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Ethical Issues in Tax Practice

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I. SOURCES OF PRACTICE STANDARDS FOR TAX PRACTITIONERS.

A. THE NATURE OF PRACTICE STANDARDS. Practice standards are ethical principles that guide the tax practitioner in balancing duty to client with duty to "system."

B. WHERE DO WE FIND TAX PRACTICE STANDARDS? Tax practice standards come from three sources: standards set by professional organizations, civil penalties set forth in the Internal Revenue Code, and the Federal regulations known popularly as "Circular 230."

1. Standards Set by Professional Organizations.

   a. Both the American Bar Association ("ABA") and the American Institute of Certified Public Accountants ("AICPA") define standards for their members. The ABA Model Rules of Professional Conduct also serve as the basis for standards set by most court systems, including the United States Tax Court (Rule 201(a)).

   b. ABA and AICPA committees issue interpretations of their standards for particular factual situations.

   c. Other professional organizations, such as the National Association of Enrolled Agents and the National Society of Public Accountants also issue standards for their members.

2. Internal Revenue Code Civil Penalty Provisions. These include the income tax return preparer penalty under section 6694 and the aiding and abetting penalty under section 6701.

*/ This outline was prepared by Mr. Holden, and it does not necessarily reflect the views of Mr. Brauer.

C. TAX RETURN ACCURACY STANDARDS.

1. Tax return accuracy standards have been established for both taxpayers and tax practitioners.

2. These standards are fundamental to tax practice, and we turn to them before considering other standards.

3. We commence with the tax return accuracy obligation of the client taxpayer before describing the accuracy required of the practitioner. This order is chosen on the theory that the practitioner cannot effectively assist the client unless the practitioner understands fully the client's own accuracy obligation under the tax law.

4. Following that, we return to the accuracy obligation of the tax practitioner.

II. THE TAX RETURN ACCURACY OBLIGATION OF THE TAXPAYER CLIENT: THE TAXPAYER ACCURACY PENALTY.

A. THE FOUR COMPONENTS OF THE TAXPAYER ACCURACY PENALTY.

A 20% penalty is imposed on any taxpayer whose return shows an underpayment of tax that is attributable to one or more of the following four components.

1. Negligence. Negligence occurs if a tax return position lacks reasonable basis or if the taxpayer does not make a reasonable attempt to comply with the tax law. Reg. § 1.6662-3(b).

   a. A taxpayer acts reasonably if the taxpayer in good faith relies on the advice of a tax professional. Chamberlain v. Commissioner, No. 94-40806 (5th Cir. 9/27/95).

2. Disregard of rules or regulations. Disregard includes any careless, reckless, or intentional disregard of the Code, temporary or permanent regulations, revenue rulings, or notices (other than notices of proposed rulemaking). Reg. § 1.6662-3(b)(2). A position contrary to a revenue ruling or notice does not disregard the ruling or notice if the position has a "realistic possibility of being sustained on its merits," a term that we define below.
3. **Substantial understatement of income tax.** A substantial understatement of income tax occurs where an income tax underpayment exceeds the greater of ten percent of the tax due or $5,000 ($10,000 for corporation) and the position giving rise to the underpayment is not supported by "substantial authority." Section 6662(d).

a. There is substantial authority for a position if the weight of authorities supporting the position is substantial in relation to the weight of authorities supporting a contrary position. Reg. § 1.6662-4(d)(2).

(1) There may be substantial authority for more than one position.

(2) The standard is objective and thus the taxpayer's belief about the accuracy of the position is not relevant.

(3) Authorities that may be considered in evaluating the presence of substantial authority include essentially all government-issued material but do not include privately-issued material such as treatises, legal periodicals, and opinions of tax professionals.

(4) If there exists no authority with regard to a position, substantial authority may rest on a well-reasoned construction of the applicable statutory provision.

b. Determining the existence of substantial authority in highly factual cases can be difficult.

