Standards of Tax Practice Accuracy-Related Penalties; ABA Opinion 85-352

J. Timothy Philipps
STANDARDS OF TAX PRACTICE
ACCURACY-RELATED PENALTIES; ABA OPINION 85-352

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OVERVIEW OF GOVERNING STANDARDS

I. A conglomeration of standards governs the tax lawyer in advising tax return positions.

II. These include statutory standards established by the Internal Revenue Code itself through the imposition of penalties on taxpayers and on tax return preparers.

   A. In these cases the lawyer’s duties are imposed directly on the lawyer or indirectly through assessment of penalties on the client.

   B. The principal penalties the lawyer needs to be concerned with are:

      1. the accuracy-related penalties imposed directly on the taxpayer. IRC §6661; and
      2. the preparer penalties imposed on the lawyer who prepares a tax return or renders substantial advice with respect to preparation of a tax return. IRC §6694.

III. Professional standards also govern the tax lawyer’s conduct in advising on return positions.

   A. State disciplinary rules govern lawyer conduct generally.

   B. These are administered by state disciplinary bodies according to the rules in each state.

   C. State rules, in turn, are greatly influenced by the ABA Model Rules of Professional Conduct and their predecessors, the Model Code of Professional Responsibility and the Canons of Professional Ethics.

      1. Although these ABA pronouncements have no binding effect in and of themselves, they have greatly influenced state disciplinary rules, having been adopted in whole or in part by state disciplinary systems.

      2. In the tax area, the ABA has promulgated three influential pronouncements:

         a. Opinion 314 (controversies and tax return positions)
         b. Opinion 346 (tax shelter opinions)
         c. Opinion 85-352 (tax return positions)
3. These form the basis for the professional standards governing tax practice.

IV. The Treasury also promulgates standards for practice before the Internal Revenue Service in Circular 230.

A. Proposals for revised tax advice standards in Circular 230 are currently under consideration, although the Treasury may have them on the back-burner for the time being.

B. Originally proposed revisions would have placed a substantial authority standard on the tax practitioner for tax return advice, identical to the substantial authority prong of the accuracy-related penalty.

C. However, many now expect the Circular 230 standard ultimately to be similar to the ABA "realistic possibility of success" (RPOS) standard promulgated in Opinion 88-352.

ACCURACY-RELATED PENALTIES

I. The Improved Penalty and Compliance Tax Act (IMPACT) imposes a single accuracy-related penalty at a rate of 20 percent. §6662(a).

A. The §6662 penalty applies to any portion of any underpayment that is attributable to:

1. Negligence, or careless, reckless, or intentional disregard of rules and regulations;

2. Any substantial understatement of income tax;

3. Any substantial valuation misstatement under chapter 1 (income tax);

   a. Formerly called a valuation overstatement;
   b. The penalty jumps to 40 percent in the case of a gross (400 percent of correct value) valuation misstatement;

4. Any substantial overstatement of pension liabilities;

5. Any substantial estate or gift tax valuation understatement. §6662(b).

B. The penalties are not cumulative:
1. If the requirements are met (e.g., the amount of tax involved is large enough) to implicate the substantial understatement penalty, that penalty will apply;
2. If the requirements to implicate the substantial understatement penalty are not met, the negligence or disregard penalty will apply.
3. Both penalties will not apply to the same understatement. Reg. §1.6662-2(c).
4. Also, the accuracy-related penalty does not apply to any portion of an underpayment that is due to fraud. Reg. §1.6662-2(a).
5. The accuracy-related penalty applies only if a return is filed, but both the §6651 failure to file penalty and the accuracy-related penalty may be applied to a late return. Reg. §1.6662-2(a).

C. The penalties do not apply to an underpayment where there was "reasonable cause" and the taxpayer acted in "good faith" with respect to the underpayment (RCGF exception). §6664(c).

D. This outline will deal with the negligence, disregard, and substantial understatement portions of the penalty.


1. The final regulations are generally applicable to returns due after December 31, 1989.
2. Certain provisions (primarily relating to adequate disclosure) are applicable to returns due after December 31, 1991.

II. The regulations describe when the IRS will assess the 20 percent penalty for negligence or disregard of rules or regulations with respect to an understatement of income tax. Reg. §1.6662-3(a).

A. Negligence includes any failure to make a reasonable attempt to comply with the revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return. Reg. §1.6662-3(b)(1).
B. Negligence also includes failure to keep adequate books and records. Id.
C. Courts have generally applied the tort law reasonably prudent test in determining taxpayer negligence.

1. The reasonably prudent test in turn requires a taxpayer to show a reasonable basis for the return position.
2. A return position that is "arguable, but fairly unlikely to prevail in court" satisfies the reasonable basis standard. Reg. §1.6662-3(d)(2).
3. The taxpayer has the burden of proof on the issue of negligence.

D. Negligence is strongly indicated where a taxpayer fails to:

1. Include on an income tax return an amount of income shown on an information return (e.g. form 1099 or 1065 K-1);
2. Make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable person to be too good to be true;
   a. Comments on the proposed regulations criticized the "too good to be true" standard on the ground it is too subjective.
   b. IRS retained the standard because it "expresses in understandable terms a typical form of negligent behavior". T.D. 8381, Preamble.
3. Treat partnership items on a return in a manner consistent with the treatment on the partnership return;
4. Treat Subchapter S items on a return in a manner consistent with the treatment on the corporation return. Reg. §1.6662-3(b)(1).

E. Defenses to negligence penalty:

1. Taxpayer has a reasonable basis for the position. Reg. §1.6662-3(b)(1).
   a. Arguable, but fairly unlikely to prevail in court;
   b. More than a 10 percent but less than a 33 percent chance of succeeding.
      (1) The stated percentages are gleaned from various commentaries.
      (2) Many doubt the efficacy of attempting to state return standards in terms of percentages.
2. Taxpayer shows that the state of the law was unsettled, provided the taxpayer's position was tenable and made in good faith.
3. Taxpayer shows reasonable reliance on the advice of a tax professional.
4. Taxpayer makes adequate disclosure.
a. The disclosure defense does not apply if the position is **frivolous**.

(1) A position is frivolous if it is "patently improper." Reg. §1.6662-3(b)(3).

(2) Comments on the proposed regulations criticized this definition for not including a **bad faith** component.

(3) IRS rejected these comments on the ground that a purely objective standard was most appropriate.

(4) Query: Is "patently improper" really objective?

(5) The IRS also rejected a "not litigable" test as too lawyer-oriented. T.D. 8381, Preamble

b. Disclosure must be made on a properly completed Form 8275 or 8275-R (The "Please Audit Me Now" Form). Reg. §1.6662-3(c)(2).

