

1987

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Repository Citation

Holden, James P., "Current Issues in Professional Responsibility" (1987). *William & Mary Annual Tax Conference*. 577.
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CURRENT ISSUES IN PROFESSIONAL RESPONSIBILITY

By

James P. Holden

I. The Rules of Professional Responsibility--Sources

A. Rules prescribed by professional organizations

1. lawyers

a. the American Bar Association prescribes model ethical rules.

i. the Model Code of Professional Responsibility was prescribed by the ABA until 1983.

ii. in 1983, the ABA adopted its Model Rules of Professional Conduct, and these represent the current ABA position.

b. the ethical rules promulgated by the ABA have no force except to the extent that they are adopted by an admitting authority, usually a State court system.

c. the ABA exercises no disciplinary authority over its members, although its Standing Committee on Ethics and Professional Responsibility does issue opinions with respect to the application of the ABA rules in particular factual settings.

d. although some version of the ABA rules has been adopted by every State, the adoption in each State is usually accompanied by numerous modifications -- there is thus less uniformity in ethical rules among the States than is generally presumed.

e. the ABA rules are often adopted, usually without significant modification, by various Federal court systems (e.g., U.S. Tax Court Rule 201(a)).

2. certified public accountants.

a. the AICPA prescribes ethical rules for its members

i. the AICPA Code of Ethics applies to all CPA activities

- ii. the AICPA Statements (1 through 10) on Responsibilities in Tax Practice apply to CPAs engaged in tax practice.
- b. the AICPA rules do have operative force in the sense that the AICPA does exercise disciplinary control over its members.
- c. the ethical rules applicable to CPAs in tax practice differ significantly from those applicable to CPAs engaged in audit practice.
 - i. in tax practice, CPAs need not be independent and they may resolve doubt in favor of their clients.
- 3. other professionals engaged in tax practice.
 - a. both the National Society of Public Accountants and the National Association of Enrolled Agents publish ethical standards for their members.
 - b. these seem to be aspirational, rather than mandatory, rules of conduct.
- B. Rules of practice prescribed by the Treasury Department
 - 1. the Treasury Department rules of practice are contained in Circular 230 (31 CFR, Subtitle A, Part 10), and they regulate all persons who practice before the Internal Revenue Service.
 - a. authority to promulgate is derived from 5 U.S.C. 301, 500; 31 U.S.C. 1026.
 - b. these rules apply to all "practitioners".
 - i. this term is generally used to include any person who is eligible to practice before the IRS -- see, e.g., § 10.33(c)(1), relating to tax shelter opinions, but the term is not defined as a term of general usage in Circular 230.
 - ii. since the term "practitioner" is becoming more widely used (see, e.g., proposed § 10.34), it should be defined more generally in Circular 230.
 - 2. eligibility to practice is available to
 - a. all attorneys and CPAs. § 10.3(a),(b) -- this provision reflects 5 U.S.C. § 500, which declares this level of eligibility.

- b. enrolled agents (persons who are neither attorneys nor CPAs and who either pass an examination or demonstrate competence by reason of former IRS employment). §§ 10.3(c), 10.4.
 - c. enrolled actuaries may practice in certain limited areas. § 10.3(d).
3. general structure of Circular 230.
- a. Part A governs eligibility to practice. §§ 10.1-10.8.
 - b. Part B establishes standards for practice. §§ 10.20-10.33.
 - c. Part C deals with disciplinary proceedings. §§ 10.50-10.76.
 - d. Part D deals with disqualification of appraisers. §§ 10.77-10.97.
- C. The preparer penalties under §§ 6694 and 6695 effectively represent a professional standard
- 1. under § 6694, any understatement of a taxpayer's liability that results from a preparer's negligent or intentional disregard of rules and regulations may subject the preparer to a \$100 penalty.
 - a. if the understatement by the preparer is willful, the penalty may be \$500.
 - 2. under § 6695, various other actions or omissions by a preparer may result in penalties (e.g., failure to sign the return, failure to furnish the preparer's identifying number, failure to retain a copy or list of returns prepared, failure to file a correct preparer information return, and negotiation of a taxpayer refund check).
 - 3. although the penalties assessable under §§ 6694 and 6695 are not ordinarily large in amount, the mere imposition of a penalty carries a professional responsibility stigma that practitioners seek diligently to avoid.
- D. Other penalty provisions of the Internal Revenue Code bear on tax practice responsibilities
- 1. some penalties, although imposed on taxpayers rather than on practitioners, have serious implications for

