

STANDARDS OF TAX PRACTICE STATEMENT

The following Standards of Tax Practice Statement is issued for the guidance of tax practitioners. It was prepared by the Committee on Standards of Tax Practice of the Section of Taxation of the American Bar Association. The Statement was reviewed before issuance by the Council of the Section of Taxation. The Statement has not been approved by the Section or by the American Bar Association and should not be construed as policy of those entities. The ABA Standing Committee on Ethics and Professional Responsibility has indicated that it has no objection to the issuance of the Statement. The Reporter for this Statement was Deborah Schenk of New York, New York. The Chair of the Committee on Standards of Tax Practice was Linda Galler of Hempstead, New York; the Vice Chair was Donald P. Lan, Jr. of Dallas, Texas; and the Chair of its Subcommittee on Standards of Tax Practice Statements was Charles Pulaski of Phoenix, Arizona.

STANDARDS OF TAX PRACTICE STATEMENT 2000-1

I. ISSUE PRESENTED

This standard addresses whether differences between the income tax return accuracy standards for taxpayers and the lawyers who advise them result in conflicts of interest between clients and their lawyers. Specifically, this standard explores whether the benefits of adequately disclosing return positions, which may affect taxpayers and advisers differently, generate conflicts of interest.

The text below first describes the relevant tax return accuracy standards and the professional standards for conflicts of interest. It then identifies a variety of factual situations and determines in each whether there is a conflict between the interests of the client and lawyer. Finally, the text discusses the ethical options available to the lawyer in those situations where a conflict exists.

II. APPLICABLE RULES

A. *Tax Return Accuracy Standards Applicable to Taxpayers*

The accuracy-related penalty of Code section 6662 articulates the tax return accuracy standard governing taxpayers. The twenty percent accuracy-related penalty applies if an underpayment of tax exists as a consequence of any one of three component elements of the penalty: (1) a disregard of rules and regulations, (2) an act of negligence, or (3) a substantial understatement of income tax.¹

¹I.R.C. § 662(a)-(b). Other components of the accuracy-related penalty, *i.e.*, valuation and pension liability misstatements, are not addressed here because adequate disclosure generally does not play a role in the application or nonapplication of these components of the penalty.

Disregard of rules and regulations will generally not expose the taxpayer to the accuracy-related penalty if the taxpayer has a reasonable basis for the return position and makes adequate disclosure.² Negligence occurs where a return position lacks a reasonable basis.³ Accordingly, a position having a reasonable basis will not expose the taxpayer to the negligence component of the accuracy-related penalty, even if the position is not adequately disclosed.

A substantial understatement of income tax exists if the understatement exceeds the greater of ten percent of the correct tax liability or \$5,000 (\$10,000 for C corporations). If there is a substantial understatement, the taxpayer may avoid the accuracy-related penalty by establishing either (1) that there was substantial authority for the position or (2) that the position had a reasonable basis and was adequately disclosed.⁴ However, substantial understatements attributable to tax shelter positions are subject to more stringent rules. If an individual taxpayer has a substantial understatement as a result of a tax shelter position, adequate disclosure is not effective to avoid the penalty; the taxpayer must establish both substantial authority and a reasonable belief that the position taken was more likely than not the correct position in order to avoid the penalty.⁵ If a corporate taxpayer has a substantial understatement as a result of a tax shelter position, the accuracy-related penalty automatically applies.⁶

No accuracy-related penalty applies to any portion of an underpayment if the taxpayer is able to establish that there was reasonable cause for that portion and that the taxpayer acted in good faith with respect to it.⁷ Reliance on the advice of counsel, although not determinative, is a factor in assessing whether reasonable cause and good faith exist.⁸

B. Tax Return Accuracy Standards Applicable to Lawyers

ABA Formal Opinion 85-352 concludes: "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." In addition, the Opinion states that the lawyer should "refer to potential penalties and other legal consequences should the client take the position advised." Although the Opinion does not define "realistic possibility of success," a task force of the ABA Tax Section has taken the position that "a position having a likelihood of success closely approximating one-third should meet the standard."⁹

²I.R.C. § 6662(d)(2)(B); Reg. § 1.6662-3(c).