(1) Unlike the substantial understatement penalty, the regulations do not provide for avoidance of the negligence (or disregard) penalty by disclosure in accordance with an annual revenue procedure. Id.

(2) Neither do the regulations provide for disclosure by means of a statement attached to the return. Id.

c. Disclosure of **recurring items** such as the basis of depreciable property must be made in each year in which the item is taken into account. Reg. §1.6662-4(f)(2).

d. **Carrybacks and carryovers:**

(1) Disclosure is adequate with respect to an item which is included in any loss, deduction or credit that is carried to another year (carryback or carryover year) only if made in connection with the return for the year in which the carryback or carryover arises (loss or credit year).

(2) Disclosure is not also required in connection with the return for the carryback or carryover year. Reg. §6662-4(f)(4).

e. Disclosure in the case of items attributable to **pass-through entities** is generally made on the return of the pass-through entity on form 8275 or 8275-R. Reg. §1.6662-4(f)(5)
An individual partner, S shareholder, etc. may also make such disclosure.

The individual taxpayer must attach the disclosure to the taxpayer's individual return and also file a copy with the Internal Revenue Service Center with which the return of the entity is required to be filed. *Id.*

5. The taxpayer shows **reasonable cause and good faith** (RCGF)

a. The determination as to whether taxpayer qualifies for RCGF is made on the basis of facts and circumstances. Reg. §1.6664-4(b)

b. The most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. *Id.*

c. Contemporaneous documentation by the taxpayer will be a significant factor in establishing RCGF.

d. Circumstances that indicate RCGF include an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer.

(1) An isolated computational or transcriptional error is not inconsistent with RCGF.

(2) Reliance on an information return or the advice of a professional does not necessarily demonstrate RCGF.

(3) Nor does reliance on facts that, unknown to the taxpayer, are incorrect necessarily indicate RCGF.

(4) However, reliance on an information return, professional advice or other facts does constitute RCGF if the taxpayer's reliance was reasonable, and the taxpayer acted in good faith.

(5) A taxpayer's reliance on erroneous information reported on an information return indicates RCGF, provided the taxpayer did not know or have reason to know the information was incorrect;

(a) A taxpayer knows or has reason to know that such information is incorrect if the information is inconsistent with other information reported to the taxpayer or inconsistent with the taxpayer's actual knowledge of the transaction.
(b) This knowledge includes knowledge of the terms of the taxpayer's employment relationship or of the rate of return on a payor's obligation. Reg. §1.6664-4(b)(1).

e. In the case of an understatement that is related to the return of a pass-through entity, RCGF by the entity generally is imputed to the taxpayer.

   (1) RCGF is not imputed from the entity to the taxpayer if there are factors that indicate the taxpayer did not individually act with RCGF.

   (2) Similarly, bad faith or a lack of reasonable cause also may be imputed from the entity to the taxpayer. Reg. §1.6664-4(c)

6. **Disregard** of rules or regulations includes any careless, reckless or intentional disregard of rules or regulations. Reg. §1.6662-3(b)(2)

7. The phrase "rules or regulations" includes:

   a. Provisions of the IRC;
   b. Temporary or final (but not proposed) Treasury regulations issued under the IRC;
   c. Revenue rulings or notices (other than notices of proposed rulemaking). Reg. §1.6662-3(b)(2)

8. Comments on the proposed regulations criticized inclusion of revenue rulings on the list because:

   a. A revenue ruling does not constitute a "rule" under the Administrative Procedure Act; and
   b. A revenue ruling is only the contention of one party and is not subject to the give-and-take of a public comment process. T.D. 8381, Preamble.

9. The IRS rejected this objection based on the legislative history of the 1976 Tax Reform Act and the fact that revenue rulings were expressly listed as "rules" under former Reg. §1.6694-1 (concerning preparer penalties). Id.

10. The regulations do not explicitly include Revenue Procedures on the list.
However, the preamble states that revenue procedures are not listed, because "they may or may not be treated as 'rules or regulations' depending on all facts and circumstances." *Id.*

This provides scant guidance, but presumably revenue procedures that contain substantive rules will be "rules" for this purpose while revenue procedures that contain mere directions to IRS personnel (e.g., requirements for information to be furnished in obtaining a ruling) will not be "rules."

F. A disregard of rules or regulations is:

1. **Careless** if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is contrary to a rule or regulation;
2. **Reckless** if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe;
3. **Intentional** if the taxpayer knows of the rule or regulation that is disregarded. Reg. §1.6662-3(a), (b)(2).

G. Defenses to disregard penalty:

1. In the case of a position contrary to a ruling or notice, the penalty will not apply if the taxpayer's position has a realistic possibility of being sustained on its merits (RPOS). §1.6662-3(a), (b)(2).
   a. This standard is the same as the standard for the IRC §6694(a) preparer penalty.
   b. According to the regulations, it requires an approximately 33 percent possibility of success. Reg. §1.6694-2(b)(1).
   c. It is similar but not strictly identical to the ABA Formal Opinion 85-352 standard infra.
   d. A comment on the proposed regulations objected to use of the RPOS standard in this context, suggesting that reasonable basis would be more appropriate.
   e. The IRS rejected this suggestion, stating that the RPOS standard is a taxpayer favorable one, since there is no statutory requirement for any such exception to the disregard penalty. T.D. 8381, Preamble
f. There is no RPOS exception for disregard of a regulation. Reg. §1.6662-3(a),(b).

2. The penalty does not apply if the taxpayer makes adequate disclosure.
   a. In the case of a regulation, disclosure must be made on a form 8275-R and represent a good faith challenge to the validity of the regulation. Reg. §1.6662-3(c)(1),(2).
   b. In the case of a ruling or notice disclosure must be made on Form 8275. Reg. §1.6662-3(c)(2).

   (1) Comments on the proposed regulations argued that disclosure on the return in accordance with an annual revenue procedure should also be adequate. T.D. 8381, Preamble.
   (2) The IRS did not accept this argument based on legislative history and a concern for uniformity. Id.

3. The penalty does not apply if the taxpayer establishes reasonable cause and good faith
   a. In the case of a regulation the statute and regulations do not explicitly state that the RCGF defense is available.
   b. Nevertheless, an overall reading of §§6662 and 6664, along with the regulations thereunder, may support its availability. See IRC §6664(c); Bischoff, Highlights of the New Taxpayer Accuracy-Related Penalty Rules, The Tax Advisor, June 1992 at 331.
   c. In the case of rulings and notices the RCGF defense also appears to be available, for example, where the taxpayer takes a position contrary to a revenue ruling after the Tax Court has repudiated the ruling.

