

Description Of Final Regulations Under Circular 230

(May 10, 2005)

The Internal Revenue Service issued final regulations, Circular 230, outlining the professional standards applicable to “tax advisors.” The regulations were issued on December 17, 2004 and are effective June 20, 2005.

The regulations are organized into the following categories

1. Best practices;
2. Covered opinions;
3. Procedures to insure compliance with covered opinions rules;
4. Other written tax advice;
5. Sanctions; and
6. Advisory Committees

Best Practices

Best practices are aspirational rather than mandatory. The best practices section, Section 10.33, recites a list of practice values akin to those appearing in the Rules of Professional Conduct. The regulations provide that best practices include “advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties...if the taxpayer acts in reliance on the advice.” So far, so good. Any aggressive tax planning necessarily involves, either explicitly or implicitly, a judgment about whether a position is “reportable” under the Section 6662 rules, and whether or not the position to be taken would expose tax preparers to preparer penalties.

Tax advisors who oversee a firm’s tax practice “should take reasonable steps to insure that the firm’s procedures for all members, associates and employees are consistent with the best practices.” This means that the firm as a whole has a direct, rather than a merely indirect stake in being able to claim that it took the Circular 230 best practices exhortations to heart. “Give a man a reputation as an early riser, and he can spend the rest of his days sleeping till noon,” said Mark Twain (Will Rogers?, Ben Franklin? Whatever). Give a lawyer or law firm a compelling narrative about its efforts to conform to Circular 230 best practices and I’ll show you a law firm with diminished exposure to malpractice claims and professional sanctions.

Covered Opinion

A character in a Moliere play expressed surprise at the discovery that he had been speaking “prose” all his life. With the advent of the new Circular 230, only the meekest of

church mice among tax advisors will confidently assume that they are not issuing “covered opinions” in the every day course of their practice. Under Section 10.35 of Circular 230, all but the church mice among us have joined the *Black & Decker* and *Long Term Capital* gang. Consequently, the covered opinions rules, complex and cumbersome though they are, bear careful consideration.

The covered opinion rules can be broken down into three categories of inquiry:

- i. The definition of a covered opinion;
- ii. Exceptions; and
- iii. Obligations of the tax advisor in issuing a covered opinion.

Definitions of Covered Opinion.

A covered opinion consists of *written advice*, (electronic communications constitute written advice) concerning one or more “Federal tax issues.” Federal tax issues in a covered opinion arise from:

- (1) a listed transaction (see e.g., Notice 2004-67 and www.irs.gov/businesses/corporations/article/0,,id=120633,00.html; see also Section 6011), or a transaction “substantially similar” to a listed transaction;
- (2) A marketed opinion;
- (3) An entity, plan or arrangement “the principal purpose” of which is to avoid or evade taxes; or
- (4) An entity plan or arrangement which has as a “significant purpose” to avoid or evade taxes.

Significant Purpose Plans or Transactions

Written advice concerning a plan or transaction having tax avoidance as one of its substantial purposes becomes a covered opinion *only* if the written advice is in a “suspect category” (my terminology, not that of Section 230). A suspect category is one or more of the following:

1. Reliance Opinion;
2. Marketed Opinion;
3. Subject to conditions of confidentiality;
4. Subject to contractual protection.

To recap the difference between principal purpose and substantial purpose transactions, advice on a principal purpose transaction is *per se* a covered opinion. If tax

avoidance or evasion is merely “a significant purpose,” it also must constitute a “suspect” category of written advice to trigger the covered opinion rules – i.e., one of the four categories listed above: reliance, marketed, confidential or contract protection.

A Deeper Discussion of Principal Purpose/Substantiated Purpose Distinction

The regulations do not define “a significant purpose of tax avoidance or evasion.” Repealed regulations under Section 6111 defined it to mean “structured to produce tax benefits that constitute an *important part of the intended results* of the arrangement” (emphasis added). Those repealed regulations, however, excluded from the definition transactions entered into in the “ordinary course of business” consistent with “customary commercial practice.” Somewhere in that formulation is an intuitive zone where one crosses from routine “horseplay,” such as special allocations and debt/equity questions into the world of one-off, Carmen Miranda headgear monstrosities.¹ Note that an opinion does not have tax avoidance as its principal purpose if the intended tax result is consistent with the “statute and Congressional purpose.”

