Washington and Lee Law Review

Volume 50 | Issue 2 Article 10

Spring 3-1-1993

It'S Not Easy Being Easy: Advising Tax Return Positions

J. Timothy Philipps

IT'S NOT EASY BEING EASY: ADVISING TAX RETURN POSITIONS

J. TIMOTHY PHILIPPS*

I. INTRODUCTION

Standards governing the tax lawyer, particularly with respect to tax return advice and preparation, are more stringent today than ever before. A myriad of professional and statutory precepts attempt to mediate the tension between the lawyer's duty to represent a client diligently and the sometimes conflicting duty to promote the administration of justice (frequently referred to as a "duty to the system").[1] In 1952, Norris Darrell summed up the dichotomy by stating, "You of course have a 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."[2] The

---

* Professor of Law, Washington and Lee University School of Law; B.S. 1962, Wheeling Jesuit College; J.D. 1965, Georgetown University; LL.M. 1966, Harvard University.
Special thanks to research assistant, William Lewis Pipkin and the Frances Lewis Law Center.

1. *See* 13 BERNARD WOLFMAN ET AL., STANDARDS OF TAX PRACTICE I ¶ 105.02 [hereinafter STANDARDS OF TAX PRACTICE]; ABA Comm. on Ethics and Professional Responsibility, Formal Op. 85-352 (1985) [hereinafter ABA Op. 85-352], *reprinted in* 39 TAX LAW. 631 (1986); STANDARDS OF TAX PRACTICE app. ¶ 2003.

2. *See* James R. Rowen, *When May a Lawyer Advise a Client That He May Take a Position on His Tax Return?*, 29 TAX LAW. 237, 237 (1976) (quoting statement by Norris Darvell concerning dual duties of tax lawyers). Justice Holmes warned in another context that "men must turn square corners when they deal with the government." Rock Island R.R. v. United States, 254 U.S. 141, 143 (1920).

From early on, commentators have taken divergent positions on the practitioner's tax return obligations based on differing views of the appropriate emphasis to be placed on the practitioner's duty to the client as contrasted to a conflicting duty to the system. For example, Randolph Paul placed a high value on duty to the system. In an early discussion he advanced a clear duty of disclosure for questionable positions:

> There are, however, cases in which there is a clear duty of disclosure which most tax attorneys would respect. For instance, in spite of the *Textile Mills* decision, and the applicable regulation, there remains some chance that legitimate lobbying expenses are deductible. Yet I think most attorneys would refuse to sanction the deduction of lobbying expenses in a return without a complete segregation of the deduction so that it would automatically come to the attention of the revenue agent.

Randolph E. Paul, *The Lawyer as Tax Advisor*, 25 ROCKY MT. L. REV. 412, 427-28 (1953), *quoted in* Rowen, *supra*, at 238.

In contrast, Mark Johnson, another prominent commentator, emphasized the primacy of the lawyer's duty to the client:

> Surely we must give our client the benefit of all reasonable doubts on the facts and the law. We of course should communicate to him our expert evaluation of all reasonable doubts, so that we will be prepared for all contingencies. But once we are honestly convinced that he has a reasonable basis for an advantageous position, we can counsel and advocate that position without first satisfying ourselves that we

standards governing the tax lawyer are often vague, sometimes inconsistent, and frequently difficult to apply. Nevertheless, the need to make decisions based on these often slippery standards occurs on a daily basis in tax practice, and even seemingly mundane situations can be problematical.

Clients do not come to tax lawyers for expensive advice on easy questions. The lawyer normally must give advice where either the law itself or the application of the facts to the law is uncertain.[3] The lawyer must decide whether a position that is neither clearly correct nor clearly incorrect may be advanced in the client's favor on the tax return.[4] The lawyer faces a client who is paying for and expects diligent, even zealous representation of his[5] interests.[6] At the same time, the lawyer must abide by standards that may require him to act in ways that appear, at least to the client, to be contrary to the client's best interests.

The standards governing a tax attorney's conduct are often clear in the abstract, but become perplexing in application. The lawyer's natural ten-

---

> would accept that position if we were a revenue agent. That kind of schizophrenia is not demanded of a lawyer in any other branch of law, and it should be no different in the tax law. By the same token, if we believe that the taxpayer's position depends upon a correct, or even reasonably tenable, interpretation of the law, we do not have to provoke controversy by advertising the grounds on which it might be attacked.

Mark H. Johnson, *Does the Tax Practitioner Owe a Dual Responsibility to His Client and to the Government?—The Theory*, 15 S. CAL. INST. 25, 31-32 (1963), *quoted in* Rowen, *supra*, at 238-39.

3. 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).

4. *Id.*

5. 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).

6. The former American Bar Association (ABA) Model Code of Professional Responsibility imposed a duty on the lawyer to represent a client "*zealously* within the bounds of the law" (emphasis added). MODEL CODE OF PROFESSIONAL RESPONSIBILITY Canon 7 (1969). Likewise the old ABA Canons of professional ethics imposed a duty of "warm zeal" on behalf of the client. CANONS OF PROFESSIONAL ETHICS Canon 15 (1908) (as amended). In contrast, the latest ABA formulation in the Model Rules requires a lawyer to "act with reasonable diligence and promptness in representing a client." MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.3 (1992). The comment to Model Rule 1.3 states, "A lawyer should act with commitment and dedication to the interests of the client and with *zeal in advocacy* upon the client's behalf." MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.3 cmt. 1 (1992). The rule itself does not refer to zeal and the comment refers to zeal only in connection with the lawyer's role as advocate. *Id.* The change may indicate a movement toward the duty to system concept. However, the drafters may only have intended to reduce the possibility of "zeal" being mistaken for "zealotry" and, thereby, preclude an overly aggressive interpretation of the lawyer's duty to client. *See* Michael C. Durst, *The Tax Lawyer's Professional Responsibility*, 39 FLA. L. REV. 1027, 1047 n.74 (1987). The tension between duty to client and duty to the system is an age-old one, and by no means confined to the tax law area. *See* Andrew Kaufman, Book Review, 94 HARV. L. REV. 1504 (1981) (reviewing ALLAN H. GOLDMAN, THE MORAL FOUNDATIONS OF PROFESSIONAL ETHICS (1980)). The philosophical basis of the lawyer-client relationship is elegantly explored in Charles Fried, *The Lawyer as Friend: The Moral Foundations of the Lawyer-Client Relationship*, 85 YALE L.J. 1060 (1976).

dency is to promote the interests of the client, who is paying the lawyer's fees—that is, the lawyer has a tendency to be easy on the client.[7] At the same time, the standards of tax practice impose upon the practitioner a duty that sometimes makes being easy on the client difficult or impossible. Hence, to paraphrase the words of a popular country music song, the practitioner may find that "[i]t's not easy being easy."[8]

Congress, the United States Treasury Department (Treasury), and the American Bar Association (ABA) should promote the policy of consistency between the various practitioner and taxpayer standards in drafting legislation, regulations, and professional practice standards. Consistency in the standards will increase the ability of practitioners and taxpayers to comply with the authorities on which our voluntary self-assessment tax system is based.

II. OVERVIEW OF GOVERNING STANDARDS

A conglomeration of standards governs the tax lawyer in advising tax return positions. These standards include statutory standards established by the Internal Revenue Code of 1986, as amended (Code), through the imposition of penalties on taxpayers and on tax return preparers. The Code imposes duties on lawyers both directly and indirectly, through assessment of penalties on the client. The principal penalties the lawyer needs to be concerned with are the accuracy-related penalty imposed directly on the taxpayer[9] and the preparer penalties imposed on the lawyer who prepares an erroneous tax return or renders substantial advice with respect to the preparation of such a return.[10]

Professional standards also govern the tax lawyer's conduct in advising tax return positions. State disciplinary rules govern lawyer conduct generally. These are administered by state disciplinary bodies according to the rules in each state. State rules, in turn, are greatly influenced by the ABA Model Rules of Professional Conduct and their predecessors, the Model Code of

---

7. *See* Matthew C. Ames, *Formal Opinion 352: Professional Integrity and the Tax Audit Lottery*, 1 GEO. J. LEGAL ETHICS 411, 424-25. Mr. Ames states,

> There will always be pressure on the lawyer to give his blessing to a client's position. The lawyer's natural tendency will be to hedge and waver and convince himself that the position does have a realistic chance of succeeding, and that it really is held in good faith.

Id.; Gwen Thayer Handelman, *Constraining Aggressive Return Advice*, 9 VA. TAX REV. 77, 102-03 (1989) (stating lawyers are "subject to mortal self-deception when self-interest or the interest of a client is implicated"); Frederic G. Corneel, *Guidelines to Tax Practice Second*, 43 TAX LAW. 297, 299-300 (1990) (describing lawyer as "stalwart defender of the client's interests in struggles with the Service").

8. S. HARRINGTON ET AL., WARNER TAMERLANE PUBLISHING CORP. (Warner Bros.) (originally sung by Janie Fricke).

9. *See* I.R.C. § 6662 (West Supp. 1993); *infra* text accompanying notes 43-90 (discussing statutory standards for tax return advice).

10. *See* I.R.C. § 6694 (1988); *infra* text accompanying notes 91-107 (discussing preparer penalties).

Professional Responsibility, and the Canons of Professional Ethics.[11] Although these ABA documents have no binding effect in and of themselves, state disciplinary systems often adopt them in whole or in part.[12] In the tax area, the ABA has promulgated three influential pronouncements—Opinion 314,[13] Opinion 346,[14] and Opinion 85-352[15]—that form the basis for the professional standards governing tax practice.[16]

The Treasury also promulgated standards for practice before the Internal Revenue Service (IRS) in Circular 230.[17] The Treasury recently proposed a revision to Circular 230 encompassing a standard similar to the ABA "realistic possibility of success standard" promulgated in Opinion 85-352.[18]

III. A "Simple" Case

Assume that Client has been a limited partner in a real estate investment activity for several years. Client has participated in the investment activity more than 500 hours each year, and hence has qualified as a material participant in the activity under the passive activity loss rules of Code section 469.[19] Client has taken substantial losses against other income over the past several years due to the real estate investment. Approximately $1,500,000 of the partnership's nonrecourse liabilities are allocated to Client under the partnership liability allocation regulations.[20]

The partnership is insolvent and Client's partnership interest is basically worthless. The principal partnership creditor has offered a workout plan under which it will forgive a portion of the partnership nonrecourse debt which substantially exceeds the value of the assets securing that debt. The debt forgiveness will reduce the liability to approximately the fair market value of the property securing the debt. Client's assets have a fair market value in excess of Client's liabilities excluding the $1,500,000 partnership liabilities allocated to Client. However, if the $1,500,000 partnership liabilities allocated to Client are included in the computation, Client's liabilities exceed Client's assets. The nonrecourse liabilities proposed to be forgiven

---

11. *See* Standards of Tax Practice, *supra* note 2, ¶ 111.

12. *See id.* ¶ 111.02.

13. ABA Comm. on Professional Ethics, Formal Op. 314 (1965), *reprinted in* Standards of Tax Practice, *supra* note 1, app. ¶ 2001.

14. ABA Comm. on Ethics and Professional Responsibility, Formal Op. 346 (1965), *reprinted in* Standards of Tax Practice, *supra* note 1, app. ¶ 2002.

15. ABA Op. 85-352, *supra* note 1.

16. *See infra* text accompanying notes 112-77 (discussing ABA Opinion 85-352).

17. *See infra* text accompanying notes 178-87 (discussing IRS Circular 230).

18. *See* 31 C.F.R. subtit. A § 10.34 (1992) [hereinafter Circular 230].

19. I.R.C. § 469 (1988); *see* Temp. Treas. Reg. § 1.469-5T(a)(1), (e)(2) (1988) (detailing requirements for material participation).

20. *See* I.R.C. § 752 (1988) (explaining treatment of partnership liabilities); Treas. Reg. § 1.752-3 (1991) (explaining distribution of nonrecourse liability in partnership). A nonrecourse liability is one for which "no partner or related person bears the economic risk of loss. . . ." Treas. Reg. § 1.752-1(a)(2) (1991). A nonrecourse liability is one for which Client has no personal liability. *Id.*

in the workout that are allocable to Client amount to $1,000,000. Hence, Client faces as much as $1,000,000 in debt forgiveness income, resulting in an amount of tax liability that will devastate Client financially.[21]

The issue is whether Client qualifies for nonrecognition of any or all the debt forgiveness income under Code section 108, which basically requires that Client be insolvent to qualify for nonrecognition treatment.[22] Although the partnership itself is insolvent, the Code clearly requires the taxpayer to make the determination of insolvency for purposes of Code section 108 at the partner level rather than the partnership level.[23] The question then becomes whether Client is insolvent for purposes of Code section 108.

Two statutory provisions bear directly on the problem. First, Code section 108(d)(1) defines indebtedness of the taxpayer to include any indebtedness "subject to which the taxpayer holds property."[24] Second, Code section 108(d)(3) defines the term insolvent to mean "the excess of liabilities over the fair market value of assets."[25] The problem thus narrows to whether the liabilities included in the calculation under the statutory defi-

---

21. For simplicity, the example assumes that the partnership will return no property to the creditor in exchange for the debt forgiveness. When property is exchanged for forgiveness of nonrecourse debt, the transaction is treated as a sale of the property in an amount equal to the amount of the liability rather than as a transaction resulting in debt forgiveness income. *See* Commissioner v. Tufts, 461 U.S. 300, 317 (1983) (concluding that sale or disposal of property encumbered by nonrecourse debt requires inclusion of amount of debt in amount realized by seller); Treas. Reg. § 1.1001-2 (1980) (requiring inclusion of discharged liabilities in amount realized, from sale of debt encumbered property).

22. I.R.C. § 108(a) (1988) provides in relevant part:

> (a) Exclusion from gross income.
>
> (1) In General.—Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—
>
> (A) the discharge occurs in a title 11 case,
>
> (B) the discharge occurs when the taxpayer is insolvent, or
>
> (C) the indebtedness discharged is qualified farm indebtedness.

Id.

