no withholding is required. Rubin and Hudson, supra, at A77. Thus, a fiduciary might make distributions to NRAs just after the end of the taxable year of the sale, thereby allowing the gain to be taxed on the fiduciary return. Alternatively, if a sale is imminent and cash is available, the fiduciary may be able to avoid withholding by making distributions before the sale. Since the maximum long term capital gain rate is 15%, and the withholding rate is 35%, the net savings to the NRA is 20%.

Tax treaties may soften the withholding burden to NRAs. For example, under the US-Japan treaty, the withholding rate on dividends is only 10%, as compared to the 30% default rate. To claim treaty benefits, the NRA must provide a "properly completed" Form W-8BEN to the fiduciary, who may rely on it. See Form W-8BEN instructions. On the W8-BEN, the NRA (i) provides his tax identification number, (ii) identifies his country of residence, (iii) cites the tax treaty article calling for a reduced rate of withholding, and (iv) explains why he is eligible for treaty benefits.

Most NRAs have no social security number and must obtain an ITIN by filing Form W-7. Proof of identity is required. If the NRA furnishes the IRS an original passport or a copy notarized by a US notary public, no further identification is needed. However, most NRAs are understandably reluctant to send an original passport to a US notary, let alone to the IRS. And getting a copy of the passport notarized overseas may require a special trip to a US embassy. It is true the IRS will accept originals or notarized copies of various other pieces of identification (such as a driver's license), but the logistical complications remain. In light of the foregoing, the savings from claiming a treaty based withholding rate may not justify the related professional fees. Example: DNI distributions to a NRA are comprised of $2,000 dividends and $3,000 interest (exempt from withholding). If the treaty withholding rate on dividends is 10%, rather than the default rate of 30%, the savings would only be $400.

If the fiduciary withholds without the benefit of a tax treaty, the NRA may claim a refund for any overpayment -- provided he files a US income tax return. If the NRA has no ITIN, a Form W-7 must be attached to the return. Given the difficulty of filing Form W-7, let alone finding an overseas accountant to prepare US returns, most NRAs probably abandon any hope of a refund and look solely to local tax credits as a compensating adjustment.

In conclusion, a fiduciary can soften the US withholding tax to NRA beneficiaries by carefully timing distributions to coincide with periods during which little or no withholding is required. For example, withholding on D NI may be unnecessary if distributions are made during the same year that attorney and accounting fees are deducted. (The fiduciary should also keep in mind that DNI comprised of certain categories of income, including most interest, is exempt from withholding.) Along the same lines, withholding on US real property capital gains can be avoided by making distributions shortly after the end of the taxable year or just prior to the sale. In theory, tax treaties may soften the withholding tax burden, although compliance costs may more than recoup the savings.

1 In limited circumstances, a qualifying individual may also make a first year election under § 1.7701(b)(4) allowing the individual to be treated as having met the "substantial presence test".

OSB TAXATION SECTION
Events Calendar

May 10, 2007
12:00 pm — Portland Taxation Section
University Club — Luncheon Speaker Series

Vincent P. Cacciottoli "Recent Developments in Deferred Compensation"

May 15, 2007
12:00 pm — Mid Valley Tax Forum
Roth's Hospitality Center

Mark Fucile "Advisors Beware – assisting a business owner to breach a fiduciary duty to co-owners can result in a tort claim against the advisor."

May 18, 2007
9:00 am — Oregon Tax Institute
Governor Hotel,
Portland

July 12, 2007
12:00 pm — Portland Taxation Section
University Club — Luncheon Speaker Series

John H. Gadon "Recent Developments in the World of Tax Credits, Including New Markets and Low-Income Housing Credits"

August 9, 2007
12:00 pm — Portland Taxation Section
University Club — Luncheon Speaker Series

Mitchel R. Cohen "Puzzling Income Tax Issues"

October 11, 2007 — Oregon Convention Center
Broadbrush Taxation

October 18, 2007
12:00 pm — Portland Taxation Section
University Club — Luncheon Speaker Series

Gersham Goldstein "Black & Decker – The Aftermath"