Recall (for the third time) that there is a required second element of a substantial purpose opinion with the term “suspect” category coined by the author. To review, suspect categories consist of (i) reliance opinions, (ii) marketed opinions, (iii) opinions subject to conditions of confidentiality and (iv) opinions subject to contractual protection.

Of the four, the reliance opinion element is of broadest interest. A reliance opinion is one that both the advisor and client understand to insulate the taxpayer from penalties. The advisor can elect out of reliance opinion status by simply engaging in the awkward, client alienating, confidence reducing act of “prominently” disclosing, in a separate section at the beginning of the written advice, in bold face type larger than any other type-face in the written advice, that the opinion 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.”

Marketed opinions are of some interest as well. The definition uses disturbingly general words like “recommended” and “used or referred to,” which could cast a wider net than salesman-driven tax scams. I can “recommend” my tax strategy to an affiliate of my client, and I can “refer to” the structure proposed by opposing tax counsel. Is either instance really supposed to fall into this heightened category of scrutiny?

Let’s summarize. Issuing a covered opinion puts you in the high scrutiny *Black & Decker/Long Term Capital* zone. All things being equal, therefore, you don’t want to be issuing covered opinions. You could be in that zone, however, either by issuing written advice on an entity, plan or transaction the “principal purpose” of which is tax avoidance or evasion, in which case its end of inquiry, no opting out, no CYA allowed, or by issuing written advice where tax avoidance or evasion is a “substantial” but not the sole purpose. In that latter case, CYA may save you.

¹ Then again, consider a memorable laugh from “Back to the Future,” when Michael J. Fox tells Christopher Lloyd that Ronald Reagan is President and Christopher Lloyd shoots back, “Yeah, and Jack Benny is Secretary of State.”

The problem – a serious one -- is not being sure if the written advice falls into the “the principal purpose” category or the “a principal purpose” category. This is a case of drafters falling in love with the logic of their concepts at the expense of function. It is the deepest flaw in Circular 230.

Assume that your hybrid-fuel, state of the art ouija board indicates that you are in the less odious “substantial purpose” category (substantial + suspect category). You are therefore in a position to hope for a way out of the “covered opinions” zone. The following paths lead out of the covered opinion zone (despite your having come to a more likely than not conclusion about the substance of the deal):

- i. use the disclaimer language and hope that your client cares as much about it as he or she does about the warranty disclaimer language that comes with the packaging for a \$30 phone at Best Buy;
- ii. the advice concerns the qualification of a qualified plan;
- iii. the advice is in documents required to be filed with the SEC;
- iv. the advisor reasonably expects to be asked to provide follow-up advice;
- v. you can drill down into the definition of a “reliance opinion,” where you discover that a reliance opinion is written advice which “concludes at a confidence level of more likely than not that one or more significant tax issue would be resolved in the taxpayer’s favor.” Does it come down to simply never concluding in writing that there is a greater than 50 percent likelihood that one or more significant federal tax issues will be resolved in favor of the taxpayer? Apparently yes.

Complying with the requirements for issuing a covered opinion.

The advisor must use reasonable efforts to identify and ascertain the facts. The opinion must identify and consider all of the relevant facts.

The opinion cannot be based on unreasonable factual assumptions, including assumptions as to future events. An unreasonable factual assumption includes a factual assumption which the practitioner knows or should know is incorrect or incomplete. An example of an incomplete factual assumption is the assumption that a transaction has a business purpose. A practitioner can’t rely on a financial forecast if the practitioner knows or should know that it is incorrect or incomplete or, significantly, or that it was prepared by a person lacking the requisite skills or qualifications. (Wow!)

The opinion must set forth all the factual assumptions relied on by the issuer of the opinion. The assumptions must be set forth in a separate section.