23. *Id.* § 108(d)(6) provides in relevant part:

> Subsections (a), (b), and (g) to be applied at partner level. In the case of a partnership, subsections (a), (b), and (g) shall be applied at the partner level.

Id.

24. *Id.* § 108(d)(1)(B). The full text of § 108(d)(1) reads as follows:

> (1) Indebtedness of taxpayer.—For purposes of this section, the term "indebtedness of the taxpayer" means any indebtedness—
>
> (A) for which the taxpayer is liable, or
>
> (B) subject to which the taxpayer holds property.

Id.

25. *Id.* § 108(d)(3). The full text of the relevant provision reads as follows:

> (3) Insolvent.—For purposes of this section, the term "insolvent" means the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.

Id.

nition of "insolvent" in Code section 108(d)(3) include the nonrecourse liabilities allocated to a partner under the partnership liability allocation rules. This in turn depends on whether "indebtedness of the taxpayer" under Code section 108(d)(1) includes nonrecourse liabilities when the debt exceeds the value of the assets.

Appraising the issue, Lawyer notes that the "subject to" phraseology in Code section 108(d)(1)(B) contraposed to the phrase "for which the taxpayer is liable" in the preceding phrase clearly refers to nonrecourse debt as being included in "indebtedness of the taxpayer." However, the statute says nothing about whether debt allocated under the partnership liability allocation rules is included in debt "subject to" which the taxpayer holds property. The only reference to partnerships in Code section 108 is in section 108(d)(6), which requires taxpayers to make determinations under subsection (a) at the partner, rather than the partnership, level. This provision appears to be only indirectly relevant. It clearly requires taxpayers to make the determination of insolvency at the partner level, but it does not say directly whether partnership nonrecourse liabilities allocated to the partner are to be taken into account for this purpose.[26]

Lawyer reasons that partnership recourse debt allocated to a partner under the partnership liability allocation rules would be includible in the computation under Code section 108(d)(1)(A) as debt for which the "taxpayer is liable,"[27] because the recourse liability allocation rules base their allocations on ultimate economic responsibility for the debt.[28] Lawyer must then decide whether it is reasonable to conclude that nonrecourse liabilities allocated to a partner under the same set of rules likewise should be included in the insolvency computation under Code section 108(d)(1).

In researching the issue, Lawyer first finds a news story concerning the question of whether nonrecourse debt should be included in the insolvency computation. The story quotes an IRS official as stating that nonrecourse debt should be included in the computation, at least to the extent that nonrecourse debt is forgiven.[29]

---

26. *See id.* § 108(d)(6) (requiring that determinations under subsections (a), (b), and (g) of § 108 be made at partner level).

27. *Id.* § 108(d)(1)(A).

28. *See* Ed R. Haden, Note, *The Final Regulations Under IRC Sections 704(b) and 752: Envisioning Economic Risk of Loss Through a Glass Darkly*, 49 WASH. & LEE L. REV. 487, 510-11 (1992) (explaining that rules allocate liability to partners bearing economic risk of loss).

29. *See Questions Arise from Cancellation of Nonrecourse Debt*, 51 TAX NOTES 959 (1991) (discussing remarks of Internal Revenue Service (IRS) Counsellor to the Commissioner Thomas Hood). The story stated,

> Nonrecourse debt may not be treated the same as recourse debt for purposes of determining insolvency under section 108(d)(3). Hood discussed the approaches that the IRS has considered for treatment of nonrecourse debt in insolvency calculations. He indicated that ignoring nonrecourse debt (entirely) in determining insolvency would be unrealistic. It would of course be consistent with Rev. Rul. 91-31 to always include nonrecourse debt in the determination of insolvency, treating both

Lawyer also finds three recent law review articles dealing with the issue. These articles conclude that nonrecourse debt should be included in the calculation at least to the extent of the fair market value of the property securing the debt plus any additional amount of nonrecourse liability, to the extent that nonrecourse liability is discharged.[30] None of the articles cites authority directly on point with respect to the issue. However, the articles do offer well-reasoned analyses of the statute that support the inclusion of forgiven nonrecourse debt in the insolvency calculation. Moreover, in addition to these secondary sources, Lawyer finds a report of an ABA Tax Section task force that also supports the inclusion of nonrecourse liability in the insolvency definition.[31]

In fact, the task force report goes so far as to state that a good argument exists that discharge of nonrecourse debt in excess of the fair market value of property securing the debt is not even includible as discharge of indebtedness income at all. The task force report cites an old Board of Tax Appeals case, *Fulton Gold Corp. v. Commissioner*,[32] that can be interpreted as authority for the proposition that forgiveness of nonrecourse debt does not result in debt discharge income at all, but rather results only in a reduction of taxpayer's basis in his partnership interest.[33] Lawyer also finds a footnote in a Supreme Court case, *Tufts v. Commissioner*[34] that cites *Fulton Gold* and might be interpreted as supporting the *Fulton Gold* position that forgiveness of nonrecourse debt results in basis reduction rather than discharge of indebtedness income.[35]

---

types of debt the same.

> Hood alluded to the possibility that nonrecourse debt may not always be included in this calculation; he might argue that it should be included in the calculation only when nonrecourse debt is being forgiven. This latter theory is called the "matching rule" for reasons not immediately apparent.

Id.

30. *See* Richard M. Lipton, *Planning for Noncorporate Debt Workouts Outside of Bankruptcy*, 70 TAXES 275, 289-90 (1992) (discussing arguments for inclusion of contingent liabilities in insolvency computation); Robert C. Livsey, *Determining if a Taxpayer is Insolvent for Purposes of the COD Income Exclusion*, 76 J. TAX'N 224, 227 (1992); Walter D. Schwidetzky, *Partnership Taxation: Restructuring Partnership Debt—Life is Change*, 11 VA. TAX REV. 523, 536 (1992) (discussing inclusion of nonrecourse debt in I.R.C. § 108 insolvency computation).

31. *See* ABA Tax Section, *Report of the Section 108 Real Estate and Partnership Task Force*, TAX NOTES TODAY, Aug. 10, 1992, *available in* LEXIS, Taxria Library, TNT File.

32. Fulton Gold Corp. v. Commissioner, 31 B.T.A. 519, 520-21 (1934). The case might also be construed more narrowly as a purchase price adjustment situation. Jeffrey T. Sheffield & Todd F. Maynes, *Selected Tax Issues in Partnership Debt Restructurings*, 68 TAXES 861, 870 n.46 (1990).

33. 31 B.T.A. 519 (1934).

34. 461 U.S. 300 (1983); *see* Schwidetzky, *supra* note 30, at 548-50 (discussing footnote 11 of Tufts v. Commissioner, 461 U.S. 300 (1983)).

35. *See Tufts v. Commissioner*, 461 U.S. at 311 n.11 (1983) (discussing *Fulton Gold*). The Court, referring to the freeing of assets theory for discharge of indebtedness income, stated:

> According to that view, when nonrecourse debt is forgiven, the debtor's basis in the

Finally, Lawyer finds three revenue rulings dealing with forgiveness of nonrecourse debt. The first ruling holds that debt forgiveness income exists in a situation where the fair market value of the securing property exceeds the amount of the debt forgiven.[36] The second ruling extended the holding of the first to a situation in which the liability exceeded the fair market value of the securing property.[37] The results of both these rulings support a conclusion that the amount of the nonrecourse liability should be included in the definition of insolvency. Otherwise, treatment of the two situations would be inconsistent. A debt would be a "taxpayer indebtedness" within the meaning of Code section 108(d)(1) but would not be a liability of the taxpayer for purposes of the section 108(d)(6) insolvency definition.[38]

The third ruling directly addresses the issue of including nonrecourse liabilities in the insolvency calculation. It holds that the nonrecourse liability should be included in the insolvency calculation to the extent of the fair market value of the property securing the debt plus any nonrecourse liability in excess of the property's fair market value, to the extent that the nonrecourse debt is forgiven.[39] The debt forgiveness transaction in question fits the facts of the ruling except in one particular: the ruling deals with nonrecourse debt of an individual, not that of a partnership.

Hence, the ruling only answers half of Lawyer's question. The ruling clearly allows nonrecourse debt directly incurred by an individual to be included in the insolvency calculation. But it does not address the question of whether the same principle applies to nonrecourse debt allocated to a partner by the partnership liability allocation rules. Of the other materials Lawyer has found, only one directly refers to this issue. The Tax Section task force on section 108, applying a well-reasoned analysis (but not citing any directly supportive authority), explicitly states that if forgiveness of nonrecourse debt allocated to a partner is included in income, the nonrecourse debt also should be included in the insolvency definition for purposes of section 108.[40] Thus, the Section 108 task force report directly supports Client's position. Assume for purposes of this example that no other authorities are relevant to the problem.[41]

> securing property is reduced by the amount of debt canceled. . . . Fulton Gold Corp v. Commissioner, 31 B.T.A. 519, 520 (1934). . . . Similarly, if the nonrecourse indebtedness exceeds the value of the securing property, the taxpayer never realizes the full amount of the obligation canceled because the tax law has not recognized negative basis.

Id. However, the Court's discussion merely explicated the *Fulton Gold* position without purporting to endorse it. *Id.*

36. Rev. Rul. 82-202, 1982-2 C.B. 35, 36. The ruling involved discounted prepayment of a nonrecourse debt secured by a residence having a fair market value in excess of the debt. *Id.* The Service held that discharge of indebtedness income was generated by the transaction. *Id.*

37. Rev. Rul. 91-31, 1991-1 C.B. 19, 20.

38. *See* Lipton, *supra* note 30, at 290.

39. Rev. Rul. 92-53, 1992-27 I.R.B. 7, 8.

40. ABA Tax Section, *supra* note 31, at pt. V.

41. The authorities cited are for purposes of illustration only and do not purport to be the result of exhaustive research into the substantive problem.

Lawyer is thus left with a less than complete answer to the problem. Although ample authority exists for the proposition that nonrecourse debt can be included in the insolvency definition in the case of individual debt, the only support for extending this principle to the nonrecourse debt allocated to a partner under the partnership allocation rules is the statement in the Tax Section section 108 task force report. Still, Lawyer must make a determination as to whether he can properly advise Client to take the position on the tax return that Client is insolvent. Client needs to take this position to be eligible under section 108 for nonrecognition of debt discharge income resulting from the debt restructuring, a position that Client must sustain to avoid financial ruin.

What are the ethical and legal considerations that apply to Lawyer in rendering the tax return advice? The analysis must begin with the fundamental premise that the taxpayer is entitled to a prepayment forum in which to assert his position. This is the *raison d'etre* of the Tax Court.[42] 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 Service may well contest, even though the taxpayer's position is not certainly correct, or perhaps even probably correct. This proposition is not controversial.[43] The next, more difficult question is the degree of certitude with

---

42. The Tax Court (formerly the Board of Tax Appeals) was created 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 creating the Board of Tax Appeals 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. ____(1924) (emphasis added), *reprinted in* 1939-1 C.B. 241 (Part 2), 246-47.

43. *See* James P. Holden, *Constraining Aggressive Return Advice: A Commentary*, 9 VA. TAX REV. 771, 773 (1990). It might be argued 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.

IRS Form 1040 (emphasis added). Also, I.R.C. § 7206 (1988) makes it a felony for a person to willfully make and subscribe to a return "which he does not believe to be *true and correct* as to every material matter." *Id.* § 7206(1) (emphasis added). Nevertheless, the "true and respect to the correctness of the taxpayer's position that is required under the various governing standards in order for Lawyer to be able to advise and participate in taking that position on the tax return.

A. *Statutory Standards*

The Code imposes certain standards of tax return advice on the lawyer to reflect the policy of encouraging voluntary self-assessment. The two statutory provisions most likely to be relevant to Lawyer's situation are the accuracy-related penalty[44] and the return preparer penalty.[45]

1. Accuracy-Related Penalty

The accuracy-related penalty imposes a duty on the taxpayer, not the lawyer per se. However, a lawyer's duties flow from the legal duty of the client to comply with the law.[46] The components of the accuracy-related penalty most relevant to Lawyer's case are the penalties for negligence,[47]

---

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 2, at 250-51. However, at least one commentator has argued for a "true and correct" standard of reporting. *See generally* Calvin Johnson, *'True and Correct': Standards for Tax Return Reporting*, 43 TAX NOTES 1521 (1989).

44. I.R.C. § 6662 (West Supp. 1993). The Improved Penalty Administration and Tax Compliance Act of 1989 (IMPACT) combined the penalties formerly contained in several sections, including the negligence, disregard of rules and regulations, substantial understatement, and valuation overstatement penalties into a single section and styled all these penalties "Accuracy-related Penalties." Notwithstanding, they remain discrete penalties with different standards for application. However, the accuracy-related penalties (basically imposed at a 20% rate) cannot be cumulated. That is, no more than one of the accuracy-related penalties will apply to a given understatement of tax. Treas. Reg. § 1.6662-2(c) (1991). The portions of I.R.C. § 6662 that impose the penalty read as follows:

> (a) Imposition of penalty.—If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.
> (b) Portion of underpayment to which section applies.—This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:
> (1) Negligence or disregard of rules or regulations.
> (2) Any substantial understatement of income tax.

Id. § 6662(a)-(b)(2) (West Supp. 1993).

45. I.R.C. § 6694 (West Supp. 1993). I.R.C. § 6695 imposes another set of complementary penalties that are not considered here. They are for (1) failure to furnish taxpayer a copy of the return, § 6695(a); (2) failure to sign return, § 6695(b); (3) failure to furnish identifying number, § 6695(c); (4) failure to retain copies or list of returns, § 6695(d); (5) failure to file correct information returns, § 6695(e); (6) improper negotiation of refund check, § 6695(f). I.R.C. § 6695(a)-(f) (West Supp. 1993).

46. *See* STANDARDS OF TAX PRACTICE, *supra* note 1, ¶ 205, ¶ 208; Harris, *supra* note 3, at 975; Holden, *supra* note 43, at 774; Handelman, *supra* note 7, at 89; Durst, *supra* note 6, at 1028-30.