³Reg. § 1.6662-3(b)(1).

⁴I.R.C. § 6662(b)(2); Reg. § 1.6662-4(d), -4(e).

⁵I.R.C. § 6662(d)(2)(C)(i).

⁶I.R.C. § 6662(d)(2)(C)(ii). A corporation, like other taxpayers, may avoid the application of the accuracy-related penalty by establishing reasonable cause and good faith under Code section 6664(c).

⁷I.R.C. § 6664(c).

⁸Reg. § 1.6664-4(c).

⁹Comm. on Standards of Tax Practice, ABA Tax Sec., *Report of the Special Task Force on Formal Opinion 85-352*, 39 Tax Law. 635, 638-39 (1986).

Formal Opinion 85-352 does not expressly state that a lawyer may advise a position not satisfying the realistic possibility standard if that position is adequately disclosed on the return. However, the Opinion summarizes its holding 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," so long as the realistic possibility standard is satisfied. (emphasis supplied.) Given the legislative and regulatory refinements to the accuracy-related penalty since the issuance of ABA Opinion 85-352, we believe that it may fairly be read to permit a lawyer to advise a position not meeting the realistic possibility standard so long as that position is adequately disclosed on the return and satisfies the not frivolous standard set forth in Rule 3.1 of the Model Rules of Professional Conduct.¹⁰

Circular 230 §10.34(a) provides that a practitioner may not sign a return as a preparer if the return contains a position not adequately disclosed that does not have a realistic possibility of being sustained on its merits. 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."¹¹ However, the practitioner may sign a return containing a position that does not meet the realistic possibility standard so long as the position is not frivolous and is adequately disclosed. A practitioner may not advise a client to take a return position, or prepare a portion of a return containing a position, if that position does not meet the realistic possibility standard unless the position is not frivolous and the practitioner advises the client of any opportunity to avoid the accuracy-related penalty by making adequate disclosure.

Under Code section 6694(a)(1), a penalty may be imposed on the preparer of a return that shows an understatement due to a position that does not have a realistic possibility of being sustained on its merits. For purposes of this penalty, the realistic possibility standard is also deemed satisfied by a one-in-three possibility of being sustained on its merits.¹² The penalty will not apply if the position is not frivolous and is adequately disclosed. In the case of a signing preparer, actual disclosure is required. In the case of a nonsigning preparer, the penalty

¹⁰Model Rule 3.1 provides in part that 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." Although the ABA Tax Section task force report denies the existence of a disclosure option where the realistic possibility standard is not satisfied, *supra* note 9 at 639, the ABA Tax Section advocated such an option for not frivolous positions in comments communicated to the Director of Practice on proposed amendments to Circular 230, ultimately reflected in section 10.34 and discussed below. See Letter from John B. Jones, ABA Tax Section Chair, to Leslie B. Shapiro, Director of Practice (February 12, 1987).

¹¹Treas. Dept. Circular 230, 31 C.F.R. pt.10 § 10.34(a)(4)(i).

¹²Reg. § 1.6694-2(b)(1).

may be avoided if the nonsigning preparer advises the taxpayer or the signing preparer of the need for or effects of adequate disclosure.¹³

C. *Conflict of Interest and Withdrawal Standards Applicable to Lawyers*

Model Rule 1.7(b) provides: "A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless: (1) the lawyer reasonably believes the representation will not be adversely affected; and (2) the client consents after consultation."

