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LAW AND ORDER COMES TO "DODGE CITY": TREASURY'S NEW RETURN PREPARER AND IRS PRACTICE STANDARDS

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Tax policy discussions tend to take the shape of proposals for change. I depart from that tradition to offer support for recent United States Treasury Department (Treasury) efforts to reinvigorate the self-assessment system. Almost seven years ago, proposed amendments to Circular 230 which sought to redefine practitioner standards of federal tax advice set off a maelstrom.[1] There followed studies, reports, revised taxpayer and preparer penalty legislation, notices, proposed and final regulations, and another round of proposed revisions to Circular 230 that generally would conform the standards of practice before the Internal Revenue Service (IRS) to those established by the preparer penalty regulations.

There has been and will continue to be no shortage of critics of the new standards. I offer the observation that the Treasury has contributed significantly to public law jurisprudence by articulating for practitioners expectations of respect for legitimate lawmaking authority and discipline in identifying the requirements of "law." Additionally, the Treasury implicitly has defined "law" in terms that are meaningful to the taxpaying public, which has been alienated by the appearance of lawlessness created by lawyers' and accountants' insistence on broad discretion to supply to "ambiguous" statutory terms virtually any content most favorable to clients.

The strength of the new standards is that they require practitioners to defer, in resolving ambiguities in the revenue statutes, to legislative, judicial and administrative "authority" as defined under the accuracy-related penalty regulations.[2] The objectivity achieved by this limitation vastly improves the administrability of the Treasury standards over the standards of the American Bar Association (ABA)[3] and the American Institute of Certified Public

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1. 51 Fed. Reg. 29,113 (1986) (to be codified at 31 C.F.R. pt. 10) (proposed July 18, 1986). Treasury Department Circular No. 230, codified at 31 C.F.R. Part 10, prescribes rules governing practice before the Internal Revenue Service (IRS). A violation of these rules may result in suspension or disbarment from representing clients before the Service. The proposed regulations would have required advised return positions to be "reasonable, meritorious and made in good faith" and would have prohibited practitioners from advising positions that would subject a client to the substantial understatement penalty, then set forth at Internal Revenue Code § 6661.

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

3. ABA Comm. on Ethics and Professional Responsibility, Formal Op. 352 (1985), *reprinted in* 39 TAX LAW. 631 (1986) [hereinafter Formal Op. 85-352].

Accountants (AICPA).[4] Moreover, the Treasury's approach soundly, if not explicitly, rejects the proposition, inherent in the ABA and AICPA standards, that taxpayers and their advisers (or even academics) may substitute their own private speculation for authoritative judgments. While further clarification would be in order, Congress and the Treasury should resist the pressure to reverse course. Bringing law and order to the tax return by prescribing professional conduct consistent with a broadly accessible concept of the rule of law may breathe new life into our self-assessment system.

The regulations assume "law" to mean "positive law," that is, norms established "by the authority of the state as contrasted with natural law or a body of ideal precepts."[5] Many of us may wish that we were subject to tax under principles of natural justice, but the content of those principles is the subject of some dispute and so, as a practical matter, varies with the identity of the person applying them. Most accept that members of the legislature, executive officials, and judges, who are the final arbiters, resolve conflicting notions of what principles of justice ought to govern in our polity. We may attain for our personal principles the status of law only by advancing them for adoption by these politically authorized decisionmakers. Whereas individuals have considerable power to define private law rights and duties, our judgments as individuals are not recognized as authoritative pronouncements of public law.

These propositions may seem unremarkable; but, as related in Section I below, for some time the federal tax system has tolerated practitioners' assessing a client's tax liability in accordance with their personal preferences as to the requirements of the tax laws. One costume in which personal preference can dress is as a prediction of a position's likelihood of prevailing in an adversarial proceeding, which is the ethical standard governing return advice adopted by the ABA and the AICPA. The ABA permits advising a return position that has a "realistic possibility of success in litigation,"[6] and the AICPA permits advising a position that has a "realistic possibility of being upheld, administratively or judicially, on its merits."[7]

The legitimacy of this formulation of the task of tax advising rests on the Holmesian or realist definition of law as a prediction of what the courts will say it is,[8] a definition that seems entirely consistent with the notion that law is the product of politically authorized decisionmakers. However, the danger of a realist definition of law in the hands of a decisionmaker without authority is that legal reasoning may become fortunetelling, an exercise of imagination influenced by wishful thinking, creative rather than

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4. AICPA Statement on Responsibilities in Tax Practice (1988 Rev.) No. 1 (Aug. 1988) [hereinafter SRTP No. 1].

5. Webster's Third New International Dictionary 1770 (1971).

6. Formal Op. 85-352, *supra* note 3, *reprinted in* 39 TAX LAW at 633.

7. SRTP No. 1, *supra* note 4, ¶ .02a.

8. Oliver W. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 461 (1897) ("The prophecies of what the courts will do in fact, and nothing more pretentious, are what I mean by the law.").

compliant. Since the practitioner may or may not conclude what a court would, the decision is not the equivalent of the judgment of an authorized decisionmaker but is simply the view of a private individual acting on behalf of private interests.

