The Ethics Environment in Which Tax Professionals Practice

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L. Stephen Cash, Thomas L. Dickens and Megan E. Mowrey examine the AICPA’s Statements on Standards for Tax Services, Circular 230 and relevant penalty provisions in the Internal Revenue Code and suggest ways for the tax professional to strengthen his or her ethical awareness.

Introduction

The ethics environment in which tax professionals operate is complex. Tax advisors, as well as their clients, must be aware of this environment, as noted in a recent decision by the Sixth Circuit:

A taxpayer is not required to be perfect for this would be an unrealistic expectation. Even tax specialists cannot be perfect. The Code is complex. Reasonable minds can differ over tax reporting and sometimes the IRS disallows certain transactions. Every time a transaction is challenged or disallowed, the taxpayer is not liable for penalties. Only those taxpayers who fail to meet the applicable standard of care—to do what a reasonable taxpayer would do under the circumstances—can be slapped with negligence penalties and interest. Again, perfection is not required, but when the predators are circling, no reasonable ostrich sticks its head in the sand. ... The ostrich that does pays the penalty.¹

Tax professionals have always been concerned with ethical issues in conducting their practice. Three prominent promulgations that impact tax profession-
The SSTs are ethical tax practice standards for AICPA members. They differ from other standards of tax practice. For example, Circular 230 (discussed below) does not provide the depth of guidance contained in the SSTs. Code Sec. 6694 (also discussed later) applies only to income-tax return preparation. Both Circular 230 and Code Sec. 6694 apply only to federal tax practice, while the SSTs apply to all tax practice.

The SSTs consist of eight statements. Statement #1 is accompanied by an interpretation. This interpretation contains the standards that an AICPA member should follow in recommending tax return positions and in preparing or signing tax returns. Statement #1 and the interpretation are relevant to advisors to ensure that the position taken on a return satisfies the AICPA's standards and avoids potential AICPA sanctions.

Statement No. 1: Tax Return Positions—The Standard

Important to applying Statement #1 (SSTS #1) is “tax return position.” SSTS #1 specifies the applicable standards for AICPA members when they recommend tax return positions, and when they prepare or sign tax returns. Tax returns include amended returns, claims for refund, and information refunds. “Tax return position” is defined in SSTS #1 as: a position that is reflected on the tax return as to which the taxpayer has been specifically advised by a member, or a position about which a member has knowledge of all material facts and, on the basis of those facts, has concluded whether the position is appropriate. The taxpayer includes a client, the AICPA member's employer, or any other third-party recipient of tax services.

SSTS #1 delineates four specific standards that apply to a member when the member provides professional services that involve tax return positions:

1. Before the AICPA member can recommend that a tax return position be taken with respect to an item, the member must have a good-faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits if challenged. In this connection, were the IRS to establish a consistent ruling position on an issue, it seems that a position against the IRS position would not have a realistic possibility of being sustained administratively. It seems that there would not be a realistic possibility, judicially, for the situation where the AICPA member advised contrary to a position that had been consistently adopted by the taxpayer’s court of appeals. However, this may not be the case had the Court of Claims and its applicable Federal Circuit addressed the issue in question, or seemingly would not be the case if the Federal Circuit had not addressed the issue, or had ruled for the taxpayer's position. It seems that member compliance with SSTS #1 requires the member to consider the court which has jurisdiction for the member's client. However, were the member's client in a circuit that is against the client's position, and there is widespread disagreement among the other circuits on the position, the member may make the argument that existing law in the circuit with jurisdiction may be reversed through the judicial process. In this instance, the member might have met the realistic possibility standard in SSTS #1.

2. An AICPA member should not prepare or sign a return that the member is aware contains a position that the member would not recommend under the standard in standard 1 above. This standard should cause the member to re-examine the reasonableness of the position to exclude an item of income if the circuit court having jurisdiction has rejected the exclusion position. Such also should be the case if the client insists that the AICPA member exclude that item on the tax return, and sign it, if the ruling circuit that has jurisdiction previously has taken the position that the amount should be included in gross income. It would seem that recommending a position counter to the ruling circuit having jurisdiction would put the AICPA member at risk of not adhering to SSTS #1. However, were there other circuit decisions for the client's position, violating SSTS #1 might not be an issue.