H. Carrybacks and carryovers

1. Because the penalty for negligence or disregard of rules or regulations is measured by the amount of understated tax, the carryback or carryover of a negligently generated loss, deduction, or credit will result in a penalty for the year to which the loss, deduction, or credit is carried (carryback or carryover year).
2. Hence, the taxpayer's negligence or disregard in one year (the loss year) follows the resulting loss, deduction, or credit to the year in which it results in an invalid tax reduction. §1.6662-3(d).
III. If any portion of an underpayment of any income tax is attributable to a substantial understatement of such income tax, there is added to the tax an amount equal to 20 percent of such portion. Reg. §1.6662-4(a).

A. An understatement is substantial if it exceeds the greater of:

1. 10 percent of the tax required to be shown on the return for the taxable year; or
2. $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). §1.6662-4(b).

B. The definition of understatement is expressed as the formula understatement = X - (Y - Z) where X = the amount of tax required to be shown on the return; Y = the amount of tax imposed which is shown on the return; and Z = any rebate. §1.6662-4(b)(2)

C. The substantial understatement penalty applies to any portion of an understatement for a year to which a loss, deduction, or credit is carried (carryback or carryover year) that is attributable to a tainted item for the year in which the carryback or carryover of the loss, deduction, or credit arises (loss or credit year). Reg. §1.6662-4(c)(1).

1. The determination of whether an understatement is substantial for a carryback or carryover year is made with respect to the return of the carryback or carryover year. Id.
2. Tainted items are taken into account with items arising in a carryback or carryover year to determine whether the understatement is substantial for that year.
3. These rules represent a change from the proposed regulations which were subject to severe criticism.
4. Example: X, a corporation properly reports $20 million of taxable income for 1991 and pays tax of $6,800,000 (34% rate). For 1992, X reports zero tax liability and a net operating loss ("NOL") of $10,030,000, which is carried back to 1991. The NOL reduces X's tax liability for 1991 to $3,389,800. On audit, the IRS reduces X's NOL for 1992 by $30,000 to $10,000,000. Accordingly the IRS increases X's 1991 taxes by 34% of $30,000 or $10,200. X's correct tax liability for 1991 is thus $3,400,000. Comments to the Proposed Regulations, submitted by the ABA Tax Section Civil Penalties Task Force, quoted in I Bernard Wolfman, James P. Holden, and Kenneth L. Harris, Standards of Tax Practice ¶5006.024 [hereafter cited as Standards of Tax Practice].
a. Under the proposed regulations, X would be liable for the substantial understatement penalty since $10,200 exceeds ten percent of the zero tax owed for 1992. Id.
b. Under the final regulations, the determination of substantiality would be made with respect to the carryback year 1991, and hence the penalty would not apply ($10,200 is less than 10 percent of 1991 tax liability).

D. Except with respect to tax shelter items, an understatement is reduced by the portion of the understatement:

1. For which there is substantial authority; or
2. With respect to which there is adequate disclosure. Reg. §1.6662-4(a).

3. Example: T files a 1990 income tax return showing taxable income of $20,000 and a tax liability of $6,000 (assuming a 30 percent tax rate). Audit adjustments increase the taxable income to $50,000 and the tax liability to $15,000. There was substantial authority for a non-tax shelter item that accounted for $8,000 of the $30,000 increase in taxable income.

a. The amount of tax shown on T's return is determined as if the item for which there was substantial authority had been given proper treatment.
b. Hence, the amount of tax treated as shown on T's return is $8,400 (30 percent of $28,000). The amount of the understatement is $6,600 ($15,000 tax required to be shown on the return minus $8,400 treated as shown on the return). The amount of the penalty would be $1,320 (20 percent of $6,600). Standards of Tax Practice ¶208.0312. See Reg. §1.6662-4(d)(1).

E. Tax shelter items receive more stringent treatment:

1. A tax shelter is a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if the principal purpose of such plan or arrangement, based on objective evidence, is to avoid or evade Federal income tax. Reg. §1.6662-4(g)(2)(i)
2. An item is a tax shelter item if the item is directly or indirectly attributable to the principal purpose of a tax shelter to avoid or evade Federal income tax. Reg. §1.6662-4(g)(3).
3. Tax shelter items are treated as if they were properly shown on the return only if:
a. There is substantial authority for the position; and
b. The taxpayer reasonably believed at the time the return was filed that the taxpayer's position was more likely than not the proper tax treatment. Reg. §1.6662-4(g)(1).

(1) A taxpayer is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if:

(a) The taxpayer analyzes the pertinent facts and authorities and reasonably concludes that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged by the IRS; or

(b) The taxpayer, in good faith, relies on the opinion of a professional tax advisor, if the opinion is based on the advisor's analysis of the pertinent facts and authorities and unambiguously states that the advisor concludes that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged by the IRS. Reg. §1.6662-4(g)(4).

4. **Disclosure** made with respect to a tax shelter item does not affect the amount of an understatement. *Id.*

F. The RCGF exception (see infra G.4.) applies to the substantial understatement penalty. Reg. §1.6662-4(a).

G. **Defenses** against substantial understatement penalty:

1. The understatement is **insubstantial** because it does not meet the $5,000 ($10,000 for a corporation other than a personal holding company or S corporation) or 10 percent of tax liability threshold.

2. The taxpayer had **substantial authority** for the return position.

   a. The substantial authority standard is:

      (1) An objective standard involving an analysis of the law and application of the law to relevant facts;

      (2) Less stringent than the more likely than not standard (greater than 50 percent likelihood of
success), but more stringent than a reasonable basis standard. Reg. §1.6662-4(d)(2).

b. The regulations do not explicitly compare the RPOS standard to the substantial authority standard.

c. Many believe substantial authority is more stringent than RPOS, so that the substantial authority standard may boil down to about a 40 percent chance of success.

d. The audit lottery odds are not relevant in determining whether the substantial authority (or reasonable basis) standard is met. Id.

e. There is substantial authority for a position only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment.

(1) All authorities relevant to the tax treatment of the item in question must be taken into account and weighed in light of the pertinent facts and circumstances.

(2) There may be substantial authority for more than one position with respect to the same item.

(3) The taxpayer's subjective belief is not relevant to the issue of whether there actually is substantial authority, because the standard is an objective one. Reg. §1.6662-4(d)(3)(i).

f. The types of authority that may be used in determining if there is substantial authority are:

(1) Applicable provisions of the IRC and other statutory provisions;

(2) Proposed, temporary, and final regulations construing such statutes;

(3) Revenue rulings and revenue procedures;

(4) Tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties;

(5) Court cases;

(6) Congressional intent, as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers;
(7) General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book);
(8) Private letter rulings and technical advice memoranda issued after October 31, 1976;
(9) AODs and GCMs issued after March 12, 1981;
(10) GCMs published in pre-1955 volumes of the Cumulative Bulletin;
(11) IRS information or press releases;

g. A taxpayer also may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

(1) This may be all that is available in the case of new or obscure provisions for which there is no authoritative guidance.