Although rarely phrased in these terms,[9] and not explicitly addressed in the regulations, the appropriate definition of law may be the core issue that has divided tax practitioners and the government. Differing theoretical perspectives may have had the practical consequence of fueling distrust and increasing animosity on both sides. Theoretical differences also may have separated practitioners from the public, leaving the impression that tax practitioners are lawless mercenaries for those who can afford their services. The articulated differences center on how to interpret "doubtful" or "questionable" statutory requirements and the propriety of requiring that, where the IRS has ruled on the meaning of a provision, practitioners either follow the IRS's view or disclose that they are not. Practitioners have protested what they regard as forced servitude to the IRS. The IRS has accused the practicing community of dishonoring the obligation to corral advice within the confines of the requirements of law.

As Section II explains, the new Treasury standards reject a lawyer's definition of law in favor of a good old-fashioned lay definition: "law" is what is on the books. Although lawyers and accountants have adopted a perhaps more theoretically respectable definition of law, prediction of what the courts would decide is an inherently speculative and subjective undertaking that results in according private individuals unaccountable lawmaking authority.

I. THE OLD REGIME

Under the original preparer penalty statute enacted in 1976,[10] tax advisers adopted the view that they were allowed broad discretion to pick and choose the regulations with which they would comply. Former section 6694(a) of the Internal Revenue Code (Code) purportedly penalized a practitioner[11] if any part of a client's understatement were due to the adviser's "negligent or intentional disregard of rules and regulations." However, the regulations under section 6694 permitted a practitioner to take a position contrary to

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9. *But see* Gwen T. Handelman, *Counseling Ordered Liberty: Reply to a Commentary*, 9 VA. TAX REV. 781 (1990); Gwen T. Handelman, *Constraining Aggressive Return Advice*, 9 VA. TAX REV. 77 (1989); Judson L. Temple, *The Tax Return and the Standard of Accuracy—Part II*, 16 REV. TAX'N OF INDIVIDUALS 64 (1992); Judson L. Temple, *The Tax Return and the Standard of Accuracy—Part I*, 15 REV. TAX'N OF INDIVIDUALS 315 (1991); David B. Wilkins, *Legal Realism for Lawyers*, 104 HARV. L. REV. 468 (1990). *See also* Gwen T. Handelman, *Sisters in Law: Gender and the Interpretation of Tax Statutes*, 3 UCLA WOMEN'S L.J. (forthcoming 1993) (discussing approaches to defining law).

10. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1203(b), 90 Stat. 1520, 1689 (1976) (amended 1989).

11. *Id.* Both former and current § 6694 penalties apply to "income tax return preparers" as defined under Code § 7701.

rules or regulations if the position were taken "in good faith" and supported by a "reasonable basis" for concluding that the rule or regulation did not accurately reflect the Code.[12] The regulations tracked the language of ABA Ethics Opinion 314,[13] which came to be known as the "laugh-aloud" standard,[14] but both the ABA and AICPA standards went beyond setting "reasonable basis" as adequate support for a position contrary to a regulation. Both organizations adopted the view that practitioners could establish "good faith" absent disclosure that a position contradicted a regulation. Reporting a position without such disclosure would seem to constitute representing a position as consistent with "law," and a *taxpayer's* knowing disregard of regulations without disclosure was not excused as undertaken in good faith.[15] However, tax advisers implicitly assumed the unique privilege of challenging administrative rulings in their offices without raising the issue to the Service or before the courts, except in the unlikely event of audit. In short, the standard of return advice was set at the same level required to assert a position in litigation, which necessarily involves affording the opposition the opportunity to rebut, even though the chance of actual adversarial confrontation with respect to a return position was remote. Unlike taxpayers, practitioners were assured of the ethical propriety of asserting their opposition to rules and regulations surreptitiously.

The old preparer penalty regime not only rested on a legal realist definition of law, but also seems to have borrowed from the era of laissez-faire a view that administrative agencies are illegitimate interlopers in a domain to which only the judiciary should be acknowledged as rightful heir.[16] Even as courts have increasingly recognized the lawmaking authority of administrative agencies,[17] tax professionals seem to cling to the common

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12. Treas. Reg. § 1.6694-1(a)(1) & (4) (as amended in 1978). *See* Richard C. Stark, *IMPACT Makes Fundamental Changes in Civil Penalties*, 72 J. TAX'N 132, 136 (1990) (discussing that prior to amendments, § 6694 allowed preparer to take position contrary to rules if position taken in "good faith").

13. ABA Comm. on Ethics and Professional Responsibility, Formal Op. 314 (1965).

14. *See* Michael J. Graetz, *Too Little, Too Late*, TAX TIMES, Feb. 1987, at 17 (discussing practical results of reasonable basis standard).

15. *See, e.g.*, Forseth v. Commissioner of Internal Revenue, 845 F.2d 746 (7th Cir. 1988); Warrensburg Bd. & Paper Corp. v. Commissioner, 77 T.C. 1107 (1981) (rejecting claims of good faith due to taxpayer's failure to disclose). *Cf.* Pullman, Inc. v. Commissioner, 8 T.C. 292 (1947); Wesley Heat Treating Co. v. Commissioner, 30 T.C. 10 (1958); Belz Inv. Co. v. Commissioner, 72 T.C. 1209 (1979) (citing disclosure as excuse for otherwise applicable penalty). *See, e.g.*, Gwen T. Handelman, *Caring Reasonably*, 20 CAPITAL U. L. REV. 345 (1991).

