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Federal Standards of Tax Practice: "Preparer" Penalties & Circular 230

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"Preparer" Penalties

I. **Code section 6694** imposes penalties on "income tax return preparers" for taxpayer understatements of tax liability attributable to advice that fails to meet the statutory standards, explained below. Final Regulations under section 6694 were issued December 31, 1991. T.D. 8382. The regulations generally are effective for documents prepared and advice given after that date. Treas. Reg. § 1.6694-1(f).

A. "**Income Tax Return Preparer**" generally is defined under section 7701 to include any person who "prepares" (or employs anyone else to prepare), for "compensation," all or "a substantial portion" of an income tax return or claim for refund of income tax. I.R.C. § 7701(a)(36)(A).

1. "Compensation" includes any profit related to return preparation, in cash or kind, and need not be received directly from the person for whom the return is considered prepared. See *e.g.* Goulding v. United States, 717 F. Supp. 545 (N.D. Ill. 1989) (holding attorney paid by general partner to prepare partnership schedules received compensation for preparation of returns of limited partners).

2. "Prepare" includes rendering advice "directly relevant" to the determination of the existence, amount or characterization of an entry on a return or claim for refund. Treas. Reg. § 301.7701-15(a)(2)(ii). See Federal Standards of Tax Practice--Examples, Examples 1(a) & 2(a) (attached).

a. Section 6694 penalties apply not only to preparers who sign a return or claim for refund, but also to nonsigning preparers "who provide advice (written or oral) to a taxpayer or to [another] preparer." Treas. Reg. § 1.6694-1(b)(2).

b. Advice on specific issues of law is considered preparation only if provided with respect to events that have already occurred and not with respect to the consequences of contemplated actions. Treas. Reg. § 301.7701-15(a)(2)(i).
3. Whether the person considered as having prepared an entry is a "preparer" depends upon whether the entry constitutes a "substantial" portion of the return. E.g., the preparer of a partnership return is considered a preparer of a partner's return if the entries on the partnership return that are reportable on the partner's return constitute a substantial portion of the partner's return. Treas. Reg. § 301.7701-15(b)(3). See e.g., Goulding v. United States, 957 F.2d 1420 (7th Cir. 1992), affg 717 F.Supp. 545 (N.D. Ill. 1989) (holding preparer of schedules for three tax shelter partnerships liable for returns of approximately 260 limited partners).

a. "Substantial" determined considering the length, complexity and amount of the entry compared to the length, complexity and amount of the return or claim for refund as a whole. Treas. Reg. § 301.7701-15(b)(1). See e.g., Adler & Dobry, Ltd. v. United States, 792 F. Supp. 579 (1992) (memorandum opinion & order) (holding that deductions taken by limited partners as a result of partnership schedules prepared by accountants, although not de minimis, did not cause preparation of schedules to constitute preparation of a "substantial portion" of investors' returns in light of the complexities of the returns).

b. Safe harbor definition of "substantial": amounts involved are (1) less than $2,000 or (2) less than $100,000 and also less than 20% of the taxpayer's gross income (or adjusted gross income for an individual). Treas. Reg. § 301.7701-15(b)(2).

4. Regulation section 301.7701-15(d) excepts from the definition of preparer:

a. a person who merely furnishes clerical assistance;

b. a person, such as in-house counsel, acting for the employer (or officer or employee of the employer) by whom the person is regularly and continuously employed;

c. a person acting as a fiduciary; and
d. a person who prepares a claim for refund in response to a
deficiency notice or extension of assessment period after
commencement of an audit.

5. Although more than one individual may qualify as a preparer
under section 7701, for purposes of section 6694, only one
individual per firm is considered a preparer with respect to the
same return or claim for refund. Treas. Reg. § 1.6694-1(b). See
Federal Standards of Tax Practice--Examples, Example 1(b)
(attached).

a. The individual subject to penalty is the signing preparer or
the person with overall supervisory responsibility for the
advice given if no preparer with the firm is a signing
preparer.

b. However, in addition to the individual preparer, the firm
as an entity also may be liable for penalty if principals
of the firm knew of the penalized conduct or failed to
establish or follow appropriate procedures to prevent
proscribed conduct. Treas. Reg. § 1.6694-2(a)(2) & 1.6694-
3(a)(2).

B. Section 6694(a): $250 penalty for a client's understatement
attributable to a position for which there is "not a realistic possibility
of being sustained on its merits" imposed on any preparer who
"knew (or reasonably should have known)" of the position.

1. A position is considered to have a realistic possibility of success
if a reasonable and well-informed analysis by a person
knowledgeable in the tax law would lead such a person to
conclude that the position has approximately a one in three or
greater likelihood of being sustained on its merits, that is,
without regard to whether the issue is, in fact, likely to be raised

a. Although stated in language similar to ABA Opinion 85-
352, the definition of the "realistic possibility" standard
under the regulations is at odds with interpretations of the
ABA standard and is essentially equivalent to "substantial
authority" as defined under the taxpayer accuracy-related
penalty regulations. See e.g., William Raby, Salting the
Voluntary Assessment System, 54 Tax Notes 187 (Jan. 13,
1992) (stating that the "differences" between the two standards are "impossible to really articulate").

(1) The "nature of analysis" (weight accorded authority and determination of relevance and persuasiveness) prescribed for determining whether substantial authority exists applies for purposes of determining whether the realistic possibility standard is satisfied. Treas. Reg. § 1.6694-2(b)(1).

(2) In determining whether a position has a "realistic possibility of success," preparers may consider only the "authorities" allowed in determining whether substantial authority exists (that is, excluding conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by other tax professionals). Treas. Reg. § 1.6694-2(b)(2). See Federal Standards of Tax Practice--Examples, Examples 3, 4 & 5 (attached).

(3) One-in-three appears to be a mandatory threshold rather than a safe harbor as the ABA Tax Section's Task Force Report on Opinion 85-352 may have intended. See I. Bernard Wolfman, James P. Holden, Kenneth L. Harris, Standards of Tax Practice ¶ 5005.06 (New Developments 1992) (hereinafter Standards of Tax Practice).