(2) The "well reasoned construction" formulation is obviously scant solace to a practitioner dealing with a deluge of tax legislation. See ABA Tax Section Comments on Circular 230 (Feb. 12, 1987):
   In view of the massive amounts of recent tax legislation, the delays in issuance of regulations and the limited coverage of regulations that have been issued, and the fact that many problems arising under the Code of long standing have not been the subject of litigation or published rulings, the result is that no authority of any kind, within the restricted meaning given that term by the section 6661 regulations, exists with respect to a large proportion of issues involved in tax returns.

(3) Although the scope of available authority has been expanded under the current regulations from the time of the ABA Tax Section comments (see infra) the fact remains that there are still many provisions for which no authority of any kind exists.
The regulations also specify materials that are not authority:

(1) **Conclusions** reached in treatises, legal periodicals, legal opinions, or opinions rendered by tax professionals are not authority. *Id.*

(a) However, the authorities underlying such expressions of opinion where applicable to the facts of a given case may give rise to substantial authority. *Id.*

(b) Query - Would a "well-reasoned construction" of an applicable statute in a treatise or article constitute an authority underlying an opinion expressed by the author?

(c) It seems unfortunate that conclusions reached in respected secondary sources are completely excluded from the scope of applicable authority.

   i) They are authority for purposes of applying the ABA Formal Opinion 85-352 RPOS standard.

   ii) A lawyer might well be under an obligation to consult such sources in order to comply with Formal Opinion 85-352, yet the regulations restrict use of these sources to their underlying authorities.

(2) An earlier authority to the extent it has been overruled or modified, implicitly or explicitly, by a body with the power to overrule or modify the earlier authority ceases to be an authority. *Id.*

(3) The original version of this rule was roundly criticized in comments on the proposed regulations on the ground that they were inconsistent with the rule that all authorities should be considered in determining whether substantial authority is present.

(4) In response to these criticisms, the final regulations "clarify that an authority ceases to be an authority once it is overruled or modified, explicitly or
implicitly, by an authority of the same or higher source." T.D. 8381 Preamble.

(a) Hence, for example, a District Court opinion is not an authority if overruled by the United States Court of Appeals for that District. Reg. §1.662-4(d)(3)(iii).

(b) By the same token, an opinion of the Tax Court is not considered overruled by a United States Court of Appeals to which the taxpayer does not have the right of appeal, unless the Tax Court adopts the holding of the Court of Appeals. Id.

(c) A private letter ruling is not authority if revoked or if inconsistent with a subsequent proposed regulation, revenue ruling, or other administrative pronouncement of the IRS. Id.

(5) The regulations also provide a general rule (to which rule (b) above appears to be an exception) that the applicability of court cases to the taxpayer by reason of the taxpayer's residence in a particular jurisdiction is not taken into account in determining whether there is substantial authority for a position. Reg. §1.6662-4(d)(3)(iv)(B).

(6) Another exception to the general rule of not considering the taxpayer's geographical location is that there is substantial authority for a position if the position is supported by controlling precedent of a United States Court of Appeals to which the taxpayer has a right of appeal with respect to the position. Id. See Golsen v. Comm'r, 54 T.C. 742 (1970), affirmed, 445 F.2d 895 (10th Cir. 1970), cert. denied, 404 U.S. 940 (1971).

(7) Comments on the proposed regulations also argued that proposed regulations are too tentative to justify the rule that proposed regulations supersede prior, inconsistent letter rulings.

(8) Nevertheless, the IRS retained the rule on the ground that, "Proposed regulations are subject to a higher level of review than private letter rulings, and, therefore, reflect the current position of the Service more accurately than previously issued private letter rulings." T.D. 8381, Preamble.
(9) Special rules apply in the case of written determinations issued to the taxpayer.

(a) There is substantial authority for a position if the position is supported by the conclusion of a ruling or determination letter (as defined in Reg. §301.6110-2(d),(e)) issued to the taxpayer, by the conclusion of a technical advice memorandum in which the taxpayer is named, or by an affirmative statement in a revenue agent's report with respect to a prior taxable year of the taxpayer. Reg. §1.6662-4(d)(3)(iv)(A).

(b) The preceding rule will not apply if there was a misstatement or omission of a material fact or the facts that subsequently develop are materially different from the facts on which the written determination is based; Id. or

(c) The written determination was modified or revoked after the date of issuance by:

i) A notice to the taxpayer to whom the written determination was issued;

ii) The enactment of legislation or ratification of a tax treaty;

iii) A decision of the United States Supreme Court;

iv) The issuance of temporary or final regulations; or

v) The issuance of a revenue ruling, revenue procedure, or other statement published in the Internal Revenue Bulletin. Id.

(d) Written determinations generally cease to be authority on the date and to the extent one of the above events occurs to modify or revoke the written determination. Id.

i) There is an exception to this rule for modifications or revocations that occur on account of misstatements of fact or subsequent development of different facts. Id.
ii) The regulations also call attention to the duty of IRS under IRC §6404(f) in certain cases to abate a penalty that is attributable to erroneous written advice furnished to a taxpayer by an officer or employee of the IRS. Id.

The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. Reg. §1.6662-4(d)(3)(ii).

(1) Authorities must be examined to determine whether they are distinguishable on their facts.
(2) Authorities that merely state conclusions are less weighty than authorities that contain well-reasoned analysis.
(3) The type of document is also relevant:

   (a) For example, a published revenue ruling is accorded more weight than a letter ruling concerning the same issue.
   (b) An older letter ruling, TCM, GCM, or AOD must be accorded less weight than a more recent one.

i) Any of the above documents that is more than 10 years old generally is accorded very little weight.

ii) However, the persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account as well as the age of the document. Id.

iii) The proposed regulations would have ruled out entirely documents more than 10 years old.

iv) In response to critical comments the IRS retreated slightly to the current formulation. T.D. 8381, Preamble

j. The time for determining substantial authority is at either:
the time the return containing the position is filed; or

or

the last day of the taxable year to which the return relates. Reg. §1.6662-4(d)(3)(iv)(C).

For example, if there is substantial authority for a position on December 31, but the authority is revoked or overruled prior to April 15, the taxpayer still has substantial authority for the position for purposes of the substantial understatement penalty.

For returns due before January 1, 1990 there is substantial authority for a position if the standard is met under either the new expanded or the old narrower list of authorities. Reg. §1.6662-4(d)(3)(v).

Under either list of authorities, authorities both for and against the position must be taken into account. Id.

This rule, which allows the IRS to use authorities that have been added to the expanded list against a taxpayer, has been criticized by some commentators as unfair to taxpayers and contrary to the legislative history which states that the legislation expands the list of authorities "upon which taxpayers may rely." See Banoff, Determining and Weighing Valid Legal Authority to Avoid Accuracy-Related and Preparer Penalties: The Proposed Regulations Continue the Controversy, 69 Taxes 259, 267-68 (1991).