16. In the early part of the twentieth century, even regulatory *statutes* were regarded as the stepchild of the law contrasted with the perceived "integrity and coherence" of judge-made doctrines. CASS R. SUNSTEIN, AFTER THE RIGHTS REVOLUTION: RECONCEIVING THE REGULATORY STATE 5 (1990).

17. Chevron v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984); Wagner Seed Co. v. Bush, 946 F.2d 918 (D.C. Cir. 1991); Peoples Fed. Sav. & Loan Ass'n v. Commissioner, 948 F.2d 289 (6th Cir. 1991); Johnson City Medical Ctr. Hosp. v. United States, 783 F. Supp. 1048 (E.D. Tenn. 1992). *See, e.g.*, Linda Galler, Chevron *and the Administrative Regulation of Indexation: Challenging the Cooper Memorandum*, 56 TAX NOTES 1791 (1992).

law bias that the basis of administrative authority is expertise rather than governmental power. It follows from such a view that administrative pronouncements are no more authoritative than the views of an equally expert practitioner.[18] Certainly the practicing community has so regarded revenue rulings. The conventional rationale is recorded in the preamble to the final accuracy-related penalties: "One commentator stated that a revenue ruling should not be treated as a 'rule' [for purposes of the penalty for disregard of rules and 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 subjected to the give and take of a public comment process."[19] Tax advisers seem loathe to respect administrative pronouncements as a form of "law," let alone defer to agency interpretations of the statutes it is charged with administering.

The routine dismissal by tax practitioners of administrative authority has exacerbated the uncertain application of the internal revenue laws that was the natural consequence of a realist definition of law. Perhaps it is to be expected that the jurisprudence of an era that favored private ordering proves hostile, or at least peculiarly unhelpful, to effective regulation of private behavior in the public interest, such as self-assessment. It is apparent that practitioner predictions will not achieve certainty and uniformity in the application of the tax laws. The interpretive venture incorporates so many considerations and sources that the outcome rests on the weight of a given factor. Some practitioners even have narrowed the endeavor to hypothesizing what the Supreme Court would decide if the matter were before it.[20] Since the Supreme Court rarely actually supplies any answers, under this formu-

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18. *See, e.g.*, Linda Galler, *Emerging Standards for Judicial Review of IRS Revenue Rulings*, 72 B.U. L. REV. 841, 852 (1992). Professor Galler states:

> While the IRS undoubtedly employs many intelligent, experienced, and accomplished individuals, it is far from clear that the individual or collective dexterity of this group distinguishes it from tax practitioners in the private sector. To accord special consideration to the IRS because its employees have superior skills gives the government an unwarranted advantage with no literal basis because, in the logical extreme, the same people comprise the public and private sectors. Indeed, the entrances to the Treasury and IRS buildings in Washington might be described figuratively, if not literally, as revolving doors, considering the numbers of professionals who pass through those portals on their way from private practice to government service, and then pass through once again as they return to the private sector.

Id. Professor Galler's article, however, is addressed to the quite different question of whether *courts* must defer to revenue rulings. I tend to agree with her that courts need not defer because the judiciary enjoys independent political authority. *See* Gwen T. Handelman, *Zen and the Art of Statutory Construction: A Tax Lawyer's Account of Enlightenment*, 40 DEPAUL L. REV. 611, 618-19 (1991). The Treasury apparently agrees. *See* text following note 66 *infra*.

19. IRS Final Regulations on Accuracy-related Penalty, 56 Fed. Reg. 67492, 67494 (1991). Revenue rulings "represent classic examples of interpretive rules." Galler, *supra* note 18, at 861 n.110. The Administrative Procedures Act mandates notice and comment procedures for "legislative," but not "interpretive," rules (whether issued in the form of revenue rulings or regulations). 5 U.S.C. § 553(b)(A) (1988).

20. *See, e.g.*, William L. Raby, *Using "Responsibility Level" Language to Control Tax Work Assignments and Channel Client Communication*, 53 TAX NOTES 1281, 1281 (1991).

lation the requirements of the "law" can remain extremely flexible indefinitely.

The conduct of most practitioners probably has been consistent with legitimate jurisprudential operating assumptions. However, it has appeared to the Service and to a substantial portion of the taxpaying public that practitioners adopt fanciful positions simply to avail their clients of the audit lottery. Not only has free-wheeling advice of professionals resulted in the noncompliance of their clients, but many taxpayers untrained in tax law have sought to imitate practitioner exploitation of ambiguity, resulting in negligent or even frivolous legal arguments.