(4) However, the realistic possibility standard generally must be satisfied as of the date of the return (rather than as of the end of the tax year at issue as generally is the case under the substantial authority standard). Treas. Reg. § 1.6694-3(b)(5).

b. The regulations include examples of the application of the realistic possibility standard, but none illustrates how the one-in-three threshold is applied where there is case law both supporting and contrary to a position. See Standards of Tax Practice ¶ 5005.02.

3. **Exceptions:**
Realistic possibility not required to support a position if the position is disclosed, provided that the position is not frivolous.

(1) "Frivolous" is defined as "patently improper" and is described as an objective standard (that is, neither the preparer's knowledge or intentions are relevant to a determination of whether the position is frivolous). T.D. 8382 Preamble.


(3) Nonsigning preparers may not be able to ensure that the client discloses on the return that a position does not satisfy the realistic possibility standard, so special disclosure rules apply.

(a) Advice rendered to a client: a nonsigning preparer's disclosure obligation is satisfied by advising the client (in writing, if the rest of the advice with respect to the position is in writing) that the position lacks "substantial authority" and therefore may subject the taxpayer to penalty under section 6662 unless adequately disclosed. Treas. Reg. § 1.6694-2(c)(3)(iii)(A). The regulations do not explain the preparer's obligation if the amounts at issue are too small to implicate the substantial understatement penalty. See Federal Standards of Tax Practice-Examples, Example 8 (attached).

(b) Advice to another preparer: a nonsigning preparer's disclosure obligation is satisfied by advising the other preparer (in writing, if the rest of the advice with respect to the position is in writing) that disclosure under section 6694(a) is required. Treas. Reg. § 1.6694-2(c)(3)(iii)(B).
b. Failure to meet the realistic possibility standard is excused if an understatement is due to **reasonable cause** and the preparer acted in **good faith**. Treas. Reg § 1.6694-4(d).

Factors to consider in determining if an understatement was due to reasonable cause and the preparer acted in good faith include:

(1) whether the error relates to a complex, uncommon or highly technical provision. Treas. Reg. § 1.6694-2(d)(2);

(2) whether there are numerous errors or a pattern of errors, but even an isolated error is not excused if it is "so obvious, flagrant or material that it should have been discovered" on review. Treas. Reg. § 1.6694-2(d)(2);

(3) whether the errors are material, but "obvious" or numerous errors not excused even if immaterial. Treas. Reg. § 1.6694-2(d)(3);

(4) whether the preparer has established and followed a normal office practice that promotes accuracy and consistency, but even if excellent office procedures are in place, "flagrant" errors are not excused. Treas. Reg. § 1.6694-2(d)(4);

(5) whether the preparer relied on the advice of another paid "preparer," as defined under the regulations (or a person who would be a preparer if the advice had constituted a substantial portion of the return). See **Federal Standards of Tax Practice--Examples**, Example 1(d) (attached).

(a) William Raby has argued that, although an article is not "authority" under the regulations, the opinion that there is a realistic possibility of success on the merits from the author of an article "should insulate the signing preparer against a section 6694(a) penalty." William Raby, **Salting the Voluntary Assessment System**, 54 Tax Notes 187 (Jan. 13, 1992).
(b) However, "good faith" is absent if the advice is unreasonable on its face or if the preparer knew or should have known that the advice was based on inadequate facts or outdated legal authority. Treas. Reg. § 1.6694-2(d)(5).

C. **Section 6694(b):** $1,000 penalty (reduced by any amount paid under section 6694(a)) for an understatement due to a preparer's:

1. **Section 6694(b)(1): willful attempt to understate tax liability.** Under Treasury Regulation section 1.6694-3(b), equated with disregard of facts "in an attempt wrongfully to reduce the [client's] tax liability"; OR

2. **Section 6694(b)(2): reckless or intentional disregard of rules or regulations, i.e., disregard of law, including Code provisions, temporary or final (but not proposed) Treasury regulations, and revenue rulings and notices (other than notices of proposed rulemaking) published in the Internal Revenue Bulletin.** Treas. Reg. § 1.6694-3(f). Revenue procedures may or may not be treated as "rules or regulations" depending on the facts and circumstances. T.D. 8382 Preamble.

   a. A preparer who makes little or no effort to ascertain the existence of a rule or regulation is "reckless" if such conduct represents a substantial deviation from the conduct of a reasonable preparer under the circumstances. Treas. Reg. § 1.6694-3(c)(1).
b. **Exceptions:**

(1) The regulations provide a disclosure exception as suggested in the legislative history. H.R. Rep. No. 247, 101st Cong., 1st Sess. 1396-97 (1989) ("specified disclosure tends to demonstrate that there was no intentional disregard of rules and regulations"). IF:

(a) the reported position is not frivolous;

(b) the position is disclosed on Form 8275 or 8275-R, as appropriate, or in accordance with special rules for nonsigning preparers;

(i) Disclosure on the return in conformance with an annual revenue procedure is **not** adequate for these purposes.

(ii) Disclosure must adequately identify the rule or regulation being challenged. Treas. Reg. § 1.6694-3(e).

AND

(c) a position contrary to a regulation must represent a good faith challenge to the validity of the regulation. Treas. Reg. § 1.6694-3(c)(2). **See Federal Standards of Tax Practice--Examples, Example 6** (attached).

(2) Additionally, preparers, like taxpayers, will not be penalized for an undisclosed position contrary to a revenue ruling or notice if the position satisfies the realistic possibility standard. Treas. Reg. § 1.6694-3(c)(3). However, no examples in the regulations illustrate how to apply the standard where there is little or no case law supporting a position contrary to a revenue ruling. **See Federal Standards of Tax Practice--Examples, Example 7** (attached).
D. **Duty to make factual inquiry:** Under both 6694(a) & (b), preparers generally may rely in good faith without verification on information provided by the client. However:

1. a preparer may not ignore the implications of information furnished or actually known to the preparer;
2. a preparer must make reasonable inquiries if information seems incomplete or incorrect; and
3. a preparer must make appropriate inquiries to determine the existence of facts and circumstances, such as substantiating documents, required by a Code section or regulation as a condition to the claiming of a deduction. Treas. Reg. § 1.6694-1(e)(1). See **Federal Standards of Tax Practice--Examples**, Example 9 (attached).