To recap, the opinion must contain a separate section outlining all the factual assumptions, and all those assumptions must be reasonable, or, more precisely, be the product of “reasonable efforts” to identify and ascertain the relevant facts. Significantly, the inquiry encompasses an assessment of the plausibility of future events.

The opinion must relate the law to the facts. The law includes all potentially applicable judicial doctrines. Presumably this will result in every covered opinion discussing the possibility of substance over form and step transaction.

The opinion must consider all “significant federal tax issues.”

The opinion must provide a conclusion as to the likelihood of prevailing on each significant federal tax issue. Here we come to the steel in these rules. With respect to each significant federal tax issue, the opinion must conclude that there is a more likely than not probability that the taxpayer will prevail on each significant tax issue, or the opinion must include appropriate disclosures. (With respect to listed transaction opinions and principal purpose transactions, there is no either or; the advisor must conclude that the taxpayer is more likely than not to prevail on every significant federal tax issue.

All covered opinions must set forth the advisor’s “overall conclusion as to the likelihood” that the anticipated tax treatment will survive IRS scrutiny. If the practitioner cannot provide an overall conclusion, the opinion must so state, and must describe the reasons for not doing so.

Note, in the context of this more likely than not disclosure, that with respect to the category of covered opinions defined as a “reliance opinion,” there is an overlap between the definitional section and the compliance section. An opinion that is otherwise not a covered opinion, but that becomes a covered opinion because it contains more likely than not language necessarily avoids the disclosure/disclaimer language just discussed. In other words, because of reliance opinion by definition always comes to a more likely than not conclusion, there will never be a case where, in such opinion, there is a disclosure/disclaimer on that issue.

Limited Scope Opinions.

Advisors may provide a limited scope opinion, an opinion that considers less than all of the significant federal tax issues, conditioned upon the following:

- i. The advisor and the taxpayer agree that the opinion cannot be relied on for purposes of avoiding penalties other than with respect to issues addressed in the opinion;
- ii. The advice (A) does not relate to a listed transaction (B) does not relate to a “principal purpose” transaction (C) is not a marketed opinion;
- iii. The opinion contains required disclosures, outlined below.

Note the clause (B) of the middle of the three conditions. The limited scope opinion escape hatch only applies where tax avoidance or evasion is “a substantial purpose,” and not when it is the “principal purpose.”

With respect to limited scope opinions, the written opinion must “prominently recite” the following:

- i. The opinion is limited to the tax issues addressed;

- ii. There may be additional issues that affect federal tax treatment; and
- iii. The opinion cannot be relied on to avoid penalties with respect to significant tax issues not addressed by the opinion.

Insofar as the opinion fails to reach a “more likely than not” conclusion, the written opinion must prominently disclose that the opinion does not reach a more likely than not conclusion with respect to one or more significant federal tax issues, together with a statement that the opinion cannot be relied on to avoid penalties relating to those less than more likely than not issues.

Respondeat Superior

Circular 230 mandates procedures to insure compliance with the covered opinions section. Each advisor who has or shares principal authority and responsibility for overseeing a firm’s practice of providing advice concerning federal tax issues must take reasonable steps to insure that the firm has adequate procedures to comply with the covered opinion rules of Section 1035 of Circular 230.

Effect of Circular 230 on Estates and Trust Planning Advice.

The substantial understatement penalty under Section 6662 does not apply to transfer taxes. Instead, the predominant sanction for overly aggressive transfer tax positions is the negligence penalty. A taxpayer need not have a more likely than not opinion in hand to avoid the negligence penalty. Instead, the IRS cannot impose the negligence penalty for a position taken on the strength of there not being a reasonable basis of success. Since a covered opinion only provides penalty protection if the giver of the opinion provides a more likely than not assessment, the practice standards applicable to tax *advisors* is more stringent in this area than the standard of care imposed on *taxpayers*.