The professions have made efforts to respond to public perceptions of wrongdoing, but both the ABA's and the AICPA's "realistic possibility" standard incorporated an unparalleled license to deviate from the prescriptions of lawful authority by substituting the adviser's judgment for "law."[21] While individuals may limit our private contractual obligations, our judgments as individuals are not recognized as authoritative definitions of public rights and duties. Yet both the ABA and the AICPA have asserted the privilege of their membership to engage in lawmaking. Perhaps neither would articulate their position in these terms, but both organizations adopted standards that permit a practitioner to advise a client to report without disclosure, as an accurate statement of the requirements of the internal revenue laws, a position supported only by a "good faith argument" for "modification" or even "*reversal* of existing law."[22] Certainly, in formulating arguments in litigation, "account must be taken of the law's ambiguities and potential for change,"[23] but even litigators are not permitted by ethical rules to misrepresent a desired outcome as the current state of the law.[24]

II. "REALISTIC POSSIBILITY" AS CONFORMING TO POLITICAL AUTHORITY

In 1989, Congress sought to improve compliance through a new regime of preparer penalties.[25] Nevertheless, in enacting new penalty legislation, Congress adopted a standard that "generally reflects the professional conduct standards applicable to lawyers and to certified public accountants."[26] Congress revised former section 6694(a) to impose a $250 penalty for a client's understatement attributable to a position for which there is "not a realistic possibility of being sustained on its merits" on a preparer who "knew (or reasonably should have known)" of the position.

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21. Formal Op. 85-352, *supra* note 3; SRTP No. 1, *supra* note 4.

22. Formal Op. 85-352, *supra* note 3 (emphasis added); SRTP No. 1, *supra* note 4, ¶¶ .02a & .07 (emphasis added).

23. MODEL RULES OF PROFESSIONAL CONDUCT Rule 3.1 cmt. (1992).

24. *Id.* Rule 3.3.

25. *See* H.R. REP. No. 247, 101st Cong., 1st Sess. 1396 (1989) (expressing belief that new standard is stricter than present law), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2866.

26. *Id.*

The Treasury, charged with the task of implementing a standard that simultaneously sought both to improve and to reflect the status quo, employed terms similar to those of the ABA and AICPA. However, the preparer penalty regulations represent important departures from previous standards of professional conduct. The regulations define the statutory "realistic possibility" standard as essentially equivalent to "substantial authority,"[27] which generally requires that an undisclosed position conform to the product of politically authorized decisionmaking processes, while recognizing the diverse authoritative sources of the tax laws, including the agency charged with their administration. The two breakthroughs are (1) the requirement that generally only "authority" as defined for purposes of section 6662 may be considered in determining whether a position reflects the requirements of "law,"[28] and (2) the recognition that administrative interpretations, including revenue rulings and notices,[29] may not be disregarded in determining the requirements of "law."[30]

Arguably, deviation from existing practitioner norms is inconsistent with congressional intent to conform the penalty standard to ABA and AICPA standards of professional conduct and calls into question the validity of the penalty regulations[31] (although not the Circular 230 practice regulations, which have an independent statutory basis). However, the legislative history of section 6694 indicates that the statutory standard was intended to reflect, but perhaps not duplicate, existing practitioner standards. The House Report states that the statutory standard "*generally* reflects the professional conduct standards applicable to lawyers and certified public accountants."[32] Moreover, practitioners do not agree on a single meaning of "realistic possibility of success."[33] The ABA and AICPA have somewhat different formulations

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27. *See* William Raby, *Salting the Voluntary Assessment System*, 54 TAX NOTES 187, 189 (1992) (stating that "differences" between two standards are "impossible to really articulate").

28. Treas. Reg. § 1.6694-2(b)(2) (as amended in 1991). *See* Treas. Reg. § 1.6662-4(d)(3)(iii) (1991).

29. Treas. Reg. § 1.6694-3(f) (1991).

30. *See* Raby, *supra* note 27 (commenting that regulations "superficially track the tax practitioner standards reflected in ABA Opinion 85-352 and AICPA Statement on Responsibilities in Tax Practice No. 1"). Mr. Raby argues, however, that because of the limitation on authorities on which the practitioner may rely in determining whether a realistic possibility of success on the merits exists "to those [authorities] that are admissible in determining 'substantial authority' under the taxpayer test," the regulatory standard actually is "at odds with basic interpretation of what those [practitioner] standards mean." *Id.*

31. I. BERNARD WOLFMAN ET AL., STANDARDS OF TAX PRACTICE ¶ 5005.03 (New Developments 1992).

32. H.R. REP. No. 247, *supra* note 25, at 1396 (emphasis supplied). *See* Stark, *supra* note 12 (observing that "context of the term in Section 6694 . . . suggests that Congress may have intended for 'realistic possibility' to mean something more" than "a reasonable litigating position").

33. *See, e.g.*, Stark, *supra* note 12, at 136 (observing that "the meaning of the 'realistic possibility' language is unclear").

of "realistic possibility,"[34] but they cannot even agree within their organizations as to its substantive content and application. Considerable controversy surrounds the proper interpretation of the ABA standard.[35] Thus, a rough approximation of the practitioner standard was the best that Treasury could have hoped to achieve. In addition, the proposed regulations succeed in articulating a more administrable standard. The limitation of authorities objectifies the "realistic possibility" standard,[36] whereas the list of considerations that a practitioner may incorporate into an assessment of "realistic possibility" is open-ended. That the objectivity achieved by the Treasury formulation vastly improves the administrability of the preparer regulations over the practitioner standards may supply a "reasonable" ground to support the administrative interpretation.