47. I.R.C. § 6662(b)(1) (West Supp. 1993).

disregard of rules and regulations,[48] and substantial understatement.[49] The penalties are not cumulative. If the requirements for imposing a penalty are met, for example, if the amount of tax involved is large enough to implicate the substantial understatement penalty, that penalty will apply. If the requirements for imposing the substantial understatement penalty are not met, the negligence or disregard penalty may apply. Both penalties will not apply to the same understatement.[50]

a. Negligence and Disregard of Rules and Regulations

Negligence includes any failure to make a reasonable attempt to comply with the revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return.[51] Courts have generally applied the tort law "reasonably prudent" test in determining taxpayer negligence.[52] The reasonably prudent test requires the taxpayer to show a reasonable basis for the return position.[53] A return position that is "arguable, but fairly unlikely

48. *Id.* Disregard of rules or regulations includes any careless, reckless or intentional disregard of rules or regulations. *Id.*; Treas. Reg. § 1.6662-3(b)(2) (1991). Rules or regulations include: provisions of the Internal Revenue Code of 1986, as amended (Code), temporary or final (but not proposed) Treasury regulations issued under the Code, and revenue rulings or notices (other than notices of proposed rulemaking). *Id.* Comments on the proposed regulations criticized inclusion of revenue rulings on the list of "rules or regulations" because (1) a revenue ruling does not constitute a "rule" under the Administrative Procedure Act, and (2) a revenue ruling is only the contention of one party and is not subject to the give-and-take of a public comment process. T.D. 8381, 1992-1 C.B. 374, 377 [hereinafter T.D. 8381]. The IRS rejected this objection based on the legislative history of the 1976 Tax Reform Act and the fact that revenue rulings were expressly listed as "rules" under former Treas. Reg. § 1.6694-1 (1991) (concerning preparer penalties). T.D. 8381, *supra*, at 377. The regulations do not explicitly include Revenue Procedures on the list. However, the preamble states that revenue procedures are not listed because "they may or may not be treated as 'rules or regulations' depending on all facts and circumstances." *Id.* This provides scant guidance, but presumably revenue procedures that contain substantive rules will be "rules" for this purpose while revenue procedures that contain mere directions to IRS personnel (for instance, requirements for information to be furnished in obtaining a ruling) will not be "rules."

49. I.R.C. § 6662(b)(2), (d) (West Supp. 1993).

50. *See* Treas. Reg. § 1.6662-2(c) (1991); Lawrence Zelenak, *Reforming Penalty Reform: Congress Should Eliminate the Profusion of Accuracy Standards*, 52 TAX NOTES 471, 471-72 (1991). Also, the accuracy-related penalty does not apply to any portion of an underpayment that is due to fraud. *See* Treas. Reg. § 1.6662-2(a) (1991). The accuracy-related penalty applies only if a return is filed, but both the I.R.C. § 6651 (1988) failure to file penalty and the accuracy-related penalty may be applied to a late return. Treas. Reg. § 1.6662-2(a) (1991).

51. *Id.* § 1.6662-3(b)(1) (1991).

52. *E.g.*, Heasley v. Commissioner, 96 F.2d 116 (5th Cir. 1992); Sammons v. Commissioner, 838 F.2d 330, 337 (9th Cir. 1988); Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967), *cert. denied*, 389 U.S. 1044 (1968); Bowman v. Commissioner, 1987-45 T.C.M. (CCH); *see* STANDARDS OF TAX PRACTICE, *supra* note 1, ¶ 208.031.

53. *See* Treas Reg. § 1.6662-3(b)(1); Sheldon I. Banoff, *Final Regulations on Accuracy Related Penalties: Taxpayers Beware, The Feds Are Out There/There's Danger in the Air—Be Aggressive If You Dare*, 70 TAXES 178, 182 (1992).

to prevail in court" satisfies the reasonable basis standard.[54] Expressed in percentage terms, a reasonable basis probably requires about a ten to twenty percent chance of success if litigated.[55] The taxpayer has the burden of proof on the issue of negligence.[56] Hence, to avoid the negligence penalty, the taxpayer needs to show that there was a reasonable basis for the return position taken. In addition, the negligence penalty can be avoided by making adequate disclosure of the return position, provided the position is not frivolous.[57]

Would Client's proposed position be in any danger of incurring the negligence penalty? Most likely not. There at least seems to be a reasonable basis for the position. The inclusion of nonrecourse debt in the insolvency definition is supported directly by a revenue ruling. Moreover, there is at least an argument that the debt forgiveness does not even result in discharge

---

54. Treas. Reg. § 1.6662-4(d)(2) (1991) (stating that arguable position satisfies reasonable basis standard); Treas. Reg. § 1.6662-3(b)(1) (1991) (providing that negligence penalty is inapplicable to positions for which taxpayer has reasonable basis).

55. *See* Sheldon L. Banoff & Harvey L. Coustan, *Final Regulations on Return Preparer 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, 175 (1992). The efficacy of using percentages to enunciate return position standards is subject to question. *See infra* text accompanying notes 201-03.

56. STANDARDS OF TAX PRACTICE, *supra* note 1, ¶ 208.0311; *e.g.*, *Marcello*, 380 F.2d at 506; Enoch v. Commissioner, 57 T.C. 781, 802 (1972) (holding IRS negligence determination prima facie correct and burden on taxpayer to establish IRS error).

57. *See* Treas. Reg. § 1.6662-3(c) (1991) (explaining disclosure required to avoid negligence penalty). This regulation provides detail with respect to the requirements for adequate disclosure to avoid the negligence penalty. The disclosure defense does not apply if the position is frivolous. *Id.* A position is frivolous if it is "patently improper." *Id.* § 1.6662-3(b)(3). Comments on the proposed regulations criticized this definition for not including a bad faith component. The IRS rejected these comments on the ground that a purely objective standard was most appropriate. "Patently improper" may not really be an objective standard. The IRS also rejected a suggested "not litigable" test as too lawyer oriented. T.D. 8381, 1992-1 C.B. 374, 377. A recent proposal by the Clinton Administration would replace the "not frivolous" standard with a "reasonable basis" standard. TREASURY DEPARTMENT, SUMMARY OF THE ADMINISTRATION'S REVENUE PROPOSALS 68 (1993).

Disclosure must be made on a properly completed Form 8275. The regulations do not provide for avoidance of the negligence or disregard penalties by disclosure in accordance with an annual revenue procedure. Treas. Reg. § 1.6662-3 (1991). Neither do the regulations provide for disclosure by means of a statement attached to the return. *Id.* Disclosure of recurring items such as the basis of depreciable property must be made in each year in which the item is taken into account. Treas. Reg. § 1.6662-4(f)(3) (1991). In the case of carrybacks and carryovers, disclosure is adequate with respect to an item which is included in any loss, deduction or credit that is carried to another year (carryback or carryover year) only if made in connection with the return for the year in which the carryback or carryover arises (loss or credit year). Disclosure is not also required in connection with the return for the carryback or carryover year. *Id.* § 6662-4(f)(4). Disclosure in the case of items attributable to pass-through entities is generally made on the return of the pass-through entity. An individual partner or S corporation shareholder also may make such disclosure. The taxpayer must attach the disclosure to the taxpayer's individual return and also file a copy with the IRS Center with which the return of the entity is required to be filed. *Id.* § 1.6662-4(f)(5).

of indebtedness income at all, based on the *Fulton Gold* case.[58] *Fulton Gold* has not been overruled explicitly by another court (although it has been repudiated in a revenue ruling),[59] and the Supreme Court cited *Fulton Gold* in *Tufts*.[60] Moreover, learned commentary and a statement of an IRS official support the taxpayer's position.[61] This seems at least to make the position "arguable," the standard articulated in the regulations on the negligence component of the accuracy-related penalty,[62] with at least a ten to twenty percent chance of success. Likewise, there seems no danger of incurring the disregard of rules and regulations component of the accuracy-related penalty. There is no disregard of any rule or regulation on this aspect of the position. In fact, a revenue ruling exists that supports the taxpayer's position.

However, the facet of the taxpayer's position that extends the use of nonrecourse liability in the insolvency definition to the nonrecourse liabilities allocated to a partner under the partnership liability allocation rules presents more of a problem. Only one of the sources Lawyer relied upon deals explicitly with this issue. The ABA Tax Section task force report on Code section 108 directly supports Client's position.[63] Lawyer also gleans from the articles and the IRS official's statement that the premise underlying Revenue Ruling 92-53[64] is that it is appropriate to include nonrecourse liabilities in the insolvency calculation when that same nonrecourse debt is the source of the discharge of indebtedness income. It would be inconsistent to require inclusion in income of nonrecourse debt forgiveness, while at the same time excluding the very same nonrecourse debt from calculation of the taxpayer's liabilities for purposes of determining whether the taxpayer is insolvent under section 108. The regulations under section 752 do allocate the liabilities to Client.[65] However, these allocation rules are by their terms directed at determination of a partner's basis in his partnership interest under section 752.[66]

---

58. *See supra* text accompanying notes 29-37 (discussing argument that debt forgiveness does not result in discharge of debt income).

59. Rev. Rul. 92-53, *supra* note 39.

60. *See supra* notes 34-35 and accompanying text (discussing *Tufts*).

61. Although the substantial authority penalty and the tax return preparer penalty exclude learned commentary and statements of IRS officials from the list of permissible authorities, *see* Treas. Reg. § 1.6662-4(d)(3)(iii) (1991); Treas. Reg. § 1.6694-2(b)(2) (1991), the regulations do not so limit the permissible authorities under the negligence penalty. *See* Treas. Reg. § 1.6662-3 (1991); Sheldon I. Banoff, *Dealing with the "Authorities": Determining Valid Legal Authority In Advising Clients, Rendering Opinions, Preparing Tax Returns, and Avoiding Penalties*, 66 TAXES 1072, 1120 (1988). Moreover, consulting such sources would seem to demonstrate reasonable care. In fact, the failure to do so might be evidence of negligence. *See* Harris, *supra* note 3, at 973; Theodore C. Falk, *Tax Ethics, Legal Ethics and Real Ethics: A Critique of ABA Formal Opinion 85-352*, 39 TAX LAW. 643 (1986).

62. *See* Treas. Reg. § 1.6662-4(d)(2) (1991).

63. *See supra* text accompanying note 40.

64. *See supra* note 39.

65. *See* Treas. Reg. § 1.752-3 (1991).

66. *See* Treas. Reg. § 1.752-1(a) (1991) ("This section provides general rules governing the application of section 752, including rules for determining a partner's share of the liabilities of the partnership").

Are the liability allocation rules at all applicable in the section 108 context? At least a plausible argument exists that they are if the section 752 rules are applicable to allocate liabilities to a partner for the purpose of finding the presence of debt forgiveness income under section 61(a)(12), which requires inclusion of "[i]ncome from discharge of indebtedness."[67] Moreover, if one applies the aggregate theory of partnerships,[68] it makes sense to allocate the liabilities in question to the individual partners.

Taking all the foregoing into account, Lawyer probably would decide that the taxpayer is not exposed to the negligence or disregard penalties by taking the proposed position. There appears to be at least a reasonable basis for the position. Moreover, Client may also have a reasonable cause and good faith defense (RCGF) against the negligence penalty if Client relied on Lawyer's advice. A determination of whether taxpayer qualifies for RCGF is made on the basis of facts and circumstances. The most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Reliance on the advice of a professional does not necessarily demonstrate RCGF. However, reliance on professional advice does constitute RCGF if the taxpayer's reliance was reasonable and the taxpayer acted in good faith.[69]

Hence, Client probably could take the position without making disclosure and still not risk incurring the negligence or disregard penalties. However, this does not resolve Lawyer's problem as to whether Lawyer may advise Client to take the position. The reasonable basis standard is lower than the standards required for Lawyer to be able to advise Client to take the position. Lawyer still must consider the substantial understatement penalty, the ABA Opinion 85-352 standard, and the tax return preparer penalty.

b. Substantial Understatement

If any portion of an underpayment of any income tax is attributable to a substantial understatement of such income tax, there is added to the tax an amount equal to twenty percent of such portion.[70] Except with respect to a tax shelter, an understatement is reduced by the portion of the understatement: for which there is substantial authority, or with respect to which there is adequate disclosure.[71] An understatement is substantial if it

67. I.R.C. § 61(a)(12) (1988).

68. The aggregate theory considers a partnership to be merely an aggregate of its individual members. This contrasts with the entity theory, which considers the partnership a separate entity from the individual partners. The provisions of Code Subchapter K represent a combination the aggregate and entity theories. *See* 1 WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 1.02 (2d ed. 1990).

69. *See* Treas. Reg. § 1.6664-4(b) (1991).

70. *See* I.R.C. § 6662(a), (b)(2) (West Supp. 1993); Treas. Reg. § 1.6662-4(a) (1991).

71. Treas. Reg. § 1.6662-4(a) (1991). For example, T files a 1992 income tax return showing taxable income of $20,000 and a tax liability of $6,000 (assuming a 30% tax rate). Audit adjustments increase the taxable income to $50,000 and the tax liability to $15,000.

exceeds the greater of (1) ten percent of the tax required to be shown on the return for the taxable year or (2) five thousand dollars (ten thousand dollars in the case of a corporation other than an S corporation or a personal holding company).[72]

With respect to a tax shelter, items are treated as if they were shown properly on the return only if substantial authority for the position exists and the taxpayer reasonably believed at the time the return was filed that the taxpayer's position was more likely than not the proper tax treatment.[73] A taxpayer is considered to have reasonably believed that the tax treatment of an item is more likely than not the proper tax treatment if (1) the taxpayer analyzed the pertinent facts and authorities and reasonably concluded that there is a greater than fifty percent likelihood that the tax treatment of the item will be upheld if challenged by the IRS, or (2) the taxpayer, in good faith, relied on the opinion of a professional tax advisor. In the latter case, the opinion must be based on the advisor's analysis of the pertinent facts and authorities and the opinion must state unambiguously that the advisor concludes that a greater than fifty percent likelihood exists that the tax treatment of the item will be upheld if challenged by the IRS.[74] To be a tax shelter with respect to the substantial understatement penalty, the principal purpose of the investment, based on objective evidence, must be to avoid or evade federal income tax.[75]

Lawyer determines that the principal purpose of the investment was not to avoid or evade federal taxes. Hence, to avoid the substantial understatement penalty, Client must disclose the position in accordance with the regulations, show substantial authority supporting the position, or show reasonable cause and good faith.