E. **Conflicts of Interest:** Some lack of coordination remains between taxpayer accuracy-related penalties and preparer penalties, posing potential conflicts between an adviser's interest in avoiding penalties and a taxpayer's interest in minimizing tax in cases where the taxpayer is not subject to penalty for nondisclosure but disclosure is required for the adviser to avoid penalty. Such cases might arise if the taxpayer reporting standard were less demanding than the preparer standard.

1. The preparer standards generally are consistent with taxpayer obligations with respect to positions in disregard of rules and regulations: taxpayers and practitioners both are subject to penalty for reporting an undisclosed position contrary to a revenue ruling or notice unless the position satisfies the realistic possibility standard; and both are subject to penalty for an undisclosed position contrary to a regulation even if the position satisfies the realistic possibility standard. Treas. Reg. § 1.6694-3(c)(3).

   a. The explanatory statement accompanying the taxpayer accuracy penalty regulations observes that "[f]raming this exception [to the penalty for disregard of a revenue ruling or notice] in terms of a standard that exists in the preparer penalty context helps coordinate the accuracy and preparer penalty regimes". T.D. 8381 Preamble.

   b. This exception is made effective for both taxpayers and preparers for documents prepared and advice given after
December 31, 1989, two years earlier than the generally applicable effective date of the preparer penalty regulations. Treas. Reg. § 1.6694-1(f).

c. It is unclear, however, whether both a taxpayer and a preparer are to determine the existence of rules or regulations and a realistic possibility of success as of the same or different dates (end of tax year or date of return).

2. The preparer standards also generally are consistent with taxpayer obligations with respect to substantial understatements: if a position does not satisfy the realistic possibility standard it also likely lacks "substantial authority," since they are virtually indistinguishable standards. Thus reporting the position without disclosure would subject the taxpayer to penalty under section 6662 just as advising reporting the position without disclosure would subject the preparer to penalty under section 6694. Treas. Reg. § 1.6694-2(c)(3)(iii)(A).

a. However, "substantial authority" may be determined as of a different date than "realistic possibility" is determined. Substantial authority may be determined as of the last day of the taxable year to which the return relates. Treas. Reg. § 1.6662-4(d)(3)(iv)(C). The preamble to the preparer regulations explains that, in determining whether a position meets the realistic possibility standard, a preparer is not permitted "to ignore developments in the law occurring after the taxable year covered by the return and before the preparer signs the return (or provides the advice)." T.D. 8382 Preamble.

(1) This discrepancy appears to account for the potential for a "rare" case, addressed by the proposed regulations, where a position has substantial authority but not a realistic possibility of being sustained on its merits.

(2) The final regulations delete the "rare case provision" because "commentators criticized this provision as unnecessary and confusing," so no guidance is provided as to how this discrepancy is to be handled. T.D. 8382 Preamble.
b. The standard of accuracy required of taxpayers to avoid the substantial understatement penalty with respect to tax shelter items is the even higher "more likely than not" standard. A position that lacks a realistic possibility of success thus would subject a taxpayer to penalty.

3. The greatest tension may exist between the taxpayer negligence penalty and the preparer penalty imposed for a position lacking a realistic possibility of success.

a. To avoid penalty for substantial understatement under section 6662(a)(2), taxpayers may not be required to disclose a position that lacks substantial authority if it results in an understatement too small to be considered "substantial," but a preparer has disclosure obligations if the position lacks a realistic possibility of being sustained on its merits.

b. Treasury claims lack of authority to address these concerns because the standards are "established by statute and cannot be changed by regulation." T.D. 8382 Preamble.

c. However, concerns about conflicts of interest may be unfounded or exaggerated. See Federal Standards of Tax Practice--Examples, Example 8 (attached).

(1) There is no conflict if the adviser is not a "preparer": if an understatement is too small to be considered "substantial" under section 6662, the adviser's involvement with the return may not be sufficiently "substantial" under section 7701 to qualify as a preparer.

(2) Also, there is no conflict if the taxpayer must disclose to avoid penalty for negligence under section 6662(a)(1).

F. Validity of Regulations: In enacting the 1989 preparer penalty legislation, Congress explained that the new statutory standard "generally reflects the professional conduct standards applicable to lawyers and to certified public accountants." H.R. Rep. No. 247, 101st Cong., 1st Sess. 1396 (1989). Treasury has employed terms similar to those of the ABA and AICPA standards but defined the statutory "realistic possibility" standard as essentially equivalent to "substantial"
authority." Arguably, deviation from existing practitioner norms is inconsistent with congressional intent to conform the penalty standard to ABA and AICPA standards of professional conduct, and calls into question the validity of the regulations. See Standards of Tax Practice ¶ 5005.03. However, the regulations probably constitute a reasonable interpretation of the statute.

1. Congress contemplated elevation of the preexisting preparer penalty standards. See H.R. Rep. No. 247, supra (expressing belief that the new standard is stricter than law then in effect).

2. The legislative history of section 6694 indicates that the statutory standard was intended "generally" to reflect, but not necessarily duplicate, existing practitioner standards. H.R. Rep. No. 247, supra. See Richard C. Stark, IMPACT Makes Fundamental Changes in Civil Penalties, 72 J.Tax’n 132, 136 (1990) ("The context of the term in Section 6694 . . . suggests that Congress may have intended for 'realistic possibility' to mean something more" than "a reasonable litigating position" adopted as the standard by practitioners).

3. There was not consensus among practitioners as to a single meaning of "realistic possibility of success." See Stark, supra (noting that "the meaning of the 'realistic possibility' language is unclear"). The ABA and AICPA had somewhat different formulations of a "realistic possibility of success" standard, and there was not even agreement within the organizations as to their substantive content and application. See e.g., ABA Civil Penalties Task Force Members Release Comments on Notice 90-20, 90 Tax Notes Today 178-4 (August 28, 1990) (asserting that the meaning of realistic possibility standard "is still debated in the Tax Section," some arguing a one-in-three chance of success appears to be "inappropriately high"). Thus, a rough approximation of the practitioner standard was the most that Congress or the Treasury could have hoped to achieve.