The taxpayer makes adequate disclosure:

a. The disclosure defense does not apply if the position is frivolous. Reg. §1.6662-4(e)(2)(1).

b. The disclosure defense does not apply to tax shelter items. Reg. Id.

c. Disclosure can be made on form 8275 and 8275-R as delineated above. Reg. §1.6662-4(f)(1).

d. For certain items, disclosure also can be made on the return in accordance with applicable forms and instructions. Reg. §1.6662-4(f)(2).

If the Revenue Procedure does not provide for disclosure of an item, disclosure is adequate only if made on Form 8275 or Form 8275-R. Reg. §1.6662-4(f)(2).

e. There is no provision in the regulations for disclosure on a statement attached to the return.

(1) Comments on the proposed regulations criticized this omission.

(a) The statute itself seems to authorize such disclosure by stating that disclosure can be made "in the return or in a statement attached to the return." §6662(d)(2)(B)(ii) (emphasis added).

(b) Schirmer v. Comm'r, 89 T.C. 277 (1987), indicated that forms of disclosure other than those currently listed in the regulations are acceptable. See Banoff, Final Regulations on Accuracy-Related Penalties: Taxpayers Beware, The Feds Are Out There/There's Danger in the Air -- Be Aggressive If You Dare, 70 Taxes 178, 200-201 (1992).

(2) The Service responded to these criticisms by stating that there is no indication in IMPACT that Congress intended to permit disclosure on the return itself, and it is in the interest of both taxpayers and IRS to have a uniform disclosure regime. Id.; T.D. 8381, Preamble.

f. Disclosure of recurring items such as the basis of depreciable property must be made in each year in which the item is taken into account. Reg. §1.6662-4(f)(3).

g. Carrybacks and carryovers:

(1) Disclosure is adequate with respect to an item which is included in any loss, deduction, or credit that is carried to another year (carryback or carryover year) only if made in connection with the return for the year in which the carryback or carryover arises (loss or credit year).
(2) Disclosure is not also required in connection with the return for the carryback or carryover year. Reg. §1.6662-4(f)(4).

h. Disclosure in the case of items attributable to pass-through entities is generally made on the return of the pass-through entity.

(1) An individual partner, S shareholder, etc. also may make such disclosure.
(2) The taxpayer must attach the disclosure to the taxpayer's individual return and also file a copy with the Internal Revenue Service Center with which the return of the entity is required to be filed. Reg. §1.6662-4(f)(5).

4. The taxpayer shows reasonable cause and good faith (RCGF)

a. The same considerations apply in the case of the substantial understatement penalty as applied in the case of the negligence penalty supra.

b. Some commentators have suggested that the substantial understatement penalty is basically a no-fault penalty. Standards of Tax Practice ¶208.0312.

c. Note that to the extent a defense of RCGF is available, the substantial understatement penalty ceases pro tanto to be a no-fault penalty.

IV. If any portion of an underpayment is attributable to a substantial valuation misstatement under chapter 1 (income tax) of the Code, there is added to the tax an amount equal to 20 percent of such portion. Reg. §1.6662-5(a).

A. No penalty is imposed on a portion of an underpayment, unless the aggregate of all portions of the underpayment attributable to substantial or gross valuation misstatements exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or personal holding company). Id.

B. The RCGF defense is available in the case of a valuation misstatement. Id.

C. No disclosure defense is available in the case of a valuation misstatement. Id.

D. There is a substantial valuation misstatement if the value or adjusted basis of any property claimed on a return under Chapter 1 of the IRC is 200 percent or more of the correct amount. Reg. §1.6662-5(e)(1).
E. The penalty increases to **40 percent** in the case of a **gross valuation misstatement**.

1. There is a gross valuation misstatement if the value or adjusted basis of any property claimed on a return under Chapter 1 of the IRC equals 400 percent or more of the correct amount. Reg. §1.6662-5(e)(2).
2. The value or adjusted basis claimed on a return of property with a correct value or adjusted basis of **zero** is considered to be 400 percent or more of such amount and, hence, subject to the 40 percent penalty. Reg. §1.6662-5(g).

F. The term property refers to both tangible and intangible property.

1. Tangible property includes property such as land, buildings, fixtures, and inventory.
2. Intangible property includes property such as goodwill, covenants not to compete, leaseholds, patents, contract rights, and choses in action. Reg. §1.6662-5(e)(3).

G. In the case of a **pass-through** entity:

1. The determination of whether there is a substantial or gross valuation misstatement is made at the entity level.
2. However, determination of the dollar limitation ($5,000 or $10,000) is made at the taxpayer level. Reg. §1.6662-5(h)(1).

**ABO FORMAL OPINION 85-352**

I. The ethical standards governing tax law practice are promulgated mainly in three formal ABA opinions:

A. Opinion 314, dealing with controversies and with tax return positions;
B. Opinion 346, dealing with tax shelter opinions;
C. Opinion 85-352, dealing with tax return positions.

D. This outline mainly considers Opinion 85-352.

II. The **standards of tax practice** for attorneys were first formalized in Opinion 314 issued in 1965 (reprinted at 51 ABA J. 671 (1965)).

A. Opinion 314 dealt with both:

1. Advising clients on positions to be taken on tax returns; and
2. Dealing with IRS after an audit has begun.

B. Opinion 314 still has effect with respect to dealing with the IRS after an audit has begun, since Opinion 85-352 only superseded Opinion 314 to the extent that Opinion 85-352 sets out new standards for advising tax return positions.

C. Opinion 314 took the position that the status of the IRS was basically that of an adversary at both the return and audit stages.

1. According to Opinion 314, the IRS in an audit situation is a "representative of one of the parties" and not a "true tribunal, nor even a quasi-judicial institution." \textit{Id.} at 671

   a. The lawyer has a duty "not to make false assertions of fact."

   b. Moreover, the lawyer "is under a duty not to mislead the Internal Revenue Service deliberately and affirmatively, either by misstatements or by silence or by permitting his client to mislead."

   c. Nevertheless, "as an advocate before a service which itself represents the adversary point of view" the lawyer is under no duty to disclose weaknesses in the client's case. \textit{Id.} at 672