A. Ascertaining the Existence of a Realistic Possibility

Under the preparer penalty regulations "[a] position is considered to have a realistic possibility of [success] if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one-in-three, or greater, likelihood of being sustained on its merits." Whether the position is likely to prevail must be determined without regard to the likelihood that the

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34. *See* Randall W. Roth & Douglas C. Smith, *Current Ethical Problems in Advising Clients* C482 A.L.I.-A.B.A. 773 (1990) (suggesting AICPA standard of "realistic possibility of being upheld, administratively or judicially, on its merits" represents approximately 25% chance of success and ABA standard of "realistic possibility of success if litigated" represents approximately 30% chance). *But see* Tax Division, AICPA, Comments on Notice 90-20 Regarding Accuracy Related and Preparer Penalties, Submitted to the Internal Revenue Service (June 1, 1990), *reprinted in* TAX NOTES TODAY 153-14 (July 24, 1990) (expressing view that a mathematical approach is inappropriate because determination of odds is impossible, thus realistic possibility of success cannot be expressed in terms of percentage odds). However, the ABA and AICPA appeared to agree on a standard for purposes of comments on the 1986 proposed amendments to Circular 230.

35. *See* ABA Civil Penalties Task Force Comments on Notice 90-20 (asserting that meaning of realistic possibility standard "is still debated in the Tax Section," with some members arguing that one-in-three chance of success appears to be "inappropriately high"). *Compare, e.g.*, Report of the Special Task Force on Formal Opinion 85-352, *reprinted in* 39 TAX LAW. 635, 637-39 (1986) (asserting that Opinion 85-352 establishes elevated standard with both objective and subjective components, requiring not only subjective belief but also objectively realistic possibility of at least one-in-three chance of success) *with* Calvin H. Johnson, *Tax Return Positions in Contempt of Civil Penalties*, 33 TAX NOTES 501, 502 (1986) (stating that realistic possibility is merely restatement, clarification, of reasonable basis) *and* Stark, *supra* note 12, at 136 (reporting as "unsuccessful" efforts to require one-in-three chance).

36. Graetz, *supra* note 14 (observing that "'substantial authority' standard was explicitly chosen by Congress to provide a different and more objective requirement than the reasonable basis test." "While this is a long way from a self-executing legal standard . . . the substantial authority requirement does introduce an element of objectivity into the standard of conduct."). *Cf.* Raby, *supra* note 27, at 189 (observing that regulations "simplify the practitioner versus taxpayer conflict" inherent in statutory scheme).

Service will, in fact, raise the issue.[37] Like the preparer standard, the proposed Circular 230 standard is framed in terms of a one-in-three likelihood of being sustained on the merits.[38]

The one-in-three formulation has been criticized as both too demanding and not demanding enough, because predictions of the odds of success are inherently speculative and subjective. My own objection to this formulation as advanced by the ABA Section of Taxation was that it accorded private individuals unaccountable lawmaking authority.[39] However, the Treasury standard imports accountability by limiting the basis of undisclosed return positions to judgments of politically authorized decisionmakers. The Treasury's "realistic possibility" standard really does not call for a predictive undertaking at all, but prescribes a mode of reasoning, with legal authority as the premise. Although phrased as a process of paralleling authoritative decisionmaking, to the extent that existing authority is the basis of the position, the legitimacy of the position does not depend upon the odds that a future politically authorized decisionmaker would support the position. The standard rests, then, not so much on a lawyer's definition of law to be a prediction of what the courts would decide, but rather, on a definition

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37. Treas. Reg. § 1.6694-2(b)(1) (as amended in 1991).

38. 57 Fed. Reg. 46,356, 46,359 (to be codified at 31 C.F.R. pt. 10) (proposed Oct. 8, 1992). However, the proposed regulations fall short of adopting a Circular 230 standard of conduct identical to the preparer penalty standard, and this raises issues that require express resolution. The Circular 230 standard appears to deviate from the preparer penalty provisions in two ways. First, Circular 230 does not expressly incorporate Treasury Regulation § 1.6694-2(b)(1), which prescribes that the weight accorded authority is to be determined based on its relevance and persuasiveness as under the accuracy-related penalties. Treas. Reg. § 1.6662-4(d)(3)(ii) (1991). This omission may give rise to the question of what it means for a position to have a realistic possibility of being "sustained on its merits," which one commentator has suggested could refer to a "hazards of litigation" settlement standard. William L. Raby, *Circular 230 Still Leaves Gaps Between Profession and the IRS*, 57 TAX NOTES 511, 512 (Oct. 26,1992). This omission also eliminates the provision that recognizes "a well-reasoned construction of the applicable statutory provision" as support for a position despite the absence of "certain types of authority."

Additionally, the proposed Circular 230 standard does not expressly prohibit advising that a position contrary to a regulation be reported without disclosure, although § 6694(b) would subject to a penalty a practitioner who did so advise a client, even if the position met the reasonable possibility of success standard. As the most minimal respect for client autonomy would dictate, the proposed amendments would require that the practitioner advise clients of their liability for penalty for disregard of rules and regulations under § 6662(a)(1) and explain the special requirements for adequate disclosure of a position contrary to a regulation. However, as presently formulated, the proposed amendments appear to allow advising nondisclosure of a position contrary to a regulation if it meets the realistic possibility standard. While a single instance may not justify discipline, such conduct ought to be identified as a violation of the Circular 230 standard and certainly taken into account in determining if there is a pattern of conduct that warrants discipline. *But see* Rita L. Zeidner, *Service Proposes New Return Preparer Guidance*, 57 TAX NOTES (Tax Analysts) 296, 298 (1992) (quoting Gerald Portney, director of tax practice at KPMG Peat Marwick in Washington to effect that requirement that practitioners let their clients know exactly which penalties could result from their risky positions forces practitioners to "play cops" for IRS).