(1) In **Osteen v. Commissioner**, 95 TNT 168-46 (11th Cir. 8/24/95), the Tax Court held that the taxpayers did not conduct their horse breeding business for profit and denied claimed loss deductions. It also imposed the substantial understatement penalty on grounds that the claimed deductions were not supported by substantial authority.
(2) The appeals court affirmed on the substantive tax issue but reversed on the penalty issue. It held that substantial authority exists if a lower-court decision in favor of the taxpayers would have been affirmed as not clearly erroneous. The appeals court concluded that there was evidence both ways, and the Tax Court could thus have found for the taxpayers. Had it done so, its decision would have been affirmed as not clearly erroneous. This, said the appeals court, is sufficient to establish substantial authority.

c. If a substantial understatement arises by virtue of a tax shelter, special rules apply. Reg. § 1.6662-4(g).

(1) A tax shelter includes any plan or arrangement having as its principal purpose the avoidance of Federal income tax. Reg. § 1.6662-4(g)(2), (3).

(2) A noncorporate taxpayer may avoid the penalty by showing that there was substantial authority for the position and by establishing that the taxpayer reasonably believed that the position taken on the return was more likely than not proper. The taxpayer may establish the required reasonable belief through personal analysis of authorities or reliance on the opinion of a professional tax advisor. Reg. § 1.6662-4(g).

(3) A corporate taxpayer does not have this option. Its tax shelter underpayments are subject to penalty unless relief is available under the reasonable cause and good faith exception of section 6664(c), discussed below. Reg. § 1.6662-4(g)(1)(ii).

4. Valuation misstatement. There are several valuation misstatement penalties that apply where income, pension, and estate or gift tax valuations exceed stated threshold limits. Section 6662(e),(f), and (g).
B. AVOIDING THE PENALTY BY MAKING ADEQUATE DISCLOSURE.

1. Effect of adequate disclosure. The taxpayer may avoid some components of the accuracy penalty by making adequate disclosure on a Form 8275 (a Form 8275-R must be used if a regulation has been disregarded).

2. Reasonable basis required. Disclosure is not effective unless there exists a "reasonable basis" for the position. Reg. § 1.6662-1.
   a. The precise meaning of "reasonable basis" in this context is unclear.
   b. While the regulations assert that the reasonable basis standard is "significantly higher than the not frivolous standard," they reserve the actual definition of the term for future resolution. Reg. § 1.6662-3(b)(3).

3. The negligence component. Negligence generally occurs only where a taxpayer acts without reasonable basis, and thus disclosure is not effective as a defense against this component of the accuracy penalty. Reg. §§ 1.6662-1, 1.6662-7(b).

4. The disregard component. The disregard component of the accuracy penalty may be avoided by disclosure so long as the taxpayer keeps adequate books and records and properly substantiates items. However, if a regulation is disregarded, disclosure will not be operative unless the taxpayer is engaged in a good faith challenge to the validity of the regulation. Reg. § 1.6662-3(c)(1).

5. The substantial understatement component. The substantial understatement component of the accuracy penalty may be avoided by disclosure except that disclosure will not be effective if (1) the position relates to a "tax shelter," or (2) the taxpayer failed to maintain adequate books and records or to substantiate items. Reg. § 1.6662-4(e).

C. AVOIDING THE PENALTY BY ESTABLISHING REASONABLE CAUSE
AND GOOD FAITH.

1. The general rule.

   a. The accuracy penalty of section 6662 may not
be imposed if the taxpayer establishes that
there was reasonable cause for the
underpayment and taxpayer acted in good
faith. Section 6664(c); Reg. § 1.6664-4.

   b. The determination of reasonable cause and
good faith is made on the basis of all facts
and circumstances, and the most important
factor is the taxpayer's effort to assess the
proper tax liability. Reg. § 1.6664-4(b).

      (1) Reliance on such factors as Forms W-2
and information returns prepared by
others may establish good faith unless
those documents are inconsistent with
other information that is available to
the taxpayer or with the taxpayer's own
knowledge. Reg. § 1.6664-4(b).

      (2) Reasonable reliance in good faith on
advice provided by others (including a
tax professional) may suffice if that
advice is based on all pertinent facts
and circumstances and is not based on
unreasonable assumptions. Reg. §
1.6664-4(b),(c).

2. Special tax shelter rule for corporate taxpayers.

   a. A corporate taxpayer seeking to avoid penalty
with respect to a tax shelter position may
avoid the penalty by establishing reasonable
cause and good faith.

   b. Ordinarily, a corporation would defend
against a penalty by stressing the "legal
justification" that it had for its position.
However, the corporation's legal
justification for a tax shelter position will
be considered only if the taxpayer first
satisfies both an "authority requirement" and
a "belief requirement." Reg. §
1.6664-4(e).