2. Opinion 314 carried this view of the IRS as adversary to the tax return preparation stage:

   a. According to Opinion 314, a lawyer asked to advise a client in the course of preparation of the tax return "may freely urge the statement of positions most favorable to the client just as long as there is reasonable basis for those positions." \textit{Id.} (emphasis added)

   b. Moreover, "[W]here the lawyer believes there is a reasonable basis for a position that a particular transaction does not result in taxable income, or that certain expenditures are properly deductible as expenses, the lawyer has no duty to advise that riders be attached to the client's tax return explaining the circumstances surrounding the transaction or the expenditures." \textit{Id.}

   c. Opinion 314 did not explicitly mention a good faith requirement, although the concept of good faith might be taken as implicit in the reasonable basis standard.
3. The reasonable basis standard originally may have been intended to set a fairly high standard. See Standards of Tax Practice ¶214.02; Harris, Resolving Questionable Positions on a Client's Federal Tax Return: An Analysis of the Section 6694(a) Standard, 47 Tax Notes 971, 972 (1990).

   a. Nevertheless, respect for the standard gradually eroded over the next 20 years.
   b. Some only half facetiously referred to the standard as the "giggle test" or the "laugh test" (if the lawyer can advance the position without giggling or laughing).
   c. Presumably the laugh test was even less than stringent than the giggle test and further erosion would have led to a guffaw test.
   d. By 1985, the reasonable basis standard had diminished to an understanding by many that it justified the "use of any colorable claim on a tax return to justify the exploitation of the lottery of the tax return audit selection process." ABA Section of Taxation, Proposed Revision to Formal Opinion 314, reprinted in Wolfman and Holden, Ethical Problems in Federal Taxation 71 (1985) [hereafter cited as Ethical Problems].

   (1) The concern was that taxpayers were burying questionable positions on their returns and depending on the audit lottery to protect them.
   (2) Moreover, the tax shelter industry exacerbated the problem, and the reasonable basis standard provided fraud insurance for investors in shaky tax shelters. See Discussion on "Questionable Positions" 32 Tax Law. 13 (1978).
   (3) IRS Commissioner Kurtz asserted that a change was in order and suggested that a no-fault type penalty for undisclosed tax return positions might be appropriate to prevent exploitation of the audit lottery. See Id.; Kurtz, Remarks to the American Institute of Certified Public Accountants, reprinted in Ethical Problems at 59; Durst, The Tax Lawyer's Professional Responsibility, 30 Fla. L. Rev. 1027, 1066 (1987)

III. The ABA Tax Section responded to the perceived problem by suggesting revisions to Opinion 314. Proposed Revision to Formal Opinion 314 supra.
A. The Tax Section proposal disavowed the adversarial approach of Opinion 314.

1. The proposal explicitly stated that, "A tax return is not a submission in an adversarial proceeding." *Id.* at 71.

   a. The nature of the tax return audit process dictates that the IRS will not pick most returns for audit.
   b. This means that a taxpayer who resolves all doubts in the taxpayer's favor always has an advantage, because the IRS probably will not audit the return.
   c. The proposal stated, "The complications of the tax law, the inadequacy of Internal Revenue Service audits, the impracticability of training revenue agents to achieve expertise and the flexibility available to the taxpayer in legitimately resolving to his own advantage numerous doubtful issue resulting from those complexities, impose a substantial burden on the government." *Id.* at 71

2. The proposal asserted that a higher standard than the minimum to avoid fraud should be expected of the tax lawyer in rendering advice on return positions.

   a. The standard adopted by the proposal was that in order to advise a taxpayer to assert a position on a return, "the position must be a meritorious one." *Id.* at 73 (emphasis added).
   b. A position is meritorious if "it is advanced in good faith, as evidenced by a practical and realistic possibility of success if litigated." *Id.*
   c. "The lawyer must honestly entertain a belief that the position well may be held to be correct, either on the merits of existing authority or by reversal of existing authority." *Id.*

3. The proposal required the lawyer to withdraw from representation where a client insists on reporting a position that does not meet the standard. *Id.* at 74.

IV. The ABA Standing Committee on Ethics and Professional Responsibility took the Tax Section proposal as the basis for Opinion 85-352, which is now the basic ethical pronouncement for lawyers on advising tax return positions. ABA Opinion 85-352, reprinted in *Standards of Tax Practice* at Appendix ¶203 and at 31 Tax Lawyer 631 (1986).
A. However, the Committee made several modifications to the Tax Section proposal.

B. The Committee eliminated the requirement that the position be meritorious which had been the basis of the Tax Section's standard.

C. The Committee also eliminated the sentence in the Tax Section Revision that explicitly stated that, "A tax return is not a submission in an adversary proceeding." See Durst, supra, at 1042-45.

1. Opinion 85-352 skirts the issue.
2. It states that, "Although the Model Rules distinguish between the roles of advisor and advocate, both roles are involved here, and the ethical standards applicable to them provide relevant guidance." Opinion 85-352 at 632.

D. The Committee changed the Tax Section's requirement that there be a practical and realistic possibility of success to a requirement that there be some realistic possibility of success. Id. at 633.


A. The Task Force Report was approved by the Tax Section Committee on Standards of Tax Practice and approved by the Council of the Section of Taxation.

1. However, the Task Force Report was not adopted by the ABA Standing Committee on Ethics and Professional Responsibility. Standards of Tax Practice ¶214.020.
2. Hence, its authoritative status is ambiguous.

B. Since ABA rules have effect only to the extent adopted by official state disciplinary bodies, the ultimate weight accorded to the Task Force Report will be decided by those bodies and the courts. Id.

VI. The standard for advising a tax return position is stated in Opinion 85-352 as follows:

In summary, a lawyer may advise reporting a position on a return even where the lawyer believes the position probably will not prevail, there is no "substantial authority" in support of the
position, and there will be no disclosure of the position in the return. However, the position to be asserted must be one which the lawyer in good faith believes is warranted in existing law or can be supported by a good faith argument for an extension, modification, or reversal of existing law. This requires that there is some realistic possibility of success if the matter is litigated. Opinion 85-352 (emphasis added).

VII. Several points are notable with respect to this formulation:

A. The meritorious standard of the Tax Section proposal is eliminated.
B. Also eliminated is the Tax Section description of RPOS as requiring that the possibility of success be "practical and realistic." See supra, III A.2.B.

1. The Tax Section Task Force interpreting Opinion 85-352 attempted to minimize these differences.
2. It stated that a "possibility of success cannot be "realistic" if it is only theoretical or impractical." Task Force Report at 638.

C. The foundation of the standard is good faith.

D. The subjective requirement of good faith is given an objective aspect by requiring that there be "some realistic possibility of success if the matter is litigated" (RPOS).

1. The lawyer need not believe that the position probably will prevail (more likely than not standard); or
2. That the position is supported by substantial authority.
3. The likelihood of audit or detection is not a permissible consideration.

E. The RPOS formulation is based on a litigation standard.

1. Opinion 85-352 cites ABA Model Rule of Professional Conduct 3.1 which deals with the standard for bringing or defending a proceeding.
2. The opinion itself refers to the possibility of success in litigation.
3. The opinion states that the "ethical standards governing the conduct of a lawyer in advising a client on positions that can be taken in a tax return are no different than those governing a lawyer's conduct in advising or taking positions for a client in other civil matters." Opinion 85-352.

