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# What Part of RPOS Don't You Understand? An Update and Survey of Standards for Tax Return Positions

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## I. Introduction

Over the past decade and a half, the tax shelter industry and other phenomena have forced tax practitioners to focus more closely than ever on the standards that govern advising and preparing tax return positions.<sup>1</sup>

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1. See, e.g., Steven C. Salch, *Tax Practice Ethics: Practitioner Discipline and Sanctions* (Part 2), ALI-ABA COURSE MATERIALS J., Feb. 1992, at 79; see also Michael C. Durst, *The Tax Lawyer's Professional Responsibility*, 39 FLA. L. REV 1027 (1987); Kenneth L. Harris, *Resolving Questionable Positions on a Client's Federal Tax Return: An Analysis of the Revised Section 6694(a) Standard*, 47 TAX NOTES 971, 972 (1990); Robert H. Mundheim, Remarks of the General Counsel of the Treasury Department Before the Securities Regulation Institute (Jan. 18, 1980), in HOW TO PREPARE & DEFEND TAX SHELTER OPINIONS 71 (Law and Business, Inc. ed., 1981); James R. Rowen, *When May a Lawyer Advise a Client That He May Take a Position on His Tax Return?*, 29 TAX LAW. 237 (1976).

This Article will not consider the problems raised by transfer pricing regulations under § 482 of the I.R.C. and the related penalties under § 6662(e). Transfer pricing refers to the price one division of a company charges another for products transferred between the divisions. RALPH L. BENKE, JR. & JAMES D. EDWARDS, *TRANSFER PRICING: TECHNIQUES AND USES* 1 (1980). Transfer pricing presents problems when one division of a company

Professional organizations, Congress, and the Treasury have all tried their hands at formulating standards for advising and preparing tax return positions. These efforts have resulted in some progress in formulating workable standards governing tax return advice and preparation. A concomitant result, however, has been a proliferation of slightly differing standards governing taxpayers and preparers (including advisors), as well as puzzlement among practitioners as to the precise meaning and application of the various standards. Bewildered practitioners have gained little if any enlightenment from two recent developments: (1) the recently finalized amendments to Circular 230,<sup>2</sup> and (2) the Omnibus Budget Reconciliation Act of 1993's (1993 Act) elevated standard for insulating a tax return position against the accuracy-related penalty by special disclosure on the return.<sup>3</sup> The amendments to Circular 230 adopt a "realistic possibility of success" (RPOS) standard for tax return preparation and advice and attempt to quantify the standard as a one-in-three chance of being sustained on the merits.<sup>4</sup> The 1993 Act raises the standard for the minimum position on a tax return that can be insulated against the taxpayer penalties for substantial understatement and disregard of rules and regulations by changing the

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is in country A and another division is in country B. By manipulating the price of the product, the company can lower its overall tax burden by allocating its income to the country with the more favorable tax laws. Under § 482 of the I.R.C., the IRS can allocate income between two businesses that are owned or controlled by the same entity I.R.C. § 482 (1988). The fair market price of a product, however, may be difficult to determine. Further, the substantial misstatement valuation of this income is penalized under § 6662(e). I.R.C. § 6662(e) (Supp. V 1993). The Omnibus Budget Reconciliation Act of 1993 amended § 6662(e) to require taxpayers to prepare, maintain, and provide documentation to substantiate intercompany transfers to avoid penalties for substantial or gross valuation of transactions. In response, the IRS, on February 2, 1994, dropped the proposed regulations published on January 21, 1993, and adopted Treasury Decision 8519. 59 Fed. Reg. 4791 (1994). These regulations provide a two-part exception from the imposition of the accuracy-related penalty with respect to transfer pricing adjustments, depending upon whether the taxpayer used a specified or unspecified method under § 482. 59 Fed. Reg. 4791 (1994). The Treasury issued final regulations governing transfer pricing under I.R.C. § 482 on July 8, 1994. 59 Fed. Reg. 34,971 (1994). It also issued temporary and proposed regulations on the accuracy-related penalty to conform the previously issued proposed and temporary regulations with the new final § 482 regulations. 59 Fed. Reg. 35,030 (1994).

2. T.D. 8545, Final Regulations Governing Practice of Individuals Before IRS, 59 Fed. Reg. 31,523 (1994) (to be codified at 31 C.F.R. subtit. A § 10 [hereinafter Circular 230]) (issued June 20, 1994) [hereinafter Amendments to Circular 230].

3. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13251, 107 Stat. 312, 531 [hereinafter OBRA of 1993].

4. See Circular 230, *supra* note 2, § 10.34(a); *infra* text accompanying notes 19-21.

standard for adequate disclosure of the position from "not frivolous" to "reasonable basis."<sup>5</sup> By contrast, the income tax preparer penalty retains a "not frivolous" disclosure standard,<sup>6</sup> thereby creating one disclosure standard for the taxpayer penalty and another for the preparer penalty

The American Bar Association (ABA) and American Institute of Certified Public Accountants (AICPA) have moved to conform their requirements to the RPOS standard<sup>7</sup> over the past several years, while the preparer penalty and Circular 230 have moved in a generally similar direction. Nevertheless, the various RPOS standards vary slightly from one another, and alternate standards, such as substantial authority and reasonable basis, may also apply in many circumstances.<sup>8</sup> Moreover, many practitioners believe that significant imperfections remain in the existing standards, not the least of which is the difficulty of applying them in practice.<sup>9</sup> For example, in fall of 1993, the authors surveyed members of

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5. OBRA of 1993, § 13251.

6. See I.R.C. § 6694(a)(3) (Supp. V 1993).

7 See American Bar Association Comm. on Ethics and Professional Responsibility (1986), *Formal Op. 85-352* (1986) [hereinafter ABA Opinion 85-352], reprinted in BERNARD WOLFMAN ET AL., *STANDARDS OF TAX PRACTICE II*, 14 Tax Transactions Libr. (CCH) ¶ 2003, at 3566 (1992) [hereinafter *STANDARDS OF TAX PRACTICE II*]. The ABA states:

A lawyer may advise reporting a position on a tax return so long as the lawyer believes in good faith that the position is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law and there is some realistic possibility of success if the matter is litigated.

*Id.* The AICPA provides:

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

American Institute of Certified Public Accountants, *Statement on Responsibilities in Tax Practice*, (1988 Rev.) No. 1, reprinted in *STANDARDS OF TAX PRACTICE II*, *supra*, ¶ 2006, at 3659.

8. See Appendix A for a table listing the myriad tax return standards that may apply to a given tax return position.

9. See, e.g., Letter from David R. Brennan, Faegre & Benson, Minneapolis, Minnesota, to the Internal Revenue Service (Nov 19, 1992), available in LEXIS, Fedtax Library, TNT File, 92 TNT 244-34 [hereinafter references to the TNT File will be cited by TNT citation only]; John A. Corry, Chairman of the Tax Section of the New York State Bar Association, *NYSBA Takes Issue With Proposed Rules on Contingency Fees*, Jan. 11, 1993, available in LEXIS, 93 TNT 19-30; Letter from Harvey L. Coustan, Chairman, Tax

the Tax Section of the Virginia Bar Association concerning their attitudes and opinions on the current state of the rules governing tax return standards. In response to one question, eighty-two percent of the respondents disagreed with the proposition that the rules are "consistent, clearly defined, and reasonably easy to apply"<sup>10</sup> This Article reviews the amendments to Circular 230 and the new reasonable basis disclosure rule and reports the above survey of tax practitioners.

## II. Circular 230

Circular 230 is the governing document that provides rules and standards for eligibility to practice before the Internal Revenue Service (IRS).<sup>11</sup> Practice before the IRS "comprehends all matters connected with a presentation" to the IRS on behalf of a client and includes "preparing necessary documents, corresponding and communicating with the Internal Revenue Service, and representing a client at conferences, hearings, and meetings."<sup>12</sup> The IRS Director of Practice can disbar a practitioner from practice before the IRS for violation of Circular 230's rules and standards.<sup>13</sup> Moreover, other practitioners are prohibited from practicing in association with a disbarred practitioner.<sup>14</sup> Hence, violation of Circular 230's rules and standards can result in the loss of a tax practitioner's livelihood.

Originally, Circular 230 held tax practitioners only to a vague standard of "due diligence" with respect to their dealings with the IRS.<sup>15</sup> Then, in

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Executive Committee of the AICPA, to The Honorable Shirley D. Peterson, Commissioner of Internal Revenue (Nov 18, 1992), *available in* LEXIS, 92 TNT 236-13; Michael C. Durst, *Circular 230 Amendments Incorporate Different Return Standards For Preparers and Taxpayers, Attorney Says*, Nov. 18, 1992, *available in* LEXIS, 92 TNT 231-25; Letter from Gary L. Green, Jr. et al., National Society of Public Accountants, to the Internal Revenue Service (Nov. 18, 1992), *available in* LEXIS, 92 TNT 235-67; Letter from Patricia Lewis et al., Tax Section of the District of Columbia Bar Association, to The Honorable Shirley D. Peterson, Commissioner of Internal Revenue (Dec. 22, 1992), *available in* LEXIS, 92 TNT 259-21; Letter from Lawrence F. Portnoy, Price Waterhouse, New York, New York, to the Internal Revenue Service (Nov 11, 1992), *available in* LEXIS, 92 TNT 235-66; William L. Raby, *Raby Finds Gaps in New Preparer Responsibility Regs.*, Oct. 15, 1992, *available in* LEXIS, 92 TNT 208-178; Letter from Steven C. Salch to the Internal Revenue Service (Nov 12, 1992), *available in* LEXIS, 92 TNT 235-68.