      (1) The corporate taxpayer satisfies the
"authority requirement" by establishing
that there was substantial authority for
the position.
(2) The corporate taxpayer satisfies the "belief requirement" by establishing that the taxpayer reasonably believed that there was a greater than 50-percent likelihood that the position would be sustained if challenged by the IRS. This belief may be based on either the taxpayer's own research or the opinion of a professional tax advisor.

c. Once these two requirements are satisfied, the corporate taxpayer's "legal justification" may be considered. Reg. § 1.6664-(e)(2).

d. Even if a corporation satisfies all of the above requirements, including legal justification, relief from the penalty may nonetheless be denied if the circumstances indicate an absence of good faith (where, for example, the taxpayer's participation in the shelter lacked a business purpose, or the taxpayer claimed benefits that are unreasonable in relation to its investment). Reg. § 1.6664-4(e)(3).

3. Negligence inconsistent with reasonable cause. While the reasonable cause exception is technically available to defend against the negligence component of the accuracy penalty, that component of the penalty should not have been proposed in the first instance if the taxpayer acted reasonably. Thus, the reasonable cause exception should not play a role in negligence situations.

D. SUMMARY OF THE TAXPAYER ACCURACY STANDARD. The fact that a taxpayer who acts reasonably is, by reason of section 6664(c), protected from the accuracy penalty suggests that the accuracy standard for a taxpayer can be summarized as a requirement that the taxpayer act reasonably with respect to the taxpayer's tax obligations.

III. THE TAX PRACTITIONER'S ACCURACY OBLIGATION.

A. THE REALISTIC POSSIBILITY STANDARD FOR TAX RETURN ACCURACY.

1. The Realistic Possibility Standard.

a. The prevailing standard requires that practitioners neither sign returns nor advise taxpayers to adopt tax return positions
unless those positions have a realistic possibility of being sustained on the merits.

b. This standard, known as "the realistic possibility standard," has been adopted in the professional organization standards, the civil penalty provisions, and Circular 230.

2. Definition of the Realistic Possibility Standard. Although there is some dispute as to whether this standard can properly be expressed in percentage terms, the Service defines the realistic possibility standard as requiring that a reasonable and well-informed person, knowledgeable in the tax law, would, upon analysis, conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits. Reg. § 1.6694-2(b).

3. The Professional Organizations.

a. ABA Opinion 85-352 and AICPA Statement No. 1 both adopt "realistic possibility" as the tax return accuracy standard for their members.

b. These organizations recognize that a position need not meet the realistic possibility standard if the position is not frivolous and is adequately disclosed on the return. Similarly, they recognize that a position not meeting the realistic possibility standard may be taken or advised in a claim for refund so long as the position is not frivolous.


a. The realistic possibility standard governs the application of the income tax return preparer penalty of section 6694(a).

b. Under section 6694(a), a $250 penalty is imposed on the preparer if an income tax return understates tax liability and the understatement is attributable to a position that fails to meet the realistic possibility standard.

(1) The penalty does not apply if the position was adequately disclosed on the return and is not frivolous (Reg. §1.6694-2(c)).
(2) It also does not apply if the preparer establishes that the understatement was due to reasonable cause. (Reg. § 1.6694-2(d)).

c. If an income tax return understates liability by reason of either (1) a willful attempt by the preparer to understate liability, or (2) a reckless or intentional disregard of rules or regulations by the preparer, a $1,000 penalty is imposed on the preparer of that return. Section 6694(b).

(1) There is no disclosure option where there has been a willful attempt to understate liability.

(2) There is, however, a disclosure option where there has been disregard of rules or regulations. As with the disregard component of the taxpayer accuracy penalty, disclosure is effective where a regulation has been disregarded only if the taxpayer is engaged in a good faith challenge to the validity of the regulation. Reg. § 1.6694-3(e).

(3) There is no stated exception to the section 6694(b) penalty for reasonable cause, but, if the preparer acted reasonably, the penalty should not have been asserted.


a. Circular 230 requires that IRS practitioners observe the realistic possibility standard. § 10.34. Circular 230 defines the standard in the same manner as do the preparer penalty regulations noted above, i.e., as requiring a one-in-three probability of prevailing.

b. Circular 230 distinguishes between a signing practitioner and a nonsigning practitioner (i.e., a practitioner who advises concerning a return position or who prepares part of a return but does not sign the return).