Recall in the discussion above the distinction, for purposes of defining a covered opinion, between transactions where tax avoidance or evasion is a substantial purpose and those where tax avoidance is the principal purpose. For substantial purpose advice, the advisor can worm out (sorry, opt out) of the more likely than not straight jacket. However, where tax avoidance is *the principal purpose*, the advisor must meet the more likely than not standard with respect to each significant Federal tax issue and cannot opt out. How does that matrix square with cases in which the courts have concluded that tax avoidance motives are irrelevant for transfer tax purposes?²

Problems with Circular 230:

- a. Some advice responds to abstract questions;
- b. Advice occurs at all stages of the process;

² *Christoffani v. Commissioner*, 97 T.C. 74 (1991); *Gulig v. Commissioner*, 293 F. 3d 279 (2002) and *Knight v. Commissioner*, 115 T.C. 506 (2000)

- c. Different advice is given to different clients, based on sophistication and budget;
- d. Advice is often incorporated in a document;
- e. Requires a judgment each time a writing is created as to whether it is a covered opinion. In particular, it requires a determination of whether tax avoidance is a significant purpose or the principal purpose.
- f. The significant purpose/principal purpose judgment needs to be made by associates each time they communicate with a client by email on a tax issue.
- g. Banner disclaimer is awkward, and engenders either suspicion or indifference.
- h. Significant purpose/principal purpose dichotomy changes in the course of working on a deal.
- i. The significant purpose/principal purpose dichotomy will differ from client to client even on the same facts.
- j. Regulations must clarify how they apply to written advice on hypothetical transactions. Also need clarification for tax advice where the facts have not yet been developed or agreed to.
- k. For written advice that does not constitute a covered opinion, the practitioner is still enjoined from relying on “unreasonable factual or legal assumptions,” such as the existence of a business purpose or valuation.
- l. For opinions other than covered opinions, the practitioner must consider all relevant facts that the practitioner knows or should know.
- m. It is unreasonable for a tax practitioner to be enjoined from advising a client on the prudence of taking a position based on the likelihood of the issue being raised at audit, or the likelihood of it being settled in Appeals.
- n. Emails are as much like oral advice as they are like formal written opinions.
- o. These rules will engender considerable delay and unwanted expense.
- p. The marketed opinion definition includes advice that is not used to market tax shelters. Note the use of the word “used or referred to” and “recommending,” which could cause advice that is shared among participants in a deal or business affiliates to be classified as a marketed opinion.
- q. The standards applicable to opinions other than covered opinions are remarkably similar to the restrictions and limitations imposed on covered opinions.

- r. Does the requirement in informal opinions that a practitioner may not make unreasonable assumptions include an assumption that a significant federal tax issue will be favorably resolved?
- s. Even in informal opinions, the practitioner cannot give advice that accounts for the possibility that an issue will or will not likely be resolved through settlement.

New York State Bar Association Suggestions:

- a. Switch from “opt-out” to “opt-in” system for principal purpose and significant purpose opinions;
- b. Exclude advice that the recipient could not reasonably construe as advice that could be relied on for avoiding penalties, considering the facts and circumstances, such as client sophistication, course of dealing and the context of written advice. (e.g. the use of words such as “preliminary,” “informal” or “initial thoughts”)
- c. The hyper-strict rules for marketed and listed transactions opinions prevent practitioners from providing useful informal advice on those issues.
- d. Lack of clarity on whether an opinion must consider the facts in law relevant to all tax issues or only the facts in law relevant to “significant” tax issues.

Likely Changes/Clarifications

The IRS Office of Professional Responsibility recently outlined some potential revisions to Circular 230. The IRS spokesman noted that the rules are generally meant for “fringe behavior involving tax scams and schemes.” He stated that clarifying language is “on the way” on the substantial purpose/principal purpose distinction. He also said that the IRS might exclude some types of post filing advice, as well as excluding advice from in-house counsel. The IRS is also examining whether or not negative advice should be subject to the covered opinion rules. In addition, the Service is likely to take a heightened interest in law firms’ upper management.