4. The objectivity achieved by prescribing that realistic possibility be determined on the basis of "authority" improves the administrability of the preparer regulations over the ABA and AICPA standards and thus may supply a "reasonable" ground to support the administrative interpretation.
II. **Code Section 6701:** Where applicable, in lieu of penalties under section 6694, Code section 6701 imposes a $1,000 penalty ($10,000 if the client is a corporation) for **aiding and abetting understatement of tax liability:**

A. For **preparation or presentation of any portion of any document** (not necessarily prepared or presented in connection with assessing tax liability):

   1. that the preparer or presenter "knows" would produce, if used in connection with any material matter arising under the internal revenue laws, an understatement of another's tax liability: actual knowledge required, but can be inferred from acts amounting to willful blindness to the existence of facts. *Mattingly v. United States*, 924 F.2d 785, 791-92 (8th Cir. 1991). See *Federal Standards of Tax Practice--Examples*, Example 10 (attached);

   AND

   2. that the preparer or presenter "knows or has reason to believe" will be used in connection with a material matter under the tax laws (actual knowledge that the document will be used for tax purposes need not be established).

B. On "any person," not only a "preparer," who assists or advises, or directs another to assist or advise, in the preparation or presentation of such a document.

   1. Specifically penalizes "knowing of, and not attempting to prevent, participation by a subordinate" and "ordering (or otherwise causing) a subordinate" to engage in the described conduct. I.R.C. § 6701(c)(1). *Cf. ABA Model Rules of Professional Conduct Rule 5.1: Responsibilities of a Partner or Supervisory Lawyer.*

   2. "Subordinate" defined broadly to include anyone over whom a person has "direction, supervision or control."

C. The burden of proof as to whether any person is liable for penalty under section 6701 is on the government. I.R.C. § 6703(a). *Mattingly v. United States*, 924 F.2d 785, 787-89 (8th Cir. 1991), held that the government bears the burden of proof by a preponderance of the evidence. *But see Warner v. United States*, 700 F.Supp. 532, 533 (S.D. Fla 1988) (holding that government must prove elements of section 6701 by "clear and convincing" evidence because of the severity of potential penalties).
Circular 230

I. Part 10 of Title 31 of the Code of Federal Regulations, commonly referred to as "Circular 230," prescribes rules governing eligibility to practice before the Internal Revenue Service, the legal obligations of such practice, and disciplinary proceedings for violations. See 5 U.S.C. § 301 (authorizing heads of executive departments to prescribe regulations for departmental governance); 31 U.S.C. § 321 (granting general authority to Secretary of the Treasury to administer revenue laws); 31 U.S.C. § 330 (specifically granting Secretary of the Treasury authority to regulate practice before the Treasury Department).

A. Section 10.1 of Circular 230 establishes the position of Director of Practice who is authorized to act upon applications for enrollment to practice before the Service, conduct disciplinary proceedings and perform other necessary and appropriate duties.

B. Section 10.2(a) of Circular 230 defines practice before the Internal Revenue Service to include all matters connected with presentation to I.R.S. personnel concerning "a client’s rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service," including preparation and filing of necessary documents, correspondence with and communications to the I.R.S., and representation of a client at conferences, hearings and meetings. Section 10.33, which addresses tax shelter opinions and offering materials, implicitly includes in the definition of practice before the Service written or oral tax shelter opinions used in marketing. See Federal Standards of Tax Practice -- Examples, Examples 1(c) & 2(b) (attached).

II. In 1986, the I.R.S. issued proposed amendments to Circular 230 specifically imposing a requirement of due diligence in "advising clients about positions taken with respect to the tax treatment of all items and returns."

A. Proposed section 10.34 would define "due diligence" to prohibit advising a position that would subject the client to the substantial understatement penalty, e.g., a position that was neither supported by "substantial authority" nor disclosed.

B. The 1986 proposed regulations have neither been finalized nor withdrawn, but revisions are expected that will establish a standard of practice before the Service compatible with the preparer penalty provisions that have been enacted in the interim.
III. Proposed revisions to Circular 230 were to have been issued in June of 1992 but were delayed due to competing legislative priorities. At the ABA Annual Meeting in August, the I.R.S. Director of Practice stated that Circular 230 amendments were a "high priority" and expressed the hope that the proposed regulations would be published in the "near future."

A. The proposed amendments are expected to focus on:

1. establishing standards for practitioners regarding tax advice and positions taken on tax returns prepared by those subject to Circular 230; and

2. specifying circumstances under which abuses of the standards will result in enforcement.

B. The proposed amendments also are expected to address:

1. prohibition of contingent fee arrangements for return preparation services;

2. clarification of the applicability of Circular 230 to those engaged in "limited practice," such as in-house return preparers; and

3. authorization of summary suspension procedures with respect to practitioners convicted of certain crimes or disciplined by state authorities.

C. If proposed regulations are issued before the 1992 William and Mary Tax Conference, they will be addressed at the "Ethical Issues in Tax Practice" session.

IV. Current\(^1\) Provisions of Circular 230

A. **Authorization** to practice before the I.R.S.

1. Section 10.3 authorizes practice before the Service by:

   a. lawyers licensed to practice under state law;

   b. certified public accountants;

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\(^1\) As of September 24, 1992.
c. enrolled agents admitted to practice under procedures specified in Section 10.4; and
d. with respect to specified employee benefit plan provisions, actuaries enrolled by the Joint Board for the Enrollment of Actuaries.

2. Section 10.7 authorizes limited practice by certain other individuals.

a. "Any person" may prepare a tax return and any return preparer may "appear without enrollment as the taxpayer's representative . . . before revenue agents and examining officers of the Audit Division in the offices of District Director (but not at the District Conference in a District Director's office)."

b. Individuals generally may appear on their own behalf and on behalf of closely-related persons and entities, such as their employer (individual or corporate), a partnership of which they are a member, a trust of which they are trustee, etc.

3. Section 10.32 provides that nothing in Circular 230 "shall be construed as authorizing persons not members of the bar to practice law."