(1) A practitioner may not sign a return that contains a position that does not meet the realistic possibility standard unless the position is not frivolous and is adequately disclosed on the return.
(2) A nonsigning practitioner may not advise a position or prepare part of a return containing a position unless the position meets the realistic possibility standard or the position is not frivolous and the practitioner advises the taxpayer of the opportunity to avoid an accuracy penalty through adequate disclosure.

B. THE AIDING AND ABETTING PENALTY APPLICABLE TO PRACTITIONERS.

1. The penalty. Section 6701 imposes a penalty on any person who assists in the preparation or presentation of any document knowing (or having reason to believe) that the document will be used for tax purposes and who knows that, if used, the document will result in the understatement of the tax liability of another person.

2. Amount. The penalty is $1,000, except that it is increased to $10,000 if the document relates to the tax liability of a corporation.

3. Where applicable. This penalty would apply, for example, to an individual employed by the taxpayer who assists in the preparation of a document for the employer, knowing that the document will understatement the employer's tax liability.

IV. THE ETHICAL OBLIGATION OF CONFIDENTIALITY.

A. THE GENERAL RULE. Virtually all professional organizations impose an obligation of confidentiality on members of the profession with respect to client affairs. We discuss this ethical obligation principally in terms of the standards developed for lawyers because they deal comprehensively with the subject.

B. ABA MODEL RULE 1.6. This rule states that a lawyer shall not reveal information relating to a representation of a client without the client's consent except where necessary to prevent the client from "committing a criminal act that the lawyer believes is likely to result in imminent death or substantial bodily harm" or to establish a claim or defense in a controversy between the lawyer and the client.

1. The privilege distinguished. The ethical obligation of confidentiality is to be distinguished from the attorney-client privilege,
which is a rule of evidence rather than an ethical rule.

2. **The privilege is more durable.** The attorney-client privilege is more durable than the obligation of confidentiality. If appropriately claimed, the privilege can survive a court order to testify. In contrast, the ethical obligation ends whenever the practitioner encounters a legal obligation to make disclosure.

3. **The privilege is narrower.** The attorney-client privilege is narrow and is available for only a limited class of communications. On the other hand, the ethical obligation is very broad and attaches to all information that the client might wish be held confidential.

4. **The privilege is restricted to lawyers.** The attorney-client privilege is available only for communications with lawyers. There is no accountant-client privilege. *United States v. Arthur Young & Co.*, 104 S.Ct. 495 (1984). The privilege for communications with an accountant may be established if the accountant is retained by an attorney for purposes of providing assistance to the attorney. *Bernardo v. Commissioner*, 104 T.C. No. 33 (June 20, 1995).

C. **TENSION WHERE THE OBLIGATION OF CONFIDENTIALITY restricts Disclosure of CLIENT FRAUD.**

1. **The problem of client fraud.** The broad obligation of confidentiality sometimes creates tension because the practitioner may feel the need to make disclosure of information where the client acts in a fraudulent or otherwise illegal manner.

2. **Guidance from the ABA rules.** Some ABA Model Rules restrict the lawyer in ways that may impinge on the obligation of confidentiality.
   a. ABA Model Rule 1.2(d) states that a lawyer may not counsel or assist in conduct that is criminal or fraudulent.
   b. Model Rule 1.16(a)(1) states that a lawyer must withdraw from a representation that will result in a violation of the rules of professional conduct or other law.
   c. Model Rule 1.16(b) states that the lawyer may withdraw if the client persists in a course of action that the lawyer reasonably believes
to be criminal or fraudulent or if the client has used the lawyer's services to perpetrate a crime or fraud.

d. Model Rule 3.3(a)(2) states that a lawyer shall not knowingly fail to disclose a material fact to a "tribunal" when disclosure is necessary to avoid assisting in a criminal or fraudulent act by the client.

e. Model Rule 4.1(b) states that a lawyer shall not fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act unless disclosure is prohibited by Rule 1.6.

3. Only limited guidance provided. Note that only Rule 3.3(a)(2) (disclosure to a tribunal) expressly frees the lawyer from the obligation of confidentiality established by Rule 1.6. In all other situations, the lawyer is left with the need to reconcile the obligation of confidentiality with the social pressure to disclose fraud.