practitioners in terms of the duty owed to clients to avoid imposition of the penalties.

- a. § 6653 -- addition to tax for negligence (5% of underpayment plus 50% of interest) or fraud (75% of underpayment plus 50% of interest).
 - b. § 6659 -- addition to tax for income tax valuation overstatement (10% to 30% of tax underpayment, depending upon degree of overvaluation).
 - c. § 6660 -- addition to tax for estate or gift tax valuation understatement (10% to 30% of tax underpayment, depending upon degree of undervaluation).
 - d. § 6661 -- addition to tax for substantial understatement of liability (25% of tax underpayment).
2. one penalty may be imposed directly on the practitioner.
 - a. § 6701 -- penalty for aiding and abetting understatement of tax liability of another (\$1,000 for other than corporate liability; \$10,000 for corporate tax liability).
 3. all of these penalties must be considered when weighing tax practice responsibilities.

II. A Proposed Professional Standard for Tax Return Advice and Preparation

A. Background

1. Circular 230 has not historically prescribed specific professional standards for particular kinds of professional tax activity -- it has instead provided broad, general standards for tax practice (e.g., § 10.20, practitioner must provide information to IRS on request; § 10.21, practitioner must advise client to correct omission known to practitioner; § 10.22, practitioner must exercise due diligence in submitting material to IRS).
2. a major departure from this generality occurred in 1984, when standards for tax shelter opinions were adopted as § 10.33.
 - a. Treasury originally defined the tax shelter opinion problem and called on the bar to take self regulatory action.

- b. when the practitioner community failed to respond, Treasury proposed to amend Circular 230 to prescribe specific professional standards for tax shelter opinions.
 - c. the ABA then issued its Formal Opinion 346 in which an alternative set of ethical standards was established for tax shelter opinions.
 - d. Treasury then amended Circular 230 to prescribe standards very similar to those contained in Opinion 346.
3. evolution of the movement for adoption of a tax return standard.
- a. this movement originated within the ABA Tax Section.
 - b. it stemmed from the Tax Section's concern that the contemporary interpretation of the "reasonable basis" standard announced in ABA Opinion 314 had substantially eroded.
 - c. it resulted ultimately in the issuance by the ABA of Formal Opinion 85-352, reprinted at 39 Tax Lawyer 631 (1986).
 - d. the ABA action was followed on August 13, 1986 by Treasury's proposed amendment to Circular 230.
 - i. however, Treasury's proposed ethical standard for tax return preparation and advice was not at all similar to the standard enunciated in Opinion 85-352;
 - ii. it was based instead on section 6661, relating to the penalty for substantial understatement of tax liability.

B. Description of the reasonable basis standard

- 1. ABA Opinion 314, adopted in 1965, holds that "a lawyer who is asked to advise his client in the course of the preparation of the client's tax returns may freely urge the statement of positions most favorable to the client just as long as there is reasonable basis for those positions. Thus where the lawyer believes there is a reasonable basis for a position . . . the lawyer has no duty to advise that riders be attached to the client's tax return explaining the circumstances" (Emphasis added.)

2. the AICPA also approved a substantial equivalent of the reasonable basis standard.

- a. Rule 102 ("In tax practice a member may resolve doubt in favor of his client so long as there is reasonable support for his position." (Emphasis added.)
- b. Statement on Responsibilities in Tax Practice No. 10 (providing that "reasonable support" is needed to justify positions contrary to Treasury interpretations).