November 8, 2007
12:00 pm — Portland Taxation Section
University Club — Luncheon Speaker Series

Robert T. Manicke Oregon Tax Legislation Update

December 20, 2007
12:00 pm — Portland Taxation Section
University Club — Luncheon Speaker Series

Mark A. Prater, Chief Legal Counsel
US Senate Finance Committee "Washington Update"

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Famous Foolish Blunders

an inappropriate tightening of the existing standard.[41] Advisors often, as a matter of maintaining proper documentation of client consent, obtain the client's written consent to a conflict waiver, and Advisors may indeed be required to do so under the ethical guidelines of their state licensing authority. It has been argued that there is no need to abandon the current rule that arguably allows the Advisor to document the client's consent.[42] Furthermore, some Advisors fear the requirement that an Advisor obtain the client's consent "at the time the existence of the conflict is known by the practitioner" is unfairly rigid.[43] For example, this new provision could be interpreted to invalidate prospective waivers of anticipated conflicts of interest, which would be, in the words of Mr. Drapkin, "at odds with the position of the ABA Standing Committee on Ethics and Professional Responsibility."[44]

While this provision of the Proposed Regulations is likely an area of continued comment and debate, it should not be elevated to a high degree of concern. Conflict waivers, as a matter of good practice, should be confirmed in writing by the affected clients. Moreover, anticipatory waivers may be problematic in some circumstances. Under Oregon Rule of Professional Conduct ("ORPC") 1.7, a lawyer may only obtain a conflict waiver upon obtaining the informed consent of each affected client. The issue arises whether any consent that is obtained when the conflict is a potential future conflict is truly "informed." <u>See</u>, <u>e.g.</u>, OSB Formal Ethics Op No. 2005-122 (ORPC 1.7 does not prohibit advance waivers <u>as long as</u> lawyer adequately explains the material risks and available alternatives, but lawyer must <u>also</u> be sensitive to situations that arise following the waiver's execution that were not contemplated in the original disclosure and whether there is a need for a subsequent disclosure and waiver).

C. CONCLUSION.

C230 continues to evolve and, if current trends hold, it appears likely that Treasury will seek to expand the scope of C230 as a tool in the government's campaign against unscrupulous Advisors. All Advisors need to educate their employees about C230, monitor internal compliance with C230, and stay abreast of new developments.

1 Special thanks to Vizzinni, the Sicilian genius from Rob Reiner's 1987 movie, "The Princess Bride."

2 Larry J. Brant is a Shareholder in Garvey Schubert Barer, P.C. and is Chair of the firm's Tax Department. Scott M. Schiefelbein is an Associate in Garvey Schubert Barer, P.C.

3 31 C.F.R. part 10.

4 Cono R. Namorato, Director of the Service's Office of Professional Responsibility from December, 2003, until his departure in 2005, reflected on these scandals, and the Service's response to them, in a recent interview: "There was a perspective that there were a lot of abuses in the [tax] profession during the 1990s . . . . A voluntary tax system cannot function without scrupulous tax practitioners." WebCPA.com, Former OPR Chief Aimed to Make it Visible, Effective, Aug. 7, 2006, http://www.WebCPA.com.

5 T.D. 9165, 69 Fed. Reg. 75839 (Dec. 20, 2004).

6 T.D. 9201, 70 Fed. Reg. 28824 (May 19, 2005).

7 71 Fed. Reg. 6421 (Feb. 8, 2006).

8 31 C.F.R. part 10 § 10.2(d).