4. Dealing With This Tension In Tax Practice.

a. ABA Opinion 314 provides guidance with respect to certain aspects of practice before the IRS.

(1) Opinion 314 concludes that proceedings before the IRS are adversarial in nature and that the IRS is thus not a "tribunal" within the meaning of Rule 3.3(a)(2). Accordingly, there is no duty to disclose client fraud to the IRS, and, in this situation, the duty to client trumps the duty to system.

(2) Opinion 314 appears to contemplate a controversy representation before the IRS. It is not clear that the same result would follow if the matter were, for example, the processing of a request for private letter ruling. Would the Service then be viewed as a tribunal? Somewhere in between might lie the representation of a taxpayer in connection with a technical advice request that arises out of an ongoing audit of the taxpayer.
(3) Opinion 314 also concludes that a lawyer who represents a client before the IRS may stress the strong points of the client's case and is not required to disclose weakness in that case. It also states that the lawyer may not mislead the IRS deliberately and affirmatively, either by misstatements or by permitting the client to mislead.

(4) Under Opinion 314, where a client has made misstatements to the IRS, the lawyer must counsel the client to correct them, and may, if the client refuses, have a duty to withdraw. The lawyer may not, however, disclose the misstatement without the client's permission.

b. ABA Opinion 92-366, which deals with a nontax situation, holds that a lawyer must withdraw from any representation where the client is engaged in an ongoing fraud if the lawyer's presence assists in that fraud.

(1) The withdrawing lawyer may disavow any of the lawyer's work product that may be used by the client to further the continuing fraud even if that act may have the collateral effect of disclosing client confidences. This is known as a "noisy withdrawal." In this situation, involving ongoing fraudulent activity, duty to the system trumps duty to the client.

(2) Continuing fraud seems to require more than a past fraudulent act. If that were not so, any prior fraudulent act would justify a noisy withdrawal. Thus, the concept of continuing fraud appears to suggest new criminal activity, as distinguished from efforts to avoid detection of prior fraudulent conduct. If, however, those efforts produce an independent criminal activity, such as a false statement (see 18 U.S.C. § 1001), a continuing fraud might be present.

(3) If the client has committed a fraud that is not a continuing one, the lawyer may withdraw but may not disavow his or her work product.
c. ABA Opinion 93-375 further elucidates these principles in the context of a regulatory agency examination of a client. Although the agency involved in the opinion was not the IRS, the same results would seem to follow in an IRS examination. Under the opinion:

(1) The lawyer has a duty not to mislead agency officials but has no duty to disclose weaknesses in the client's case or to reveal confidential information.

(2) The lawyer must conduct herself in a way that does not assist in fraud by the client on the agency.

(3) If the client has a duty to disclose information to the agency, the lawyer should counsel the client to make that disclosure. If the client fails to do so, the lawyer need not withdraw.

(4) If the client makes a misrepresentation to the agency in the presence of the lawyer, the lawyer is not required to make a "noisy withdrawal" but is obligated to counsel the client in private to correct the misrepresentation. If the client refuses, the lawyer may have the obligation to "climb the corporate ladder" (i.e., to counsel the client's superior if the client is an employee) to secure a different result. The lawyer may also be required under Model Rule 1.16(b) to consider withdrawal.

(5) If the lawyer does not withdraw and is asked directly by an agency representative about the subject of the misrepresentation, the lawyer's only permissible option is to decline to respond, regardless of the negative inference that may be drawn from that action. The lawyer should caution the client in advance of any such meeting about this possibility and the risks presented by allowing the lawyer to continue to function in this "impaired state."
D. CIRCULAR 230 AND THE OBLIGATION OF CONFIDENTIALITY.

1. **Practitioner must advise client of omission.** If a practitioner discovers that a client has not complied with the tax law or has made an error in any document, the practitioner is required to advise the client promptly of that fact. § 10.21.

2. **Practitioner disclosure not directed.** Circular 230 does not require or permit disclosure of the omission by the practitioner.

E. CAUTION CONCERNING DIFFERENT RULES IN DIFFERENT JURISDICTIONS.

1. **ABA Rules are advisory only.** The ABA Model Rules and opinions interpreting the rules have no operative effect unless and until they are adopted by admitting courts.