Circular 230
Analysis of practice standards for Covered Opinions
and Other Written Advice

The standard:	Covered Opinions	Other Written Advice
Consider all relevant facts (including future facts)	<i>yes</i>	<i>yes</i>
No unreasonable factual assumptions (including future facts); e.g., business purpose	<i>yes</i>	<i>yes</i>
No unreasonable reliance on statements or representations; e.g., appraisal	<i>yes</i>	<i>yes</i>
No unreasonable legal assumptions (including assuming a significant Fed tax issue will be favorably resolved)	<i>yes</i>	<i>yes</i>
<u>Can't consider possibility of audit or resolution prior to litigation</u>	<i>yes</i>	<i>yes</i>
Relate the law to all relevant facts	<i>yes</i>	no
No internally inconsistent analysis or conclusions	<i>yes</i>	no
Provide a conclusion for each significant Fed tax issue	<i>yes</i>	no
Provide an overall conclusion (or explain why it can't be reached)	<i>yes</i>	no
<u>DISCLOSURE/DISCLAIMER</u> <u>required in absence of <i>more likely than not</i> conclusion</u>	<i>yes</i>	no

SAMPLE CIRCULAR 230

DISCLOSURES

“Circular 230 Disclosure: The following disclosure is required pursuant to Circular 230 which sets forth best practices for tax advisors. This 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.”

“Circular 230 Disclosure: This opinion was not intended or written by the practitioner to be used, and it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.”



Internal Revenue Service IRS.gov

DEPARTMENT OF THE TREASURY

Abusive Tax Shelters and Transactions

The Internal Revenue Service is taking steps to combat abusive tax shelters and transactions. A comprehensive strategy is in place to:

- Identify and deter promoters of abusive tax transactions through audits, summons enforcement and targeted litigation.
- Keep the public advised by publishing guidance on transactions and shelters that are determined to be abusive.
- Promote disclosure by those who market and participate in abusive transactions.
- Develop and implement alternative methods for resolving abusive transactions claimed by taxpayers.

Office of Tax Shelter Analysis Hotline

New Tax Law Provisions Enacted to Combat Abusive Tax Shelters

The American Jobs Creation Act of 2004 (P.L. 108-357) was signed into law by the President on October 22, 2004. This new legislation contains many provisions that will affect abusive tax shelter promotions, advisors and investors.

Recent Tax Shelter Developments and Additions to This Site

- [Stock Option Settlement FAQs](#) - Updated 5/4/2005 - Frequently asked questions relating to Announcement 2005-19.
- [Announcement 2005-19](#) - A settlement initiative has been announced for executives and companies that participated in an abusive tax avoidance transaction involving the transfer of stock options or restricted stock to family controlled entities. These transactions were designated as listed transactions in [Notice 2003-47](#).
 - [Stock Option Settlement Press Release](#)
 - [Stock Option Settlement Fact Sheet](#)
 - [Form 13656](#) - Settlement Election For Executives and Related Parties
 - [Form 13657](#) - Settlement Election for Corporations.

Listed Abusive Tax Shelters and Transactions

IRS, the Office of Chief Counsel and Treasury issue formal guidance on certain tax avoidance transactions that are referred to as "listed transactions". Taxpayers are required to disclose their participation in listed transactions. To date, 30 listed transactions have been identified and addressed in formal guidance. [Notice 2004-67](#) Updated Listed Transactions

Regulations on Abusive Tax Shelters and Transactions

Treasury regulations require that certain tax shelters and transactions be registered and that lists of investors be maintained by parties who organize or sell interests in the shelter(s). Investors in certain shelters and transactions are required to disclose their participation on their tax returns.

Lead Executives and Technical Contacts

Designated lead IRS executives provide oversight and direction in developing strategies to combat abusive tax avoidance transactions.

Mandatory Information Document Request (IDR)

An information document request is required in all LMSB examinations. The purpose of the IDR is to assist agents in identifying and developing tax shelter issues relating to listed transactions.

Tax Accrual Workpapers

IRS policy is to request tax accrual and other financial audit workpapers relating to the tax reserve for deferred tax liabilities, and to footnotes disclosing contingent tax liabilities appearing in audited financial statements.