3. Notwithstanding the standards set forth in 1 and 2 above, an AICPA member may recommend a tax return position, or prepare or sign a return, as long as two conditions are met: (a) the member concludes that the return position is not frivolous; and (b) the member advises the client to appropriately disclose the position. In this connection, formal disclosure (say, on IRS Form 8275) is raising the red flag, and the client may resist disclosure. Such resistance may give the member cause to withdraw from the engagement, or else to risk violating SSTS #1.
The ethics environment in which tax professionals operate today is important, and ever changing.

Statement No. 1: Tax Return Positions—Meeting the Standard
The AICPA states in SSTS #1 that in order for an AICPA member to meet the standards discussed in the previous section, he or she should in good faith believe that the tax return position is warranted in existing law or can be supported by a good-faith argument for an extension, modification or reversal of existing law. What is very critical about the AICPA’s position on a “good-faith argument” is the basis the member may rely on to make such an argument. As an example, SSTS #1 states that to make a good-faith argument, the member may consider the following: (1) a well-reasoned construction of the applicable statute (Code section); (2) well-reasoned articles or treatises; or (3) pronouncements that are issued by the applicable taxing authority, e.g., the IRS in federal income tax matters. SSTS #1 states that it does not matter whether the sources on which the member relies are “authority” under Code Sec. 6662, and the Treasury regulations under Code Sec. 6662.

SSTS #1 indicates that the situation could exist where the position on the client’s return does not satisfy the member’s good-faith belief that it has a realistic possibility of being sustained administratively or judicially on its merits if challenged, yet the client wishes to take the position on the return. SSTS #1 requires two items if the member is to prepare and sign the client’s tax return: (1) appropriate disclosure, and (2) the position may not be frivolous. There is a difference between the threshold the client needs to reach to avoid the accuracy-related penalty (Code Sec. 6662) and the threshold the member needs to reach to satisfy SSTS #1. The client must have a reasonable basis to avoid the accuracy-related penalty with disclosure, and that level is higher than not being a frivolous position. SSTS #1 defines a frivolous position as being one that is knowingly advanced in bad faith and is patently improper.

SSTS #1 requires the member to advise the taxpayer if the member believes that a taxpayer penalty might be imposed on the client. The member also is called on to advise the client how to avoid the penalty through disclosure.

Basically, SSTS #1 provides that a member meets the realistic possibility (REPOS) standard by having a good-faith belief (1) that the position is warranted by existing law, or (2) that the position can be supported by a good-faith argument for an extension, modification or reversal of the existing law through the administrative or judicial process. SSTS #1 states that the REPOS standard is less stringent than the Code’s “more likely than not” and “substantial authority” standards. However, the REPOS standard is more stringent than the Code’s “reasonable basis” standard.

Recall that SSTS #1 also specifies that, in determining if a tax return position meets the REPOS standard, the member may rely on authorities in addition to those that are specified as authority under Code Sec. 6662. Thus, a member could rely on well-reasoned treatises, articles in recognized professional tax publications (e.g., this article), and other reference tools and sources of tax analyses that are used by tax advisors and return preparers.

SSTS #1 essentially requires the member to implement a sound tax research methodology to determine if a realistic possibility exists. There are five steps in a sound tax research methodology:

1. Establish relevant background facts.
2. Distill the appropriate questions from the background facts.
3. Search for authoritative answers to the questions that are identified.
4. Resolve the questions by weighing the authorities found by the search.
5. Arrive at a conclusion that is supported by the authorities.
SSTS #1 indicates that a member may conclude that more than one position meets the REPOS standard.