9 Id. § 10.3.

10 See 31 C.F.R. part 10.

11 While Treasury has been careful to refrain from making public statements directly linking these scandals to its changes to C230, it is clear that Treasury is concerned about the recent spate of tax abuses. For example, in an effort to demonstrate Treasury's "commitment to ensuring the integrity of the tax system and recognition of tax professionals as an integral part of effective tax administration," in January 2003, Treasury created the "Office of Professional Responsibility" that replaced the office of the "Director of Practice." Reg-122380-02. The Proposed Regulations also contain a broader ban on contingent fees (discussed in greater detail below) because "Treasury and the IRS believe that a rule restricting contingent fees for preparing tax returns supports voluntary compliance with the Federal tax laws by discouraging return positions that exploit the audit selection process. Additionally, a broader prohibition against contingent fee arrangements is appropriate in light of concerns regarding attorney and auditor independence." Id. The Service's current efforts focused on combating these abusive tax shelters are published on its website, www.irs.gov, on the page entitled "Abusive Tax Shelters and Transactions." http://www.irs.gov/businesses/corporations/article/0,,id=97384,00.html (last visited on Dec. 1, 2006).

12 Stephen Joyce, "Little Progress Made in Considering Written Advice Standards Changes, Practitioners Say," BNA Daily Tax Report, No. 181, G-6 (Sept. 19, 2006). In that article, Cono Namorato, then-director of the Office of Professional Responsibility, was quoted as follows: "[C]omponents of Section 10.35 are 'too broad and sweep in unintended and uncontroversial tax advice. My advice is let's be patient while we consider [practitioner] concerns. In the interim, let's all use common sense in interpreting this rule.' " Id.

13 WebCPA.com, Former OPR Chief Aimed to Make it Visible, Effective, Aug. 7, 2006, http://www.WebCPA.com. Based on Mr. Namorato's comments and his term of office (December 2003 to 2005), he would have come to this realization sometime in 2004.

14 Stephen Joyce, "OPR to Review Circular 230 Changes, Initial Monetary Penalties Use in 2007," BNA Daily Tax Report, No. 9, p. S-16 (January 16, 2007).

15 These new rules were discussed in great detail in a prior article written by Larry J. Brant for this publication, Treasury Department Circular 230 and Final Regulations, published in October 2005 (Vol. 8, No. 2).

16 IR-2003-3 (January 8, 2003).

17 Stephen Joyce, "Practitioners Urged to Increase Awareness of Circular 230 Obligations at AICPA Meeting," BNA Daily Tax Report, No. 216, G-4 (Nov. 8, 2006).

18 71 Fed. Reg. 6421 (Feb. 8, 2006).

19 Stephen Joyce, "OPR to Review Circular 230 Changes, Initial Monetary Penalties Use in 2007," BNA Daily Tax Report, No. 9, p. S-16 (January 16, 2007).

20 Id.

21 71 Fed. Reg. 6421 § (c)(1)(i)-(ii).

22 Id. § 10.50(c)(2).

23 See the comments regarding the Proposed Regulations submitted by Dennis Drapkin of the American Bar Association Section of Taxation on June 6, 2006. 2006 TNT 110-18. See also "Comments on Proposed Modifications to Treasury Department Circular 230 Regulating Practice Before the Internal Revenue Service," submitted by the National Association of Tax Professionals (April 14, 2006).

24 Stephen Joyce, "OPR to Review Circular 230 Changes, Initial Monetary Penalties Use in 2007," BNA Daily Tax Report, No. 9, p. S-16 (January 16, 2007).

25 Notice 2007-39 is scheduled to be published in the Internal Revenue Bulletin on May 14, 2007. Notice 2007-39, IRB 2007-20 (May 14, 2007).

26 Comments must be submitted by August 13, 2007. Comments should be submitted to: Internal Revenue Service, CC:PA:LPD:PR (Notice 2007-39), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20224. Comments may be submitted electronically at: Notice.Comments@irscounsel.treas.gov. Include "Notice 2007-39" in the subject line of any electronic submissions.

27 C230 Section 10.27(b) provides that a "practitioner may not charge a contingent fee for preparing an original return or for any advice rendered in connection with a position taken or to be taken on an original tax return," but that a "contingent fee may be charged for preparation of or advice in connection with an amended tax return or a claim for refund (other than a claim for refund made on an original tax return), but only if the practitioner reasonably anticipates at the time the fee arrangement is entered into that the amended tax return or refund claim will receive substantive review by the [Service]." 31 C.F.R. part 10 § 10.27(b)(2)-(3).