B. Practitioners may be suspended or disbarred from practice before the I.R.S. for incompetence; willfully and knowingly misleading or threatening a client or prospective client with the intent to defraud; "disreputable conduct"; or willful violation of the rules prescribed in Subpart B of Circular 230.

1. "Disreputable conduct," as defined under Circular 230 section 10.51, includes but is not limited to:

a. conviction of crimes involving dishonesty, breach of trust or violation of federal tax law;

b. knowingly providing false or misleading information to the I.R.S.;

c. willful failure to file a tax return or participation in any attempt to evade federal tax; knowingly suggesting illegal
tax evasion schemes to clients or prospective clients; or concealing one's own or others' assets to evade tax;

d. failure promptly to remit funds received from a client to be applied to payment of taxes;

e. attempting to influence I.R.S. personnel through threats, false accusations, coercion, or special inducement;

f. disbarment or suspension from practice as an attorney, accountant or actuary;

g. knowingly assisting an ineligible, disbarred or suspended practitioner to practice before the Service (violation presumed if maintaining a law or accounting partnership with a practitioner disbarred from practice before the Service);

h. contemptuous conduct (including use of abusive language, knowingly making false accusations or circulating or publishing malicious or libelous matter) in connection with practice before the Service;

i. knowingly, recklessly, or through gross incompetence giving a false or misleading opinion, or a pattern of providing incompetent opinions, on questions arising under federal tax law.

(1) Reckless conduct is a highly unreasonable omission or misrepresentation, involving not merely simple or inexcusable negligence, but an extreme departure from the standards of ordinary care, that is either known or so obvious that the competent practitioner must or should have been aware of it; and

(2) gross incompetence includes conduct that reflects gross indifference, preparation which is grossly inadequate under the circumstances, and a consistent failure to perform obligations to the client.

(3) False opinions include those arising from: knowing misstatement of fact or law; assertion of a position known to be unwarranted under existing law;
counseling conduct known to be illegal or fraudulent; concealment of matters legally required to be revealed; conscious disregard of information indicating that material facts expressed in a tax opinion or offering material are false or misleading.

2. **Duties and restrictions** on practitioners established under subpart B:

   a. duty to supply information to I.R.S. upon proper and lawful request. Circular 230 § 10.20;

   b. duty to advise client upon discovery of any error or omission or other noncompliance with the tax laws. Circular 230 § 10.21;

   c. duty to exercise due diligence as to accuracy of submissions and statements to I.R.S. Circular 230 § 10.22;

   d. duty not to unreasonably delay disposition of I.R.S. matters. Circular 230 § 10.23;

   e. prohibition against employing or working for any person disbarred or suspended from practice before the I.R.S. Circular 230 § 10.24;

   f. prohibition against representing clients in a matter on which the practitioner's partner substantially participated while in government employment; Circular 230 § 10.25;

   g. prohibition of former government employees from working on matters they participated in as government employees. Circular 230 § 10.26;

   h. prohibition against acting as notary in I.R.S. matters. Circular 230 § 10.27;

   i. prohibition of unconscionable fees. Circular 230 § 10.28;

   j. prohibition against representing conflicting interests except with consent of directly interested parties. Circular 230 § 10.29;
k. restrictions on permissible advertising and prohibition of misleading advertising and coercive solicitation, conforming to recent Supreme Court commercial speech decisions. Circular 230 § 10.30;

l. prohibition against negotiating taxpayer refund checks. Circular 230 § 10.31; and

m. duty to observe specified due diligence requirements with respect to tax shelter opinions. Circular 230 § 10.33.
Federal Standards of Tax Practice
Examples

1. Attorney A provides advice to Client C concerning the proper treatment of an item on C's income tax return. In preparation for providing that advice, A discusses the matter with Attorney B, who is associated with the same firm as A. B recommends that A advise C to take an undisclosed position. Although A is the attorney with overall supervisory responsibility for providing the advice, A in good faith follows B's recommendation. Neither attorney A nor any other attorney associated with A's firm signs C's return as a preparer. It is later determined that the position that A advised C to adopt without disclosure does not satisfy the realistic possibility standard. Treas. Reg. § 1.6694-1(b)(3).


Attorney A is a nonsigning preparer if the entry(ies) with respect to which A provided advice constituted a "substantial portion" of the return.

(b) Is Attorney B an income tax return preparer? Treas. Reg. § 1.6694-1(b)(1).

Attorney B is not a preparer because only one adviser per firm is a preparer and that is A because A had overall supervisory responsibility.

(c) Does either attorney's conduct constitute "practice before the Internal Revenue Service"? Circular 230 §§ 10.2(a) & 10.7.

Apparently both A and B are engaged in practice before the Service by virtue of their involvement in the preparation of documents to be submitted to the I.R.S. The definition of practice before the Service is very broad and does not include a de minimis exception, but normally no sanction would be imposed for a single breach of diligence.

(d) If Attorney A is considered a preparer, could A avoid penalty under the reasonable cause and good faith exception on account of A's reliance on the advice of B? Treas. Reg. § 1.6694-2(d)(5).

No, because to be excused for reliance on another preparer, A must rely on a "preparer" as defined under the regulations, and B is not because A and B are with the same firm.
2. Attorney A provides advice to the accountant of corporate Client C in connection with the preparation of the corporation's financial statements. The accountant is attempting to determine if the reserve for taxes is reasonable and asks for A's opinion on the tax consequences of a transaction which the corporation has consummated. Treas. Reg. § 301.7701-15(a)(2)(ii).


A is not a preparer because A did not provide advice "directly relevant" to an entry on a return or claim for refund since the accountant was not at the time acting as a preparer of the corporation's tax returns.

(b) Does Attorney A's conduct constitute "practice before the Internal Revenue Service"? Circular 230 §§ 10.2(a) & 10.7.

No, because the document with respect to which A provided advice was not prepared for presentation to the I.R.S. nor for the purposes of marketing a tax shelter.

3. A statute is silent as to whether a taxpayer may take a certain position on the taxpayer's 1991 Federal income tax return. Three private letter rulings issued to other taxpayers in 1987 and 1988 support the taxpayer's position. However, proposed regulations issued in 1990 are clearly contrary to the taxpayer's position.