Circular 230

Circular 230 governs the practice of attorneys, certified public accountants, enrolled agents and certain others who represent clients before the IRS. Circular 230 sets forth standards for signing returns, and for advising a client to take a position on a return or preparing the portion of a return on which a position is taken. 13

Circular 230 contains practitioner standards that apply to advising with respect to tax return positions and for preparing or signing returns. It is useful to think of these standards in two categories:

1. The practitioner’s signing a tax return as a preparer. The practitioner is not to sign a tax return as a preparer if the practitioner determines that the tax return contains a position that does not have a realistic possibility of being sustained on its merits (REPOS), unless the position is not frivolous and it is adequately disclosed to the IRS.

2. The practitioner’s advising a client to take a position on a tax return, or preparing the portion of a tax return on which a position is taken. The practitioner is not to advise as to a position, or prepare a return on which a position is taken, unless either of two levels of assurance is reached:

   a. The practitioner determines that the position satisfies the REPOS standard, or

   b. The position is not frivolous (a position is frivolous if it is patently improper), and the practitioner advises the client of any opportunity to avoid the Code Sec. 6662 accuracy-related penalty, through adequately disclosing the position.14 The practitioner is to specify to the client the requirements for adequate disclosure.

Circular 230 provides details as to its REPOS standard. A tax return position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well-informed analysis of the law and the facts by a person who is 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. Authorities that are in Reg. §1.6662-4(d)(3)(iii) may be taken into account in conducting the REPOS analysis. 15 Circular 230 states that the possibility that a tax return will not be audited, that an issue will not be raised on audit or that an issue will be settled may not be taken into account in considering if a tax return position meets the REPOS standard.

Circular 230 places two requirements on the practitioner with respect to advising clients on potential penalties. First, a practitioner advising a client to take a position on a tax return, or preparing or signing a tax return as a preparer, must inform the client of the penalties that are reasonably likely to apply to the client with respect to the position advised, prepared or reported. Second, the practitioner must inform the client of any opportunity to avoid the penalty by disclosure, if relevant, and of the requirements for adequate disclosure. There are three methods of making adequate disclosure:

1. The IRS may, by annual revenue procedure or otherwise, prescribe the circumstances under which disclosure of information on a return in accordance with applicable forms and instructions is adequate. (Note: The IRS usually issues such a procedure once a year.) 16

2. If the revenue procedure does not include an item, disclosure is adequate with respect to that item only if disclosure is made on a properly completed Form 8275 (“Disclosure Statement”).

3. In the case of a position that is contrary to a Treasury regulation, disclosure must be made on Form 8275-R ("Regulation Disclosure Statement"). 17

Circular 230 sets forth best practices for tax advisors who provide advice to taxpayers relating to federal tax issues or submissions to the IRS. There are four best practices18:

1. Communicating clearly with the client regarding the terms of the engagement. (Note: This practice underscores the importance of an engagement letter, where appropriate, that outlines the terms and expectations of a client engagement.) The IRS admonishes the tax practitioner to determine the client’s expected purpose for and use of the advice, and to have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.

2. Establishing the relevant facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion that is supported by the law and the facts. (Notes: This practice is implemented by ensuring that there are adequate and sufficient facts and is-
sues exchanges between the practitioner and the client. Two items are suggested by this IRS expectation of a practitioner to relate the applicable law:

a. Well-established judicial doctrines, such as substance over form, and business purpose for a transaction, must continually be borne in mind by the practitioner in dealing with his or her client.

b. The practitioner must be alert to current judicial decisions that establish new doctrine. With respect to arriving at a supportable conclusion, the practitioner should ensure that he or she regularly adheres to a sound methodology when researching a client issue, e.g.: 1. obtaining relevant facts through substantive practitioner/client discussions, ii. identifying clearly all relevant issues, iii. conducting research that identifies the applicable law, and iv. analyzing and evaluating the applicable law, and v. drawing conclusions that are consistent with the research that was conducted.

3. Advising the client regarding the import of the conclusions that the practitioner reaches, including for example whether the client may avoid accuracy-related penalties under Code Sec. 6662 if the client acts in reliance on the practitioner’s advice. (Note: In this regard, the practitioner should consider the form of the client recommendations, that is the propriety of oral and/or written communications.)