10. See Practitioner Survey, App. B, Responses to Question 11.
11. See Circular 230, *supra* note 2, § 10.0.
12. *Id.* § 10.2(e).
13. *Id.* § 10.50.
14. *Id.* §§ 10.24, 10.51(h).
15. James P. Holden, *Practitioners' Standard of Practice and the Taxpayer's Reporting*

1986, in response to concerns with overly aggressive positions being taken on tax returns, the Treasury proposed to tighten the standard with respect to tax return positions. The 1986 proposal would have prohibited practitioners from advising tax return positions that would subject the taxpayer to the substantial understatement penalty under former I.R.C. § 6661.<sup>16</sup> This proposal met vehement opposition from tax practitioners, including the ABA and AICPA, who joined together in suggesting that the RPOS standard be substituted for the substantial authority standard.<sup>17</sup> Practitioners based their objections on: (1) the nature of the old substantial understatement penalty as essentially a no-fault penalty; and (2) the limited nature of authorities on which a taxpayer could rely under the old law. In the face of this opposition, Treasury did nothing further with the proposal for several years. Then, in October 1992, Treasury proposed the amendments to Circular 230 that it recently adopted.<sup>18</sup>

As amended, Circular 230 basically adopts the I.R.C. § 6694 RPOS standard,<sup>19</sup> which in turn is a more stringent version of the RPOS standard set out in ABA Opinion 85-352. In order for a practitioner to advise a position on a tax return, the practitioner must first determine "that there is a realistic possibility of the position being sustained on its merits."<sup>20</sup> Circular 230 defines a realistic possibility of success as being present "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."<sup>21</sup>

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*Position*, 20 CAP. U. L. REV 327, 335 (1991) (citing Circular 230, § 10.22).

16. 51 Fed. Reg. 29,113 (1986) (proposed to be codified at 31 C.F.R. subtit. A § 10) (proposed Aug. 14, 1986). For a summary of these proposals, see *IRS Regulations*, 32 TAX NOTES 639 (1986). The substantial understatement penalty under old I.R.C. § 6661 has been recodified at I.R.C. § 6662(d).

17. See, e.g., Holden, *supra* note 15, at 337; Letter from John B. Jones, Jr., Chair, ABA Section of Taxation, to Leslie S. Shapiro, Director of Practice, Internal Revenue Service (Feb. 12, 1987), reprinted in Paul J. Sax, *Ethics in Tax Practice: Current Issues*, 38 TUL. TAX INST. ch. 18, at 57 (1988); Letter from Leonard Podolin, Chairman, AICPA Responsibilities in Tax Practice Subcommittee, to Leslie S. Shapiro, Director of Practice, Internal Revenue Service (Feb. 13, 1987), reprinted in Sax, *supra*, at 79, 82.

18. See Proposed Amendments to Circular 230, 57 Fed. Reg. 46,356 (1992); Amendments to Circular 230, *supra* note 2.

19. See I.R.C. § 6694(a)(1) (Supp. V 1993); Treas. Reg. § 1.6694-2(b) (1993).

20. Circular 230, *supra* note 2, § 10.34(a)(1)(i).

21. *Id.* § 10.34(a)(4)(i). The possibility that a position will not be challenged because of the audit lottery odds cannot be considered in making this determination. *Id.*

In addition, Circular 230 restricts the authorities on which a practitioner may rely in determining if there is a realistic possibility of success to those available for determining if there is substantial authority under the substantial understatement penalty rules.<sup>22</sup>

If the practitioner cannot determine that the position satisfies the relevant tax return standards, he<sup>23</sup> must advise the client of possible penalties likely to apply and of the opportunity to avoid any penalty by making adequate disclosure of the position.<sup>24</sup> A practitioner may not sign a return containing a position that fails to meet the RPOS standard unless the position is "not frivolous" and the taxpayer makes adequate disclosure to the IRS.<sup>25</sup> Circular 230 provides some leniency for inadvertent deviations from the standard by providing that "only violations [of the RPOS and disclosure standards] that are willful, reckless, or a result of gross incompetence will subject a practitioner to suspension or disbarment from practice before the Service."<sup>26</sup> Hence, advising an undisclosed position that fails to meet the RPOS standard and thereby incurs the § 6694 preparer penalty, will not necessarily result in Circular 230 sanctions, even though the Circular 230 RPOS standard is virtually (but not precisely) identical to the § 6694 RPOS standard.<sup>27</sup>

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22. *Id.*

23. This Article uses the pronouns he, him, and his in the traditional generic sense to indicate both the masculine and feminine gender when the antecedent's gender is indeterminate. *See* 1 U.S.C. § 1 (1988).

24. Circular 230, *supra* note 2, § 10.34(a)(2).

25. *Id.* § 10.34(a)(1). A return position is frivolous if it is "patently improper." *Id.* § 10.34(a)(4)(ii).

26. *Id.* § 10.34(b), § 10.52.

27 Both Circular 230 and the regulations under § 6694 define RPOS as "approximately a one in three, or greater, likelihood of being sustained on its merits." *Id.* § 10.34(a)(4)(i); Treas. Reg. § 1.6694-2(b)(1) (1991). Both also restrict the authorities that may be considered to those set out in § 1.6662-4(d)(3)(iii) of the substantial understatement penalty regulations. *See* Treas. Reg. § 1.6662-4(d)(3)(iii) (1991). However, the § 6694 regulations state that:

The analysis prescribed by § 1.6662-4(d)(3)(ii) for purposes of determining whether substantial authority is present applies for purposes of determining whether the realistic possibility standard is satisfied.

Treas. Reg. § 1.6694-2(b)(1) (1991). By contrast, Circular 230 does not contain this sentence, but states only that the "authorities listed in § 1.6662-4(d)(3)(iii), or any successor provision, of the substantial understatement penalty regulations may be taken into account for purposes of the [RPOS] analysis." Circular 230, *supra* note 2, § 10.34(a)(4)(i). Hence, Circular 230, unlike the preparer penalty regulations, is silent on the extent to which it

### A. Restriction on Authorities

In formulating the Circular 230 RPOS standard, the Treasury moved toward conforming its own standard to those of the ABA and AICPA.<sup>28</sup> Nevertheless, significant differences remain among those standards. The most vital difference is Circular 230's limitation of authorities on which the practitioner may rely to those listed under the substantial understatement penalty regulations. Circular 230, unlike the ABA and AICPA standards, limits the authorities on which the practitioner may rely for purposes of determining whether a return position meets the RPOS standard to the "authorities described in section 1.6662-4(d)(3)(iii) of the substantial understatement penalty regulations."<sup>29</sup>

Unlike the regulations under the preparer penalty, Circular 230 does not expressly incorporate the mode of "analysis prescribed" by the substantial understatement regulations.<sup>30</sup> The significance of this difference is not clear. What is clear is that the authorities upon which a practitioner

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incorporates the analysis prescribed by the substantial understatement penalty regulations.

28. See 57 Fed. Reg. 46,356 (1992).

29. Circular 230, *supra* note 2, § 10.34(a)(4)(i). A practitioner may use the following types of authority in determining if there is substantial authority:

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. Actions on Decisions and General Counsel Memoranda issued after March 12, 1981,
10. [GCMs] published in pre-1955 volumes of the Cumulative Bulletin;
11. IRS information or press releases; and
12. Notices, announcements, and other administrative pronouncements published by the Service in the Internal Revenue Bulletin.

Treas. Reg. § 1.6662-4(d)(3)(iii) (1991). By contrast, the ABA and AICPA standards do not so limit the authorities upon which a practitioner can rely. See *infra* notes 45-46.

30. See *supra* note 27



may depend for purposes of Circular 230 RPOS are the same as the authorities upon which one may rely to determine if there is substantial authority for a tax return position. Consequently, although the Treasury claimed to be moving toward the ABA and AICPA tax return standards in its Circular 230 amendments,<sup>31</sup> in actual practice, the Circular 230 RPOS standard may be closer to the substantial authority standard than to either the ABA or AICPA RPOS standards.

The permissible authorities upon which one may rely under either Circular 230 or the substantial understatement penalty standards are the same. Both standards are below "more likely than not" (fifty percent chance of success) and the Circular 230 RPOS standard must be around thirty-three percent or more.<sup>32</sup> If the same authorities restrict both standards, if both standards are below "more likely than not" (fifty percent chance of success), and if Circular 230 RPOS must be approximately thirty-three percent or more, it is very hard to discern any significant distinction between the two. Thus, a tax return position supported by permissible authorities sufficient to satisfy the Circular 230 RPOS standard will almost always satisfy the substantial authority standard as well. It will be a rare case indeed when a position satisfies Circular 230 RPOS, but does not have sufficient support to meet the substantial authority standard. It will be an even rarer mortal mind that can recognize that subtle difference if it does arise. In practice, the two standards are very likely to meld together.

This would not necessarily be an undesirable result, provided appropriate modifications were made to the list of permissible authorities. A uniform standard for tax return positions is preferable to the profusion of standards that exist currently. In the practitioner survey, approximately sixty percent of the respondents favored a single uniform standard and about seventy-two percent found acceptable a standard similar to the ABA RPOS standard.<sup>33</sup> However, the limitation of authorities under both the Circular 230 and substantial understatement penalty needs to be changed. Currently, conclusions reached in legal treatises and periodicals are not permissible authority for purposes of Circular 230, the substantial understatement penalty, or the preparer penalty. This places a substantial restriction on practitioners who, of necessity, often have to rely on these

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31. See Amendments to Circular 230, *supra* note 2.

32. See Circular 230, *supra* note 2, § 10.34(4)(i) (realistic possibility of success defined as "approximately a one in three, or greater, likelihood of being sustained" on merits).

33. See Practitioner Survey, App. B, responses to questions 7, 8.

sources when other authority is not available, or when there are not sufficient time and resources to research a matter in great depth.