2. **Variations in different jurisdictions.** Some of the ABA Model Rules regarding confidentiality, disclosure, and withdrawal have been adopted in widely varying forms among the various states.
   
   a. In some states, the obligation of confidentiality has been downgraded by permitting the lawyer to make a noisy withdrawal even in the absence of continuing fraud.
   
   b. Still other states condition the obligation of confidentiality by permitting the lawyer to make disclosures that are necessary to prevent financial fraud by a client.

3. **Local knowledge is essential.** For these reasons, it is imperative that a lawyer consult the form in which the rules have been adopted in his or her particular state.
V. THE DUTY OF LOYALTY -- AVOIDING CONFLICT OF INTEREST.

A. CONFLICT OF INTEREST. ABA Model Rule 1.7 and Circular 230 § 10.29 both require that a lawyer avoid representation of conflicting interests. This rule relates to present clients and prior clients, and it generally precludes a lawyer from representing a client in a proceeding where the lawyer will be an essential witness.

B. TAX COURT RULE 24(f). Tax Court Rule 24(f) requires a lawyer (1) who was involved in planning or promoting a transaction or operating an entity connected to an issue in a case, (2) who represents more than one person with differing interests in a case, or (3) who may be a witness in a case, to (a) secure informed consent of the client (but only as to (1) and (2)), (b) withdraw, or (c) take whatever other steps are necessary to obviate a conflict of interest or other violation of the ABA Model Rules.

C. CLIENT WAIVER OF CONFLICT.

1. Client waivers permitted. Generally, affected clients may waive the protection of the conflict rule and consent to the representation. However, the court ultimately must approve conflict situations, particularly those involving the lawyer as a witness.

2. Informed client required. Before the client is asked to consent, the client must be fully informed of the risks of continued representation of conflicting interests.

3. Lawyer's belief important. Under the ABA rule, a lawyer must also reasonably believe that the representation will not be adversely affected by the conflict.

D. CONFLICTS AND FORMER CLIENTS. ABA Model Rule 1.9 provides that, unless a former client consents, a lawyer may not accept a representation adverse to the interest of the former client if the subject matter is substantially related to the former representation.

E. ISSUE CONFLICTS.

1. ABA Formal Opinion 93-377. This opinion deals with "issue conflicts," i.e., situations in which a lawyer, already engaged to represent one client on a matter, accepts representation of a second client who seeks a contrary result on the same issue.
2. **Client consent permitted.** Where there is substantial risk that representation of one client may result in a precedent that may undercut the legal position of the other client, or that the effectiveness of the representation of one client will be materially limited by the representation of the other, disclosure to and consent of both clients is required.

3. **Client consent not permitted.** If the lawyer believes that one representation will be adversely affected by the other, the conflict cannot be cured by the client's consent. The lawyer must withdraw from one of the representations.

VI. **THE DUTY OF COMPETENCE.**

A. **THE GENERAL OBLIGATION OF COMPETENCE.** ABA Model Rule 1.1 requires that a lawyer provide competent representation to a client.

B. **LEVEL OF COMPETENCE REQUIRED.** The text of the rule states that competent representation requires "the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."

VII. **THE AMOUNT AND NATURE OF FEES.**

A. **FEES MUST BE REASONABLE.** ABA Model Rule 1.5(a) requires that a lawyer's fee be reasonable. Circular 230, § 10.28, prohibits a practitioner from charging an unconscionable fee for any matter before the IRS.

B. **CONTINGENT FEES.**

1. **The ABA Rules.** ABA Model Rule 1.5(d) prohibits contingent fees in certain types of cases but does not mention tax cases.

2. **The Circular 230 rule.** Circular 230, § 10.28 prohibits the charging of a contingent fee for preparation of a return. It allows a contingent fee to be charged for an amended return or a claim for refund where it is reasonably anticipated that the amended return or claim will receive substantive attention by the IRS.

VIII. **DEALING WITH TAX PRACTICE STANDARDS IN DAY-TO-DAY TAX PRACTICE.**

A. **SITUATION NO. 1.**

1. Your client, a closely held corporation, is considering a plan to refinance certain
outstanding indebtedness. The plan would achieve modest business savings but would also substantially reduce the company's income tax liabilities for several years. The plan would require that the company take a position on its return that is contrary to a regulation. The company advises you that it has studied the regulation carefully and believes that it is not valid because it incorrectly interprets the controlling statute. The company asks you to review the matter and advise it with respect to adopting the plan and adopting a tax return with respect to the plan.

