American Bar Association

TAX RETURN ADVICE; RECONSIDERATION OF FORMAL OPINION 314

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

The Committee has been requested by the Section of Taxation of the American Bar Association to reconsider the 'reasonable basis' standard in the Committee's Formal Opinion 314 governing the position a lawyer may advise a client to take on a tax return.

Opinion 314 (April 27, 1965) was issued in response to a number of specific inquiries regarding the ethical relationship between the Internal Revenue Service and lawyers practicing before it. The opinion formulated general principles governing this relationship, including the following:

[A] lawyer who is asked to advise his client in the course of the preparation of the client's tax returns may freely urge the statement of positions most favorable to the client just as long as there is a reasonable basis for this position. (Emphasis supplied).

The Committee is informed that the standard of 'reasonable basis' has been construed by many lawyers to support the use of any colorable claim on a tax return to justify exploitation of the lottery of the tax return audit selection process. [FN1] This view is not universally held, and the Committee does not believe that the reasonable basis standard, properly interpreted and applied, permits this construction.

However, the Committee is persuaded that as a result of serious controversy over this standard and its persistent criticism by distinguished members of the tax bar, IRS officials and members of Congress, sufficient doubt has been created regarding the validity of the standard so as to erode its effectiveness as an ethical guideline. For this reason, the Committee has concluded that it should be restated. Another reason for restating the standard is that since publication of Opinion 314, the ABA has adopted in succession the Model Code of Professional Responsibility (1969, revised 1980) and the Model Rules of Professional Conduct (1983). Both the Model Code and the Model Rules directly address the duty of a lawyer in presenting or arguing positions for a client in language that does not refer to 'reasonable basis.' It is therefore appropriate to conform the standard of Opinion 314 to the language of the new rules.

This opinion reconsiders and revises only that part of Opinion 314 that relates to the lawyer's duty in advising a client of positions that can be taken on a tax return. It does not deal with a lawyer's opinion on tax shelter investment offerings, which is specifically addressed by this Committee's Formal Opinion 346 (Revised), and which involves very different considerations, including third party reliance.

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 from those governing a lawyer's conduct in advising or taking positions for a client in
other civil matters. Although the Model Rules distinguish between the roles of advisor and advocate, [FN2] both roles are involved here, and the ethical standards applicable to them provide relevant guidance. 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. This normally occurs in situations when a lawyer advises an aggressive position on a tax return, not when the position taken is a safe or conservative one that is unlikely to be challenged by the IRS.

Rule 3.1 of the Model Rules, which is in essence a restatement of DR 7-102(A)(2) of the Model Code, [FN3] states in pertinent part:

A lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis for doing so that is not frivolous, which includes a good faith argument for an extension, modification or reversal of existing law.

Rule 1.2(d), which applies to representation generally, states:

A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

On the basis of these rules and analogous provisions of the Model Code, a lawyer, in representing a client in the course of the preparation of the client's tax return, may advise the statement of positions most favorable to the client if the lawyer has a good faith belief that those positions are warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law. A lawyer can have a good faith belief in this context even if the lawyer believes the client's position probably will not prevail. [FN4] However, good faith requires that there be some realistic possibility of success if the matter is litigated.

This formulation of the lawyer's duty in the situation addressed by this opinion is consistent with the basic duty of the lawyer to a client, recognized in ethical standards since the ABA Canons of Professional Ethics, and in the opinions of this Committee: zealously and loyally to represent the interests of the client within the bounds of the law.

Thus, where a lawyer has a good faith belief in the validity of a position in accordance with the standard stated above 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 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 or the expenditures.

In the role of advisor, the lawyer should 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. Section 6661 of the Internal Revenue Code imposes a penalty for substantial understatement of tax liability which can be avoided if the facts are adequately disclosed or if there is or was substantial authority for the position taken by the taxpayer. Competent representation of the client would require the lawyer to advise the client fully as to whether there is or was substantial authority for the position taken in the tax return. If the lawyer is unable to conclude that the position is supported by substantial authority, the lawyer should advise the client of the penalty the client may suffer and of the opportunity to avoid such penalty by adequately disclosing the facts in the return or in a statement attached to the return. If after receiving such advice the client decides to risk the penalty by making no disclosure and to take the position initially advised by the lawyer in accordance with the standard stated above, the lawyer has met his or her ethical responsibility with respect to the advice.

In all cases, however, with regard both to the preparation of returns and negotiating administrative settlements, the lawyer is under a duty not to mislead the Internal Revenue Service deliberately, either by misstatements or by silence or by permitting the client to mislead. Rules 4.1 and 8.4(c); DRs 1-102(A)(4), 7-102(A)(3) and (5).
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. In addition, in his role as advisor, the lawyer should refer to potential penalties and other legal consequences should the client take the position advised.

[FN1] This criticism has been expressed by the Section of Taxation and also by the U.S. Department of the Treasury and some legal writers. See, e.g., Robert H. Mundheim, Speech as General Counsel to Treasury Department, reprinted in How To Prepare and Defend Tax Shelter Opinions: Risks and Realities for Lawyers and Accountants (Law and Business, Inc. 1981); Rowen, When May a Lawyer Advise a Client That He May Take a Position on a Tax Return? 29 TAX LAWYER 237 (1976).


[FN3] DR 7-102(A)(2) states:
In his representation of a client, a lawyer shall not:

(2) Knowingly advance a claim or defense that is unwarranted under existing law, except that he may advance such claim or defense if it can be supported by good faith argument for an extension, modification or reversal of existing law.

[FN4] Comment to Rule 3.11; see also Model Code EC 7-4.