28 This comment was submitted to Mark W. Everson, Commissioner of Internal Revenue, in the May 9, 2006 letter from Thomas J. Purcell, III, that accompanied the AICPA's official comments to the Proposed Regulations.

29 Preamble to Proposed Regulations, 71 Fed. Reg. 6421, 6424.

30 Mr. Drapkin submitted these comments on June 6, 2006 and have been published by Tax Analysts at 2006 TNT 110-18 (June 6, 2006).

31 See 31 C.F.R. part 10 §§ 10.0, 10.2(d).

32 2006 TNT 110-18 (June 6, 2006).

33 31 C.F.R. part 10 § 10.27(b)(1).

34 71 Fed. Reg. 6421 § 10.27(c)(1).

35 2006 TNT 110-18.

36 Stephen Whitlock, acting Director of the OPR, said that this change to the publicity of disciplinary hearings would "tell people what we're prosecuting and what kind of sanctions we're seeking." Id.

37 National Association of Tax Professionals, Comments on Proposed Modifications to Treasury Department Circular 230 Regulating Practice Before the Internal Revenue Service (Apr. 14, 2006).

38 For example, Dennis Drapkin of the ABA Section of Taxation submitted the following comments to the Proposed Regulations on June 6, 2006: "The proposed change puts the reputation of practitioners in jeopardy prematurely. . . . [Practitioners] fear that individual practitioners may feel pressured to accede to voluntary sanctions or other concessions as part of the disciplinary process that may not be factually justified simply in order to avoid the prospect of public identification. Moreover, it appears that the premature identification of a practitioner's identity is not necessary in order to further the laudable goals the proposal is intended to advance." 2006 TNT 110-18 (June 6, 2006).

39 Section 10.29(b) of C230 provides that a practitioner may represent a client if, inter alia, each "affected client gives informed consent, confirmed in writing." This language is identical to the language of Section 1.7(b)(4) of the ABA Model Rules of Professional Conduct. Due to the fact that there is no modifier indicating who may confirm the informed consent, arguably this means that the Advisor may do so.

40 71 Fed. Reg. 6421 § 10.29(b)(3).

41 AICPA Comments to C230 Proposed Regulations (May 9, 2006).

42 See Mr. Drapkin's comment: "There is no reason to impose upon tax practitioners under [C230] a higher standard than that set out in the ABA Model Rules." 2006 TNT 110-18 (June 6, 2006).

43 ABA Section of Taxation Comments to C230 Proposed Regulations, 2006 TNT 110-18 (June 6, 2006).

44 Id., citing ABA Formal Opinion 05-436 (May 11, 2005).

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Lawyer Liability

however, law firms need to continue to keep *Granewich*'s cautionary tale in mind.

ABOUT THE AUTHOR

Mark J. Fucile of Fucile & Reising LLP focuses on legal ethics, product liability defense and condemnation litigation. In his legal ethics practice, Mark handles professional responsibility, regulatory and attorney-client privilege matters and law firm related litigation for lawyers, law firms and legal departments throughout the Northwest. He is a past member of the Oregon State Bar's Legal Ethics Committee, is a past chair of the Washington State Bar Rules of Professional Conduct Committee, is a member of the Idaho State Bar Professionalism & Ethics Section and is a co-editor of the OSB's Ethical Oregon Lawyer and the WSBA's Legal Ethics Deskbook. Mark also writes the monthly Ethics Focus column for the Multnomah (Portland) Bar's Multnomah Lawyer, the quarterly Ethics & the Law column for the WSBA Bar News and is a regular contributor on risk management to the OSB Bar Bulletin, the Idaho State Bar Advocate and the Alaska Bar Rag. Mark's telephone and email are 503.224.4895 and Mark@frllp.com.

1 329 Or at 54.

2 *Id.* at 55.

3 197 Or App at 577.

4 This approach is consistent with OSB Formal Ethics Opinion 2005-92, which concludes that a lawyer can generally advise a client to breach a contract as long as the conduct suggested does not constitute fraud or is otherwise unlawful.

5 RPC 1.13 deals specifically with entity representation.

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