4. Acting fairly and with integrity in practicing before the IRS.

The IRS requires that there be procedures to ensure that these best practices are implemented for tax advisors. Tax advisors who have the responsibility for overseeing a firm’s tax practice of providing advice with respect to federal tax issues or preparing or assisting in preparing submissions to the IRS are to take reasonable steps to ensure that the firm’s procedures for all of its members, associates and employees are consistent with the four best practices.

Circular 230 contains special rules for “covered opinions.” A covered opinion is written advice that concerns one or more federal tax issues that arise from (1) a listed transaction; (2) any plan or arrangement with the principal purpose of avoiding or evading any tax; and (3) any plan or arrangement with a significant purpose of avoiding or evading tax if the written advice is a reliance opinion or a marketed opinion, or if it is subject to conditions of confidentiality or contractual protection. Written advice includes an electronic communication. A listed transaction is a transaction that is the same as or substantially similar to a type of transaction that the IRS has determined to be a tax avoidance transaction and has identified as a listed transaction by notice, regulation, or other form of published guidance. Here are some examples of listed transactions: (1) transactions that generate losses that result from artificially inflating the basis of a partnership interest; (2) transactions that involve compensatory stock options and related persons to avoid or evade federal income and employment taxes; and (3) S corporation transactions that involve shifting income to tax-exempt organizations.

There are four requirements for a covered opinion:

1. **Factual matters.** The practitioner must use reasonable efforts to identify and ascertain the facts, which may relate to future events if a transaction is prospective or proposed, and to determine which facts are relevant; the practitioner must not base the opinion on any unreasonable factual assumptions; and the practitioner must not base the opinion on any unreasonable factual representations, statements, or findings of the taxpayer or any other person.

2. **Relating law to facts.** The opinion must relate the applicable law to the relevant facts; the practitioner generally must not assume the favorable resolution of any significant federal issue; and the opinion must not contain internally inconsistent legal analyses or conclusions.

3. **Evaluating significant federal tax issues.** The opinion generally must consider all significant federal tax issues; it must provide the practitioner’s conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each significant federal tax issue that is considered in the opinion; and, in evaluating the significant federal tax issues that are addressed in the opinion, the practitioner must not take into account the possibility that a tax issue is not confirmed by facts.
return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised (special rules exist for marketed opinions\textsuperscript{21} and limited scope opinions\textsuperscript{22}).

4. Making an overall conclusion. The opinion generally should provide the practitioner’s overall conclusion as to the likelihood that the federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment and the reasons for that conclusion. If the practitioner is not able to reach an overall conclusion, the opinion must state that the practitioner is unable to reach an overall conclusion and it must describe the reasons for the practitioner’s inability to reach a conclusion. There are special disclosure rules that apply to covered opinions.

Statutory Penalties

There are increased penalty concerns for tax advisors and their clients who fail to comply with the Code. Some penalties apply to the return and some apply to the actor (both tax preparer and taxpayer). Defenses to some penalties depend on the presence of sufficient relevant authorities to support the position taken, while other defenses are more concerned with the actions of the taxpayer/tax preparer—\textit{i.e.}, the exercise of due care and good faith and the existence of reasonable cause for the actions taken.

Statutory Penalty Concerns—Tax Professional

\textbf{Tax Understatement Penalty: Returns Due Before January 1, 2008}

There are a number of penalty provisions, both civil\textsuperscript{23} and criminal,\textsuperscript{24} that govern the practice of taxation by attorneys, accountants and others. The provision practitioners most often are concerned with is the penalty for under statement of income tax liability by the income tax preparer.\textsuperscript{25} This provision is very broad, and it affects tax planning, the giving of tax advice and the preparation of income tax returns.