Adequate disclosure generally requires that the position be reported on Form 8275, sometimes referred to as the "Please Audit Me Now" form.[76] In some instances, for purposes of the substantial understatement penalty but not the negligence penalty,[77] a taxpayer may be able to make disclosure

---

Substantial authority existed for a non-tax shelter item that accounted for $8,000 of the $30,000 increase in taxable income. The amount of tax shown on T's return is determined as if the item for which substantial authority existed had been given proper treatment. Hence, the amount of tax treated as shown on T's return is $8,400 (30% of $28,000). The amount of the understatement is $6,600 ($15,000 required to be shown on the return minus $8,400 treated as shown on the return). The amount of the penalty would be $1,320 (20% of $6,600). STANDARDS OF TAX PRACTICE, *supra* note 1, ¶ 208.0312. *See generally* Treas. Reg. § 1.6662-4(d)(1) (1991).

72. *See* I.R.C. § 6662(d)(1)(A) (West Supp. 1993); Treas. Reg. § 1.6662-4(b) (1991).

73. *See* I.R.C. § 6662(d)(2)(C) (West Supp. 1993); Treas. Reg. § 1.6662-4(g)(1) (1991).

74. *See* Treas. Reg. § 1.6662-4(g)(4) (1991). Disclosure made with respect to a tax shelter item does not affect the amount of an understatement.

75. *See* I.R.C. § 6662(d)(2)(C)(ii) (West Supp. 1993); Treas. Reg. § 1.6662-4(g)(2)(i) (1991). An item is a tax shelter item if the item is directly or indirectly attributable to the principal purpose of a tax shelter to avoid or evade federal income tax. *See* Treas. Reg. § 1.6662-4(g)(3).

76. *See* Treas. Reg. § 1.6662-4(f)(1) (1991).

77. *See* Treas. Reg. § 1.6662-3(c)(2) (1991).

on the return itself in accordance with applicable forms and instructions.[78] Revenue Procedure 92-23[79] currently provides authorization for such disclosure in certain circumstances. However, Lawyer determines that Client's situation is not one of the circumstances listed in the revenue procedure.

The statute also seems to sanction disclosure on a "statement attached to the return."[80] However, no provision exists in the regulations for disclosure on a statement attached to the return. The regulations take the position that if the Revenue Procedure does not provide for disclosure of an item, disclosure is adequate only if made on Form 8275 (or Form 8275-R in the case of a position contrary to a regulation).[81] Hence, unless Client files Form 8275 (thereby inviting increased IRS scrutiny), Client must be able to show that substantial authority exists for the position in order to avoid the substantial understatement penalty.

Consequently, Lawyer must determine whether Client has substantial authority for the position. The revenue rulings clearly are authority under the regulation. The cases are also authority because *Fulton Gold*, although an old case, has not been overruled by the Tax Court or a United States Court of Appeals. Its age is relevant to the degree of its persuasiveness, not to whether it is authority at all.[82] Moreover, the Improved Penalty Administration and Compliance Tax Act of 1989 (IMPACT) expanded the definition of substantial authority to include materials such as private letter rulings and General Explanations of tax legislation by the Joint Committee on Taxation (Blue Books).[83]

---

78. *See* Treas. Reg. § 1.6662-4(f)(2) (1991).

79. Rev. Proc. 92-23, 1992-13 I.R.B. 21.

80. I.R.C. § 6662(d)(2)(B)(ii) (West Supp. 1993) provides for reduction of the understatement on which the penalty is based by that portion of the understatement attributable to "any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in *a statement attached to the return*." *Id.* (emphasis added).

81. *See* Treas. Reg. § 1.6662-4(f)(2) (1991) (stating that if no procedure for disclosure exists, disclosure is adequate only if made on forms 8275 (Disclosure Statement) or 8275R (Regulation Disclosure Statement)). Comments on the proposed regulations criticized the regulation's failure to state that taxpayers could disclose on a statement attached to the return. Comments pointed out that the statute itself seems to authorize such disclosure and that Schirmer v. Commissioner, 89 T.C. 277 (1987), indicated that forms of disclosure other than those currently listed in the regulations are acceptable. *See* Banoff, *supra* note 49, at 200-01 (discussing how regulations limit acceptable forms of disclosure). The IRS responded to these criticisms by stating that IMPACT gives no indication that Congress intended to permit disclosure on the return itself, and it is in the interest of both taxpayers and IRS to have a uniform disclosure regime. *Id.* at 201; T.D. 8381, *supra* note 48, at 67,494.

82. Treas. Reg. § 1.6662-4(d)(3)(ii), (iii) (1991).

83. The types of authority that may be used in determining if substantial authority exists are:

1. Applicable provisions of the Code 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

However, Lawyer's problem is that none of the permissible authorities under the substantial understatement penalty directly addresses the question of how the section 108 insolvency definition is to be applied in the context of nonrecourse debt of a limited partner. The ABA Tax Sections's section 108 task force report supports Client's position on this issue, but its conclusions are not permissible authority for the purpose of establishing substantial authority.

The regulations still exclude from the definition of authority conclusions reached in materials such as treatises, articles and other learned commentary.[84] Therefore, the conclusions reached in the articles and by the task force are not themselves authority. Nonetheless, the regulations also provide that the authorities "underlying such expressions of opinion" may give rise to substantial authority and that a taxpayer may have substantial authority for a "position that is supported only by a well-reasoned construction of the applicable statutory provision."[85] The opinions expressed in these articles and by the task force are based on well-reasoned constructions of the statute. Hence, the "well-reasoned" constructions of the statute contained in the articles may qualify as substantial authority under a broad reading of these regulations provisions.[86]

Therefore, Lawyer may conclude that a plausible statutory construction supports Client's position, based on the aggregate theory of partnership taxation and on Code section 752 with its accompanying regulations. Is this enough to constitute substantial authority? The theory sounds good, but it basically depends on lawyer's own analysis of the relationship of Subchapter K to Code section 108. This in turn depends on Lawyer's assumptions regarding the nature and premises of Code section 752 and its accompanying regulations. Clearly, Lawyer is at least beginning to touch on the realm of abstract theory and speculation here.

---

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 (AODs) and General Counsel Memoranda (GCMs) issued after March 12, 1981;
10. CMs published in pre-1955 volumes of the Cumulative Bulletin;
11. IRS information or press releases;
12. Notices, announcements and other administrative pronouncements published by the IRS in the Cumulative Bulletin.

Treas. Reg. § 1.6662-4(d)(3)(iii) (1991).

84. *Id.*

85. *Id.* § 1.6662-4(d)(3)(ii) (1991).

86. *See supra* text accompanying notes 63-68 (discussing liability allocation rules to taxpayer in partnership context).

Perhaps Lawyer can approach the problem by appraising the percentage chance of success of Client's position. Neither the statute nor the regulations themselves place a percentage number on the substantial authority standard. However, the regulations under the preparer penalty say that a realistic possibility of success requires a one-in-three chance of success.[87] Furthermore, the regulations under the accuracy-related penalty state that the substantial authority standard is less stringent than a 50 percent likelihood of success, but more stringent than a "reasonable basis."[88]

General agreement exists that substantial authority is a more stringent standard than the one-in-three realistic possibility of success standard.[89] That would put the percentage chance of success required at more than one in three, but less than one half, perhaps about forty percent.[90] This is vague guidance at best when the law is not clear.[91] At worst, it degenerates into the kind of metaphysical speculation that characterized the corruption of Scholastic philosophy (how many pure spirits can dance on the head of a pin?). Moreover, the substantial authority standard, as enunciated in the statute, is phrased in qualitative rather than quantitative terms, so that a percentage formulation of the substantial authority standard may not be appropriate at all.[92]

Lawyer also might rely on the reasonable cause and good faith exception. The same considerations apply in the case of the substantial understatement

---

87. *See* Treas. Reg. § 1.6694-2(b) (1991) (discussing procedure for liability determination of tax preparer).

88. *See* Treas. Reg. § 1.6662-4(d)(2) (1991) (discussing substantial authority standard). This is apparently based on the legislative history of the substantial understatement penalty. H.R. Rep. No. 97-760, 97th Cong., 2d Sess. 309-10 (1982), *reprinted in* 1982-2 C.B. 650 (discussing expected court interpretation of "substantial understatement").

89. *See* Zelenak, *supra* note 50, at 473-74; Holden, *supra* note 43, at 772; Banoff, *supra* note 61, at 1127; Durst, *supra* note 6, at 1042. ABA Op. 85-352 assumes that realistic possibility is a lower standard than substantial authority. ABA Op. 85-352, *supra* note 1, *reprinted in* 39 Tax Law. at 632-34.

90. *See* Banoff, *supra* note 61, at 1127-28 (discussing odds or chances of success under various legal standards).

91. *See* Lin M. Trucksess, Note, *Painting the Gray Zone Grayer: Why Substantial Authority Fails as a Replacement for Practitioner Conduct Under Circular 230*, 8 Va. Tax Rev. 743, 759 (1989):

> [H]ow should practitioners weigh large quantities of conflicting authority on a tax position. At what point is support "substantial"? Since substantial authority is "less" than a "more likely than not" standard (which is a greater-than-50% chance of success standard) but more than a "reasonable basis" standard (which some estimate as a greater-than-20% chance of success), how is a practitioner to know when he has satisfied the requisite percentage?

Id.

92. The statute and regulations basically address the kind and weight of authority required, not the percentage chance of success. I.R.C. § 6662(d)(2)(B)(i) (West Supp. 1993); Treas. Reg. § 1.6662-4(d) (1991); Sheldon I. Banoff, *Determining and Weighing Valid Legal Authority to Avoid Accuracy-Related and Preparer Penalties: The Proposed Regulations Continue the Controversy*, 69 Taxes 259, 277 (1991); Falk, *supra* note 61, at 657.

penalty as apply in the case of the negligence penalty discussed above.[93] Since Lawyer has acted diligently and in good faith, Client may be able to rely on the RCGF defense.

2. Preparer Penalty

Code section 6694, as amended by IMPACT, imposes penalties on a tax return preparer where a position on a return falls below certain standards. Specifically, section 6694(a) imposes a penalty of $250 per return on a tax return preparer when any part of an understatement of liability "is due to a position for which there was not a realistic possibility of being sustained on its merits."[94] The penalty does not apply if the position is not frivolous and is disclosed adequately.[95] Section 6694 also imposes a penalty on the tax return preparer when any part of an understatement of liability is due to a willful attempt to understate the tax liability or a reckless or intentional disregard of rules or regulations by the income tax return preparer.[96]

The term "income tax preparer" generally includes any person who prepares or employs anyone else to prepare, for compensation, an income tax return or claim for refund of income tax or "a substantial portion" of a return or claim for refund.[97] The term encompasses one who renders advice "directly relevant" to the determination of the existence, characterization or amount of an entry on a return, provided that the entry constitutes

---

93. *See supra* text accompanying note 70 (describing 20% substantial understatement penalty). Some commentators have suggested that the substantial understatement penalty is basically a *no-fault* penalty. *See* STANDARDS OF TAX PRACTICE, *supra* note 1, ¶ 208.0312 (describing substantial understatement penalty as no-fault penalty); Durst, *supra* note 6, at 1065-73 (describing congressional motivations for creating substantial understatement penalty). Note that to the extent a defense of reasonable cause or good faith (RCGF) is available, the substantial understatement penalty ceases pro tanto to be a no-fault penalty.

94. I.R.C. § 6694(a)(1) (West Supp. 1993). The portion of IRC § 6694 that imposes the penalty reads as follows:

> (a) Understatements Due to Unrealistic Positions.—If—
>
> (1) any part of any understatement of liability with respect to any return or claim for refund is due to a position for which there was not a realistic possibility of being sustained on its merits,
>
> (2) any person who is an income tax return preparer with respect to such return or claim knew (or reasonably should have known) of such position, and
>
> (3) such position was not disclosed as provided in section 6662(d)(2)(B)(ii) or was frivolous,
>
> such person shall pay a penalty of $250 with respect to such return or claim unless it is shown that there is reasonable cause for the understatement and such person acted in good faith.

I.R.C. § 6694(a)(1)-(3) (West Supp. 1993).

95. I.R.C. § 6694(a)(3) (West Supp. 1993). In the case of a preparer who is required to sign a tax return, the regulations under § 6694 incorporate by reference the disclosure standards of Treas. Reg. § 1.6662-4(f). Treas. Reg. § 1.6694-2(c)(3) (1992).

96. I.R.C. § 6694(b) (West Supp. 1993).

97. I.R.C. § 7701(a)(36)(A) (West Supp. 1993).

a substantial portion of the return.[98] Undoubtedly, Client's potential debt forgiveness income is a substantial item for purposes of the preparer penalty.[99] Hence, Lawyer could be exposed to the preparer penalty.

No willful intent to understate tax liability exists here; nor does any reckless or intentional disregard of rules or regulations exist.[100] Consequently, the only likely basis for imposition of the preparer penalty is failure to meet the realistic possibility of success (RPOS) standard. A position is considered to have a realistic possibility of success if a reasonable and well-informed analysis would lead a person knowledgeable in the tax law to conclude that the position has approximately a one-in-three, or greater, likelihood of being sustained on its merits.[101]

This one-in-three percentage presumably is based on the interpretation of the RPOS standard set out in the ABA Tax Section task force that interpreted ABA Opinion 85-352. However, it differs from the ABA RPOS standard in at least two respects: (1) The ABA RPOS standard, as interpreted by the Tax Section task force, seemed to establish the one-in-three percentage as a safe harbor, while the section 6694 regulations prescribes the one-in-three percentage as a minimum;[102] and (2) The authorities that can be considered under the section 6694 RPOS standard are confined to those that can be considered for purposes of the substantial understatement penalty,[103] while the authorities that can be considered under the ABA RPOS standard include all those that might be considered by a court in making a decision, including authorities such as treatises and articles.[104] Hence, the section 6694 RPOS in reality may be closer to the substantial understatement standard than to the ABA RPOS.[105]

The considerations with respect to exposure to the preparer penalty thus are similar to those concerning the substantial understatement penalty, except

98. Treas. Reg. § 301.7701-15(b)(1) (1992). This rule can make potential liability quite extensive, especially for practitioners who render advice with respect to pass-through returns. For example, a practitioner who renders advice with respect to a partnership return may be liable for the penalty on the returns filed by individual partners if the item is substantial in relation to other items on the partners' returns. *See* Goulding v. United States, 957 F.2d 1420 (7th Cir. 1992) (holding partnership liable for penalty assessed against individual partners).