F. Opinion 85-352 does not completely abandon the premise of Opinion 314 that the tax return process is adversarial in nature.
1. Opinion 85-352 states that both the role of advisor and the role of advocate are involved.
2. It further states that in many cases "a lawyer must realistically anticipate that the filing of the tax return may be the first step in a process that may result in an adversarial relationship between the client and the IRS." *Id.*
3. In contrast, the Task Force report suggests, "The Opinion does not state that the general ethical guidelines governing advocacy in litigation are determinative, or suggest that tax returns are adversarial proceedings," and merely "blends" the ethical rules governing advocacy and advising. *Task Force Report* at 640.
4. This may be stretching the actual words of Opinion 85-352 to suit the Task Force's own attitude.

**G.** Opinion 85-352 does not state explicitly what the lawyer's duty is if the RPOS standard is not met.

1. The Task Force Report indicates that the lawyer is under an obligation to withdraw "from the engagement, at least to the extent that it involves advice as to the position to be taken on the return." *Task Force Report* at 639.
2. This is consistent with Model Rule 1.16(a) which provides that a lawyer must withdraw if the representation will involve the lawyer in a violation of the rules of professional conduct. *See Standards of Tax Practice* 214.0241
3. There may be difficulty in determining the extent of the engagement in this circumstance.
4. If the client desires to contest the issue, the position may be advanced by payment of the tax and filing a refund claim.
   a. Under Model Rule 3.1 the lawyer may assert a position in litigation that is non-frivolous.
   b. Hence, the lawyer may represent the client in refund proceedings, even though the RPOS standard is not met, as long as the claim is non-frivolous. *Id.*
5. Withdrawal may be difficult or impossible in situations where to do so might amount to a breach of the duty of confidentiality.
6. Adequate disclosure may be an acceptable alternative to withdrawal where there is a non-frivolous position that does not meet the RPOS standard, but that is unclear. *See infra, H.*

**H.** Adequate disclosure performs an equivocal role in Opinion 85-352.
1. Where the RPOS standard is met, "the lawyer has no duty to require as a condition of his or her continued representation that riders be attached to the client's tax return explaining the circumstances of the transaction." *Id.*

2. However, the Opinion also requires the lawyer to "counsel the client as to whether the position is likely to be sustained by a court if challenged by the IRS, as well as of the potential penalty consequences to the client if the position is taken on the tax return without disclosure." *Id.*

3. The Opinion further states that competent representation requires that the lawyer determine if the substantial understatement penalty is potentially applicable, and advise the client of the possibility of avoiding the penalty by disclosure. *Id.*

4. If the position meets the RPOS standard and the client decides to risk the substantial underpayment penalty by not disclosing, "the lawyer has met his or her ethical responsibility" with respect to the client." *Id.*

5. In all cases (both with respect to return preparation and negotiating administrative settlements) the lawyer is under a duty not "mislead the Internal Revenue Service deliberately either by misstatements or by silence, or by permitting the client to mislead." *Id.*

6. The Opinion does not explicitly state that disclosure exonerates a position that fails to meet the RPOS standard (substandard position).

7. The Task Force Report, by failing to state affirmatively that disclosure cures a substandard position, implies that if the RPOS standard is not met, disclosure will not cure the defect. *Task Force Report* at 639-40.

8. The Task Force Report states, "Only if the position meets the standard may the lawyer prepare the return, sign it, and present it to the client." *Id.* at 639.

9. However, subsequently, the ABA Tax Section in comments on proposed revisions to Treasury Circular 230 took the view that a return position that does not meet the RPOS standard may be taken provided:

   a. The position is not frivolous; and is either
   b. Adequately disclosed; or
   c. Presented on an amended return filed as a claim for refund. *Standards of Tax Practice* ¶214.0242
10. Permitting adequate disclosure to cure a non-frivolous substandard position would be consistent with the goal of diminishing the role of the audit lottery.

a. The audit lottery was the problem that initiated the search for a new tax return standard in the first place.

b. Hence, permitting disclosure would conform to the purposes for issuance of Opinion 85-352.

I. Opinion 85-352 does not express the RPOS standard in numerical percentage terms.

1. Nevertheless, a commonly accepted convention is that RPOS requires about a one-in-three chance of success.

2. This formulation apparently derives from the Task Force Report.

   a. The Task Force Report stated that "A position having only a 5 or 10 percent likelihood of success, if litigated, should not meet the standard."


      (1) The Task Force Report's one-third percentage was apparently meant as a safe-harbor, so that positions with a chance somewhat below one-third might be sufficient.

      (2) However, the one-in-three formulation has been adopted as a minimum standard in the preparer regulations. See Reg. §1.6694-2(b)(1).

J. The text of Opinion 85-352 does not explicitly address the lawyer's ethical duties with respect to tax planning and advice.

1. The Tax Section's proposed revision to Opinion 314 stated that the same principles that apply to advising a return position should also apply to tax planning and advice. Proposed Revision to ABA Opinion 314 at 71.

2. Since advising on tax return positions is inherent in most tax planning, Opinion 85-352 appears to apply to tax planning by logical extension. Standards of Tax Practice ¶214.021

3. The Tax Section Task Force Report agreed with this understanding, stating that the principles of Opinion 85-352
"should apply to all aspects of tax practice to the extent tax return positions would be involved." Task Force Report at 636.

K. Conclusion: The RPOS standard is commonly accepted, as a more stringent one than reasonable basis.

1. Nevertheless, a reasonable person comparing the two standards with no knowledge of their prior history might conclude that their differences are insignificant.
2. Much of the content of the RPOS standard must be gleaned from its history, a formidable task for the harried practitioner.
3. Perhaps good faith and common sense provide the ultimate standard in the everyday world outside the ivory tower: Don't be greedy and don't be a smart-alec.
# REPORTING STANDARDS SUMMARY