Comment [4] to Model Rule 1.7(b) provides: "Loyalty to a client is also impaired when a lawyer cannot consider, recommend or carry out an appropriate course of action for the client because of the lawyer's other responsibilities or interests." Comment [6] to Model Rule 1.7(b) provides: "The lawyer's own interests should not be permitted to have adverse effect on representation of a client. . . . If the probity of a lawyer's own conduct in a transaction is in serious question, it may be difficult or impossible for the lawyer to give a client detached advice."

Circular 230 section 10.29 provides that "no attorney . . . shall represent conflicting interests in his practice before the Internal Revenue Service, except by express consent of all directly interested parties after full disclosure has been made."

Model Rule 1.16(a) provides that "a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if: (1) the representation will result in violation of the rules of professional conduct or other law."

III. DISCUSSION

A. *Presentation of Hypothetical Situations*

The following discussion identifies some of the situations in which a conflict exists between the interests of the client and lawyer. It is assumed that the hierarchy of tax return accuracy standards is as follows, listed from highest to lowest: more likely than not, substantial authority, realistic possibility, reasonable basis, and not frivolous. It is also assumed that the lawyer is advising the client with respect to a return position and/or preparing the return.

1. *Taxpayer Exposure to the Disregard Component*

(1) Adoption of a tax return position that disregards rules or regulations but has a reasonable basis and does not expose the taxpayer to the disregard component of the accuracy-related penalty if the position is adequately disclosed and, in the case of a regulation, the taxpayer in good faith seeks to challenge the validity of the regulation.¹⁴ Accordingly, disclosure will benefit the taxpayer,

¹³Reg. § 1.6694-2(c).

¹⁴Reg. § 1.6662-3(c).

and the lawyer should advise disclosure. Disclosure also would benefit the lawyer because the position is not frivolous. If the position is contrary to a revenue ruling or notice and satisfies the realistic possibility standard, disclosure is not necessary to protect the taxpayer or the lawyer from the disregard penalty and is not required by the lawyer's professional standards. There is no conflict between the client and lawyer because disclosure either will benefit, or is not necessary for both the client and the lawyer.

(2) Adoption of a tax return position that disregards rules and regulations, does not have a reasonable basis, and is not frivolous exposes the taxpayer to the disregard component of the accuracy-related penalty. Disclosure will not benefit the taxpayer. The lawyer will violate professional standards and be exposed to a penalty unless the position is adequately disclosed, and thus disclosure is of benefit to the lawyer. There is a conflict between the interests of the client and lawyer.

2. *Taxpayer Exposure to the Negligence and Substantial Understatement Components*

(3) Adoption of a return position supported by substantial authority does not expose the taxpayer to either the negligence or substantial understatement component of the accuracy-related penalty, and disclosure does not benefit the taxpayer.¹⁵ In addition, since the return position will satisfy the realistic possibility standard, the lawyer does not violate professional standards or incur a penalty, and disclosure does not benefit the lawyer. Accordingly, there is no conflict between the interests of the client and lawyer.

(4) Adoption of a return position not supported by substantial authority, but satisfying the realistic possibility standard, exposes the taxpayer to the substantial understatement component of the accuracy-related penalty unless adequate disclosure is made. There is no exposure to the negligence component even if no disclosure is made (because reasonable basis will exist). The lawyer does not violate professional standards or incur a penalty because the realistic possibility standard is satisfied. There is no conflict between the interests of the client and lawyer because disclosure benefits the client and does not disadvantage the lawyer.

(5) If a return position has a reasonable basis (but is not supported by substantial authority and does not meet the realistic possibility standard), the taxpayer is in the same position as in (4) above, *i.e.*, adequate disclosure is necessary to avoid exposure to the substantial understatement component of the accuracy-related penalty. The realistic possibility standard is not satisfied, but the lawyer does not violate professional standards or become exposed to a penalty if

¹⁵We assume here that the understatement of income tax is "substantial" and that the return position does not relate to a tax shelter. For situations where the understatement is not substantial, see (8), (9), and (10) below. For situations where the return position is related to a tax shelter, see (11) and (12) below.

the position is adequately disclosed. There is no conflict between the interests of the client and lawyer because disclosure benefits both.