The reality is that practitioners regularly use these sources. Taxpayers and the IRS cite them in audit and at the appellate office level. Everyday tax return preparers and even more sophisticated advisors are forced to rely on them.<sup>34</sup> Given the amount and complexity of new legislation over the past several years, there often is simply no authority interpreting a given Code provision.<sup>35</sup> The practitioner has no choice but to depend on his own analysis of the provision and that of learned colleagues published in the professional literature.<sup>36</sup>

Obviously, some secondary authorities are less than completely reliable. For example, it would be poor practice for a practitioner to rely on an everyday tax return manual to support a complex tax return position.<sup>37</sup> Moreover, some secondary sources may be self-serving or overly taxpayer-favorable in their analyses.<sup>38</sup> Nevertheless, there are also extremely reliable sources upon which practitioners rely, such as Bittker and Eustice<sup>39</sup> in the corporate tax area and McKee, Nelson and

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34. See Sheldon I. Banoff & Harvey L. Coustan, *Final Regulations on Return Preparer's Penalties: IRS Refuses to Deal, Preparers' Fears Prove to Be Real/Penalty Roulette—Roll the Wheel/Who Knows How the Courts Will Feel*, 70 TAXES 137, 160, 162 (1992); Calvin Johnson, "True and Correct:" *Standards for Tax Return Reporting*, 43 TAX NOTES 1521, 1526 (1989). Calvin Johnson states:

In determining whether a legal position is likely to prevail, a model taxpayer sometimes has to rely on good tax theory, wise commentators, and public speeches by Treasury or congressional officials, even if such "quasi-law" sources do not technically qualify as "authority "

*Id.*

35. See Letter from John B. Jones, Jr. to Leslie S. Shapiro, reprinted in Sax, *supra* note 17, at 72 (transmitting individual comments of members of Section of Taxation concerning proposed Amendments to Circular 230).

36. See Banoff & Coustan, *supra* note 34, at 160.

37. See Stengel v. Commissioner, 64 T.C.M. (CCH) 903 (1992) (taxpayer negligent in relying on J.K. Lasser guidebook and IRS publication 547 to support novel tax return position).

38. Conversely, an analysis may be overly favorable to the government position. This seems especially true of articles written by professors as contrasted to those written by practitioners. See, e.g., Gwen T. Handelman, *Law and Order Comes to "Dodge City"*—*Treasury's New Return Preparer and IRS Practice Standards*, 50 WASH. & LEE L. REV. 631 (1993); Johnson, *supra* note 34.

39. BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (6th ed. 1994).

Whitmire<sup>40</sup> in the partnership tax area. Moreover, courts also frequently consult and cite such authorities.<sup>41</sup>

The unreliability of some secondary sources should not preclude reliance on all secondary sources. It is possible to include the reliability and expertise of the secondary authority as part of any RPOS analysis of secondary authority. Practitioners should not be denied reliance on these well-recognized, expert authorities when, in fact, most practitioners appropriately recognize the value of these sources and conduct their practices accordingly.<sup>42</sup>

An argument against permitting taxpayers and practitioners to rely on secondary sources is that such reliance would obviate the role of duly constituted political authorities to make law. The argument is that the law is only what the authorities promulgated by government officials say it is. Hence, to sanction use of secondary sources as permissible authority would allow taxpayers and their advisors to usurp the role of lawmaker properly confined to the duly constituted political officials authorized to promulgate primary authorities.<sup>43</sup>

40. WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* (2d ed. 1990).

41. *E.g.*, *Flora v. United States*, 362 U.S. 145, 148 n.2 (1960); *Claridge Apartments Co. v. Commissioner*, 323 U.S. 141, 146 n.9 (1944); *Helvering v. Griffiths*, 318 U.S. 371, 373 n.4 (1943). Professor Bittker states:

Once a court decides to look beyond the four corners of the [Internal Revenue Code], there are no formal restrictions on the material that may be taken into account in interpreting the statutory language. Thus, courts in federal tax cases look not only to such formal sources of legislative history as committee reports and legislative debates but also to less formal sources such as hearings, memoranda by trade groups, and commentators.

1 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS* ¶ 4.2.2, at 4-23 (2d ed. 1989).

42. Reluctance to recognize secondary authority presumably results from the primacy of judicial interpretation in the Anglo-American legal tradition. By contrast, in the civilian tradition in which the statute has primacy, judicial precedent and the writings of a legal scholar have parity with respect to persuasiveness. C. Garrison Lepow, *Deconstructing Los Angeles or a Secret Fax from Magritte Regarding Postliterate Legal Reasoning: A Critique of Legal Education*, 26 U. MICH. J.L. REF 69, 95 n.100 (1992). *See generally* JOHN H. MERRYMAN, *THE CIVIL LAW TRADITION: AN INTRODUCTION TO THE LEGAL SYSTEM OF WESTERN EUROPE AND LATIN AMERICA* 56, 60 (2d ed. 1985).

43. *See* Amendments to Circular 230, *supra* note 2, pmb1. (rejecting suggestions that secondary authority be made permissible on ground that standard should be "grounded" in laws made); Letter from Gwen T. Handelman, Associate Professor of Law, Washington and Lee University, to the Internal Revenue Service (Nov 13, 1992), *available in* LEXIS, 92

While this is a perfectly respectable jurisprudential position on the nature of law and lawmaking, it is not the only nor the most realistic one. Lawmaking is a process that properly involves those governed as well as those governing. The IRC is not self-executing. Taxpayers and practitioners must apply the Code to a given case, and by this act of specification, they either expand or restrict and, hence, "change" the Code.<sup>44</sup>

Taxpayers and their advisors faced with making decisions in conducting their affairs must take actions dependent on a given interpretation of the law. Often, there is little primary authority on an issue. Taxpayers and their advisors, using the available resources, including secondary authority, must plot a course of action based on their own best interpretation of the law. These decisions may then face the scrutiny of administrators or judges. If the taxpayer's interpretation of the law is correct, it may acquire the status of primary authority in a case or ruling, and the taxpayer and advisor will in a real sense have "made law." The standards of both the ABA<sup>45</sup> and the AICPA<sup>46</sup> reflect this by sanctioning resort to secondary authority.

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TNT 235-69.

44. See STANLEY FISH, *DOING WHAT COMES NATURALLY: CHANGE, RHETORIC, AND THE PRACTICE OF THEORY IN LITERARY AND LEGAL STUDIES* 150-51 (1989); Lepow, *supra* note 42, at 95.

45. The ABA RPOS standard, by basing the norm on possible success in litigation, sanctions resort to whatever authority a court might consider. Courts often consider secondary authority. See *supra* text accompanying note 41.

46. The AICPA provides:

For example, the CPA may reach a conclusion on the basis of well-reasoned articles, treatises, IRS General Counsel Memoranda, a General Explanation of a Revenue Act prepared by the staff of the Joint Committee on Taxation, and Internal Revenue Service written determinations (for example, private letter rulings), whether or not such sources are treated as "authority" under section 6661.

AICPA, *Statement on Responsibilities in Tax Practice*, (Rev. 1988) No. 1, reprinted in *STANDARDS OF TAX PRACTICE II*, *supra* note 7, ¶ 2006, at 3659. AICPA Interpretation No. 1-1 states:

In determining whether a tax return position meets the CPA's realistic possibility standard, a CPA may rely on authorities in addition to those evaluated in determining whether substantial authority exists. Accordingly, CPAs may rely on well-reasoned treatises, articles in recognized professional publications, and other reference tools and sources of tax analysis commonly used by tax advisors and return preparers.

*Id.* at 3661, quoted in Banoff & Coustan, *supra* note 34, at 160 n.167

As a matter of fact, in some circumstances a practitioner's failure to consult secondary sources may constitute negligence. Consequently, the lawmaking process involves more than the Austinian view of law merely as commands from political superiors to political inferiors.<sup>47</sup> Taxpayers and practitioners play a proper role in this process by interpreting the law as best they can in conducting their affairs.

Finally, the substantial understatement penalty regulations provide that practitioners may rely on the "authorities underlying" the conclusions in the secondary sources, as contrasted to the conclusions themselves.<sup>48</sup> Moreover, in the absence of primary authority, the practitioner may rely on a "well-reasoned" construction of the statute as authority. But a "well-reasoned" construction of the statute is precisely what many secondary sources purport to attempt. If an article does cite authority that underlies the article's conclusions, it will inevitably contain a reasoned analysis of that authority, which in turn should qualify as a well-reasoned analysis of the statute the cited authority interprets. Thus, the distinction between conclusions in a secondary source and the authorities underlying those conclusions collapses upon itself.

Taxpayers and practitioners must as a practical matter rely on secondary authority on an everyday basis. Judges do likewise. The

47 See John Austin, *The Province of Jurisprudence Determined*, reprinted in PHILIP SHUCHMAN, COHEN AND COHEN'S READINGS IN JURISPRUDENCE AND LEGAL PHILOSOPHY 8 (1979). Austin states:

Laws proper, or properly so called, are commands; laws which are not commands, are laws improper or improperly so called. Laws properly so called, with laws improperly so called, may be aptly divided into the four following kinds.

1. The divine laws, or the laws of God: that is to say, the laws which are set by God to his human creatures.
2. Positive laws: that is to say, laws which are simply and strictly so called, and which form the appropriate matter of general and particular jurisprudence.
3. Positive morality, rules of positive morality, or positive moral rules.
4. Laws metaphorical or figurative, merely metaphorical or figurative.

The divine laws and positive laws are laws properly so called. Of positive moral rules, some are laws properly so called, but others are laws improper.

*Id.* at 8. "The matter of jurisprudence is positive law: law, simply and strictly so called: or law set by political superiors to political inferiors." *Id.* at 13.

48. See Treas. Reg. § 1.6662-4(d)(3)(iii) (1991); T.D. 8382, 1992-1 C.B. 394. It is likely, but not entirely certain, that this interpretation applies in the case of Circular 230 as well as under the substantial understatement penalty. The reason for this uncertainty is a slight difference in the wording of the Circular 230 regulations. See *supra* note 27 and text accompanying notes 29-30.

standards of both the ABA and the AICPA recognize this. It is a fiction to pretend that secondary sources do not exist for purposes of the Circular 230 RPOS standard. In the practitioner survey, 65% of the respondents favored allowing reliance on secondary authority, while a mere 17.5% opposed such reliance and 17.5% were undecided.<sup>49</sup> Hence, a substantial majority of the responding practitioners favored permitting reliance on secondary authority. The law should recognize the common practice of the profession. The Circular 230 RPOS standard (as well as the preparer penalty RPOS standard to which Circular 230 conforms) should permit reliance on secondary authority, with the analysis taking into account the persuasiveness (or lack thereof) of such authority.