99. Whether an item is substantial is determined by considering the length, complexity and amount of the entry compared to the length, complexity and amount of the return or claim for refund as a whole. Treas. Reg. § 301.7701-15(b)(1) (1992).

100. *See supra* text accompanying note 64 (noting that return position is supported by revenue ruling).

101. Treas. Reg. § 1.6694-2(b)(1) (1992). The one-in-three odds are to be assessed without regard to the chance that the position may not be discovered. *Id.*

102. *See infra* text accompanying notes 147-49 (noting that one-in-three percentage is minimum standard under Code § 6694 but safe harbor under Tax Section task force report).

103. Treas. Reg. § 1.6694-2(b)(2) (1992).

104. *See infra* text accompanying notes 157-59 (describing authorities preparer may rely on to meet RPOS standard).

105. *See* William Raby, *Salting the Voluntary Assessment System*, 54 TAX NOTES 187, 189 (1992) (suggesting Code § 6694 RPOS standard resembles substantial understatement standard).

that the percentage chance of success required to avoid the preparer penalty is about 33 percent, whereas the percentage chance of success required to avoid the substantial understatement penalty is somewhat higher (assuming that a percentage of success standard is even appropriate under the substantial understatement penalty). Additionally, the preparer penalty is imposed directly on the preparer, not on the taxpayer. Here the application of the preparer penalty is uncertain for the same reasons as the application of the substantial understatement penalty—the only authority directly on point concerning the inclusion of partnership liabilities in the insolvency definition is excluded from the list of permissible authorities for purposes of Code section 6694.[106]

Lawyer can also defend against the preparer penalty by making an adequate disclosure of the position, provided the position is not frivolous.[107] Generally, the disclosure requirements are the same as the requirements for disclosure to avoid the substantial understatement penalty. To be adequate, disclosure must be on Form 8275 (or 8275-R) or in accordance with an annual revenue procedure.[108]

Finally, Lawyer might defend on the ground that there was "reasonable cause" for the understatement and Lawyer acted in good faith. Factors to consider under the reasonable cause or good faith (RCGF) defense include the complexity of the issue, its materiality, and whether Lawyer followed good office practice.[109] Lawyer also can make the RCGF defense by showing that Lawyer relied on the advice of another preparer whom Lawyer had reason to believe was competent to render such advice. The RCGF advice cannot come from a person in the same firm as the preparer.[110] The latter rule may place a premium on obtaining advice from outside counsel.[111] Here Lawyer, to obtain protection under the RCGF defense, would have to seek an opinion from outside counsel. This obviously would add to the cost of giving the advice to Client.

---

106. *See* Treas. Reg § 1.6694-2(b)(2) (1992) (listing permissible authorities for purposes of Code § 6694); *supra* text accompanying notes 82-86 (same).

107. Treas. Reg. § 1.6694-2(c) (1992).

108. *Id.* § 1.6694-2(c)(3)(i) (1992). Special disclosure rules also exist for nonsigning preparers. *Id.* § 1.6694-2(c)(3)(ii).

109. *Id.* § 1.6694-2(d).

110. The regulations provide that there can be only one preparer per firm. *Id.* § 1.6694-1(b)(1). Hence, no other person in the preparer's firm can also be a preparer. The regulations require that the person giving the RCGF advice be a preparer. Therefore, the RCGF advice cannot come from another person in the same firm as the preparer asserting the RCGF defense. *See* Raby, *supra* note 102, at 188 (describing "one preparer per firm" rule).

111. Raby, *supra* note 105, at 188. This may result in increased business for some firms. One commentator tells of

> at least one law firm/tax boutique that anticipates a sharp upswing in its revenue from what it calls "concurring opinions" for CPAs, EAs, and other preparers. The firm reasons that, in the past, preparers in medium-size and large firms primarily relied on others within their own firms for concurring opinions when they were faced with problems that had no obvious answers.

Id.

B. *ABA Opinion 85-352*

Lawyer also must consider the ethical rules governing the practice of law. Although each state has its own binding ethical rules, the ABA Model Rules and their interpretations are highly influential in applying the state rules.[112] The ethical standards governing advice with respect to tax practice are promulgated mainly in three formal ABA opinions: (1) Opinion 314, dealing with controversies and with tax return positions;[113] (2) Opinion 346, dealing with tax shelter opinions;[114] and (3) Opinion 85-352, dealing with tax return positions. Lawyer is primarily concerned with Opinion 85-352.[115]

The standards of tax practice for attorneys were first formalized in Opinion 314,[116] issued in 1965. Opinion 314 dealt with both advising clients on tax return positions and dealing with the IRS after an audit has begun. Opinion 314 still has effect with respect to dealing with the IRS after an audit has begun, because Opinion 85-352 superseded Opinion 314 only to the extent that Opinion 85-352 sets out new standards for advising tax return positions.[117]

Opinion 314 stated that the status of the IRS was basically that of an adversary at both the return and audit stages.[118] According to Opinion 314, the IRS is a "representative of one of the parties" and not a "true tribunal, nor even a quasi-judicial institution."[119] The lawyer in audit situations has a duty "not to make false assertions of fact."[120] Moreover, the lawyer "is under a duty not to mislead the Internal Revenue Service deliberately and affirmatively, either by misstatements or by silence or by permitting his client to mislead."[121] Nevertheless, "as an advocate before a service which itself represents the adversary point of view" the lawyer is under no duty to disclose weaknesses in the client's case.[122]

Opinion 314 carried its view of the IRS as adversary to the tax return preparation stage. 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

---

112. *See* STANDARDS OF TAX PRACTICE, *supra* note 1, ¶ 111.02.

113. ABA Comm. on Professional Ethics, Formal Op. 314 (1965), *reprinted in* STANDARDS OF TAX PRACTICE, *supra* note 1, app. ¶ 2001.

114. ABA Comm. on Ethics and Professional Responsibility, Formal Op. 346 (1965), *reprinted in* STANDARDS OF TAX PRACTICE, *supra* note 1, app. ¶ 2002.

115. As detailed below, Opinion 314 has been superseded with respect to tax return advice. Opinion 346 concerns tax shelter opinions, a subject outside the scope of this Article.

116. ABA Formal Op. 314, *supra* note 113.

117. *See* ABA Op. 88-352, *supra* note 1, at 632; Standards of Tax Practice, *supra* note 1, ¶ 214.021.

118. *See* ABA Formal Op. 314, *supra* note 113, at 671-72; Durst, *supra* note 6, at 1030-32; Rowen, *supra* note 2, at 248.

119. ABA Formal Op. 314, *supra* note 113, at 671.

120. *Id.* at 672.

121. *Id.*

122. *Id.*

reasonable basis for those positions."[123] Moreover, "[W]here the lawyer believes there is a reasonable basis for a position that a particular transaction does not result in taxable income, or that certain expenditures are properly deductible as expenses, the lawyer has no duty to advise that riders be attached to the client's tax return explaining the circumstances surrounding the transaction or the expenditures."[124] Opinion 314 did not explicitly mention a good faith requirement, although the concept of good faith might be taken as implicit in the reasonable basis standard.

The reasonable basis standard originally may have been intended to set a fairly high standard.[125] Nevertheless, respect for the standard gradually eroded over the next twenty years. Some only half-facetiously referred to the standard as the chuckle test or the laugh test—whether the lawyer can advance the position without chuckling or laughing.[126] Presumably, the laugh test was even less stringent than the chuckle test, and further erosion would have led to a guffaw test. By 1985, the reasonable basis standard had diminished to an understanding by many that it justified the "use of any colorable claim on a tax return to justify the exploitation of the lottery of the tax return audit selection process."[127]

The IRS became concerned that taxpayers were burying questionable positions on their returns and depending on the audit lottery to protect them. Moreover, the tax shelter industry exacerbated the problem because the reasonable basis standard provided fraud insurance for investors in tax shelters of questionable legitimacy.[128] Former IRS Commissioner Jerome Kurtz asserted that a change was needed and implied that a no-fault type penalty for undisclosed tax return positions might be appropriate to prevent exploitation of the audit lottery.[129]

The ABA Tax Section responded to the perceived problem by suggesting revisions to Opinion 314.[130] The Tax Section proposal disavowed the adver-

---

123. *Id.*

124. *Id.*

125. *See* STANDARDS OF TAX PRACTICE, *supra* note 1, ¶ 214.02; Harris, *supra* note 3, at 972.

126. *See* Falk, *supra* note 61, at 644; *IRS Urged to Rewrite Proposal Tying Ethics Standard for Tax Return Preparers to Taxpayer Understatement Penalty*, Daily Tax Rep. (BNA), at K-1 (Feb. 24, 1987) (quoting Professor Michael Graetz).

127. *See* ABA Section of Taxation Proposed Revision to Formal Opinion 314 (1984), *reprinted in* BERNARD WOLFMAN & JAMES P. HOLDEN, ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE 71 (2d ed. 1985) [hereinafter cited as ETHICAL PROBLEMS].

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

129. *See generally id.* at 15-16 (discussing various options to reporting standard problem); Durst, *supra* note 6, at 1066 (discussing effect of penalties as financial disincentives for substantial understatement and noting that former Commissioner Kurtz suggested use of such penalties to limit number of aggressive positions); Jerome Kurtz, *Remarks to the American Institute of Certified Public Accountants*, 103 Daily Tax Rep. (BNA), at J-3 (May 26, 1977), *reprinted in* ETHICAL PROBLEMS, *supra* note 127, at 60-62 (examining mandatory disclosure of questionable positions on tax return).

130. *See* ETHICAL PROBLEMS, *supra* note 127, at 71.

sarial approach of Opinion 314. The proposal explicitly stated that "a tax return is not a submission in an adversarial proceeding."[131] The nature of the tax return audit process dictates that most returns will not be picked for audit. This means that a taxpayer who resolves all doubts in his own favor always has an advantage, because the return is not likely to be audited. In effect, this treatment decides almost all doubtful questions in favor of the taxpayer.[132]

The proposal stated that a higher standard than the minimum to avoid fraud should be expected of the tax lawyer in advising return positions. The standard adopted by the proposal was that in order to advise a taxpayer to assert a position on a return, "the position must be a *meritorious* one."[133] A position is meritorious if "it is advanced in good faith, as evidenced by a *practical and realistic possibility of success*, if litigated."[134] "The lawyer must honestly entertain a belief that the position well may be held to be correct, either on the merits of existing authority or by reversal of existing authority."[135] The proposal required the lawyer to withdraw from representation when a client insists on reporting a position that does not meet the meritorious standard.[136]

The ABA Standing Committee on Ethics and Professional Responsibility used the Tax Section proposal as the basis for Opinion 85-352, which is now the basic ethical pronouncement for lawyers on advising tax return positions.[137] However, the committee made several modifications to the Tax Section proposal. First, the committee eliminated the requirement that the position be "meritorious," which had been the basis of the Tax Section's standard. The committee also eliminated the sentence in the Tax Section proposal which explicitly stated, "A tax return is not a submission in an adversary proceeding."[138] Opinion 85-352 basically skirts this issue by stating, "Although the Model Rules distinguish between the lawyer's roles of advisor and advocate, both roles are involved here, and the ethical standards applicable to them provide relevant guidance."[139] Finally, the committee

---

131. *Id.*

132. *See* STANDARDS OF TAX PRACTICE, *supra* note 1, ¶ 214.01. The Tax Section proposal stated:

> The complications of the tax law, the inadequacy of Internal Revenue Service audits, the impracticability of training revenue agents to achieve expertness and the flexibility available to the taxpayer in legitimately resolving to his own advantage numerous doubtful issues resulting from those complexities, impose a substantial burden on the government.

ETHICAL PROBLEMS, *supra* note 127, at 71.

133. ETHICAL PROBLEMS, *supra* note 127, at 73 (emphasis added).

134. *Id.* (emphasis added).

135. *Id.*

136. *Id.* at 74.

137. ABA Op. 85-352, *supra* note 1, at 631.

138. *See* Durst, *supra* note 6, at 1042-45.

139. ABA Op. 85-352, *supra* note 1, at 632 (footnote omitted). Moreover, the opinion lends credence to the adversarial viewpoint by stating further that, "In many cases a lawyer must realistically anticipate that the filing of the tax return may be the first step in a process that may result in an adversary relationship between the client and the IRS." *Id.*

changed the Tax Section's requirement that a return position have a "practical and realistic possibility of success" if litigated to a requirement that the position have *"some realistic possibility of success."*[140]

Apparently to counteract what it perceived might be adverse inferences from these modifications by the committee, a special task force of the Tax Section in turn issued a document stating its own interpretation of Opinion 85-352.[141] The task force report was approved by the Tax Section Committee on Standards of Tax Practice and approved by the Council of the Section of Taxation.[142] However, the task force report was not adopted by the ABA Standing Committee on Ethics and Professional Responsibility.[143] Hence, the task force report's authoritative status is ambiguous. Because ABA rules have effect only to the extent official state disciplinary bodies adopt the rules, the ultimate weight accorded to the task force report will be decided by those bodies and the courts.[144]

The final ABA 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.*[145]

As noted above, the "meritorious" standard of the Tax Section proposal is eliminated, along with the Tax Section's description of RPOS as requiring that the possibility of success be "practical and realistic." The Tax Section task force interpreting Opinion 85-352 attempted to minimize these differences by asserting that a possibility of success cannot be "realistic" if it is only "theoretical or impracticable."[146]

Opinion 85-352 does not express the RPOS standard in numerical percentage terms. Nevertheless, a commonly accepted convention is that RPOS requires about a one-in-three chance of success. This formulation apparently derives from the Tax Section task force report. The task force report stated that "[a] position having only a 5% or 10% likelihood of

140. *Id.* at 633 (emphasis added).