Does the position satisfy the realistic possibility of success standard? Treas. Reg. § 1.6694-2(b)(3), Ex. 5.

Only "authority" as defined under section 6662 may be considered. After issuance of proposed regulations, inconsistent private rulings are no longer authority because, according to the preamble to the final preparer regulations, "proposed regulations are subject to a higher level of review than private rulings and it is not appropriate to retain as an authority a document that does not accurately reflect the current status of the law and position of the Service." Therefore, the rulings are not taken into account in determining whether the position satisfies the realistic possibility standard.

The explanation of Regulation section 1.6694-2(b)(3), Example 5 states that the position may or may not satisfy the realistic possibility standard, depending on an analysis of all the relevant authorities. It is unclear whether this statement contemplates the existence of
authorities other than those specifically mentioned in the example or is intended to imply that a position may be supported by a realistic possibility of success without any supporting "authority" if the only contrary authority is a proposed regulation. The latter conclusion seems inconsistent with the requirement that only "authority" under section 6662 may be considered in determining the existence of a realistic possibility. It would seem that if there is only one authority, and that is contrary to the position, the position could not be supported by a realistic possibility of success.

However, Regulation section 1.6662-4(d)(3)(ii) (made applicable to the determination of a realistic possibility of success on the merits by Regulation section 1.6694-2(b)(1)) states that there may be substantial authority for a position despite the absence of "certain types of authority," and so "a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision." The regulations nowhere explain which "certain types of authority" were meant, but this example suggests that a well-reasoned construction of the statute may establish a realistic possibility of success absent contrary authority more weighty than proposed regulations (and private rulings, which carry even less weight). It may be that a proposed regulation, which counts as "authority" but not as a "rule or regulation," is of such little weight that a well-reasoned construction of a statute is sufficient counterweight to establish a one-in-three likelihood of success.

4. Your client manufactures widgets. A new Code provision provides that "No deduction shall be allowed to any manufacturer" for certain expenses, deduction of which was allowed under prior law. You believe that the new statute is inequitable as applied to your client's situation. There are no regulations and there is no other authority under the new statute except the statutory language and committee reports.

(a) If the committee reports do not specifically address your client's situation, does a policy argument favoring an exception to the statute for widget manufacturers satisfy the realistic possibility standard? Treas. Reg. §§ 1.6694-2(b)(3), Ex. 2; 1.6694-2(b)(5)(i) & (ii).

A position contrary to the statute does not satisfy the realistic possibility standard. A well-reasoned construction of the statute does not constitute a realistic possibility in the face of "unambiguous" statutory language. Further, "realistic possibility" must be determined as of the date the return was signed or the advice was given (depending
on whether the adviser is a signing or nonsigning preparer), so the provisions of prior law are irrelevant.

(b) If the committee reports indicate that the statute was not intended to apply to widget manufacturers, and there is thus a conflict between the "unambiguous" general language of the statute (which adversely affects your client's transaction) and a specific statement in the committee reports that transactions such as your client's are not adversely affected, does a position consistent with the committee reports satisfy the standards established by section 6694? Treas. Reg. § 1.6694-2(b)(3), Ex. 3.

The explanation of Regulation section 1.6694-2(b)(3), Example 3 states that the position has a realistic possibility of being sustained on its merits, presumably because the committee report constitutes "authority" (as defined in the accuracy-related penalty regulations) on which a court might rely in interpreting the statute not to apply to the client. However, the position disregards "a rule or regulation" and so must be disclosed.

5. In the course of researching whether an interpretation of a statutory phrase has a realistic possibility of being sustained on its merits, you discover that identical language under another section of the Internal Revenue Code has consistently been interpreted by the courts and the Service in a manner that would be favorable to your client. No authority has interpreted the phrase applicable to the client's situation.

Does an interpretation of the applicable statutory language consistent with the authorities under the identical language satisfy the realistic possibility of success standard? Treas. Reg. § 1.6694-2(b)(3), Exs. 7 & 8.

The explanations of Regulation section 1.6694-2(b)(3), Examples 7 and 8 state that constructions given other provisions of the Code (or other federal or state law) are not "authority" for purposes of determining whether the interpretation of the applicable language (a separate provision) has a realistic possibility of success. However, as in the case of conclusions reached in treatises and legal periodicals, the authorities underlying the judicial decisions and I.R.S. rulings may be relevant to the taxpayer's situation. Further, the interpretations themselves are relevant in arriving at a well-reasoned construction of the language at issue, but the context in which the language arises also must be taken into account in determining whether the realistic possibility standard is satisfied.
6. Final regulations provide that certain expenses incurred in the purchase of a business must be capitalized. One Tax Court case has expressly invalidated that portion of the regulations.

May you advise your client to deduct expenses currently, in violation of the regulation? Treas. Reg. § 1.6694-3(d), Ex. 4.

The explanation of Regulation section 1.6694-3(d), Example 4 states that a position contrary to the final regulations will subject the preparer to the section 6694(b) penalty for intentional disregard of rules and regulations if the position is not adequately disclosed even though it "may" have a realistic possibility of being sustained on its merits. The position may be reported if adequately disclosed, however, because on these facts it represents a good faith challenge to the validity of the regulations.

7. A revenue ruling holds that certain expenses incurred in the purchase of a business must be capitalized. The Code is silent as to whether these expenses must be capitalized or may be deducted currently.

(a) If several cases from different courts hold that these particular expenses may be deducted currently, and there is no other authority, is reporting without disclosure a position contrary to the ruling reckless or intentional disregard of a rule or regulation? Treas. Reg. § 1.6694-3(d), Ex. 3.

No, because a position contrary to a revenue ruling may be reported without disclosure if it has a realistic possibility of being sustained on its merits. The preamble explains that the example in the final regulations refers to "several" rather than to "five" courts used in the proposed regulations in response to comments that the proposed regulations "created a negative inference that a position supported by fewer than five courts would not satisfy the [realistic possibility] standard" when "[n]o such inference was intended."