### B. One-in-Three Quantification of RPOS Standard

Circular 230, as well as the preparer penalty regulations, attempts to quantify the RPOS standard by stating that a tax return position satisfies the RPOS standard 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."<sup>50</sup> Thus, the standard requires the practitioner to become an oddsmaker at best, a divine at worst. There is considerable doubt among practitioners about the practicability of this quantitative requirement.<sup>51</sup>

The one-in-three standard had its genesis in an ABA Tax Section Task Force Report that interpreted ABA Opinion 85-352 subsequent to issuance of that opinion.<sup>52</sup> The Task Force Report stated that "[a] position having

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49. Practitioner Survey, App. B, Question 9.

50. Circular 230, *supra* note 2, § 10.34(a)(4)(i).

51. See, e.g., Letter from David R. Brennan to the Internal Revenue Service, *supra* note 9; David L. Brunori, *AICPA Continues Fight for Simplification; Leadership Bemoans "Workload Compression,"* Preparer Penalty Regs., Mar. 22, 1994, available in LEXIS, 94 TNT 55-3; Letter from Patricia Lewis et al. to The Honorable Shirley D. Peterson, *supra* note 9; Letter from Lawrence F. Portnoy to the Internal Revenue Service, *supra* note 9; Raby, *supra* note 9; Letter from Steven C. Salch to the Internal Revenue Service, *supra* note 9.

52. See Report of the Special Task Force on Formal Opinion 85-352, reprinted in 39 TAX LAW. 635 (1986) and in STANDARDS OF TAX PRACTICE II, *supra* note 7, ¶ 2004, at 3596 [hereinafter 85-352 Task Force Report]. The ABA Tax Section originally suggested a version of the RPOS standard in a proposal to revise ABA Opinion 314. See ABA Section of Taxation, *Proposed Revision to Formal Op. 314* (1984), reprinted in BERNARD WOLFMAN & JAMES P. HOLDEN, ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE 71 (2d ed. 1985).

only a 5 or 10 percent likelihood of success, if litigated, should not meet the standard."<sup>53</sup> But "[a] position having a likelihood of success closely *approaching one-third* should meet the standard."<sup>54</sup> The Task Force Report's one-third percentage may have been meant as a safe-harbor, so that positions with a chance somewhat below one-third would be sufficient. In addition, although the Committee on Standards of Tax Practice and the Council of the Section of Taxation approved the Task Force Report,<sup>55</sup> it was not adopted by the ABA Standing Committee on Ethics and Professional Responsibility.<sup>56</sup> Hence, the Task Force Report was never officially adopted as an ABA position. Nevertheless, the one-in-three formulation has been adopted as a minimum standard in the Circular 230 amendments (as well as the preparer penalty regulations),<sup>57</sup> and it appears to be entering the folklore of taxation.

This is unfortunate because a quantified formulation of the RPOS standard has significant drawbacks. In the first place, the one-in-three formulation imparts an appearance of precision and objectivity to the RPOS standard that simply does not exist. Although practitioners may sometimes discuss the chances of a particular position's success in terms of odds, in the difficult cases, few would be willing to characterize the accuracy of their oddsmaking as much more than educated guesses. In the close cases, what practitioner can truly believe that the odds of success are thirty-three percent and not, say, thirty percent or twenty-five percent? Perhaps one who is under a delusion of being endowed with divine omniscience would be so bold, but few others are likely to possess such hubris. One is reminded of the supposed medieval practice of determining the number of angels that can dance on the head of a pin.

The ABA RPOS standard set out in Opinion 85-352 does not actually mention a quantified standard. The ABA did not officially adopt the one-

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The ABA Standing Committee on Ethics and Professional Responsibility modified the Tax Section's proposal by issuing Opinion 85-352. The purpose of the Task Force report apparently was to counteract what the Task Force perceived might be adverse inferences from these modifications to the version of ABA Opinion 85-352 that the Tax Section originally proposed.

53. 85-352 *Task Force Report*, *supra* note 52, at 638.

54. *Id.* at 638-39 (emphasis added).

55. See BERNARD WOLFMAN ET AL., STANDARDS OF TAX PRACTICE I ¶ 214.020, 13 Tax Transactions Libr. (CCH) (1992) [hereinafter STANDARDS OF TAX PRACTICE I].

56. *Id.*

57. See *supra* text accompanying notes 19-21.

in-three formulation of the Tax Section Task Force.<sup>58</sup> Moreover, several practice groups and commentators have opposed a quantified formulation of the RPOS standard on grounds that it is unrealistic.<sup>59</sup> One commentator pithily summarized the arguments against quantification of the RPOS standard:

Frankly, I think it is naive and unrealistic. I have been involved in the litigation of tax cases for the last thirty years and have never been able to predict a specific value for a client's claim in litigation. It seems to me that the realistic possibility of success standard is the standard one generally employs in approaching the case from a settlement or litigation standpoint. To cloud that issue with percentages is simply unrealistic.<sup>60</sup>

The preparer penalty regulations do provide some examples of the one-in-three standard, but they involve obvious situations and are basically worthless in the difficult case.<sup>61</sup> In the problem situations, the practitioner is left with the task of divining the odds of success for positions that by definition are ambiguous at best. The price of being proven wrong can be the preparer penalty under I.R.C. § 6694, or in more extreme cases, possible sanctions under Circular 230.<sup>62</sup> The practitioner is thus left

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58. See *supra* text accompanying notes 55-57

59. See, e.g., Letter from Harvey L. Coustan to The Honorable Shirley D. Peterson, *supra* note 9; Letter from Patricia Lewis et al. to The Honorable Shirley D. Peterson, *supra* note 9; Letter from Lawrence F. Portnoy to the Internal Revenue Service, *supra* note 9; Letter from Steven C. Salch to the Internal Revenue Service, *supra* note 9.

60. Letter from David R. Brennan to the Internal Revenue Service, *supra* note 9. Another commentator termed the one-in-three standard "ludicrous." Brunori, *supra* note 51 (quoting Harvey L. Coustan, Chairman, AICPA Federal Tax Division).

61. Treas. Reg. § 1.6694-2(b)(3) (1991).

62. Circular 230 provides that failure to meet the RPOS standard will subject a practitioner to suspension or disbarment only if the violation is "willful, reckless, or a result of gross incompetence." Circular 230, *supra* note 2, §§ 10.34(b), 10.52. Hence, an occasional inadvertent deviation from the RPOS standard should not result in Circular 230 sanctions. Such a deviation, however, could bring an assertion of the I.R.C. § 6694 preparer penalty. If the IRS asserts the preparer penalty, the regulations provide that the practitioner can raise a reasonable cause and good faith defense, but in that event, the burden of proof is on the practitioner to prove reasonable cause and good faith. See Treas. Reg. § 1.6694-2(d)-(e) (1991). Moreover, the Internal Revenue Manual now provides that a determination of whether the preparer penalty should be assessed will be made in every examination and recorded in the examination workpapers. Consolidated Penalty Handbook, 6 Internal Revenue Man. (CCH) pt. (20)(11)13, at 50,402; see Larry B. Wolod, *Stricter Disclosure Standards Under Section 6662: Who Will Step Forward and Pay the \$496 Million Tab?*, Feb. 18, 1994, available in LEXIS, 94 TNT 34-72.



exposed for a failure of oddsmaking acumen determined by resort to hindsight.<sup>63</sup>

Aside from the nature of oddsmaking as an educated guess at best, another difficulty is that tax positions are not necessarily all-or-nothing propositions. Many issues are settled by compromise somewhere between the IRS's and taxpayers's positions. The one-in-three standard does not seem to take this into account. Rather, it focusses on the odds of either winning or losing completely. Again, this approach does not conform to reality.

Perhaps a more satisfactory approach if the one-in-three standard remains would be to phrase the rule in terms of an expected settlement percentage.<sup>64</sup> For example, the question would be what is the settlement value of this position, rather than what are the odds of winning it completely. Consequently, a position that the practitioner estimates has a settlement value of thirty-three cents on the dollar would meet the RPOS standard. This approach would still involve an educated guess, but it would at least take into account the realities of settlement and compromise inherent in the tax enforcement process.

Finally, the practicalities of enforcing a quantified standard are daunting. When the IRS asserts that a practitioner has violated the standard the resultant proceeding is likely to break down into two phases. First, the parties will present expert opinion testimony about whether the practitioner met the one-in-three standard. The testimony on this issue is likely to be conflicting, and the tribunal must make a subjective evaluation of the opposing experts' views.<sup>65</sup> If the tribunal finds that the practitioner did not meet the one-in-three standard, or if, as is more likely, the issue is not clear-cut, the tribunal will then determine whether the practitioner acted with reasonable cause and in good faith in the case of the preparer penalty, or whether the practitioner's conduct was willful, reckless, or a result of gross incompetence in the case of Circular 230 sanctions.<sup>66</sup> Both of these

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63. See Letter from Steven C. Salch to the Internal Revenue Service, *supra* note 9.

64. See Letter from Patricia L. Lewis et al. to The Honorable Shirley D. Peterson, *supra* note 9; Raby, *supra* note 9.

65. See Letter from Steven C. Salch to the Internal Revenue Service, *supra* note 9.

66. *Id.* The preparer penalty regulations explicitly make reasonable cause and good faith on the part of the practitioner a defense to the penalty. Treas. Reg. § 1.6694-2(d)-(e) (1991). Circular 230 does not explicitly make reasonable cause and good faith a defense. It may accomplish a similar effect, however, by providing that sanctions against a practitioner will not apply for violation of the RPOS standard, unless the violation was "willful, reckless, or a result of gross incompetence." Circular 230, *supra* note 2,

inquiries introduce an unavoidable element of subjectivity and ultimately lead to the issue of whether the practitioner acted prudently, and whether it was unreasonable and in bad faith for the practitioner to advise the particular tax return position.<sup>67</sup> If this is the ultimate issue anyway, quantification of the RPOS standard only adds perplexity, rather than objectivity, to the process.<sup>68</sup>

The one-in-three standard adds no real objectivity, lends a false air of precision to an inherently imprecise process, and is impracticable to apply. The IRS should eliminate it from the preparer penalty regulations and from Circular 230.