- [Interim Guidance Memo on Requesting Audit, Tax Accrual, and Tax Reconciliation Workpapers \(07/09/2004\)](#)
- [IRM 4.10.20 - Requesting Audit, Tax Accrual, or Tax Reconciliation Workpapers](#)
- [LMSB/SBSE Memorandum - 2002](#)
- [Announcement 2002-63](#)
- [Tax Accrual Workpaper FAQs - 2002](#)

Penalty Policy Relating to Abusive Transactions

An [LMSB Commissioner Memorandum](#) issued to LMSB executives, managers, and examiners provides guidance on consideration and application of penalties in an impartial, consistent and fair manner. A separate LMSB Commissioner Memorandum covers [Penalty Policy in Disclosure Initiative Cases](#).

IRS Initiatives to Resolve and Identify Abusive Tax Shelters and Transactions

- Taxpayers were afforded the opportunity to participate in a "[Son-of-Boss](#)" [settlement initiative](#) announced in May, 2004. Taxpayers who qualified for the offer paid outstanding tax, interest and applicable penalty.
- IRS conducted a [settlement initiative](#) from October 2002 through March 2003 to allow taxpayers engaged in certain abusive transactions to resolve the tax consequences arising from their participation in the transactions. The transactions covered by the initiative were §302 / 318 Basis Shifting, §351 Contingent Liabilities, and Corporate Owned Life Insurance (COLI).
- A prior [Tax Shelter Disclosure Initiative](#) conducted from December 2001 to April 2002 resulted in 1,690 transaction disclosures from 1,212 taxpayers. The transactions disclosed involved \$30 billion in claimed losses and deductions.
 - [Announcement 2002-2, Disclosure Initiative](#)
 - [LMSB Commissioner Memorandum, Penalty Policy in Disclosure Initiative Cases](#)

Examination Guide -- Abusive Tax Shelters and Transactions

This guide was developed to support IRS field personnel in the identification and the consistent development of abusive tax shelter and transaction issues. The guide covers transactions engaged in by all types of taxpayers, including "listed transactions" (known abusive), identified transactions that have not been listed, and emerging transactions. The guide is published here in separate sections in pdf format.

Office of Tax Shelter Analysis

The Office of Tax Shelter Analysis (OTSA) in the LMSB Division collects and analyzes information about abusive tax shelters and transactions, and coordinates LMSB's tax shelter planning and operations.

IRS maintains a hotline that people can use to provide information (anonymously if preferred) about abusive tax shelters.

- Toll free (866) 775-7474
- Fax (202) 283-8354
- Email irs.tax.shelter.hotline@irs.gov
- mail Internal Revenue Service
Office of Tax Shelter Analysis
Mint Building M3-336
1111 Constitution Ave. NW
Washington, DC 20224

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Other Abusive Tax Schemes

In addition to the highly complex abusive technical transactions covered on this page, IRS is combating other types of abusive tax schemes, such as offshore tax avoidance schemes.

Click here for information on steps IRS is taking to combat these other schemes:

- [Abusive Tax Avoidance Schemes](#)
 - [Employee Plans Abusive Tax Transactions](#)
-

Legal Matters: The importance of being zealous
by David Borinsky

"Although I may marry others, and marry often," says the heroine, bosom heaving, to her one true love, "nothing can alter my eternal devotion to you."

Which makes perfect sense if you are a lawyer. Consider the following:

Attorney Algernon represents Gwendolyn and Cecily in the incorporation of a florist shop. (Algernon, Gwendolyn and Cecily are characters in "The Importance of Being Earnest," a play written by 19th-century author Oscar Wilde. Wilde, a celebrated wit, once observed that "it is only by not paying one's bills that one can hope to live in the memory of the commercial class." We shall honor Wilde for his keen insight into the business mind by adapting his characters to a modern business case study.)

After incorporation, Algernon provides routine legal services to the company. The business falters. Algernon, a gentleman, introduces the ladies to another client, Lady Bracknell, who is in the business of investing in privately-held firms such as Gwendolyn and Cecily's florist shop. Bracknell agrees to lend the company sufficient funds to continue its business, in exchange for which she takes back a promissory note. Gwendolyn and Cecily guarantee the note. Algie handles the paperwork.