141. *See Report of the Special Task Force on Formal Opinion 85-352, reprinted in* 39 TAX LAW. 635, 639 (1986) [hereinafter *85-352 Task Force Report*].

142. *See* STANDARDS OF TAX PRACTICE, *supra* note 1, ¶ 214.02.

143. *Id.*

144. *Id.*

145. ABA Op. 85-352, *supra* note 1, at 633-34 (emphasis added).

146. *85-352 Task Force Report*, *supra* note 141, at 638.

success, if litigated, should not meet the new standard."[147] But a "position having a likelihood of success closely *approaching one-third* should meet the standard."[148] The task force report's one-third percentage may have been meant as a safe harbor. If so, positions with a chance somewhat below one-third would be sufficient. However, the one-in-three formulation has been adopted as a minimum standard in the preparer regulations.[149]

The foundation of the RPOS standard is good faith. The subjective requirement of good faith is given an objective aspect by requiring that there be "some realistic possibility of success if the matter is litigated" (RPOS). The lawyer need not believe that the position probably will prevail (more likely than not standard), or that the position is supported by substantial authority. However, the likelihood of audit or detection is not a permissible consideration.

The RPOS formulation is based on a *litigation* standard. Opinion 85-352 cites as authority ABA Model Rule of Professional Conduct 3.1, which deals with the standard for bringing or defending a proceeding. The opinion itself refers to the possibility of success in "litigation" and states that the "ethical standards governing the conduct of a lawyer in advising a client on positions that can be taken in a tax return are no different than those governing a lawyer's conduct in advising or taking positions for a client in other civil matters."[150] Moreover, Opinion 85-352 does not abandon the premise of Opinion 314 that the tax return process is adversarial in nature.[151] It lends credence to the adversarial approach by explicitly stating that in many cases "a lawyer must realistically anticipate that the filing of the tax return may be the first step in a process that may result in an adversary relationship between the client and the IRS."[152] In contrast, the task force report asserts, "The Opinion does not state that the general ethical guidelines governing advocacy in litigation are determinative, or suggest that tax returns are adversarial proceedings," and the report suggests that Opinion 85-352 merely "blends" the ethical rules governing advocacy and advising. This may be stretching the actual words of Opinion 85-352 to suit the task force's own attitude.[153]

---

147. *Id.* at 638.

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

149. *See supra* text accompanying notes 101.

150. ABA Op. 85-352, *supra* note 1, at 632.

151. *See supra* text accompanying notes 138-39.

152. ABA Op. 85-352, *supra* note 1, at 632.

153. *85-352 Task Force Report*, *supra* note 141, at 640. The relevant portion of the Task Force report states:

> To the contrary, a tax return initially serves a disclosure, reporting, and self-assessment function. It is the citizen's report to the government of his or her relevant activities for the year. The Opinion says that because some returns, particularly aggressive ones, may result in an adversary relationship, there is a place for consideration of the ethical considerations regarding advocacy. Thus, the Opinion blends the ethical guidelines governing advocacy with those applicable to advising, from which the new ethical standard is derived.

Id.

The text of Opinion 85-352 does not address explicitly the lawyer's ethical duties with respect to tax planning and advice. The Tax Section's proposed revision to Opinion 314 stated that the same principles that apply to advising a return position also should apply to tax planning and advice.[154] Because advising on tax return positions is an inherent part of most tax planning, Opinion 85-352 appears to apply to tax planning by logical extension.[155] The Tax Section task force report agreed with this understanding, stating that the principles of Opinion 85-352 "should apply to all aspects of tax practice to the extent tax return positions would be involved."[156]

Here Lawyer's advice clearly comes within the scope of Opinion 85-352, because the advice pertains directly to a tax return position Client proposes to take. Consequently, Lawyer must decide whether the one-in-three RPOS standard is met. Similar considerations apply as have been discussed with respect to the other standards. The problem is that the only authority that directly supports Client's position that nonrecourse liabilities allocated to a partner under the Code section 752 partnership liability allocation rules are to be included in calculation of insolvency under section 108 is the Tax Section's section 108 task force report.

The question then becomes whether the section 108 task force report constitutes authority under Opinion 85-352. It appears that the Opinion 85-352 RPOS standard allows a greater range of authorities to be considered than do the substantial authority and return preparer standards discussed previously.[157] The Opinion 85-352 standard refers to a realistic possibility of success in litigation. Therefore, in applying the Opinion 85-352 standard, Lawyer also may consider any authorities that a court might consider.[158] Consequently, Lawyer may consult sources such as articles and treatises in making an assessment of the position. Accordingly, the section 108 task force report should be permissible authority for purposes of Opinion 85-352. Lawyer also may rely on a "well-reasoned construction of the statute."[159] Lawyer's construction of the relevant statutory provisions appears quite plausible and Lawyer is acting in good faith, the foundation of the RPOS standard. Consequently, Lawyer may well decide that Client's position satisfies the RPOS standard.

Suppose Lawyer decides that the position satisfies the RPOS standard but falls below the substantial authority standard. This, of course, requires applying some rather fine mathematical analysis, if one accepts the percentage chance of success standards. How does Lawyer distinguish between

---

154. *See* Ethical Problems, *supra* note 127, at 71.

155. *See* Standards of Tax Practice, *supra* note 1, ¶ 214.021.

156. *85-352 Task Force Report*, *supra* note 141, at 636.

157. *See supra* text accompanying notes 82-86, 104.

158. *See* Standards of Tax Practice, *supra* note 1, ¶ 214.022; Banoff, *supra* note 61, at 1117.

159. *Cf.* Treas. Reg. § 1.6662-4(d)(3)(ii) (1991) (discussing determination of whether substantial authority is present).

a forty percent (substantial authority) and a thirty-three percent (RPOS) chance of success? Nevertheless, the governing standards seem at least to sanction, if not require, such an analysis. The Tax Section task force expressly sanctioned the one-in-three standard,[160] and one also can infer a percentage chance of success formulation of the substantial authority standard.[161]

When Lawyer decides that Client's position does not satisfy the substantial authority standard, but does satisfy ABA RPOS, Opinion 85-352 requires Lawyer to advise Client of the potential penalty and of the opportunity to avoid the penalty by making adequate disclosure of the position.[162] If Client decides not to make disclosure, even though substantial authority does not exist for the position, Lawyer "has met his or her ethical responsibility with respect to the advice."[163] Therefore, Opinion 85-352 permits Lawyer to advise Client with respect to a position for which Client may incur a penalty, so long as the position satisfies the RPOS standard.[164]

Suppose Lawyer decides that the position falls below the RPOS standard as well, but Client wants to contest the issue. Opinion 85-352 does not state explicitly what the lawyer's duty is if the RPOS standard for a position taken on the tax return is not met. The task force report indicates that the lawyer is under an obligation to withdraw "from the engagement, at least to the extent that it involves advice as to the position to be taken on the return."[165] This is consistent with Model Rule 1.16(a), which provides that a lawyer must withdraw from representation that will involve the lawyer in a violation of the rules of professional conduct.[166]

The difficulty lies in determining the extent of the representation in this circumstance. For example, if the advice involves one small aspect of a business transaction for which the lawyer is the overall advisor, a duty to withdraw from the entire representation seems harsh. However, it is clear that the lawyer cannot sign the taxpayer's return that contains the substandard position.[167] Moreover, the task force report requires withdrawal from further representation that "involves advice as to the [substandard] position to be taken on the return."[168] Accordingly, if the position in question is an essential though minor part of the transaction, the task force interpretation may well require withdrawal from the entire representation.[169]

---

160. *85-352 Task Force Report*, *supra* note 141, at 638-39.

161. *See supra* text accompanying notes 89-92 (discussing stringency of substantial authority standard).

162. ABA Op. 85-352, *supra* note 1, at 633.

163. *Id.*

164. *Id.* The rationale for this apparent anomaly is that the substantial understatement penalty is basically in the nature of a no-fault penalty. *See* STANDARDS OF TAX PRACTICE, *supra* note 1, ¶ 208.0312; Durst, *supra* note 6, at 1065-71.

165. *85-352 Task Force Report*, *supra* note 141, at 639.

166. *See* STANDARDS OF TAX PRACTICE, *supra* note 1, ¶ 214.0241.

167. *See id.*

168. *85-352 Task Force Report*, *supra* note 141, at 639.

169. *See* STANDARDS OF TAX PRACTICE, *supra* note 1, ¶ 214.0241.

Lawyer may also advise Client to advance the position by payment of the tax and filing a refund claim.[170] Under Model Rule 3.1 the lawyer may assert a position in litigation that is nonfrivolous. Hence, the lawyer may represent the client in refund proceedings even though the RPOS standard is not met, as long as the claim is nonfrivolous.[171] However, this is small solace for the client who cannot possibly pay the potential tax liability and who is accordingly precluded from making a refund claim.

Another possibility for Client when his return position falls below the RPOS standard may be to make adequate disclosure of the position. Adequate disclosure performs an equivocal role in Opinion 85-352. Where the RPOS standard is met, "the lawyer has no duty to require as a condition of his or her continued representation that riders be attached to the client's tax return explaining the circumstances surrounding the transaction."[172] However, the Opinion also requires the lawyer to "counsel the client as to whether the position is likely to be sustained by a court if challenged by the IRS, as well as of the potential penalty consequences to the client if the position is taken on the tax return without disclosure," and further requires the lawyer to advise the client of the possibility of avoiding the substantial understatement penalty by disclosure.[173] But that is basically all the Opinion has to say about disclosure.[174]

The Opinion does not state explicitly that disclosure exonerates a position that fails to meet the RPOS standard (a substandard position). The Tax Section task force report states that if the RPOS standard is not met, disclosure will not cure the defect.[175] However, subsequently, the ABA Tax Section in comments on proposed revisions to Treasury Circular 230 took the view that taxpayers may take a return position that does not meet the RPOS standard, provided the position is not frivolous and is either adequately disclosed or presented on an amended return filed as a claim for refund.[176] Lawyer is consequently in a position of uncertainty with respect to the possibility of curing the substandard position by disclosure. Opinion 85-352 is silent, and the ABA Tax Section, which has performed a principal role in interpreting the Opinion, has taken inconsistent positions.

---

170. *85-352 Task Force Report*, *supra* note 141, at 639.

171. *See* STANDARDS OF TAX PRACTICE, *supra* note 1, ¶ 214.0241.

172. ABA Op. 85-352, *supra* note 1, at 633.

173. *Id.*

174. *See id.* Of course, in all cases lawyers are under a duty not to "mislead the Internal Revenue Service deliberately, either by misstatements or by silence or by permitting the client to mislead." *Id.*

175. The American Bar Association's Committee on Standards of Tax Practice 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 in the return." *85-352 Task Force Report*, *supra* note 141, at 639.

176. *See* Letter of 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 TULANE TAX INST. ch. 18, at 57 (1988).

Permitting adequate disclosure to cure a nonfrivolous substandard position would be in consonance with the goal of diminishing the role of the audit lottery and would promote the policy of consistency between the Treasury regulations and the ABA standards. The audit lottery was the problem that initiated the search for a new tax return standard. Hence, permitting disclosure would conform to the original purposes for issuance of Opinion 85-352. Nevertheless, the issue is murky at best.[177]

C. *Circular 230*

Circular 230[178] governs practice before the Internal Revenue Service. Circular 230 requires that the practitioner exercise "due diligence" in preparing, assisting, approving, and filing returns and other documents with the IRS.[179] The due diligence standard has been understood to require the same degree of care and accuracy as the reasonable basis standard under Opinion 314.[180] Because some question existed as to whether Circular 230 governs tax return advice, as opposed to preparation, the proposed amendments to Circular 230 expressly extend Circular 230's reach to tax return advice.[181] The proposed amendments also would raise the standard for tax return advice to the "realistic possibility" standard. Under this standard, a practitioner may advise a tax return position only if the position has a realistic possibility of being sustained on the merits, or the position is not frivolous and the practitioner also advises the client to disclose the position on the return.[182] The changes promote consistency between the Treasury

---

177. *See* Sax, *supra* note 176, at 6-7. Although all the tax return reporting standards forbid playing the audit lottery, actual practice may well differ. For example, a recent article explicitly incorporated an audit lottery calculation in formulating a pure economic analysis of the decision whether voluntarily to make a change from an incorrect to a correct method of accounting. *See* W. Eugene Seago et al., *The Persuasive Powers of Rev. Proc. 92-20*, 56 TAX NOTES 791 (1992).

178. The Treasury Department is authorized by 31 U.S.C. § 330 to provide practice standards for all persons who practice before the IRS. These standards are listed in Circular 230.

179. *See* Circular 230, *supra* note 18, § 10.22; STANDARDS OF TAX PRACTICE, *supra* note 1, ¶ 217.

180. *See* STANDARDS OF TAX PRACTICE, *supra* note 1, ¶ 217 (citing *Report on Civil Tax Penalties by Executive Task Force*, Commissioner's Penalty Study, Internal Revenue Service, Tax Notes (Microfiche) Doc. 89-1586 at VIII-3).

181. Proposed Amendments to Circular 230 § 10.34, 57 Ref. Reg. 46,356-01 (1992).

182. *Id.* The proposed amendments state:

> (a) *Standard of conduct*—(1) *Realistic possibility standard.* A practitioner may not sign a return as a preparer if the practitioner determines that the return contains a position that does not satisfy the realistic possibility standard, unless the position is not frivolous and is adequately disclosed to the Service. A practitioner may not advise a client to take a position on a return, or prepare the portion of a return on which a position is taken, unless—
>
> The practitioner determines that there is a realistic possibility of the position being sustained on its merits (the "realistic possibility standard"); or
>
> The position is not frivolous and the practitioner advises the client to

regulations and Circular 230 and thus enhance the administrative ease with which practitioners operate our self-assessment system. The Treasury promoted this consistency by accepting public criticism and abandoning an earlier proposal to adopt a substantial authority standard.[183]

An added concern under Circular 230 is that its violation could disbar a lawyer from practice before the IRS. Circular 230 authorizes the Secretary of the Treasury to suspend or disbar from practice before the Code any practitioner for any of several reasons, among which are disreputable conduct and failure to comply with Circular 230.[184] Although a disbarred

---

adequately disclose the position.