### C. A RPOS Standard for the IRS

The preparer penalty regulations, Circular 230, and relevant professional standards all impose one version or another of the RPOS standard on tax practitioners. This duty flows from the double duty of the practitioner to the system as a whole as well as to the client.<sup>69</sup> Just as citizens have a duty to "turn square corners when they deal with the government,"<sup>70</sup> likewise the IRS should have a concomitant duty to turn square corners when it deals with taxpayers and practitioners.

Some practitioners have voiced concern that such a duty, although implicit in the nature of government service, is not explicitly set out in current law.<sup>71</sup> There is a perception that some IRS employees propose adjustments that fail to meet a standard comparable to the RPOS standard

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§§ 10.34(b), 10.52. Circular 230, in turn, defines "reckless conduct" as "a highly unreasonable omission or misrepresentation involving an extreme departure from the standards of ordinary care that a practitioner should observe under the circumstances." *Id.* § 10.51(j). All of this taken together implies that good faith and reasonable cause on the part of the practitioner should be a valid defense to Circular 230 sanctions.

67. Letter from Steven C. Salch to the Internal Revenue Service, *supra* note 9.

68. *Id.*

69. See STANDARDS OF TAX PRACTICE II, *supra* note 7, ¶ 105. In 1952, Norris Darrell summed up the dichotomy in an unpublished paper: "You have a course of double duty: a duty to do your best for the client and not to bring the lightning down upon him, and a duty to live up to your professional responsibility." *Quoted in* Rowen, *supra* note 1, at 237.

70. *Rock Island, Ark. & La. R.R. v. United States*, 254 U.S. 141, 143 (1920) (Holmes, J.).

71. See Letter from Patricia L. Lewis et al. to The Honorable Shirley D. Peterson, *supra* note 9.

and that they sometimes raise issues and assert penalties that have little merit for the purpose of inducing a settlement.<sup>72</sup>

Practitioners must meet the Circular 230 and preparer penalty standards under threat of severe sanction. Fairness dictates that the IRS should hold itself to a similar standard when dealing with taxpayers and practitioners.<sup>73</sup> The Service should promulgate ethical standards for IRS examination personnel that parallel standards for practitioners under I.R.C. § 6694 and Circular 230. This would enhance taxpayer confidence in the system by explicitly holding IRS personnel to ethical standards similar to those governing taxpayers and practitioners.<sup>74</sup>

### III. Elevation of the Disclosure Standard for Taxpayers

The 1993 Act established a new minimum reporting standard—new reasonable basis—that taxpayers must meet before adequate disclosure will absolve from the accuracy-related penalty a tax return position that is not supported by substantial authority. The House version of the bill would have extended the new reasonable basis standard to the § 6694 preparer penalty as well. However, the Senate version of the bill and, ultimately, the Conference Report limited the application of the heightened standard to the accuracy-related penalty while retaining the old rules for the preparer penalty.<sup>75</sup>

Formerly, adequate disclosure would absolve a substandard position from the accuracy-related penalty as long as the position was not frivolous.

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72. *Id.* That IRS employees may sometimes be less above reproach than Caesar's wife was vividly brought home recently by allegations of IRS employee misuse of computer information to gain access to private information of private acquaintances and celebrities. See Hubert H. Herring, *At the I.R.S., Just Looking*, N.Y. TIMES, July 24, 1994, at C2; *Wandering Eyes at the IRS*, U.S. NEWS & WORLD REP., Aug. 1, 1994, at 13; *Who's Reading Your Tax Return.* ., WASH. POST, July 23, 1994, at A21.

73. See Letter from Patricia L. Lewis et al. to The Honorable Shirley D. Peterson, *supra* note 9.

74. See *id.*

75. See S. 1134, 103d Cong., 1st Sess. (1993); H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 669 (1993), reprinted in 1993 U.S.C.C.A.N. 1088, 1358; see also OBRA of 1993, § 13251, Rita L. Zeidner, *Conferees' Double Standard is Good News for Preparers, Not Taxpayers*, 60 TAX NOTES 689 (1993). The Senate apparently dropped the preparer penalty portion of the bill because of a procedural objection to it under the Budget Act. Confusingly, the Senate Committee Report indicated that the preparer penalty provisions remained intact. See SENATE COMM. ON FINANCE, 103D CONG., 1ST SESS., FISCAL YEAR 1994 BUDGET RECONCILIATION RECOMMENDATIONS 219-20 (Comm. Print 1993); Wolod, *supra* note 62.

This absolution for adequate disclosure was based on the notion that overly aggressive tax reporting positions had their genesis in taxpayers playing the audit lottery by burying the positions on their tax returns.<sup>76</sup> The regulations defined the term "frivolous" as "patently improper."<sup>77</sup> Moreover, the amendments to Circular 230 include a similar "not frivolous" provision absolving an adequately disclosed position that falls below the RPOS standard from sanction under Circular 230.<sup>78</sup>

The 1993 Act, however, changed the statutory minimum disclosure standard for the accuracy-related penalty from requiring that the tax return position be not frivolous to requiring that the position have a reasonable basis. The House Committee Report explained that: "Under the bill, the 'reasonable basis' standard replaces the 'not frivolous' standard for purposes of the accuracy-related and income tax return preparer penalties. The Committee intends that 'reasonable basis' be a relatively high standard of tax reporting."<sup>79</sup> The Committee further stated that the former not frivolous standard did not "sufficiently discourage taxpayers and preparers from taking unreasonable return positions."<sup>80</sup> Accordingly, the Committee decided to encourage compliance by imposing "tougher standards."<sup>81</sup> The "tougher standard"—reasonable basis—did not survive the legislative process in the case of the preparer penalty, but it remained intact in the case of the accuracy-related penalty

Hence, now a tax return position must meet at least a "reasonable basis" standard for adequate disclosure to exonerate the position from the substantial understatement and disregard portions of the accuracy-related penalty. Moreover, disclosure will no longer be relevant in the case of the negligence penalty because the standard for negligence is already reasonable basis.<sup>82</sup> This is a step in the wrong direction. The new standard revives the old and rejected reasonable basis standard. The RPOS standard replaced the reasonable basis standard because the latter had been

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76. See Jerome Kurtz et al., *Discussion on "Questionable Positions,"* 32 TAX LAW. 13, 15 (1978) (discussing problems with reporting standards).

77. See Treas. Reg. § 1.6662-3(b)(3) (1993).

78. 57 Fed. Reg. 46,356, 46,359 (1992) (to be codified at 31 C.F.R. § 10.34(a)(1), (4)) (proposed Oct. 8, 1992).

79. HOUSE WAYS AND MEANS COMM., 103D CONG., 1ST SESS., FISCAL YEAR 1994 BUDGET RECONCILIATION RECOMMENDATIONS 317 (Comm. Print 1993) [hereinafter HOUSE COMMITTEE REPORT].

80. *Id.*

81. *Id.*

82. See *id.*

interpreted too laxly<sup>83</sup> In the alternative, the new use of the term "reasonable basis" will require creation of an entirely new standard. The new reasonable basis will likely run contrary to the taxpayer's traditional right to litigate a tax return position prior to payment of tax by setting the standard higher for a disclosed position than for a litigable position.<sup>84</sup>

The main impetus for the stir of activity regarding standards for tax return positions over the past decade and a half has been concern with taxpayers taking aggressive tax return positions and betting on the audit lottery that the positions will go unchallenged.<sup>85</sup> Although the details differ, the general consensus has been that the remedy should lie in setting tax return position standards higher than the old reasonable basis standard<sup>86</sup> and

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83. See Richard C. Stark, *Let's Reconsider the "Reasonable Basis" Standard*, 59 TAX NOTES 1845 (1993). In ABA Opinion 85-352, reprinted in STANDARDS OF TAX PRACTICE II, *supra* note 7, ¶ 2003, at 3566, the ABA Committee on Ethics and Professional Responsibility stated its reason for moving away from the reasonable basis standard:

The Committee is informed that the standard of "reasonable basis" has been construed by many lawyers to support the use of any colorable claim on a tax return to justify exploitation of the lottery of the tax return audit selection process. This view is not universally held, and the Committee does not believe that the reasonable basis standard, properly interpreted and applied, permits this construction.

However, the committee is persuaded that as a result of serious controversy over this standard and its persistent criticism by distinguished members of the tax bar, IRS officials and members of Congress, *sufficient doubt has been created regarding the validity of the standard so as to erode its effectiveness as an ethical guideline*. For this reason, the Committee has concluded that it should be restated.

*Id.* (emphasis added) (footnote omitted).

84. So far the Treasury has punted on defining the term "reasonable basis" under the new act by reserving the definition in the temporary and proposed regulations. See Temp. Treas. Reg. § 1.6662-7T(d)(1) (1994); Prop. Treas. Reg. § 1.6662-3(b)(3), 59 Fed. Reg. 12,565 (1994) (to be codified at 26 C.F.R. § 1.6662-3(b)(3)) (proposed Mar. 1, 1994).

85. See Kurtz, *supra* note 76.

86. The reasonable basis standard was originally enunciated in ABA Opinion 314. 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." ABA Comm. on Professional Ethics, Formal Op. 314 (1965), reprinted in 51 ABA J. 671 (1965) and in STANDARDS OF TAX PRACTICE II, *supra* note 7, ¶ 2001, app. The reasonable basis standard originally may have been intended to set a fairly high standard. See STANDARDS OF TAX PRACTICE I, *supra* note 55, ¶ 214.02; Kenneth L. Harris, *Resolving Questionable Positions on a Client's Federal Tax Return: An Analysis of the Revised Section 6694(a) Standard*, 47 TAX NOTES 971, 972 (1990). Nevertheless, respect for the standard gradually eroded over the next 20

that positions falling below a new higher standard should be specially disclosed to the IRS.