39. Gwen T. Handelman, *Constraining Aggressive Return Advice*, *supra* note 9.

of "law" based upon what politically authorized decisionmakers have already articulated.

Most important is the requirement that, in making the determination of whether a realistic possibility of success supports a position under both the preparer penalty and Circular 230 regulations, preparers may consider only the "authorities" expressly allowed under the substantial authority regulations.[40] The definition of "authorities" excludes conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by other tax professionals who do not hold positions of political authority. The preparer penalty regulations also incorporate Treasury Regulation section 1.6662-4(d)(3)(ii), which prescribes the "nature of analysis"—weight accorded authority and determination of relevance and persuasiveness—for determining whether substantial authority exists.[41] This provision applies for purposes of determining whether the position satisfies the realistic possibility standard, although the weight of authorities supporting the taxpayer's position need not be "*substantial* in relation to the weight of authorities supporting contrary treatment."[42] However, a balancing analysis necessarily implies that if contrary authority exists, then at least a single authority must support the taxpayer's position.[43]

The determination of whether "realistic possibility" supports a position is not left to the taxpayer's or adviser's judgment as to the equity of an outcome, but instead, with reference to "authority."[44] The Treasury has held fast in defining "authority" to include only judgments of politically authorized decisionmakers. It is true that courts take account of opinions in treatises and periodicals, "so practitioners find it hard to accept the fact that they cannot do likewise";[45] but courts are politically authorized decisionmakers and practitioners are not.[46] The Treasury regulations include one limited exception to the general requirement that a practitioner may consider *only* "authority" in ascertaining whether a realistic possibility exists. The "nature of analysis" incorporated into the preparer regulations provides that "a well-reasoned construction of the applicable statutory

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40. Treas. Reg. § 1.6662-4(d)(3) (iii) (1991). Unlike the substantial authority standard, however, the realistic possibility standard requires that the status of authority generally must be determined as of the date of the return rather than as of the end of the tax year at issue. *Id.* § 1.6694-3(b)(5).

41. *Id.* § 1.6694-2(b)(1).

42. Treas. Reg. § 1.6662-4(d)(3)(i) (1991) (emphasis added).

43. *See* Galler, *supra* note 18, at 847 (noting that "where the only existing authority is a revenue ruling" taxpayers must choose among complying with ruling, disclosing position or risking penalty).

44. *See, e.g.*, Treas. Reg. § 1.6694-2(b)(3), Example 2 (as amended in 1991).

45. Raby, *supra* note 38, at 512.

46. Another means to limit pratitioners' pronouncements as to the requirements of law is the requirement that undisclosed return positions must reflect the law as of the date of the return rather than as of the end of the tax year at issue. Treas. Reg. § 1.6694-3(b)(5) (as amended in 1991).

provision" counts as support for a position despite the absence of "certain types of authority."[47]

Although some of the illustrative examples under the preparer penalty regulations[48] raise as many questions as they answer, the examples provide guidance as to how to resolve ambiguities in the revenue statutes with appropriate deference to the judgments of politically authorized decision-makers. Examples under section 6694(a) indicate that private views must give way to politically authorized judgments, although one example suggests that a position may be considered to meet the "realistic possibility standard" without any supporting "authority" if the only contrary authority is a proposed regulation or private ruling.[49]

Example five under regulation section 1.6694-2(b)(3) posits a statute that is silent as to whether a taxpayer may take a certain position on the taxpayer's 1991 federal income tax return. Three private letter rulings issued to other taxpayers in 1987 and 1988 support the taxpayer's position. However, proposed regulations issued in 1990 are clearly contrary to the taxpayer's position. The explanation reiterates that only "authority" as defined under section 6662 may be considered and that after issuance of proposed regulations, inconsistent private rulings are no longer authority.[50] According to the preamble to the final preparer regulations, "proposed regulations are subject to a higher level of review than private rulings and it is not appropriate to retain as an authority a document that does not accurately reflect the current status of the law and position of the [IRS]."[51] Therefore, lawyers should not take the rulings into account in determining whether the position satisfies the realistic possibility standard.

However, the explanation of the example states that the position contrary to the proposed regulations may or may not satisfy the realistic possibility standard, depending on an analysis of all the relevant authorities. The existence of authorities other than those specifically mentioned—authorities supporting the reported position—may be implied. However, an alternative interpretation is that, even without the support of any "authority," a position can have a realistic possibility of success if the only contrary authority is a proposed regulation, depending on the relative quality of the reasoning underlying the proposed regulations and the preparer's construction of the statute.

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47. Treas. Reg. § 1.6662-4(d)(3)(ii) (1991). The proposed amendments to Circular 230 do not incorporate this provision. *See supra* note 38. The implication of omitting this exception to the general rule that *only* authority may be counted in assessing whether a position has a realistic possibility of success is that such a position must be supported by at least one authority even if no contrary authority exists. If at least one authority does not exist, the practitioner must advise disclosure of the position. If this omission was an oversight, the final regulations will probably remedy it.