(b) If the revenue ruling is the only "authority" on the issue, is reporting without disclosure a position contrary to the ruling reckless or intentional disregard of a rule or regulation? Cf. Treas. Reg. § 1.6694-3(d), Exs. 3 & 4.

A revenue ruling may be disregarded if the reported position meets the "realistic possibility" standard. However, a realistic possibility of success probably cannot be established in the absence of contrary authority. More likely, a revenue ruling is authority that is too weighty for the realistic possibility standard to be satisfied if a contrary position is supported simply by a well-reasoned construction of the
statute and no authority. The explanation in Regulation section 1.6694-3(d), Example 3 (discussed in Example 7(a), above) that "several," although fewer than five, court decisions establish a realistic possibility of success when weighed against a contrary revenue ruling may imply that at least some authority must support a position contrary to a revenue ruling to satisfy the realistic possibility of success standard. A single contrary authority may be sufficient, however. Regulation section 1.6694-3(d), Example 4 (discussed in Example 6, above) states that a position contrary to a regulation that was invalidated by only one Tax Court case "may" have a realistic possibility of being sustained on its merits.

8. A client wishes to take a position that a lawyer has determined has a reasonable basis but is not supported by substantial authority. However, the amount of tax involved is less than $5,000, so the substantial understatement penalty is inapplicable. The lawyer has serious doubts that there is a realistic possibility of success on the merits, taking into account only those authorities permitted by the regulations, although arguments in the legal literature lead the lawyer to conclude that there is a "realistic possibility of success" under Opinion 85-352. See Lawrence Zelenek, Reforming Penalty Reform: Congress Should Eliminate the Profusion of Accuracy Standards, 52 Tax Notes 471, 474 (July 22, 1991); William Raby, Salting the Voluntary Assessment System, 54 Tax Notes 187 (Jan. 13, 1992).

What should the lawyer advise the client? See Letter from Gwen T. Handelman to Editor, 56 Tax Notes 113 (July 6, 1992).

A reasonable basis is not adequate support for an undisclosed position under section 6694, so there may be a conflict between the practitioner's interest in advising disclosure to avoid the preparer penalty and the taxpayer's interest in not disclosing a position that is not required to be disclosed to avoid the accuracy-related penalties. The Virginia Code of Professional Responsibility, DR 5-101(A), provides that except with the client's consent "after full disclosure," a lawyer must not "accept employment" if the lawyer's professional judgment on behalf of the client will be or reasonably may be affected by the lawyer's financial, business, property, or personal interests." It appears, then, that the lawyer must withdraw from representation unless the client consents to the lawyer continuing the engagement notwithstanding the conflict.

It may be, however, that the circumstances of this example do not present a conflict, either because the lawyer is not subject to penalty for advising the position be taken without disclosure or because the client is subject to penalty for reporting the position without disclosure.
Either may be the case. For example, it is possible that the lawyer is not a "preparer" with respect to the return, particularly if the only advice given is in connection with this one item, because the adviser may not be considered the preparer of a "substantial portion." Additionally, the preparer may be excused from penalty under the "reasonable cause and good faith" exception if the adviser retains tax counsel, perhaps the author of an article as to the merits of the position, and relies on the advice of the other preparer that the position meets the statutory realistic possibility standard.

On the other hand, although not liable for the substantial understatement penalty under section 6662(b)(2), the taxpayer may be liable for penalty under section 6662(b)(1) for reporting the position without disclosure. First, the taxpayer may be subject to the penalty for disregard of a rule or regulation if the position is contrary to a regulation, revenue ruling or notice. A position contrary to a revenue ruling or notice must be disclosed if the position fails to satisfy the realistic possibility standard, and a position contrary to a regulation must be disclosed even if supported by a realistic possibility of success. Thus, the taxpayer and the adviser would be subject to the same standard, and there would be no conflict.

As a practical matter, if there is no contrary rule or regulation, it is quite unlikely that a position a lawyer concludes has a reasonable basis would not have a realistic possibility of success. As discussed in Example 3(a), above, if the authority contrary to a position is less weighty than rules or regulations, a realistic possibility of success probably may be established by a well-reasoned construction of the statute resembling a position supported by a reasonable basis. The preamble to the accuracy-related penalty regulations states that "reasonable basis" is higher than the litigating (non-frivolous) standard. T.D. 8381 Preamble. The substantial authority regulations describe the reasonable basis standard as met by a "position that is arguable, but fairly unlikely to prevail in court." Treas. Reg. § 1.6662-4(d)(2). While this may represent litigation odds somewhat longer than the one-in-three formulation of the realistic possibility standard, the distinction is certainly difficult to articulate.

If there were such a position, not contrary to rules and regulations, that a lawyer concluded was supported by a reasonable basis but not by a realistic possibility of success, it is far from clear that the taxpayer so advised would be relieved of liability for penalty either under the negligence standard or the reasonable cause and good faith exception of section 6664. The section 6662 regulations do not establish
that an adviser's opinion that a return position is supported by a reasonable basis is sufficient to protect a client from the negligence penalty. A position without a reasonable basis is regarded as attributable to negligence. Treas. Reg. § 1.6662-3(b)(1). However, the regulations do not necessarily imply the converse (i.e., that a position with a reasonable basis is not negligent).

The negligence penalty defined in the final regulations is imposed upon conduct, not positions. Penalty provisions "historically have muddled the distinctions between the standard of accuracy and the duty of care." Judson Temple, The Tax Return and the Standard of Accuracy—Part I, 15 Rev. Tax’n of Individuals 315, 321 & n.24 (1991). Although negligence represents "a failure to exercise a duty of care," in excusing "reasonable basis" positions, "a standard of accuracy was superimposed" on the former negligence standard. Id. The final regulations under section 6662 return to a standard of care, defining taxpayer negligence as the "failure to make a reasonable attempt to comply with the provisions of the internal revenue laws." Similarly, taxpayers may be excused for reasonable cause, and "the extent of the taxpayer's effort to assess the taxpayer's proper tax liability" is the touchstone. Treas. Reg. § 1.6664-4(b). "Circumstances that may indicate reasonable cause and good faith include honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer." Id. The advice of counsel elevates the knowledge of the taxpayer. Thus, "reasonable care" in these circumstances may effectively elevate the taxpayer standard of accuracy to "realistic possibility of success," which the final regulations describe less as a type of position and more in terms of a prescribed course of careful conduct in deciding tax issues (that is, identifying the appropriate sources and "nature of analysis").