C. Description of Opinion 85-352

1. in Opinion 85-352, the ABA revoked the reasonable basis standard of Opinion 314 and adopted a more stringent position.
2. the new opinion permits lawyers to "advise the statement of positions most favorable to the client if the lawyer has a good faith belief that those positions are warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law. A lawyer can have a good faith belief in this context even if the lawyer believes the client's position probably will not prevail. However, good faith requires that there be some realistic possibility of success if the matter is litigated." (Emphasis added.)
3. some questions not addressed in Opinion 85-352 were considered by an ABA Tax Section Task Force on that opinion. 39 Tax Lawyer 635 (1986). The report of the task force concludes that
 - a. the principles of Opinion 85-352 apply to all aspects of tax practice to the extent that tax return positions are involved, including tax shelter opinions governed by Opinion 346 (or § 10.33).
 - b. the probability that the return may not be audited is not a factor to be considered in evaluating whether the standard is met.
 - c. "some realistic possibility of success if litigated" is a higher standard than what had come to be the accepted interpretation of "reasonable basis."
 - d. if a proposed position does not meet the standard, that deficiency may not be overcome by disclosure

or "flagging" of the position on the return -- but a position not meeting the standard may be advanced by way of a claim for refund.

- e. the lawyer advising a client with respect to a tax return position should counsel the client also with respect to the substantial understatement penalty of § 6661 and the opportunity to avoid that penalty through disclosure.

D. The Treasury Department proposal

1. on August 13, 1986, the Treasury Department issued proposed regulations to amend Circular 230 by adding a new § 10.34, dealing with responsibilities of tax practitioners who recommend or advise tax return positions or who prepare or sign tax returns.
2. this proposal would amend § 10.22, which now requires that practitioners use due diligence in dealing with the IRS, by adding a new subsection (a) requiring due diligence specifically

" (a) In advising clients about positions taken with respect to the tax treatment of all items on returns."

3. this proposal would also add a new § 10.34 as follows:

Section 10.34 Advice regarding positions on tax matters where Internal Revenue Code section 6661 may be applicable. In advising a taxpayer about the tax treatment of any item on a return, a practitioner must comply with the following requirements:

(a) A practitioner must advise a client fully about the addition to tax provisions of section 6661 . . . if, in the exercise of due diligence, the practitioner determines that the taxpayer filing the return may be liable for an addition to tax under the section as a result of a position taken with respect to the tax treatment of any item on the return.

(b) A practitioner may not advise or recommend to a client that a position be taken with respect to the tax treatment of any item on a return unless in the exercise of due diligence the practitioner determines that the taxpayer filing the return will not be liable for an addition

to tax under section 6661 of the Internal Revenue Code as a result of the position.

(c) A practitioner may not prepare or sign a return unless in the exercise of due diligence the practitioner determines that the taxpayer filing the return will not be liable for an addition to tax under section 6661 of the Internal Revenue Code as a result of a position taken with respect to the treatment of any item on the return. (Emphasis added.)

4. the Treasury proposal thus would tie the practitioner's professional standard directly to the § 6661 penalty. Under the proposed standard, unless the practitioner "determines" that the taxpayer "will not" be liable for the penalty, the practitioner may not advise or recommend the position and may not prepare or sign the return.

E. The alternative proposal offered by the ABA Tax Section/AICPA Federal Tax Division

1. the ABA Tax Section and the AICPA Federal Tax Division have both acknowledged that it is appropriate for Treasury to promulgate a professional tax return standard applicable to all practitioners, and these organizations have joined together to recommend a standard different from the Treasury proposal and acceptable to both organizations.
2. this ABA/AICPA proposed standard draws heavily on ABA Opinion 85-352 and offers an alternative proposed § 10.34 as follows (bracketed language in text appears in AICPA version but not in ABA version; underscored language appears in ABA version but not in AICPA version):

Section 10.34 Standards for advising or recommending tax return positions or preparing or signing returns. With respect to tax return positions, practitioners must comply with the following standards:

(a) A practitioner may not advise or recommend to a client that a position be taken with respect to the tax treatment of any item on a return unless the practitioner has a good faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits if challenged.