48. No examples exist under the proposed revisions to Circular 230.

49. Treas. Reg. § 1.6694-2(b)(3), Example 5 (as amended in 1991).

50. *Id.*

51. T.D. 8382, 1992-1 C.B. 392, 394.

This seems inconsistent with the proposition that only "authority" under section 6662 may be considered in determining the existence of a realistic possibility. It would seem that if only one authority exists, and that authority is contrary to the position, the position could not be supported by a realistic possibility of success. However, the incorporated substantial understatement regulations state that substantial authority for a position may exist despite the absence of "certain types of authority," and so "a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision."[52] The regulations fail to explain which "certain types of authority" were meant. However, example five suggests that a well-reasoned construction of the statute may establish a realistic possibility of success absent contrary authority more weighty than proposed regulations and private rulings, which carry even less weight than proposed regulations. It may be that a proposed regulation, which counts as "authority" but not as a "rule or regulation," is of such minimal weight that a well-reasoned construction of a statute is sufficient counterweight to establish a one-in-three likelihood of success.

To nail down the distinction between "authority" and personal opinion, Treasury regulation section 1.6694-2(b)(3), examples seven and eight state that judicial and administrative interpretations of other provisions of the Code or other federal or state law, are not "authority" for purposes of determining the meaning of the same words in a separate provision. Of course, as in the case of conclusions reached in treatises and legal periodicals, the authorities underlying the judicial and administrative decisions may be relevant to determining whether the taxpayer's position meets the realistic possibility standard, and the interpretations themselves are relevant in arriving at a well-reasoned construction of the language at issue. However, the context in which the language arises also must be taken into account in determining whether the position satisfies the realistic possibility standard.

B. Deference to Administrative Authority

Perhaps even more significant than the definition of "authority" is new Code section 6694(b) which imposes on return preparers a $1,000 penalty, reduced by any amount paid under section 6694(a), for an understatement due to either (1) "a willful attempt" to understate tax liability, equated under the regulations with disregard of *facts* "in an attempt wrongfully to reduce the [client's] tax liability"[53]; or (2) "reckless or intentional disregard of rules or regulations," or in other words, a disregard of *law*.[54] Consistent with former section 6694, the Treasury has defined "rules and regulations" to include Code provisions, temporary or final Treasury regulations, and

52. Treas. Reg. § 1.6662-4(d)(3)(ii) (1991) (applying to determination of realistic possibility of success on merits by virtue of regulation § 1.6694-2(b)(1)).

53. Treas. Reg. § 1.6694-3(b) (as amended in 1991).

54. I.R.C. § 6694(b) (1988).

revenue rulings.[55] The Treasury also has added notices published in the Internal Revenue Bulletin.[56] The Statute provides no express exception for disclosure; but the legislative history indicates that rules and regulations contradicted by a disclosed position are not considered disregarded if the reported position is not frivolous,[57] and the regulations provide a disclosure exception. A position contrary to a regulation must represent a good faith challenge to the validity of the regulation,[58] and the disclosure must adequately identify the rule or regulation being challenged.[59]

Another nonstatutory exception to the penalty for disregard of rules or regulations provides that a preparer will not be penalized for an understatement due to a position contrary to a revenue ruling or notice if the position satisfies the realistic possibility standard.[60] Due to this provision, the regulations under the section 6694(b) penalty for disregard of rules and regulations also provide guidance as to the content of "realistic possibility." The section 6694(b) regulations indicate that a personal view, even though "well-reasoned," is inadequate to justify representing a position contrary to a revenue ruling as consistent with law.

Regulation section 1.6694-3(d), example four illustrates the applicability of the disclosure exception to the prohibition against reporting a position contrary to a regulation. Example four posits two authorities relevant to a taxpayer's situation: (1) final regulations that require capitalization of certain expenses incurred in the purchase of a business and (2) a Tax Court opinion, expressly holding the regulations invalid. The explanation states that advising a deduction contrary to the regulations without adequate disclosure will subject the preparer to the section 6694(b) penalty even though it "may" have a realistic possibility of being sustained on its merits. On these facts, the position may be reported if adequately disclosed because it represents a good faith challenge to the validity of the regulations.[61]

Considered together with example three under regulation section 1.6694-3(d), example four also may help illumine the content of a "realistic possibility" sufficient to balance a revenue ruling. Example three posits, instead of a regulation, a revenue ruling that holds that the expenses incurred in the purchase of a business must be capitalized and several cases from different courts that hold that these particular expenses may be deducted currently. No other authority exists. The explanation states that taking the deduction without disclosure is not reckless or intentional disregard of a

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55. Treas. Reg. § 1.6694-3(f) (as amended in 1991).

56. *Id.* Revenue procedures may or may not be treated as "rules or regulations" depending on facts and circumstances. *Id.*

57. H.R. REP. No. 247, *supra* note 25 ("specified disclosure tends to demonstrate that there was no intentional disregard of rules and regulations").

58. Treas. Reg. § 1.6694-3(c)(2) (as amended in 1991).

59. *Id.* § 1.6694-3(e).

60. *Id.* § 1.6694-3(c)(3). A similar exception applies for purposes of the disregard penalty on taxpayers under the § 6662 regulations.