The reasonable basis standard proved unworkable, thus requiring a new standard under which the audit lottery option would not seem so attractive to taxpayers who had to disclose their questionable positions to the IRS when they filed their returns. Professional associations, Congress, and the Treasury reworked the reasonable basis standard into the more stringent RPOS and substantial authority standards,<sup>87</sup> but in most cases in which a position fell below the required standard, adequate disclosure could cure the failure.<sup>88</sup>

Disclosure did not absolve a substandard position only when the position fell below a low minimum standard. That standard was "not frivolous." The regulations defined a frivolous position as one that is "patently improper."<sup>89</sup> Hence, as long as the tax return position was not patently improper, adequate disclosure absolved the position from penalties or other sanctions.

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years. Some only half-facetiously referred to the standard as the chuckle test or the laugh test (if the lawyer can advance the position without chuckling or laughing). See Theodore C. Falk, *Tax Ethics, Legal Ethics, and Real Ethics: A Critique of ABA Opinion 85-352*, 39 TAX LAW. 643, 644 (1986); *IRS Urged to Rewrite Proposal Tying Ethics Standard for Tax Return Preparers to Taxpayer Understatement Penalty*, Daily Tax Rep. (BNA) No. 35, at K-6 (Feb. 24, 1987) (quoting Professor Michael Graetz).

87 See, e.g., I.R.C. §§ 6662, 6694 (Supp. V 1993); Circular 230, *supra* note 2; ABA Opinion 85-352, reprinted in STANDARDS OF TAX PRACTICE II, *supra* note 7, ¶ 2003, at 3566.

88. See, e.g., I.R.C. §§ 6662, 6694 (Supp. V 1993); Circular 230, *supra* note 2, § 10.34 (a)(1)(ii). The exception to adequate disclosure absolving a substandard tax return position is ABA Opinion 88-352. The Opinion does not explicitly state that disclosure exonerates a position that fails to meet the RPOS standard (substandard position). The original Tax Section Task Force Report that proposed the RPOS standard stated that if the RPOS standard is not met, disclosure will not cure the defect. See *85-352 Task Force Report*, *supra* note 52. It stated: "If there is not a realistic possibility of success, if litigated, the new standard could not be met by disclosure or 'flagging' of the position on the return." *Id.* at 639. Subsequently, however, 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 the position is not frivolous and is either: (1) adequately disclosed; or (2) presented on an amended return filed as a claim for refund. See STANDARDS OF TAX PRACTICE I, *supra* note 55, ¶ 214.0242; Letter from John B. Jones, Jr. to Leslie S. Shapiro, reprinted in Sax, *supra* note 17, at 62-63.

89. See Treas. Reg. §§ 1.6662-3(b)(3) (as amended in 1993), 1.6694-2(b)(c)(2) (as amended in 1993); Circular 230, *supra* note 2, § 10.34(a)(4)(ii).

The justification for setting the disclosure standard at not frivolous is the taxpayer's right to litigate a tax return position prior to payment of the tax. The taxpayer is entitled to a prepayment forum in which to assert his position. This is the *raison d'être* of the Tax Court and is a fundamental feature of the federal tax enforcement process.<sup>90</sup> The corollary of this is that, at least within some range of possible outcomes, the taxpayer should be able to assert a position on the tax return that the IRS may well contest, even though the taxpayer's position is not certainly correct, or perhaps not even probably correct. This proposition is not controversial.<sup>91</sup>

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90. The Revenue Act of 1924 created the Tax Court (formerly the Board of Tax Appeals) for the specific purpose of providing the taxpayer a prepayment forum for contesting disputed tax return positions. The House of Representatives Ways and Means Committee Report accompanying the Revenue Act of 1924 stated:

The committee recommends the establishment of a Board of Tax Appeals to which a taxpayer may appeal prior to the payment of an additional assessment of income, excess-profits, war profits, or estate taxes. Although a taxpayer may, after payment of his tax, bring suit for the recovery thereof and thus secure a judicial determination of the questions involved, he can not, in view of section 3224 of the revised statutes, which prohibits suit to enjoin the collection of taxes, secure such determination prior to the payment of the tax. The right of appeal after the payment of the tax is an incomplete remedy, and does little to remove the hardship occasioned by an incorrect assessment. The payment of a large additional tax on income received several years previous and which may have, since its receipt, been either wiped out by subsequent losses, invested in nonliquid assets, or spent, sometimes forces taxpayers into bankruptcy, and often causes great financial hardship and sacrifice. These results are not remedied by permitting the taxpayer to sue for the recovery of the tax after this payment. *He is entitled to an appeal and to a determination of his liability for the tax prior to its payment.*

H.R. REP. NO. 179, 68th Cong., 1st Sess. 7 (1924) (emphasis added).

91. See James P. Holden, *Constraining Aggressive Return Advice: A Commentary*, 9 VA. TAX REV 771, 773 (1990). One might argue that the *jurat* on the form 1040 requires the taxpayer to be certain of a position's correctness. It states: "Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are *true, correct, and complete.*" 2 Fed. Tax Forms (CCH) ¶ 500, at 2044 (emphasis added). Also, § 7206 makes it a felony for a person to willfully make and subscribe a return "which he does not believe to be *true and correct* as to every material matter." I.R.C. § 7206(1) (1988) (emphasis added). Nevertheless, the true and correct belief criterion has not prevailed as the required standard, largely because a rule that depends too much on the taxpayer's subjective state of mind would not be workable. See Rowen, *supra* note 1, at 250-51. At least one commentator, however, has argued for a "true and correct" standard of reporting. See Johnson, *supra* note 34, at 1523.

The more difficult question is how strong a tax return position has to be in order for a taxpayer to assert that position on the return with adequate disclosure. The standard for an adequately disclosed position should not be as high as for an undisclosed position because a fully disclosed position does not present the same audit lottery possibilities for a taxpayer as an undisclosed position. The standard for an adequately disclosed tax return position should be set at a level sufficient to protect the right to prepayment litigation of a tax return position, but should be high enough to prohibit positions with practically no chance to succeed in litigation.

Formerly, the accuracy-related<sup>92</sup> and preparer penalties<sup>93</sup> regulations (as well as the proposed Circular 230 amendments) set the disclosure standard at not frivolous. The accuracy-related penalty regulations defined frivolous as "patently improper," and commentators objected to this formulation on the ground that it was too vague and would require the development of new case law to further define the meaning of the term.<sup>94</sup> Commentators suggested a standard of "not litigable" rather than "patently improper,"<sup>95</sup> but the IRS rejected this standard as too lawyer-oriented.<sup>96</sup>

The not litigable standard is preferable to either the not frivolous or reasonable basis standard. The justification for the disclosure exemption is the right of a taxpayer to prepayment litigation of a tax return position. If this is the basis of the exemption, it makes sense that the minimum standard

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92. See Treas. Reg. § 1.6662-3(b)(3) (1991).

93. See Treas. Reg. § 1.6694-2(c)(2) (1991).

94. See Stark, *supra* note 83, at 1846. Comments on the proposed regulations criticized this definition for not including a bad faith component. T.D. 8381 pmbL., 1992-1 C.B. 374, 377. The IRS rejected these comments on the ground that a purely objective standard was most appropriate. *Id.* One must question, however, whether "patently improper" is really objective.

95. The Civil Penalties Task Force of the ABA Section of Taxation proposed the following definition for "frivolous" in the proposed accuracy-related penalty regulations:

A "frivolous" position with respect to an item is one that is not litigable.

A position is litigable only if, to the best of the taxpayer's knowledge, information, and belief formed after reasonable inquiry, it is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law, and is not interposed for any improper purpose. Other words used to describe positions that fall below the minimum requirements for reporting a position on a tax return, such as "lacks a reasonable basis" or "patently improper," have the same meaning.

ABA Section of Taxation, *ABA Task Force Members Instruct Service on Reforming Reform*, June 7, 1991, available in LEXIS, 91 TNT 123-46, quoted in Stark, *supra* note 83, at 1846.

96. See T.D. 8381 pmbL., 1992-1 C.B. 374, 377



for an adequately disclosed tax return position should be whether the position is in fact a litigable one. Current procedural rules prescribe a litigating standard for actions brought in the Tax Court and in the federal courts.<sup>97</sup> The Tax Court Rules<sup>98</sup> and the Federal Rules of Civil Procedure<sup>99</sup> both state that the signature of an attorney or party constitutes a certification by the attorney or party that:

[T]o the best of the signer's knowledge, information, and belief formed after reasonable inquiry, it is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law, and that it is not interposed for any improper purpose.<sup>100</sup>

The standard of the Federal Rules of Civil Procedure and the Tax Court Rules forms the basis for the ABA RPOS standard. The ABA RPOS standard provides that an attorney can advise a position when there is a realistic possibility of success if the matter is litigated. 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.<sup>101</sup>

Hence, a not litigable standard conforms to the ABA RPOS standard. Moreover, it is consistent with the virtually identical AICPA RPOS standard.<sup>102</sup>

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97. See Stark, *supra* note 83, at 1846.

98. See T.C.R. 33(b).

99. FED. R. CIV. P. 11 (prior to Dec. 1, 1993).

100. *Id.*, T.C.R. 33(b).