(b) A practitioner may not prepare or sign a return [on behalf of a client] if

[such practitioner knows] that [the] return takes a position that the practitioner could not advise or recommend under the standard expressed in paragraph (a).

(c) Notwithstanding paragraphs (a) and (b), the practitioner may advise or recommend that a position be presented in the context of either: (1) a return on which the position is adequately disclosed [as such], or (2) an amended return that serves as a claim for refund (e.g., a Form 1040X or 1120X), in either case so long as the practitioner concludes that there is a basis for doing so that is not frivolous.

(d) In advising or recommending a return position where there is not or may not be substantial authority for the position, or in preparing or signing a return on which such a position is taken, a practitioner must [where relevant] advise the client fully as to the potential penalty consequences under section 6661 of the Internal Revenue Code and, if relevant, the opportunity to avoid the penalty through disclosure or other means.

(e) In preparing or signing a return, a practitioner may in good faith rely without verification upon information furnished by the client or by third parties. However, the practitioner may not ignore the implications of information furnished and must make reasonable inquiries if the information furnished appears to be incorrect, incomplete, or inconsistent, either on its face or on the basis of other known facts.

3. the formulation in paragraph (a) "realistic possibility of being sustained administratively or judicially on its merits if challenged" is a paraphrase of "realistic possibility of success if litigated" as used in Opinion 85-352.
4. the ABA/AICPA recommended standard would permit positions not satisfying the basic standard to be advised or recommended so long as those positions are "adequately disclosed" on the return -- this is a departure from the position of the ABA Tax Section task force on Opinion 85-352 -- see II.C.3.d. above.

III. Problems Presented By The Treasury Department's Proposed Standard

A. Policy issues

1. § 6661 is a penalty provision designed to stimulate taxpayer compliance -- it was not designed to prescribe also the limits of practitioner responsibility.
2. There is no fundamental requirement for an identity between
 - a. the limits on taxpayer penalty-free conduct, and;
 - b. the limits on acceptable practitioner conduct.

B. Problems arising from the narrow definition of "substantial authority"

1. as defined in the § 6661 regulations, the term "authority" does not include treatises, periodicals, legal opinions, action on decisions, technical advice memoranda, general counsel memoranda, proposed regulations and private rulings.
2. in an age of inherent uncertainty in tax law, it is not acceptable to hold that a position adopted in reliance on such materials is unprofessional.
3. the very narrow definition of the term "authority" in these regulations is one factor that makes § 6661 inappropriate as a professional standard.
4. this conclusion is not altered by the fact that the regulations under § 6661 would accept a "well-reasoned" construction of the statute.
 - a. any application of the professional standard by the Director of Practice is likely to be retrospective, occurring only after the taxpayer has received an adverse substantive holding on the asserted position.
 - b. under these circumstances, it is unrealistic to place on the practitioner the burden of showing that the unsuccessful position was nonetheless well reasoned.

C. The influence of irrelevant facts

1. application of the § 6661 penalty depends in part on the relative size of the understatement (10% of tax liability or \$5,000).
2. to know whether a client was likely to encounter the penalty, the practitioner would thus have to review the entire return to ascertain whether the threshold has been reached -- a practitioner providing only advice, perhaps early in the taxable year, would have no basis for making this assessment.
3. if practitioner conduct is in fact unprofessional, it should not be excused by the operation of such mechanical tests, even though they are useful in the general context of administering the § 6661 penalty as applied to taxpayers.