Code Sec. 6694(a) provides a penalty of $250 for any position taken by a tax preparer on a return if there is an understatement of tax and there was not a realistic possibility of the position’s being sustained based on the merits for the position taken. The penalty can be cumulative. Adequate disclosure of a debatable position taken on a nonfrivolous return is a defense to this penalty.\textsuperscript{26} Reasonable cause for the understatement, where the return preparer acts in good faith, also is a defense.\textsuperscript{27} The penalty increases to $1,000 if the position is willful or reckless.\textsuperscript{28} The reasonable cause and good faith defense does not apply to the willful or reckless portion of the penalty.

“Tax preparer” is broadly defined. Any person who prepares a substantial portion of the return, or knew (or should have known) that a questionable position might be taken based on advice given, can be a preparer.\textsuperscript{29}

A “realistic possibility of being sustained on the merits” has been defined as having one chance out of three that the position taken on the return will be sustained.\textsuperscript{30} This is thought to be a lower standard than the substantial authority test taxpayers must meet to avoid the substantial understatement of income tax component of the accuracy penalty. Thus, tax preparers have some leeway in working with clients in taking questionable positions on the return since they are held to a slightly lower standard. So, the preparer could reach his or her required level of threshold support, but not reach the level required for the client. However, return preparers always should advise their clients of the possibility of taxpayer penalties being applied in these situations even if the tax preparer believes his lower standard has been met.

In addition, as stated above, reasonable cause and good faith is also a defense to the Code Sec. 6694(a) $250 penalty. Reasonable cause and good faith can be shown by following proper office procedure and making a good faith attempt to comply with Circular 230, the SSSTs and the tax law. Reliance on a revenue agent’s previous determination is given as an example of the reasonable cause and good faith defenses in the Treasury regulations.\textsuperscript{31} Although realistic possibility of success on the merits appears to be authority oriented (\textit{i.e.}, is there sufficient authority to support the position taken on the return), good faith and reasonable cause are action oriented—what acts did the taxpayer perform in attempting to comply with the law. Thus, since reasonable cause and good faith is a separate defense, it should apply even if the authorities turn out to be less substantial than was originally believed.\textsuperscript{32}

Finally the penalty is on the tax preparer, not on the return. Special appeal procedures also apply here.\textsuperscript{33}

\textbf{Tax Understatement Penalty: Returns Due After December 31, 2007}

Significant changes were made to some tax preparer penalties by the Small Business and Work Opportu-
nity Tax Act of 2007 ("Small Business Tax Act").\(^\text{34}\) The Small Business Tax Act amended Code Sec. 6694 by replacing “income tax return preparer” with “tax return preparer,” thus expanding the scope of the statute.\(^\text{15}\) Also, the penalty for unreasonable positions taken by a tax preparer under Code Sec. 6694(a) is increased from $250 to the greater of (1) $1,000 or (2) 50 percent of the income derived by the tax preparer from the return or claim. If there is willful intent or there is an intentional disregard of the rules and regulations, the penalty in Code Sec. 6694(b) is increased from $1,000 to the greater of (1) $5,000 or (2) 50 percent of the income derived by the tax preparer from the return or claim.

Of even more importance, the definition of an unreasonable position under Code Sec. 6694(a) has been changed. The “realistic possibility of success on the merits” standard has been replaced by a requirement that if the tax preparer knew, or should have known, of the position taken on the return, then (1) for an undisclosed position, the tax preparer must have had a reasonable belief that the position taken had a more likely than not chance of being sustained on the merits,\(^\text{36}\) or (2) for a disclosed position, there was a reasonable (no longer just non frivolous) basis for the position taken. The Code Sec. 6694(a) change is effective for returns, amended returns and claims due after December 31, 2007\(^\text{37}\) and appears to be a response to many uncertainties for preparers as well.

Fortunately, the defense available to the tax preparer in Code Sec. 6694(a)(3) still exists. If the preparer can show reasonable cause for the understatement and the return preparer acted in good faith, the Code Sec. 6694(a) penalty will not apply. This more subjective defense now takes on increased importance in view of the changes in the standards for unreasonable positions.