(2) *Advising clients on potential penalties.* A practitioner advising a client to take a position on a return, or preparing or signing a return as a preparer, must inform the client of the penalties reasonably likely to apply to the client with respect to the position, of the opportunity to avoid any such penalty by disclosure, if relevant, and of the requirements for adequate disclosure.

(3) *Relying on information furnished by clients.* A practitioner advising a client to take a position on a return, or preparing or signing a return as a preparer, generally may rely in good faith without verification upon information furnished by the client. However, the practitioner may not ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent, or incomplete.

(4) *Definitions.* For purposes of this section:

(i) *Realistic possibility.* A position is considered to have a realistic possibility of being sustained on its merits 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. The authorities described in 26 CFR 1.6662-4(d)(3)(iii) of the substantial understatement penalty regulations may be taken into account for purposes of this analysis. The possibility that a position will not be challenged by the Service (*e.g.*, because the taxpayer's return may not be audited or because the issue may not be raised on audit) may not be taken into account.

(ii) *Frivolous.* A position is frivolous if it is patently improper.

(b) *Standard of discipline.* As provided in § 10.52, only violations of this section that are willful, reckless, or a result of gross incompetence will subject a practitioner to suspension or disbarment from practice before the Service. [Reg. § 10.34.]

Id.

183. *See IRS Urged to Rewrite Proposal Tying Ethics Standard for Tax Return Preparers to Taxpayer Understatement Penalty*, Daily Tax Rep. No. 35 (BNA), Feb. 24, 1987 p. K-1; *IRS' Director of Practice Clashes With CPAs Over Proposed Ethics Standard*, Daily Tax Rep. No. 233 (BNA), Dec. 4, 1986 p. G-2.

184. *See* Circular 230, *supra* note 17, § 10.50. Circular 230 also might come into play when a practitioner incurs the preparer penalty. Until enactment of the Revenue Reconciliation Act of 1989, 103 Stat. 2301 (1989), conduct which resulted in the imposition of penalties had been regarded as "disreputable conduct," although not expressly enumerated as such in Circular 230. *See generally* Steven C. Salch, *Tax Practice Ethics: Practitioner Discipline and Sanctions*, C690 ALI-ABA 157 (1991) (discussing ethical problems for tax practitioner in light of various standards and sources, including Circular 230). The Internal Revenue Manual ¶ 4297.9 required automatic referral to the Director of Practice of practitioners subject to the preparer penalty. *See* STANDARDS OF TAX PRACTICE, *supra* note 1, ¶ 308.062. Consequently, imposition of a

practitioner generally can continue to prepare returns, no other person eligible to practice before the IRS may continue to be associated in practice with the disbarred practitioner.[185] Thus, the disbarred practitioner's partners could be subject to discipline if they continue in association with the disbarred practitioner.[186] Moreover, because the Treasury Director of Practice may notify state disciplinary authorities of the suspension or disbarment of a practitioner, state disciplinary action may ensue upon violation of Circular 230.[187] Obviously, violation of Circular 230 can result in the loss of a lawyer's livelihood.

IV. Suggestions for Improvement

In the relatively simple case discussed above, Lawyer, acting in good faith, faces a client on the brink of financial ruin, a theoretically plausible tax return position that could pull Client from the brink, little direct authority with respect to the position, and a profusion of vague standards governing the propriety of advising Client to take the position. Client should be entitled to contest the issue prior to paying the tax.[188] Moreover, Client ought to be entitled to retain legal counsel in carrying out that contest, since the ability to contest such a complex issue is of little value without the assistance of counsel.

Yet, if the position falls below the RPOS standard, Opinion 85-352 requires Lawyer to withdraw if Client takes the position, thereby depriving Client of counsel even if the position has a reasonable basis and is not frivolous.[189] For Client, the alternative of paying the tax and claiming a refund is unavailable for all practical purposes. In this case, sound reasons exist to believe that the position conforms to all the applicable standards, but that is by no means certain. If Lawyer advises Client to take the position, he will be doing so with at least some degree of uncertainty

---

preparer penalty might also result in discipline under Circular 230. Administrative recommendations to the IRS appearing in the Conference Report on the Revenue Reconciliation Act of 1989 criticized this practice. *See* H.R. Rep. No. 386, 101st Cong., 1st Sess. 661-63 (1989). The Conference Report stated that the IRS should refer to the Director of Practice only those matters which involve willful conduct or a pattern of failure to meet required standards. *Id.* Presumably, penalties will no longer be referred automatically to the Director of Practice unless they meet the criteria set out in the Conference Report. However, in those cases meeting the Conference Report criteria, the exposure to discipline on account of imposition of the preparer penalty remains.

185. *See* Standards of Tax Practice, *supra* note 1, ¶ 117.0154. Circular 230 § 10.51(h) prohibits any practitioner from maintaining a partnership for the practice of law, accountancy, or related professions with a person who is under disbarment from the IRS. Standards of Tax Practice, *supra* note 1, ¶ 117.0154.

186. Standards of Tax Practice, *supra* note 1, ¶ 117.0154.

187. *Id.* The Treasury Director of Practice has entered into agreements with several states to provide for notification of state authorities in the event of suspension or disbarment of an individual licensed in the state. Leslie S. Shapiro, *Management and Operation of the Office of Director of Practice*, 43 N.Y.U. Fed. Tax Inst. 11-1, 11-11 (1985).

188. *See supra* text accompanying notes 42-43.

189. *See supra* text accompanying notes 162-66.

concerning whether it meets all the standards. Moreover, in the case of the ABA RPOS standard, it may be that making disclosure of the position will not cure a substandard position.[190] Thus, even a fully disclosed position having a reasonable basis, say a one-in-four chance of success, may be substandard under the ABA RPOS standard.

While there has been considerable improvement over the past decade or so in articulation of tax return advice and preparation standards, there is still room for considerable improvement. As analysis of a simple case illustrates, the area is still plagued by too many different standards, uncertainty, and inconsistency with the premise that taxpayers should have a prepayment forum in which to contest tax liability. Furthermore, the trend in the past several years has been to place the Lawyer more and more into the role of overseer of the client's conduct, in effect conscripting the lawyer as part of the government's enforcement mechanisms. Some may see this development as desirable. However, it can conflict with the lawyer's duty to the client, and carried to the extreme, could do serious damage to the lawyer-client relationship.[191]

Shifting more of the burden of enforcing the compliance system to practitioners involves imposing greater economic costs on practitioners and clients who are making good faith efforts to comply with statutory standards governing their conduct. The policy focus of efforts over the past several years to improve tax return position standards was on the "bad guys" who played the audit lottery, particularly with respect to tax shelters, by taking questionable positions they hoped would win in the audit lottery.[192] The time may have come to focus tax policy more on the "good guys," practitioners and clients who make good faith efforts to comply with a complex tax law that often defies human understanding.

It also may be time to pay more attention to the problems confronted by the lawyer in a small or mid-sized firm, who may lack the resources of a lawyer in a large firm. It is apparent from reading the literature that the tax practice standards area is dominated by large firm practitioners who represent the ABA and the American Institute of Certified Public Accountants (AICPA). This orientation cannot help but affect the development of tax practice standards toward more complex and time-consuming requirements.

The approach should be from the standpoint of the conscientious practitioner who is not pushing the line, who sometimes takes aggressive but supportable positions, and who is not necessarily part of the ABA elite. These lawyers may welcome better standards, because that would relieve

190. *See supra* text accompanying notes 172-77.

191. The tendency to put the lawyer in the role of the client's policeman is not confined to the tax field. *See* Philip A. Lacovara, *Follow the Money*, WASH. POST, July 21, 1992, at A19 (criticizing government actions holding lawyers and accountants liable for savings and loan losses).

192. *See supra* notes 128-29 and accompanying text (discussing questionable return positions).

pressure and competition from less scrupulous practitioners. Zeal to put a stop to undoubtedly questionable practices should not blind policymakers to the problems that proposed solutions may cause to compliant practitioners and taxpayers, who remain in the vast majority.

Although these problems, particularly the problem of uncertainty, never can be completely obviated, they can be diminished. Following are some suggestions for possible improvements. This is not to say that the goal should be a perfect system. The goal is progress, not perfection, for often the perfect is the enemy of the good. What this article suggests are improvements that should make the self-assessment system simpler and more workable.

A. Adopt a Uniform Standard for All Purposes

There should be a single uniform reporting standard for all purposes. This is not a novel suggestion.[193] One of the most difficult problems the practitioner faces is the proliferation of standards for tax return advice. There are at least six reporting standards enunciated by various sources ranging from more-likely-than-not correct to nonfrivolous.[194] The differences among some of the reporting standards are quite subtle. Whatever purposes having these different standards may serve are outweighed by the compliance effort they demand and the confusion they engender.

Simply familiarizing oneself sufficiently with the nuances of all the relevant standards involves an inordinate amount of effort that, as a practical matter, many busy practitioners may be unable or unwilling to expend. Furthermore, the differences between some standards, such as RPOS and substantial authority, are easy enough to state generally but perplexing actually to apply. To be honest, no one really can say with any degree of assurance that a position has a forty percent chance of success as opposed to a thirty-three percent chance. And no one would be able to discern the difference between RPOS and reasonable basis in the absence of the Tax Section task force's telling us what it is.[195] The whole area is in danger of becoming bogged down in ever-expanding degrees of refinement, as policymakers become increasingly enamored with the subtlety and elegance of their own formulations.

The most appropriate standard for tax return positions would seem to be the ABA Opinion 85-352 RPOS standard with a minor modification. The modification would eliminate the ABA standard's focus on success in litigation. Instead, the standard would require "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."[196] The

---

193. *See* Zelenak, *supra* note 50, at 472; Banoff & Coustan, *supra* note 55, at 155.

194. *See* Appendix—*Reporting Standards, infra.*

195. *See 85-352 Task Force Report*, *supra* note 141, at 638-39.

196. *See* Letter of John B. Jones, Jr., Chair, ABA Section of Taxation, to Leslie S. Shapiro, Director of Practice, Internal Revenue Service (Feb. 12, 1987), *reprinted in* Sax, *supra* note 176, at 57, 58.

change from focusing purely on a position's chance of success if litigated to also considering a position's chance of being sustained administratively takes into account the fact that most tax cases are decided at the administrative level. Moreover, most tax returns are not prepared by lawyers. Any uniform standard necessarily would apply to many nonlawyers who are not trained to take into account the hazards of litigation. The broader focus takes this into account.

Some consensus exists among practitioners with respect to the appropriateness of the RPOS standard. Representatives of both the ABA and AICPA joined in urging such a standard on the Treasury for purposes of Circular 230.[197] Most practitioners seem to approve of the RPOS standard. This consensus supports adoption of the RPOS standard. Practitioners should not be subject to sanctions for actions that are consistent with "thoughtfully developed and appropriate professional standards of behavior."[198] The RPOS standard seems more appropriate than the two possible alternatives, the substantial authority and reasonable basis standards. As currently interpreted, the substantial authority standard limits too severely the authority which may be consulted under that standard.[199] Reasonable basis, while it may have been an appropriate standard as originally understood, has been eroded to such an extent that it is no longer usable as the basic norm.[200]

The RPOS standard still is subject to the criticism that, as interpreted by the Tax Section task force, it incorporates a percentage chance of success test (one-in-three). Some practitioners and scholars have doubted the feasibility of applying such a test in practice.[201] Task forces of both the ABA Tax Section and the AICPA have commented critically on the use of a percentage standard.[202] Some have compared it to a spin of the roulette

---

197. *See id.*; Letter of 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* note 176, at 79, 82.

198. Banoff & Coustan, *supra* note 55, at 155.

199. *See supra* text accompanying notes 79-80, and *infra* notes 198-212 and accompanying text.

200. *See supra* text accompanying notes 120-22.

201. *See* T.D. 8381, *supra* note 48, at 67,494; Banoff & Coustan, *supra* note 55, at 156-57.

202. The ABA Tax Section Civil Penalties Task Force, commenting on use of RPOS as the benchmark for the preparer penalty, stated:

> The Task Force believes that the proposed definition of "realistic possibility of being sustained on its merits" is ill advised. While a numerical indicator such as "one-in-three" may be useful to give a feel for the standard, it provides no concrete guidance to the professional practitioner or to the Service or a court whether or when the standard is breached. It is a standard that does not turn on a legal or technical analysis. Rather, it is inherently arbitrary.

Letter from ABA Section on Taxation Civil Penalties Task Force to Fred T. Goldberg, Commissioner of Internal Revenue, 91 TAX NOTES TODAY 123-46, June 7, 1991, *available in* LEXIS, Fedtax Library, TNT file. Therefore, one Tax Section Task force has called into question the very one-in-three benchmark that another Task Force interpreting Opinion 85-

wheel or roll of the dice.[203] However, use of such percentages now seems entrenched, and practitioners do make such estimates among themselves when assessing possible courses of action.

Finally, the standard continues the element of good faith as a basis for the standard. The system should encourage good faith efforts at compliance, not punish them. Although this involves an element of subjectivity, it is unfair and ultimately self-defeating for the system to impose sanctions on practitioners who make good faith efforts to comply.

B. *Allow All Authorities to be Considered*

One of the principal criticisms of the substantial authority standard is that it limits the authorities upon which the taxpayer can depend in assessing a return position. The regulations under section 6694 extend application of this limited list to the preparer penalty.[204] Although the list of permissible authorities has expanded to include materials such as letter rulings and the Blue Book, the list still excludes conclusions reached in secondary sources such as treatises and articles.[205]

The IRS claims it would be "too difficult to administratively determine which secondary sources were well-reasoned or were otherwise accurate expressions of the tax law."[206] Perhaps the IRS does not want to be "at the mercy of Prentice-Hall or CCH or every law review editor in country."[207] However, it is undeniable that practitioners routinely consult secondary

---

352 advanced. *See supra* text accompanying notes 147-79.