D. The issue of taxpayer intent

1. in the context of a tax shelter, the § 6661 penalty may be avoided only if the taxpayer reasonably believed the position to be more likely than not correct.
2. thus, in tax shelter settings, the practitioner's liability to discipline would turn on the mental state of the taxpayer.
3. this is clearly an unsatisfactory basis for discipline.

E. Level of assurance required

1. the Treasury Department's proposed standard requires that the practitioner "determine" that the taxpayer "will not" incur the § 6661 penalty.
2. given the high level of uncertainty on many tax issues, the required level of assurance is unrealistic.

F. Potential client/practitioner conflict of interest

1. the mechanical nature of Treasury's proposed standard risks automatic assertion of professional misconduct whenever a § 6661 penalty is asserted against a client.
2. even if the charge of misconduct were not finally pursued, the mere mention of the possibility by an

agent seeking an agreed audit report could distort the process.

3. the practitioner would be placed in a position of personal risk by reason of the mere reference to a possibility of misconduct, a position inherently in conflict with his responsibility to client.
4. similarly, if both the client and the practitioner are charged, the client may elect to accept the § 6661 penalty, if it has modest monetary consequences, leaving the practitioner with no basis to defend the charge of professional misconduct.
5. a practitioner who may be subject to disciplinary action if the § 6661 penalty is imposed in a case will risk the appearance (or actuality) of "selling his client out" if the practitioner's penalty risk is dropped in return for a taxpayer concession on other points.
6. these problems are lessened, though not eliminated, if the practitioner conduct standard is decoupled from the client penalty standard, as would be the case under the ABA/AICPA alternative.
7. it appears inevitable that there will be some conflict of interest potential in any case in which the practitioner's conduct is under scrutiny.

G. The importance of peer review

1. neither the Treasury proposal nor the ABA/AICPA proposal calls for peer participation in the process of evaluating professional conduct.
2. § 10.76 of Circular 230 authorizes the Director of Practice to establish an "advisory committee" to review and make recommendations concerning alleged violations of the tax shelter opinion rules of § 10.33, but no action has been taken with respect to appointment of such a committee since 1984, when this provision was adopted.
3. it is important to establish a peer review process if a tax return standard is adopted, and it is important that Treasury activate the process in both the tax return and tax shelter opinion areas.
4. in many circumstances, practitioners and the IRS operate as adversaries, and it is thus inappropriate that the IRS Director of Practice exercise sole control of the disciplinary process.

5. under many State grievance procedures, a panel of practicing lawyers reviews charges of practitioner misconduct and authorizes, or recommends, the commencement of a judicial grievance procedure.

H. The standard for disciplinary action

1. the Treasury proposal contains no guidance as to the level of practitioner misconduct required before disciplinary action is instituted.
2. the ABA/AICPA proposal would amend § 10.51, which defines "disreputable conduct" to provide that willful violation of proposed § 10.34, or a pattern of violation, whether or not willful, would constitute disreputable conduct.
3. it is important to establish that a single inadvertent violation is not a basis for disciplinary action -- this is very important under the Treasury proposal, where near automatic assertion of the penalty may reasonably be feared, and it is less important, but still significant, under the ABA/AICPA alternative.

I. The need to deal with the practitioner's right to rely on information furnished by third parties

1. the ABA/AICPA alternative recognizes the need of the practitioner to be able to rely on tax return information furnished by the taxpayer or by a third party -- the Treasury proposal does not deal with the issue.
2. it is important to resolve this issue because of its significance to many practitioners, and it is to be hoped that Treasury will adopt the ABA/AICPA provision.
3. the standard, and the actual practice of the Director, must recognize the practical necessity for tax return preparers to rely upon documents and information without, absent a reason to do so, the need for verification or substantive review -- responsibility should not be imposed on the return preparer for the judgments and positions taken by those who prepared Forms 1099, K-1, etc., or even for taxpayer-supplied data which is accepted in good faith without reasonable indication of a reason to go beyond what is presented.