(6) Adoption of a return position that lacks a reasonable basis (but is not frivolous) exposes the taxpayer to both the negligence and substantial understatement components of the accuracy-related penalty. Disclosure will not serve to avoid the penalty because reasonable basis is not present. The realistic possibility standard is not satisfied, but the lawyer (as in situation (5) above) does not violate professional standards or become exposed to a penalty if the position is adequately disclosed. There is a conflict between the interests of the client and lawyer because disclosure does not benefit the client but does benefit the lawyer.

(7) Adoption of a frivolous return position exposes the taxpayer to the accuracy-related penalty and causes the lawyer to violate professional standards and to become exposed to a penalty. There is no conflict between the interests of the client and lawyer.¹⁶

3. Taxpayer Exposure Where an Understatement of Income Tax is Not Substantial

(8) The facts are the same as in situation (4) (no substantial authority, realistic possibility satisfied) except that the understatement of income tax is not “substantial,” *i.e.*, it does not exceed the greater of 10 percent of liability or \$5,000 (\$10,000 for a C corporation). The taxpayer is not exposed to either the substantial understatement component (because the threshold amount is not present) or the negligence component (because reasonable basis exists), and disclosure does not benefit the taxpayer. Disclosure does not benefit the lawyer because the realistic possibility standard is satisfied. There is no conflict between the interests of the client and lawyer because disclosure benefits neither.

(9) The facts are the same as in situation (5) (reasonable basis, but no substantial authority and realistic possibility not satisfied) except that the understatement of income tax is again not “substantial.” The taxpayer is exposed to neither the substantial understatement component (because the threshold amount is not present) nor the negligence component (because there is reasonable basis), and disclosure does not benefit the client. Disclosure, however, benefits the lawyer because the realistic possibility standard is not satisfied. There is a conflict between the interests of the client and lawyer.

(10) The facts are the same as in situation (6) (no reasonable basis but not frivolous) except that the understatement of income tax is again not “substantial.” The taxpayer avoids exposure to the substantial understatement component (because the threshold amount is not present) but is exposed to the negligence component (because reasonable basis does not exist). Disclosure does not benefit the taxpayer (because disclosure is not effective where reasonable basis does

¹⁶The lawyer should advise the client against taking the return position and, if the client persists, should withdraw.

not exist). Since the realistic possibility standard is not satisfied, disclosure benefits the lawyer. There is a conflict between the interests of the client and lawyer.

4. *Taxpayer Exposure Where the Proposed Return Position Relates to a Tax Shelter*

(11) The facts are the same as in either situation (3) (substantial authority exists) or situation (4) (no substantial authority but realistic possibility satisfied) except that the proposed tax return position relates to a tax shelter. In both situations, the taxpayer is exposed to the substantial understatement component, and disclosure does not benefit the taxpayer (because disclosure is not effective with regard to a tax shelter position).¹⁷ The lawyer does not violate professional standards or become exposed to a penalty because the realistic possibility standard is satisfied, and disclosure does not benefit the lawyer. There is no conflict between the interests of the client and lawyer.

(12) The facts are the same as in either situation (5) (reasonable basis, no substantial authority, and realistic possibility not satisfied) or situation (6) (no reasonable basis, not frivolous, realistic possibility not satisfied) except that the return position relates to a tax shelter. The taxpayer is again subject to the substantial understatement component of the accuracy-related penalty, and disclosure does not benefit her. The realistic possibility standard is not satisfied, and disclosure does benefit the lawyer. There is a conflict between the interests of the client and lawyer.

B. *Discussion of Lawyer's Ethical Options Where Conflict Exists*

In situations 2, 6, 9, 10, and 12, a conflict exists between the interests of the client and the lawyer. In each of these situations, the client will not benefit from adequate disclosure of the proposed return position (either because the taxpayer has no penalty exposure [9 and 10] or because disclosure will not avoid the taxpayer's existing penalty exposure [2, 6 and 12]), but disclosure will protect the lawyer (because the position disregards a rule or regulation or the realistic possibility standard is not satisfied).