101. ABA Opinion 85-352, reprinted in STANDARDS OF TAX PRACTICE II, *supra* note 7, ¶ 2003, at 3657 (emphasis added).

102. See AICPA, *Statement on Responsibilities in Tax Practice*, (1988 Rev.) No. 1, reprinted in STANDARDS OF TAX PRACTICE II, *supra* note 7, ¶ 2006, at 3659. The AICPA standard provides:

A CPA should not recommend to a client that a position be taken with respect to the tax treatment of any item on a return unless the CPA has a good

Adopting a not litigable standard for disclosure would, therefore, contribute to a desirable consistency in standards. In addition, the not litigable standard conforms to Federal Rule 11 and Tax Court Rule 33(b), which have a history of interpretation behind them. By contrast, the reinstatement of the reasonable basis standard as a "relatively high standard," in the words of the legislative history,<sup>103</sup> may bring a new version of the standard that has been discredited, along with the attendant problems of interpretation and application of the new version. This will result in inconsistent application, an inability of practitioners to understand and comply with the new version, and a consequent lessening of respect for the new version—the very problems the RPOS standard was supposed to ameliorate.<sup>104</sup>

Congress enacted the accuracy-related penalties, the ABA and AICPA adopted the RPOS tax reporting standard, and Treasury revised Circular 230 principally to remedy unscrupulous exploitation of the audit lottery.<sup>105</sup> Requiring adequate disclosure of a position that may fall below the penalty standards appropriately addresses this problem. The requirements for adequate disclosure, such as filing a Form 8275 (the "please audit me now" form), or filing in accordance with an annual revenue procedure<sup>106</sup> are sufficient to put the IRS on notice of positions that may fall below the standard. Furthermore, adequate disclosure is compelling evidence of good faith on the part of the taxpayer or practitioner.

In general, substantial penalties should not be imposed on taxpayers who act in good faith in the exercise of their right to prepayment litigation of a tax return position, but who turn out to be wrong in hindsight. Nevertheless, that may be exactly the result of the new supposedly stronger reasonable basis minimum disclosure standard. This, of course, will

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faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits if challenged.

*Id.*

103. HOUSE COMMITTEE REPORT, *supra* note 79, at 317

104. *See Stark, supra* note 83, at 1846.

105. *See Stark, supra* note 83, at 1845; *see also Kurtz, supra* note 76.

106. *See* Treas. Reg. § 1.6662-3(c)(2) (1991) (disclosure on Form 8275 or 8275-R absolved from negligence penalty prior to 1993 Tax Act); *id.* § 1.6662-4(f) (1991) (disclosure on Form 8275, 8275-R, or on return in accordance with annual revenue procedure absolves from substantial understatement penalty); *id.* § 1.6694-2(c)(3) (as amended in 1991) (disclosure on Form 8275, 8275-R, or on return in accordance with annual revenue procedure absolves from income tax return preparer penalty); Circular 230, *supra* note 2, § 10.34(a)(1)(ii) (adequate disclosure avoids Circular 230 sanctions).

depend on how stringently courts and the IRS interpret the new standard. Congress has stated that it intends that the new version of reasonable basis be a "relatively high standard of tax reporting."<sup>107</sup> Hence, this new higher standard may result in the imposition of penalties on taxpayers who act in perfectly good faith in taking and disclosing a tax return position, but who turn out to have been wrong in hindsight. This is true despite the possible availability of the reasonable cause and good faith defense in I.R.C. § 6664(c) because the good faith taxpayer may not always be able to take advantage of that defense.<sup>108</sup>

Additionally, the new reasonable basis standard may deprive taxpayers of the time-honored right to prepayment litigation to the extent that it prevents taxpayers from taking adequately disclosed positions that would be litigable under Tax Court Rule 33(b). This right has a long and well established history,<sup>109</sup> and steps that diminish it should not be taken lightly. Tax practitioners have already expressed their dissatisfaction with the new version, and this dissatisfaction can only be expected to grow as more and more taxpayers confront the new version.<sup>110</sup>

Finally, instituting a reasonable basis minimum standard for taxpayers under I.R.C. § 6662 while retaining the not frivolous standard for income tax return preparers under I.R.C. § 6694 injects an additional element of inconsistency into the already complex rules governing tax return positions. There is, in effect, a double standard for disclosure, one for taxpayers (the "new improved" reasonable basis standard) and another for income tax return preparers (the old not frivolous standard). At best, this double

107 See HOUSE COMMITTEE REPORT, *supra* note 79, at 317

108. See I.R.C. § 6664(c) (Supp. V 1993). The taxpayer may not be able to prove reasonable cause and good faith. Because the standard of reasonableness is part of the reasonable basis test and also part of the reasonable cause and good faith exception, failure to meet the reasonable basis test may carry with it failure to meet the reasonable cause and good faith exception. See Treas. Reg. § 1.6664-4(b)(1) (1991). The regulations provide:

The most important factor [in determining application of the exception] is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is *reasonable* in light of the experience, knowledge and education of the taxpayer.

*Id.* (emphasis added).

109. See *supra* text accompanying notes 90-96.

110. See *Rules Do Not Implement Congress' Intent on Accuracy-Related Penalty, Groups Say*, Daily Tax Rep. (BNA) No. 130, at G-3 (July 11, 1994); Rita L. Zeidner, *Penalty Changes Will Do More Harm Than Good, Practitioners Say*, 60 TAX NOTES 428, 429 (1993).

standard will engender confusion and, at worst, may result in conflicts of interest between taxpayers and practitioners. For example, suppose a taxpayer is considering a position in the gray area between reasonable basis and not frivolous. The taxpayer will be constrained by the new reasonable basis standard for purposes of the accuracy-related penalty, but the practitioner will be guided by the not frivolous standard for purposes of the preparer penalty. The taxpayer may be reluctant to make adequate disclosure if it appears that reasonable basis may be present (because reasonable basis avoids the negligence penalty in any event), but the practitioner, to protect his own interests, may want to disclose in order to avoid the preparer penalty if the position is below RPOS but is not frivolous. The new standard may result in the opposite of its intended effect—less disclosure rather than more—because taxpayers (if not practitioners) may be more willing to take their chances on nondisclosure in such situations.

The new reasonable basis minimum disclosure standard was originally proposed as part of the 1993 budget package.<sup>111</sup> Hence, the President and Congress may have intended it as a revenue measure.<sup>112</sup> If so, fiddling with the ethical rules that have been formulated so painstakingly over the past decade and a half is an extremely poor way to raise a relatively small

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111. See H.R. 2141, 103d Cong., 1st Sess. § 14252(a)(1) (1993). The proposal provided:

Clause (ii) of section 6662(d)(2)(B) (relating to reduction for understatement due to position of taxpayer on disclosed item) is amended to read as follows:

"(ii) any item if—

(I) the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and

(II) there is a reasonable basis for the tax treatment of such item by the taxpayer."

*Id.* The language was subsequently enacted through H.R. 2264 in the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13251, 107 Stat. 312, 531.

112. See Zeidner, *supra* note 75, at 689; Wolod, *supra* note 62. The Ways and Means Committee listed the new reasonable basis standard in its Committee Report under "Revenue Raising Provisions." HOUSE COMMITTEE REPORT, *supra* note 79, at XIII. The Joint Committee on Taxation estimated that the original reasonable basis proposal (applying the reasonable basis standard to both the accuracy-related taxpayer penalty and to the income tax return preparer penalty) would produce additional revenue (presumably through taxpayers taking less aggressive positions to avoid the penalty and through enhanced penalty collections) of \$484 million over the five year period 1994-98. JOINT COMM. ON TAXATION, WAYS AND MEANS COMMITTEE MARKUP OF THE ADMINISTRATION'S REVENUE PROPOSALS (JCX-1-93) (1993), reprinted in Daily Tax Rep. (BNA) No. 85, at L-3 (May 5, 1993); see Zeidner, *supra* note 75, at 689.

amount of additional revenue. The rejection of the near consensus on disclosure of tax return positions, along with the resultant damage to the integrity of the tax system, will far outweigh any paltry revenue gain. Congress should change the law to permit a taxpayer to take an adequately disclosed position without penalty, provided the position is litigable under Tax Court Rule 33(b) and Federal Rule 11.

#### *IV A Survey of Tax Practitioner Attitudes*

The authors took an informal survey of practitioners' attitudes in conjunction with this Article. Two hundred-fifty-six surveys were mailed to tax attorneys throughout Virginia. Practitioners returned ninety-seven surveys. The survey results are reported in Appendix B.

The survey results reflect consensus in several areas. For instance, most of the respondents were unhappy with the state of affairs that exists in the reporting laws today. When asked whether they thought the ABA and IRS rules governing lawyers in advising tax returns were consistent, clearly defined, and reasonably easy to apply, 82.5% of the respondents felt that they were not, and only one respondent (1%) thought that they were. One respondent added: "They may be clearly defined academically, but not in the heat of practice with a fee-paying client." A large majority (71.1%) of the respondents disagreed with ABA Opinion 85-352's requirement that a lawyer withdraw representation if his client takes a position that falls below RPOS. Only 13.4% of the respondents agreed with this requirement. One respondent noted that "this denies the client representation which is central to our judicial system." Nearly one-half of the respondents (44.3%) disagreed with the change in the 1993 Act that requires a position to have at least a reasonable basis and be disclosed in order for a taxpayer to be absolved of the substantial understatement penalty, while leaving the not frivolous standard for the preparer penalty unchanged. Only 34% of the respondents favored the law. About one-fifth (18.6%) of the practitioners were undecided and three respondents left the question blank. While this indecision may result from the newness of the law, a significant percentage of the respondents were unsatisfied with the double standard that the 1993 Act created.

The survey also illustrates some confusion over how to quantify the various standards in practice. When asked if they would advise a client to take a position with RPOS but without substantial authority, 45.4% of the practitioners answered no and 35% replied that they would. Nearly one in five lawyers did not know what they would do (19.6%). An overwhelming

majority (93.8%) of lawyers, however, would favor taking the position if the client made disclosure. One respondent observed: "Clients aren't interested in the murky distinctions between 'reasonable basis,' 'realistic possibility of success,' 'nonfrivolous,' etc. I can't quantify when a position has a one in three chance of success. No one can." Thus, the difference between RPOS and substantial authority (33.3% versus 40%) seemed to be difficult for the respondents to quantify. While lawyers did not believe that they could tell the difference between RPOS and substantial authority, they seemed to think that the IRS could and would. Furthermore, most preparers and taxpayers are "good guys" who will not take a tenuous position without letting the IRS know that they are unsure of it themselves.