Elevation of the expectations of accuracy may be the tradeoff for the greater familiarity with opportunities for tax savings that comes with professional tax advice and the protection from liability for penalties afforded by reasonable reliance on an adviser. Further, it is not necessarily the case that "an unaided taxpayer may freely take a position which a preparer would refuse to take because of the risk of penalty" and that a taxpayer so advised would be penalized for taking in view of the taxpayer's enhanced knowledge. Zelenek, supra, at 474. It has been suggested that the taxpayer's "duty of care may mandate, in some cases, that professional advice be obtained." Then, the reasonableness of the conduct of a taxpayer with issues demanding professional expertise would be considered in light of the expert advice that should have been solicited. See Judson Temple, The Tax Return
and the Standard of Accuracy--Part II, 16 Rev. Tax'n of Individuals 64, 75 (1992). Whether or not such taxpayers actually obtain the benefit of a practitioner's advice, they may be required to meet the professional standard of competence--realistic possibility--with respect to undisclosed positions or be liable for "failure to make a reasonable attempt to comply with the internal revenue laws." Treas. Reg. 1.6662-3(b)(1).

Because exposure to penalty depends not only on the status of authority, but also on the existence of reasonable cause and good faith which reliance on a tax adviser can supply, it has been argued that the adviser yields exculpatory power with "corrosive" effects on the relationship between the taxpayer and the adviser. "The taxpayer can now be expected to ask whether he or she can be viewed as having acted on the basis of reasonable cause and good faith" and "to pressure the practitioner for a favorable determination on this subjective issue," i.e., "the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." The taxpayer will "seek the practitioner's opinion as a key dispensational element needed to establish reasonable cause and good faith." James Holden, Practitioners' Standard of Practice and the Taxpayer's Reporting Position, 20 Cap. U.L. Rev. 327, 340-41 (1991).

But, even reliance on an adviser's opinion as to the substantive tax issues does not necessarily demonstrate reasonable cause and good faith. Treas. Reg. § 1.6664-4(b)(1) & (2). Certainly reliance on the adviser's views as to the existence of reasonable cause and good faith will not establish them.

Whether a client has acted with reasonable cause in good faith depends on all the facts and circumstances. Treas. Reg. § 1.6694-4(b)(1). A lawyer may not ethically either misrepresent those facts for presentation to third parties nor influence the facts and circumstances by making affirmative misrepresentations to or withholding information from the client. Virginia Disciplinary Rules provide that in representing a client a lawyer must not knowingly make a "false statement of law or fact." Virginia Code of Professional Responsibility DR 7-102(A)(5).

Finally, that it is difficult to tell a client something unpleasant does not establish a conflict of interest, and the tension it may create is not "corrosive" of an appropriate attorney-client relationship. Indeed, the ABA Model Rules mandate that a lawyer acting in an advisory capacity must "exercise independent professional judgment and render candid advice." Model Rules of Professional Conduct Rule 2.1 (1983). The Comment states:
A client is entitled to straightforward advice expressing the lawyer's honest assessment. Legal advice often involves unpleasant facts and alternatives that a client may be disinclined to confront. In presenting advice, a lawyer endeavors to sustain the client's morale and may put advice in as acceptable a form as honesty permits. However, a lawyer should not be deterred from giving candid advice by the prospect that the advice will be unpalatable to the client.

Although Virginia has no analog to Rule 2.1, failure to apprise a client of unpleasant facts and alternatives may constitute an ethical breach because the issue may reduce to one of competence as well as truthfulness.

9. A client states that she paid $6,500 in medical bills and $5,000 in deductible travel and entertainment expenses during the tax year. The lawyer, who has no reason to believe that the expense information is incorrect or incomplete, does not ask for underlying documentation or inquire about the existence of expense records. The lawyer properly calculates deductions for medical and travel and entertainment expenses based on the client's representations, but in fact the client had paid smaller amounts, and an understatement of tax liability results.

Is the lawyer subject to penalty under section 6694? See Treas. Reg. § 1.6694-1(e)(2) (example).

The example in Regulation section 1.6694-1(e)(2) states that the preparer was not liable under section 6694 in circumstances where the preparer did not ask for underlying documentation of the medical expenses but did inquire about the existence of travel and entertainment expense records. The implication is that the lawyer in our example is not subject to penalty with respect to the medical expenses but is liable for the understatement attributable to travel and entertainment expense deductions. Because section 274 requires substantiating documents as a condition to deduction of travel and entertainment expenses, a lawyer is obligated to make appropriate inquiries to determine the existence of substantiation.

10. Attorney A prepared for a computer software partnership a tax opinion letter which was not intended for investor distribution. The letter was specifically limited in scope to the tax aspects of the partnership and disclaimed any attempt to deal with the individual tax consequences to partners. The letter also stated that "the determination of fair market value is essentially a factual
issue and we are not competent to express an opinion as to the ultimate
determination of the fair market value of the software masters." In spite of
the disclaimer, the letter was circulated to investors. The partnership
subsequently was found to be an abusive tax shelter due to the overvaluation
of the software.

Is Attorney A liable for penalty under Code section 6701? Gard v. U.S.,
69 AFTR2d (P-H) 891 (N.D. Ga. Feb. 26, 1992); Raby, Section 6701 Aiding-and
Abetting Cases: What Does the Service Have to Prove?, 55 Tax Notes 367
(April 20, 1992).

Gard held that the attorney was not liable because he did not
"know" that the valuation of the software would result in an
understatement, and there was no evidence of "willful blindness": "The
only reasonable inference that can be drawn from plaintiff's conduct is
that plaintiff should have taken additional steps to investigate the value
of the software. That reasonable inference stands in vivid contrast to
an inference that plaintiff performed no investigation because he knew
that such investigation would reveal an overvaluation."