2. You research the matter and learn that several law review articles criticize the regulation and question its validity. In addition, one Federal district court case held the regulation invalid, but the case was reversed on other grounds by the U.S. court of appeals for that circuit. Your client is not located in that particular district or circuit. Upon finishing your research, you conclude that the taxpayer's proposed position would probably lose if it were challenged by the Service. However, you believe that the taxpayer's odds of prevailing are somewhere between 20 and 30 percent.

3. Before reporting back to the taxpayer, you ponder the situation. If you advise the taxpayer to adopt the proposed return position, what risks do you face? Are you an income tax return preparer? If so, does that status put you in a position of risk? What are those risks? How can they be ameliorated? Are your interests consistent with those of your client? Would adequate disclosure of the return position by your client on the return affect your exposure?

4. If the client adopts the position in question with your advice and concurrence, what risks does the client face? How can those risks be ameliorated? Is the negligence penalty implicated? The disregard penalty? The substantial understatement penalty? How would adequate disclosure affect the client's exposure to penalty liability?
5. Is there an opportunity for the client to escape penalty risk by reason of the reasonable cause and good faith exception? What would that require?

6. After digesting this information, you discuss it with the client. After hearing you out, the client advises you that it desires to adopt the return position in question, that it does not choose to make adequate disclosure of the position on the return, and that it wants a written opinion from you expressing your professional views. How do you respond?

7. The taxpayer asks you to explain the IRS examination procedure, including the probability that its return may be examined. How do you respond to this request?

8. The taxpayer files its return, reporting the position in question. One year later, the management of the tax department changes, and a new tax director, who is risk averse, concludes that the company should not be exposed to any penalty risks. The tax director consults you and asks if the company can file an amended return, pay any tax attributable to the reversal of the position in question, and thereby avoid penalty risk. How do you advise?

B. SITUATION NO. 2.

1. You have advised a closely-held corporation for some years with respect to tax matters. The business was created by the sole shareholder, X, who remains active but is ready to withdraw. There are two officers, A and B, who currently handle most of the business affairs. X wants to retire and sell the business to A and B. The business is X's principal asset, and its purchase would be a major commitment for both A and B. A is a veteran of the business and knows it well. B is X's nephew and, while intelligent and well educated, is not experienced in business matters. X, A, and B approach you concerning the sale and ask that you represent them with respect to the transaction. Are you prepared to move forward with this representation?
2. The sale transaction is completed, and several years later the Service, in auditing the corporation, questions the tax character of the deal, proposing adjustments that would increase the tax liability of the corporation and that of A and B. You represent the interests of the corporation as well as A and B before the Service, and the case moves to the Tax Court. In the Tax Court, the Government moves to disqualify you as counsel under Tax Court Rule 24(f) on the ground that you were involved in planning the transaction and on the additional ground that you will be a necessary witness. How should the court rule?

C. SITUATION NO. 3.

1. You represent the sole proprietor of a business that is being audited by the Service. You are making good progress with the agent on the matters that have been raised by the Service. In the course of gathering information requested by the agent, you become aware of the fact that the client neglected to report a capital gain that was realized in the year under audit. While there is no doubt that a gain was realized, you conclude that the nonreporting was a result of error rather than an intent to evade tax liability. You call this error to the attention of the client, who asks you if he is obligated to correct it. He also asks if he will violate any law by not doing so. Then he asks if you can continue to represent him in the audit if he does not disclose the error. How do you respond to these questions?

2. The audit proceeds through the protest stage, and you and your client attend a conference in appeals. There is one large unresolved issue. The appeals officer raises a new point and states that, if the facts are of a particular nature, she would be inclined to find in favor of the taxpayer. The taxpayer, without consulting with you, tells the appeals officer that the facts are as described by the appeals officer. This surprises you somewhat because you thought that the facts were otherwise. However, you remain silent, and the appeals officer then states that she will resolve the case in favor of the
taxpayer. After leaving the IRS office, you convey your surprise to the taxpayer, who admits that he fabricated his response to the appeals officer. What do you do? Should you have intervened when the taxpayer misstated the facts?