<table>
<thead>
<tr>
<th>Standard</th>
<th>Percentage</th>
<th>Description</th>
<th>Disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Correct</td>
<td>Near 100%</td>
<td>Near certainty</td>
<td>Not needed</td>
</tr>
<tr>
<td>More likely than not</td>
<td>Over 50%</td>
<td>Probably correct</td>
<td>Not relevant</td>
</tr>
<tr>
<td>Substantial authority</td>
<td>Around 40%</td>
<td>Authority substantial but less than probably correct; relevant authorities limited</td>
<td>Absolves §6662(b)(2)</td>
</tr>
<tr>
<td>Realistic possibility of being sustained on the merits (§6694)</td>
<td>33.33%</td>
<td>Authority not substantial but still has a decent chance; relevant authorities limited</td>
<td>Absolves §6694</td>
</tr>
<tr>
<td>Realistic possibility of success if litigated (ABA 85-352)</td>
<td>33.33% or somewhat less</td>
<td>Same as above, except good faith required and relevant authorities broader</td>
<td>Does not absolve?</td>
</tr>
<tr>
<td>Reasonable basis</td>
<td>10-20%</td>
<td>Arguable but fairly unlikely to prevail</td>
<td>Absolves §6662(b)(1)</td>
</tr>
<tr>
<td>Non-frivolous</td>
<td>5-10%</td>
<td>Not patently improper but less than reasonable basis</td>
<td>Absolves §6662(b)(1)</td>
</tr>
<tr>
<td>Frivolous</td>
<td>0-5%</td>
<td>Patently improper</td>
<td>Does not absolve</td>
</tr>
</tbody>
</table>
PROBLEMS

1. Client needs to help Mother financially and has decided to put her on the payroll of Client's business at $30,000 a year, perhaps as Secretary and Director. She comes up from Florida several times a year to visit the family, and Client could arrange to have meetings at that time. Mother could attend and sign the minutes. Client asks for your reaction. ABA Section of Taxation, 1992 May Meeting Materials.

2. The following exchange occurs between Lawyer and Client with respect to a tax return position ("Position A") that Client is considering:

   Lawyer: I am quite familiar with the issues presented by Position A. In my professional judgment, that position is certainly not frivolous. Therefore, under our tax system, which permits you to test positions in litigation with the Service before payment of tax, you have a right to adopt Position A on your tax return. If your return is audited, the Service will almost certainly disagree with the position and will thus assert a deficiency in tax. However, you will be entitled to litigate the validity of the issue prior to payment in the United States Tax Court. In my opinion, adoption of Position A presents no issues of fraud or negligence whether or not that position is expressly disclosed on the return. However, I must also advise you that I do not believe that substantial authority within the meaning of Section 6662 of the Code exists to support Position A. As a consequence, if the position is adopted on your return but is not adequately disclosed and if it is ultimately not sustained, you would likely be held liable for the twenty percent substantial understatement penalty. You may avoid any risk of incurring that penalty by making adequate disclosure on the return. Under the circumstances, if you are determined to adopt Position A, I advise you to make adequate disclosure.

   Client: I would like to understand all aspects of this situation. [There follows a discussion in which Lawyer and Client discuss fully the merits of the position and other relevant factors. In this discussion, Lawyer is fully candid and truthful and operates with well-informed and thoughtful professional judgment.]

   Lawyer: I think that about sums up all of the relevant considerations. I can't think of anything else that you need to do to make your decisions. I reiterate my advice that it is in your best interest to make adequate disclosure if Position A is adopted.
Client: Thank you very much. I now think that I understand the situation in full. I have decided to adopt Position A. While I do appreciate your advice that disclosure would be a prudent step to avoid risk of the substantial understatement penalty, and while I accept your judgment that it is in my best interest to do so, it is also contrary to my personal and business philosophy to telegraph and signal that a position that I adopt is thought by me to have a weakness. Disclosure here would seem to me to do just that, even though I acknowledge your view that this is not necessarily so. Since you advise me that Position A, whether or not disclosed, presents no issues of fraud or negligence, and because you advise me that the law does not demand my disclosure of Position A, I have decided against disclosure. Holden, Constraining Aggressive Return Advice: A Commentary 9 VA. TAX REV. 771, 775 (1990).

3. Lawyer, thoroughly researches a position to be taken on Client’s return. Lawyer finds the following “authorities”: (a) a 20-year old Federal District Court decision in another state which is on all fours factually and supports the Taxpayer’s proposed position, but with very weak reasoning; (b) an 11-year old Tax Court Memorandum case written by the current Chief Judge which is not on all fours and supports the IRS’ contrary position in result, but in dictum suggests a different and highly technical rationale (each step of which is conceptually sound) as supporting the District Court’s result (but not its reasoning) and, hence, the Taxpayer’s proposed position; and (c) a published 3-year old Revenue Ruling which specifically rejects the Tax Court memorandum dictum rationale. The Taxpayer takes the position which results in an understatement of $30,000. There is no “adequate disclosure” of the Taxpayer’s position. Thanks for this problem to Professor John Lee of the Marshall-Wythe School of Law.

4. The relevant authorities relating to the treatment of an item on Taxpayer’s return are four Federal Circuit Court cases and a provision of the Internal Revenue Code. All four cases are factually indistinguishable from the taxpayer’s case. Three of the cases favor the government’s position. The remaining case, favoring Taxpayer’s position, has been decided in the jurisdiction in which T resides. Standards of Tax Practice ¶ 208.0312.

5. Practitioner is engaged to prepare the tax return for Client Corporation. In reviewing the prior year return (that Practitioner did not prepare), Practitioner discovers that the ending inventory for the prior year was understated, with the result that taxable income for
that year was likewise understated. Practitioner discussed the error with Client, and is satisfied that the error was inadvertent. However, Client declines to file an amended return to correct the error. Client observes that it would have to amend not only the Federal return but also the returns in all states in which it does business and that this would be a large and expensive burden. Client asks that Practitioner simply proceed with the current return carrying forward the erroneous figure. What are the issues? Standards of Tax Practice § 223.043.

6. Client engages Practitioner to prepare Client’s federal income tax return. Client owns a limited partnership interest and provides Practitioner with a Schedule K-1 reflecting Client’s share of the partnership’s items of income and loss for the year. The Schedule K-1 mistakenly reflects a partnership loss for the year, due to inclusion of the full amount of a nonrecourse note in the basis of the partnership’s property without reduction for the amount of unstated interest with respect to the note. If the information reported on the Schedule K-1 does not reflect the nature of the partnership financing, may Practitioner rely on the depreciation figures used? Standards of Tax Practice §223.013.

7. Client engages Lawyer to form a non-tax shelter limited partnership that is expected to produce tax losses in the early years. After thorough research, Lawyer concludes that, because the general partner, a corporation, has insufficient capital, the partnership is likely to be treated as a corporation for federal tax purposes, and, as a consequence, that the losses will not be deductible by the "partners." Lawyer informs Client that the treatment of the venture as a partnership for federal tax purposes and the deduction of the losses by the partners does not have a realistic possibility of success if challenged. Notwithstanding Lawyer’s advice, Client, unable to find a way to come up with additional capital, insists on retaining the current plan. What should Lawyer do? Standards of Tax Practice §223.022.

8. Assume the same facts as in number 7 above, except that the issue in controversy involves whether the partnership may deduct fees paid for "tax advice" in connection with the sale of the limited partnership interests. Lawyer concludes that the deduction, which is "minor" in comparison to the partnership's overall return, does not possess a realistic possibility of success if challenged. Id.