The respondents were more certain of the distinction between reasonable basis and RPOS (10-20% versus 33.3%), than the smaller gap RPOS and substantial authority (33.3% versus 40%). Most of the practitioners (76.3%) would not advise a client to take a position with only a reasonable basis instead of RPOS if the client was unwilling to make disclosure. One reason for their hesitance may be the influence of ABA Opinion 85-352, which would force the lawyer to withdraw if the client takes this position. If, on the other hand, the client was willing to make disclosure, a majority of respondents (58.8%) agreed that they would advise their client to take the position. Some respondents may have felt that the act of disclosure itself was a sign of good faith. Coupled with the broader range of authorities that may be used under 85-352, some respondents may have felt that they could raise the possibility of a client's position enough so that they would not have to withdraw representation.

Another area in which the respondents agreed was how many reporting standards to have and what the standards should be. Nearly two-thirds (59.8%) of the respondents agreed with the proposition that a single, uniform reporting standard should be used for all reporting purposes, and only 15.5% opposed this proposition. Significantly, almost one-fourth (24.7%) of the practitioners were undecided. Some of this indecision may be explained by one of the respondent's comments: "A single standard would be nice dependent upon who sets the standard." When asked whether they thought the standard that requires a good faith belief that a tax return position has a realistic possibility of being sustained administratively or judicially on the merits would be the most appropriate single standard, 72.2% answered in the affirmative. Just over 11% disagreed. One respondent who disagreed commented that the standard was "too low—wild, wild west approach." Most of the practitioners, however, concluded that a single RPOS-based reporting standard would be the most appropriate.

Finally, the majority of the respondents (65%) felt that the availability of secondary sources for a preparer to determine whether a position has substantial authority should be expanded. Of the 17.5% in disagreement, one respondent stated: "Including articles and treatises presents too many variables if the goal is to narrow the range of acceptable interpretations." Despite these dissenters, most of the respondents recognized the everyday necessity for consulting secondary sources as the law has grown more complex and the number of standards has proliferated.

In conclusion, the informal survey bears out many of this Article's points. Many practitioners want some type of guidance, although it is unclear by which standard they wish to be governed. While lawyers professed an ability to divine between RPOS and reasonable basis, when the question became one of RPOS versus substantial authority, they were much more comfortable in advising their client to take a position if they had the safety net of disclosure. ABA Opinion 85-352 was unpopular because it creates more problems than it solves by requiring a lawyer to withdraw if the client does not wish to disclose and RPOS has not been met.

Much discussion is required before a single standard is imposed. The majority of respondents, however, *did* favor going to a single standard. The majority might have been larger if they knew what the standard would be. The ABA Opinion 85-352 RPOS standard was popular with the respondents. Finally, most respondents favored expanding the number of secondary sources available to them.

### *Postscript*

Since 1966, I have had the privilege of attempting to teach literally scores of law students something about one of the greatest of abominations created by a mankind corrupted by original sin—the Internal Revenue Code. During that time, I have often mused on the idea that perhaps their and my time could be better spent on something (almost anything) else, such as planting corn or tomatoes. I leave with one consolation—during all that time I have strived and sometimes succeeded in teaching law students how to keep money out of the hands of the federal government and in the pockets of their clients!

J Timothy Philipps

*Appendix A*  
*Reporting Standards Summary*

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



*Appendix B*  
*Survey Results*

The following results were tabulated from the ninety-seven surveys that were returned.

Lawyer interviews Client with regard to income tax position A (relating to a substantial item on the tax return), which Client wishes to take and determines that position A has a reasonable basis and is neither frivolous nor fraudulent. Lawyer also determines that the position lacks substantial authority under IRC § 6662, and that the IRS is very likely to disagree with position A. Lawyer advises Client of these findings. Lawyer further advises Client of the possibility of avoiding the substantial understatement penalty by making adequate disclosure of position A and advises Client to do so. Client declines to make adequate disclosure. See Holden, *supra* note 91, at 775.

In the hypothetical above, Position A has a reasonable basis but does not have substantial authority. For questions 1 and 2, assuming that Position A has a Reasonable Possibility of Success if litigated (RPOS) (ABA Opinion 85-352):

1. Would you be willing to advise Client to take Position A if Client refused to disclose?

YES — 34 (35%)  
UNDECIDED — 19 (19.6%)  
NO — 44 (45.4%)

2. Would you be willing to advise Client to take Position A if Client was willing to disclose?

YES — 91 (93.8%)  
UNDECIDED — 5 (5.2%)  
NO — 1 (1%)

For questions 3 and 4, assuming that Position A has only a reasonable basis:

3. Would you be willing to advise Client to take Position A if Client refused to disclose?

YES — 7 (7.2%)  
UNDECIDED — 16 (16.5%)  
NO — 74 (76.3%)

4. Would you be willing to advise Client to take Position A if Client was willing to disclose?

YES — 57 (58.8%)  
UNDECIDED — 16 (16.5%)  
NO — 24 (24.7%)

5. Would you be willing to discuss the client's chances of being audited with him?

YES — 76 (78.4%)  
UNDECIDED — 7 (7.2%)  
NO — 14 (14.4%)

6. ABA Opinion 85-352 requires a lawyer to withdraw representation if Client takes a position which falls below RPOS even if the position has a reasonable basis and is not frivolous. Do you agree or disagree with this requirement?

AGREE — 13 (13.4%)  
UNDECIDED — 15 (15.5%)  
DISAGREE — 69 (71.1%)

7. Would you agree or disagree with the proposition that a single, uniform reporting standard should be used for all reporting purposes?

AGREE — 58 (59.8%)  
UNDECIDED — 24 (24.7%)  
DISAGREE — 15 (15.5%)

8. Some have argued that the most appropriate single standard for tax return positions should be a good faith belief that the tax return position under consideration has a realistic possibility of being sustained administratively or judicially on its merits if challenged. Would you agree or disagree?

AGREE — 70 (72.2%)  
UNDECIDED — 16 (16.5%)  
DISAGREE — 11 (11.3%)

9. Some also argue that secondary sources such as treatises and articles should be allowed to be used when a lawyer is assessing whether a position has substantial authority. Would you agree or disagree?

AGREE — 63 (65%)  
UNDECIDED — 17 (17.5%)  
DISAGREE — 17 (17.5%)

10. Adequate disclosure formerly cured a nonfrivolous substantial position under the negligence, disregard of rules and regulations, substantial understatement, and preparer penalties (although ABA Opinion 85-352 is ambiguous on this point). The Revenue Reconciliation Act of 1993 changed the law so that a position must have at least a reasonable basis and be disclosed in order for a taxpayer to be absolved of the substantial understatement penalty, while it left the not frivolous standard for the preparer penalty unchanged. Would you agree or disagree with this change?

AGREE — 33 (34%)  
 UNDECIDED — 21 (21.7%)  
 DISAGREE — 43 (44.3%)

11. In your opinion, are the ABA and IRS rules governing lawyers in advising tax return positions consistent, clearly defined, and reasonably easy to apply?

AGREE — 1 (1%)  
 UNDECIDED — 16 (16.5%)  
 DISAGREE — 80 (82.5%)

#### Comments to Specific Questions:

1. Answered "yes" and added: "Prior to 1993, the disclosure of positions not supported by substantial authority was rare. After the new legislation, such disclosure will be even rarer."

2. Answered "yes" and added: "Clients want recommendations as to what they should do. They aren't interested in the murky distinctions between 'reasonable basis', 'reasonable possibility of success', 'non frivolous', etc. that lawyers have contrived to show how bright they are, 'perfect' the system, and run up bills. If there is a reasonable, non-laughable argument that can be made in support of a position, that position will be (and should be) taken. I can't quantify when a position has a one in three chance of success. No one can."

5. Answered "yes" and added: "and would discuss full potential cost—penalty, interest and attorneys fees."

Answered "yes" and added: "but advise/urge against audit lottery mentality "

6. Answered "disagree" and added: "This denies the client representation which is central to our judicial system."

Answered "disagree," circled the word "reasonable" in the question and added: "if truly reasonable."

7 Answered "disagree" and added: "A single standard would be nice dependent upon who sets the standard. Additionally, since laws tend to evolve and interpretations change, a set standard may inhibit and delay future changes."

Answered "disagree" and added: "The reason I disagree re Question 7 is that the burden should not be as strenuously enforced re: a fiduciary in an estate tax or fiduciary income tax situation as opposed to an individual filing his or her own personal income tax."

8. Answered "agree" and added: "difficult or impossible to enforce/administer."

Answered "disagree" and added: "too low—wild, wild west approach."

9 Answered "disagree" and added: "Including articles and treatises presents too many variables if the goal is to narrow the range of acceptable interpretations."

Answered "agree" and added: "but only to the extent that *no* other authority exists compared to the situation where the secondary source weighs competing authorities."

10. Answered "disagree" and added: "'reasonable' will be determined by the trier of fact after the fact."

Answered "agree" and added: "Ambiguous question."

Answered "disagree" and added: "Unclear for many what the real standard is."

11. Answered "disagree," circled the words "clearly defined" in the question, and added: "academically maybe, but not applied in the heat of practice with a fee paying client."

#### General Comments:

The survey is leading.

The biggest single problem in applying tests to a specific set of facts is the large amount of research required to evaluate a position relative to the standards in many cases where the client does not want to pay and/or will not pay to have research done. If the matter is important enough, the choice is either pay the freight or withdraw. Reality is that the client will

find a lawyer or CPA with less knowledge in the area (or more reckless [*sic*]) and will file the way he wants. 9 times out of 10 nothing will happen and the client believes he was right and you were wrong. In practice, very few clients want the *right answer*, they want the answer they want to hear.

Some of us lawyers are also CPAs and we have yet a third set of rules to consider with these issues!

Current IRS standards are confusing and difficult to comply with. It is not fair that the IRS can impose penalties for positions taken which have been upheld in court, but which the IRS disagrees with (for example, penalties may be imposed for taking a position contrary to proposed regulations).