A task force of the American Institute of Certified Public Accountants Tax Division concluded that a mathematical approach to return standards is inappropriate. Sheldon I. Banoff, *Determining and Weighing Valid Legal Authority to Avoid Accuracy-Related and Preparer Penalties: The Proposed Regulations Continue the Controversy*, 69 TAXES 259, 284 (1991).

203. *See* Banoff & Coustan, *supra* note 55, at 137. One tax expert declared:

> The more tax cases I read, the more uncomfortable I become at guessing at the probable outcome of the hypothetical controversy. Had I been asked to guess at the chances of success of the taxpayers in *Selfe* [872 F.2d 519 (11th Cir. 1986)] (guaranteed loan and S corporation basis), *Lessinger* [872 F.2d 519 (2d Cir. 1989)] (excess liabilities in Section 351 transaction), or *Soliman* [94 T.C. 20 (1990)] (the focal point test for the home office deduction), I would have put each of their chances for success at well below one in three.

Banoff, *supra* note 202, at 284 n.212 (quoting RABY REPORT ON TAX PRACTICE, June 1990, at 7).

204. Treas. Reg. § 1.6694-2(b)(2).

205. *See supra* text accompanying notes 84-86 (discussing substantial authority definition and continued exclusion of treatises and articles as authority).

206. T.D. 8382, 56 Fed. Reg. 67,511 (1991) (codified at Treas. Reg. §§ 1.6694-0 to 1.6694-4); *see* Banoff & Coustan, *supra* note 55, at 161-62 (discussing IRS's rejection of secondary material as authority).

207. *See* Banoff & Coustan, *supra* note 55, at 162 n.180 (quoting Professor Lawrence Zelenak in Minutes of Meeting of ABA Section of Taxation Committee on Standards of Tax Practice (Washington, D.C., May 17, 1991)).

sources such as Bittker & Eustice[208] in the corporate tax area and McKee, Nelson & Whitmire[209] in the partnership area. Courts also consult and cite such authorities.[210] Finally, the standards of both the ABA[211] and the AICPA[212] sanction resort to secondary authority.

The reality is that everybody uses secondary sources. They are cited by taxpayers and the IRS in audits and at the appellate level. Everyday tax return preparers and even more sophisticated advisors are forced to rely on them.[213] Given the amount and complexity of new legislation over the past several years, there often is simply no authority interpreting a given Code provision.[214] The tax advisor is left with no choice but to depend on the

---

208. BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS (5th ed. 1987).

209. MCKEE ET AL., *supra* note 68.

210. *E.g.*, Flora v. United States, 362 U.S. 145, 148 n.2 (1960); Clavidge 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 points out:

> [O]nce a court has decided to look beyond the four corners of the statute, 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.

BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 4.2.2 (2d ed. 1989).

211. 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* note 210 (discussing how courts use secondary authority).

212. AICPA Statements on Responsibilities in Tax Practice, Statement No. 1 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.

Id. § .07. AICPA Interpretation 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 tax publications, and other reference tools and sources of tax analysis commonly used by tax advisors and return preparers.

Id. § .07, *quoted in* Banoff & Coustan, *supra* note 55, at 160 n.167.

213. *See* Banoff & Coustan, *supra* note 55, at 160, 162; Johnson, *supra* note 43, at 1526:

> 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.

214. *See* Letter of John B. Jones, Jr., Chair, ABA Section of Taxation, to Leslie S. Shapiro, Director of Practice, Internal Revenue Service (Feb. 13, 1987) (transmitting Comments on Notice of Proposed Rule Making Under 31 CFR, Part 10 (Circular 230)), *reprinted in* Sax, *supra* note 76, at 68, 72.

advisor's own analysis of the provision and that of learned colleagues published in the professional literature.[215]

For example, for years no cases existed interpreting Code section 305 governing stock dividends, and the regulations left many questions unanswered. The Bittker & Eustice treatise contained an excellent analysis of Code section 305.[216] In the many situations that might arise in which Code section 305 could expose the client to tax, the tax advisor almost certainly would consult the treatise. In the case under discussion here, the only directly relevant authority Lawyer has with respect to the inclusion of partnership nonrecourse liabilities in the calculation of a partner's insolvency is the ABA Tax Section section 108 task force report.[217] Presumably the authors of the task force report are among the more knowledgeable practitioners with respect to the issue under consideration. Their opinion should bear some weight in the substantial authority analysis. It would be silly to say that Lawyer cannot rely on the task force report because it is not permissible authority. In reality, courts and practitioners use this type of authority every day. A uniform tax return advice standard should not deny that reality.

The Service concedes that practitioners may rely on the "authorities underlying the conclusions in the secondary sources," as contrasted to the conclusions themselves.[218] This may be a distinction without a difference. In the absence of primary authority, the practitioner must rely on a "well-reasoned" construction of the statute as authority. But well-reasoned statutory constructions are precisely what many secondary sources attempt to provide. Should lawyers not consider the well-reasoned construction in an article, treatise, or task force report? In addition, if an article does cite authority that underlies the article's conclusions, the article inevitably will contain a reasoned analysis of that authority, which in turn should qualify as a well-reasoned analysis of the statute that the cited authority interprets. If that is so, there is little reason to retain the distinction between conclusions in a secondary source and the authorities underlying those conclusions.

C. *Permit Disclosure to Cure a Substandard Position*

Adequate disclosure currently cures a nonfrivolous substandard position under the negligence, disregard of rules and regulations, substantial understatement, and preparer penalties.[219] However, ABA Opinion 85-352 does

---

215. *See* Banoff & Coustan, *supra* note 55, at 160.

216. *See* BORRIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.62 (4th ed. 1979).

217. *See supra* note 31 and accompanying text.

218. T.D. 8382, *supra* note 206, at 67,511.

219. Treas. Reg. § 1.6662-3(c) (1991) (governing negligence or disregard of rules or regulations); § 1.6662-4(a), (e), (f) (as amended 1992) (governing substantial understatement); § 1.6994-2(c), (e) (as amended 1992) (governing preparer penalties). The AICPA Statements on Responsibilities in Tax Practice also provide that adequate disclosure cures a nonfrivolous substandard position. AICPA Statements of Responsibility in Tax Practice, Statement No. 1 § .09 (1988), *reprinted in* STANDARDS OF TAX PRACTICE ¶ 2006.

not address expressly the effect of adequate disclosure on a substandard position, and some ambiguity exists concerning the effect of adequate disclosure under Opinion 85-352.[220] Adequate disclosure of a substandard position should relieve a taxpayer or practitioner of sanctions in all cases, except where the position is frivolous. In addition, the definition of a frivolous position should be changed to require a lack of good faith.

The main impetus for tightening return position standards was the fear of taxpayers' taking advantage of the audit lottery by taking undisclosed substandard positions, especially with respect to tax shelters.[221] Adequate disclosure removes one of the principal weapons of the taxpayer taking advantage of the audit lottery by removing the possibility of burying the position on the return.

Some have expressed concern that disclosure of all substanard positions would result in a new audit lottery for taxpayers who take questionable positions but seek to avoid sanctions through disclosure.[222] This is indeed a possibility. However, disclosure is normally evidence of good faith. Allowing disclosure to give absolution for a substandard position would protect the taxpayer and practitioner who make a good faith compliance effort, but are unable to determine the correctness of their position with certainty.

The administrative burden on the Service might be lessened by including more properly designed questions and checkoffs on the return than presently exist.[223] For example, a taxpayer submitting a Form 8275 might have to so indicate by checking a box on the front page of the return.[224] In any event, if increased amounts of disclosure overwhelm the IRS, such a system's failures would be considerably more serious than any amount of tinkering with return position standards could cure. Because disclosure absolves the taxpayer and practitioner in many cases now, extending the absolution to nonfrivolous positions for all purposes should not be inordinately unwieldy.

Allowing adequate disclosure as a cure also would avoid the existing problem under the ABA's RPOS standard of a lawyer having to withdraw from representation of a taxpayer who has a nonfrivolous position that falls below the RPOS standard. A lawyer could continue to represent the client, provided the client made adequate disclosure. This would promote the fundamental right of the taxpayer to contest an issue prior to payment of the tax. The present situation can frustrate the taxpayer's ability to

---

220. *See supra* text accompanying notes 172-77 (discussing uncertainties in ABA Op. 85-352).

221. *See* Jerome Kurtz, *Notes to a New Commissioner of Internal Revenue*, 12 TAX NOTES 1195, 1196 (1981) (citing tax shelters as "progeny" of reasonable basis standard), *quoted in* Johnson, *supra* note 43, at 1527; Kurtz et al., *supra* note 128, at 14-15. *See generally* Rowen, *supra* note 2.

222. *IRS' Director of Practice Clashes with CPAs Over Proposed Ethics Standard*, Daily Tax Rep. (BNA), Dec. 4, 1986, *available in* LEXIS, Fedtax Library, BNADTR File.

223. *See* Kurtz et al., *supra* note 128, at 18-19 (discussing possibility of adding more questions to tax forms).

224. William L. Raby, *Fact or Fantasy? Contemplating Tax Practice in the Year 2000*, 55 TAX NOTES 1115, 1118 (1992).

pursue a reasonable legal claim by requiring prepayment of the tax or denying taxpayer legal counsel (where the lawyer is required to withdraw because of a nonfrivolous substandard position).[225] Requiring lawyers to withdraw when clients take nonfrivolous substandard return positions also may retard development of the law by discouraging novel positions.[226]

Finally, the definition of a frivolous position should be changed to exclude any position that is taken in good faith. The final regulations interpreting the accuracy-related and preparer penalties rejected comments to the proposed regulations suggesting a subjective good-faith standard on the ground that a purely objective standard is more appropriate.[227] Again, however, where a taxpayer or practitioner makes disclosure in the good faith belief that the position is not frivolous, that individual may be ignorant but is not a fit subject for punishment.[228]

D. *Impose a Compliance Toll Charge on Taxpayers and the IRS*

The substantial understatement penalty originally was suggested as a no-fault penalty for playing the audit lottery.[229] To the extent that a taxpayer now can make a reasonable cause and good faith defense against that penalty, the no-fault aspect has been abrogated. In addition to adopting a uniform RPOS standard, Congress, the Treasury, and the ABA should eliminate the substantial understatement penalty. Nevertheless, some penalty or charge to compensate for the cost of enforcement ought to be imposed on taxpayers who take undisclosed positions that fall below the uniform RPOS standard, even if they act in good faith. The charge should be imposed in every case where the taxpayer owes a deficiency due to an undisclosed position regardless of whether the uniform RPOS standard is met.

The suggested charge is not in the nature of a penalty or a tax, but rather a reimbursement to compensate the government for its costs connected

---

225. *See* Trucksess, *supra* note 91, at 745-48 (discussing various criticism of practitioners due to IRS's linkage of Circular 230 standards and substantial understatement penalties of Code).

226. *Id.*

227. T.D. 8381, *supra* note 48, at 67,494-95. The ABA Tax Section Task Force on Civil Penalties suggested a definition of frivolous as "not litigable." Under the task force formulation,

> [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.

Letter from ABA Section on Taxation Civil Penalties Task Force to Fred T. Goldberg, Commissioner of Internal Revenue, 91 Tax Notes Today 123-46, June 7, 1991, *available in* LEXIS, Fedtax Library, TNT File. This formulation, of course, incorporates a good faith criterion.

228. The theological formulation of this is that an individual is not culpable for wrongs committed in invincible ignorance.

229. *See supra* note 93 (suggesting that substantial understatement penalty was originally no-fault penalty).

with income tax enforcement.[230] The toll charge should be low[231] to reflect its nature as a compensatory toll charge rather than a penalty. The costs of tax system enforcement should be placed on taxpayers who fail to make disclosure rather than on those who disclose.

By the same token, what is sauce for the goose also should be sauce for the gander. Costs incurred by the taxpayer on account of the IRS asserting incorrect positions against the taxpayer are more properly allocated to the government than to the taxpayer. Hence, a similar toll charge should be imposed on the IRS when it asserts an incorrect deficiency and the taxpayer is found to owe no additional tax, to compensate the taxpayer for costs connected with the enforcement proceeding. These toll-charges would allocate the cost of enforcement to those responsible for the costs.

V. Conclusion

Our system of taxation is a voluntary one. To be sure, some pay because of a sense of duty and civic pride, some pay because they fear the repercussions of not paying, and others do not pay at all unless they are caught. It is apparent that the latter two groups are a less efficient source of income than the first. Taxpayers and practitioners are more likely to comply willingly with the income tax if they understand the "rules of the game." The importance of preparer and taxpayer standards is that they greatly narrow the universe of results among similarly situated taxpayers. The key to tax policy in the preparer and taxpayer compliance area is the promotion of consistent, understandable rules that encourage the voluntary compliance upon which our self-assessment system is founded.

---

230. *See* Rev. Proc. 93-1, 1991-1 I.R.B. 333 (providing users fees for private letter rulings).

231. One commentator has suggested a level of five to seven percent. *See* Johnson, *supra* note 43, at 1530.

APPENDIX

REPORTING STANDARDS SUMMARY

STANDARD	PERCENTAGE	DESCRIPTION	DISCLOSURE*
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; Proposed Amendment to Circular 230)	33.33%	Authority not substantial, but still has a good chance of being sustained if litigated; relevant authorities limited	Absolves § 6694; Prop. Circ. 230 § 10.34(a)
Reasonable possibility of success if litigated (ABA Op. 85-352)	33.33% or somewhat less	Same as above, except good faith required and relevant authorities broader	Does not absolve
Reasonable basis	10-20%	Arguable but fairly unlikely to prevail	Absolves § 6662(b)(1)
Nonfrivolous	5-10%	Not patently improper, but less than reasonable basis	Absolves § 6662(b)(1)
Frivolous	0-5%	Patently improper	Does not absolve

* A recent proposal by the Clinton Administration would replace the "not frivolous" standard with a "reasonable basis" standard.