In determining whether the lawyer will actually benefit from disclosure, it is necessary to consider whether the lawyer acts only as advisor or nonsigning preparer of the return, or whether, in contrast, the lawyer acts as a signing preparer of the return. Where the lawyer acts only as advisor or nonsigning preparer, both Circular 230 and Code section 6694(a) permit him to advise a return position that does not satisfy the realistic possibility standard so long as

¹⁷The taxpayer may escape the application of the substantial understatement component of the penalty if substantial authority exists and she is able to establish a good faith belief that the position was more likely than not the correct position. However, this opportunity is independent of disclosure.

he advises the taxpayer of any opportunity to avoid the accuracy-related penalty through disclosure. Although disclosure will not in fact affect the taxpayer's penalty exposure in these five factual situations, the lawyer discharges his responsibility under Circular 230 and Code section 6694(a) by advising the taxpayer that adequate disclosure will not be effective to avoid penalty exposure.¹⁸ Although Formal Opinion 85-352 does not explicitly permit the lawyer to advise in these circumstances, it is reasonable to construe it as allowing the lawyer to advise with respect to the position. Certainly, that should be true where the taxpayer faces no penalty exposure (9 and 10). While less clear where there is taxpayer penalty exposure that will not be eliminated by disclosure (2, 6 and 12), we believe that the lawyer who does not act as a signing preparer of the return in these circumstances discharges his professional responsibility and satisfies the penalty standard by advising the taxpayer that adequate disclosure will not benefit the taxpayer.

If the lawyer acts as signing preparer of the return in any of the five situations where a conflict exists between client and lawyer, the lawyer should advise the client fully concerning the penalty aspects of adopting the proposed return position and the fact that adequate disclosure will not benefit the taxpayer. The lawyer should advise the client that the client's decision regarding disclosure will affect the lawyer's ability to sign the return as preparer, as well as the reasons why that decision impacts the lawyer's ability to act in these capacities. However, the lawyer must make it clear to the taxpayer that disclosure will not advance the client's interests and may even be detrimental to those interests. The lawyer should advise the client that it may be in the client's best interests to seek independent legal counsel on the question whether to make adequate disclosure of the tax return position.¹⁹ The lawyer may not advise the client to make adequate disclosure where the only purpose is to benefit the lawyer. See Model Rule 1.7(b), relative to conflicts of interest attributable to the lawyer's own interests.

If the client seeks independent counsel, the client and lawyer should be guided by the opinion of that counsel. If the client, after having been fully informed, declines to seek independent counsel and decides to make adequate disclosure, the lawyer may proceed with the representation. If the client, after having been fully informed, determines, either with or without the advice of independent counsel, not to make adequate disclosure, the lawyer must withdraw from further assisting the client with regard to the tax return engagement in question. To proceed in situations where the taxpayer does not disclose the position and the position either disregards a rule or regulation or does not satisfy the realistic

¹⁸Treas. Dept. Circular 230, 31 C.F.R. pt. 10 § 10.34(a)(1)(ii); Reg. § 1.6694-2(c)(3)(ii)(A).

¹⁹We do not believe that a lawyer consulted solely to advise a taxpayer whether to disclose a tax return position should be viewed as an income tax return preparer under Code section 6694 or be subject to Circular 230 § 10.34 with respect to that issue. To conclude otherwise effectively would deprive the taxpayer of the opportunity to seek legal counsel from a lawyer free of conflicts of interest.

possibility standard and the taxpayer does not disclose the position would cause the lawyer to violate both professional standards and penalty standards.²⁰

²⁰See Model Rules of Prof'l Conduct R. 1.16(a) (relative to withdrawal from representations in violation of the rules of professional conduct).