Gwendolyn and Cecily prove no more skillful in spending Lady Bracknell's money than in spending their own, and the business soon closes. Algernon, on the other hand, proves adept at earning a fee at every phase of this drama. Lady Bracknell retains him to sue Gwendolyn and Cecily on the guarantees.

Cut! Do you see what's missing from this script?

"Yes, it's utterly trivial and pedestrian," you respond. "Gwendolyn and Cecily are lousy managers, Lady Bracknell is a poor judge of business talent, the money is gone, and Algernon is a parasitic lawyer. Sounds like a sequel to a B-school case study," you sniff.

"What's missing is novelty."

True, but irrelevant. What's really missing is an explanation of how Algernon can represent every participant in this sorry, contentious tale. The explanation is that he can't. "Morality is that attitude we adopt towards people we dislike," said our Victorian quipmeister, and an ethics complaint is the attitude unhappy clients adopt toward a lawyer who lacks the wit to save them from their mistakes.

Generally, a lawyer cannot represent a client against a former client whom the attorney represented in the same or related manner. When the real world Algernon filed suit against the real world Gwendolyn and Cecily, the ladies claimed they were Algie's former clients and complained to the state bar. Algernon argued that he owed eternal devotion to the entity only, and not to its owners. In a disciplinary proceeding against Algernon, the state supreme court (Oregon) disagreed, ruling that an attorney in such a situation represents the owners as well as the entity unless the attorney clearly informs the owners otherwise. Multiple representation can pay, but it's seldom romantic, and never funny when it brings trouble from the state bar.

The question of who the client is bears not only on the question of which lawyer can represent whom in litigation, but also on issues of disclosure, divided loyalty and confidentiality. If Algernon suspects Cecily of surreptitious borrowing from the register, can Algernon disclose this to Gwendolyn? Must he disclose it? Can he take sides? It is always true that the entity is the client, but it is not always clear who else, if anyone, is as well. The entity may be the client, but the entity cannot speak, reason or direct the attorney. Instead, the entity acts through its agents, typically its officers, some of whom are dishonorable, and some of whom have disagreements with their fellow officers, board members and owners.

If, as is the case in Oregon (and possibly in Maryland), active owners of a closely-held business are also clients of corporate counsel, then corporate counsel is engaged in multiple representation. The Rules of Professional Conduct require an attorney to zealously represent his or her client, with no distinction intended, or allowed, between a client who has explicitly retained the lawyer and a client whose relationship with the lawyer arises by implication.

The lawyer bears the burden of recognizing when joint representation creates a conflict.

Some conflicts cannot be waived, in which case the lawyer must withdraw. In the case of the leaky cash drawer, Algie needs to disclose the problem if there is someone to turn to -- another officer, a shareholder -- and if not, to resign.

May the attorney go further? May the attorney -- or rather must the attorney -- disclose the proposed wrongful conduct to outsiders, such as to the police, to passive owners, or to regulatory bodies?

Let's take them one by one.

If the client proposes criminal conduct and there is no higher authority within the organization to which to appeal, a set of ethical rules kick in which are, happily, outside my professional experience.

As to passive owners, that is, owners who are not involved in management, many courts have viewed shareholders as quasi-clients, and it would almost always be appropriate, when management is unresponsive to the lawyer's ethical concerns, to disclose those concerns to the outside owners. The American Bar Association toyed with the possibility in the 1980s of requiring lawyers under certain conditions to engage in whistle-blowing to outsiders, but the idea was dropped in the face of ferocious opposition.

In the wake of recent accounting scandals, Congress ordered the Securities and Exchange Commission to consider whether to impose whistle-blowing obligations on counsel to publicly traded firms. The ABA is also considering rules which, if enacted, would require lawyers to effect a "noisy withdrawal," that is, to disclose to outsiders the fact of the lawyer's withdrawal, whether the client is publicly or privately owned. In addition, the Internal Revenue Service has imposed limited outside disclosure obligations on lawyers representing taxpayers engaged in aggressive tax planning.

Oscar Wilde anticipated this trend: "It is perfectly monstrous," complains Lord Illington in "A Woman of No Importance," "the way people go about, nowadays, saying things against one behind one's back that are absolutely, entirely true."