61. *Id.* at § 1.6694-3(d), Example 4.

rule because a preparer may report without disclosure a position contrary to a revenue ruling if it has a realistic possibility of being sustained on its merits.[62] The preamble explains that the example in the final regulations refers to "several" rather than to "five" courts used in the proposed regulations in response to comments that the proposed regulations "created a negative inference that a position supported by fewer than five courts would not satisfy the standard" when "[n]o such inference was intended."[63] Thus, example three explicitly contemplates that fewer than five relevant and persuasive judicial opinions may justify reporting a position contrary to a revenue ruling. A single Tax Court opinion may be sufficient because example four states that a position contrary to a regulation, more weighty authority than a revenue ruling, that was held invalid by only one Tax Court decision "may" have a realistic possibility of being sustained on its merits.

The regulations do not address directly the circumstance in which a revenue ruling is the only "authority" on the issue. However, the several examples together imply that a well-reasoned construction of the statute is not sufficient by itself to counterbalance a revenue ruling, which is weightier authority than a letter ruling or proposed regulation. A revenue ruling is an authority of sufficient weight to count as a "rule or regulation," and the reference in example three to "several" court opinions contrary to the revenue ruling implies that at least *some* authority must support a position contrary to a revenue ruling to satisfy the realistic possibility of success standard. These examples also raise the question whether one Tax Court opinion may be the equal of "several" opinions from unidentified courts.

C. Identification of Ambiguity

Finally, the Treasury leaves no room for representing private judgment as law if the statute is "not ambiguous" and implicitly addresses the question of how "ambiguity" is to be defined and identified. Practitioners must adhere to the literal meaning of the words of a statute and not engage in searches of the legislative history or free-floating speculation as to legislative intent to identify ambiguity. Lawyers, particularly, are trained to appreciate the potential for ambiguity in all language and can be quite condescending toward the notion that a provision is "clear." But the Treasury has prescribed a strict plain meaning approach, rejecting classic lawyerly justifications for deviating from apparent meaning.

The inequity of a potential application of the statute does not give rise to ambiguity that the lawyer may resolve in favor of equity and report, without disclosure, as "law" on a client's return.[64] Treasury regulation section 1.6694-2(b)(3), example two posits a client who manufactures widgets, a new Code provision that provides no deduction for certain expenses

62. *Id.* § 1.6694-3(d), Example 3.
63. T.D. 8382, 1992-1 C.B. 392, 394.
64. Treas. Reg. §§ 1.6694-2(b)(3), Example 2 (as amended in 1991).

allowed under prior law, and a practitioner who believes that the new statute is inequitable as applied to the client's situation. No regulations or other authority exist under the new statute except the statutory language and committee reports. If the committee reports do not specifically address the client's situation, a position contrary to the statute does not satisfy the realistic possibility standard. A well-reasoned construction of the statute does not constitute a realistic possibility in the face of "unambiguous" statutory language.

Neither does inconsistency between the statutory language and statements in committee reports give rise to ambiguity that the lawyer is justified in resolving without disclosure.[65] Treasury Regulation section 1.6694-2(b)(3), example three provides that a position has a realistic possibility of being sustained on its merits if a conflict exists between the "unambiguous" general language of a statute which adversely affects the client's transaction and a specific statement in the committee reports that such transactions are not adversely affected. However, the position disregards "a rule or regulation" and so the preparer must disclose.[66]

The regulations are silent as to whether the "inequity" of an application of a statute is sufficient basis to support reporting the position, *with* disclosure, as nonfrivolous. Approval is implied, however, because the Treasury does acknowledge that a position consistent with the committee report may have a realistic possibility of success, even though the preparer must disclose the position to avoid "disregard of rules or regulations." Implicitly, then, the Treasury acknowledges that the *courts* may uphold a nonliteral, intentionalist, or perhaps even nonintentionalist "equitable" reading of the statutory terms, although the lawyer is foreclosed from making that decision independently without the benefit of an authorized decision-making forum.

The "plain meaning" approach, of course, does not eliminate all statutory ambiguity.[67] If the statute is ambiguous within the strict definition provided by the regulations, selection of the applicable meaning generally must be determined considering only "authority" as defined for purposes of section 6662 and in conformance with "rules and regulations." In the absence of weighty authority, an adviser's sound independent interpretation of a statute may stand in for law.

CONCLUSION

The definition of law implicit in the regulations is not entirely theoretically satisfying or internally consistent. It does not make sense to say that the "law" is the "literal" meaning of a statute if it is at odds with the explicit intention of the drafter reliably memorialized in a committee report. The words of a statute are recognized as law and graffiti is not because of

65. *Id.* § 1.6694-2(b)(3), Example 3.

66. *Id.*

67. *See* Handelman, *supra* note 18, at 633-39.

their different sources. The regulations generally embrace the view that the identity of the source determines the legal authority of words. It is incoherent then to take the view that it does not matter what the author *meant*. Nevertheless, I endorse the approach adopted by the regulations on the grounds of their administrability. Reasonable people may differ over what is equitable or what a reasonable legislator might have considered equitable. Reasonable people also may disagree as to whether legislative history in fact reflects legislative intent or instead represents a cynical manipulation and abuse of the legislative process by a counter-majoritarian special interest group. However, by articulating for tax practitioners expectations of respect for legitimate lawmaking authority, the Treasury has kindly but firmly ordained that, henceforth, taxpayers and their advisers may substitute their own private speculation for those of duly-constituted public authorities only if their views are disclosed as not, or not yet, "law."