**Other Tax Professional Penalties**

As stated above, the penalty under Code Sec. 6694 increases if the position is willful or reckless.\(^\text{40}\) In addition, there are additional penalties for promoting abusive tax shelters,\(^\text{41}\) aiding and abetting in the understatement of a tax liability\(^\text{42}\) and taking a number of other improper actions (or failing to act when required) under the Code.\(^\text{43}\)

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**Promoters of Abusive Tax Shelters**

With regard to promoters of abusive tax shelters, any person who organizes a tax shelter or sells (directly or indirectly) an interest in the shelter and makes a statement (or causes another person to make a statement) with respect to the allowance of a deduction or credit or the exclusion of income, knowing (or having reason to know) that the statement is false as to any material matter, is subject to a penalty.\(^\text{44}\) There is no requirement for the IRS to establish that an investor relied on the false statement. Making the statement itself triggers the penalty. The IRS does not have to prove all the elements of common law fraud. It has been ruled that the language of the statute does not require that a common law tort be perpetrated, it only requires that a false or fraudulent statement be made or furnished.\(^\text{45}\) Organizing a tax shelter and selling each interest in it constitute separate activities.

The penalty is the lesser of $1,000 or 100 percent of the gross income derived from the shelter.\(^\text{46}\) If a penalty is assessed for aiding and abetting, no penalty will be imposed under the abusive tax shelter provision.\(^\text{47}\)

The penalty for abusive tax shelters is not time-sensitive. The IRS is not generally barred by the usual three-year statute of limitations,\(^\text{48}\) and there is no specific statute of limitations in the abusive tax shelter provision.

**Disclosure of Information by Tax Preparers**

Code Sec. 7216 provides a penalty of $1,000 and/or one year of imprisonment for tax preparers who disclose any information provided to them in connection with the preparation of any tax return, or who use such information in any manner other than in the preparation of a return.\(^\text{49}\) Some practitioners have raised concerns that sharing information (e.g., for tax planning purposes) among members of the same firm may violate this section. There is no specific exception in Code Sec. 7216 for this type of sharing, but Congress has delegated to the IRS the ability to determine, by regulations, what exceptions will apply here.\(^\text{50}\) The regulations do specifically sanction this type of information sharing among members and employees of the same firm in the performance of legal and accounting matters in the normal course of business, and for the client (and in some instances for other clients) where the information is retained within the firm.\(^\text{51}\) Thus, this concern seems unnecessary. However, this statute could become a serious trap for tax planners if this information be disseminated, without the consent of the client, to others outside of the firm even if the information were used only within the scope of tax planning matters for the client.
**Statutory Penalty Concerns—Client**

**Taxpayer Accuracy Penalty**

Tax advisors must always be aware of penalty provisions that, if violated, may cost their clients additional payments to the IRS. Given the uncertainly that exists in many areas of the federal income tax law, taxpayers and their advisors should be aware of the penalty implications of taking a position on a return for which there is not adequate and sufficient support in the tax law.

Code Sec. 6662 contains some of the more important taxpayer provisions, all under the “accuracy-penalty” umbrella. There are five components, two of which (negligence and substantial understatement of income tax) are more likely to be relevant to taxpayers.

The Internal Revenue Code limits imposition of the accuracy penalty to only one component. For example, if a taxpayer is guilty of negligence, and also substantially understates his or her income tax, only one 20-percent penalty will be applied.52

**Negligence**

The negligence component of the accuracy penalty applies if the underpayment of any tax is due to negligence or disregard of rules or regulations.54 The penalty is 20 percent of the underpayment (the excess of the tax that should have been shown on the return over the tax imposed based on the information shown on the return, minus any rebate).55

The negligence provision applies only to the portion of the underpayment that is due to negligence and for which there is no reasonable basis for the position taken on the return. Reasonable basis is making a reasonable attempt to comply with the tax law.56

“Negligence” is the failure to make that reasonable attempt.57 It requires more than a difference of opinion as to the law but less than a deliberate disregard of rules and regulations. Exercise of due care is the key. “Disregard” is any careless, reckless or intentional disregard of rules and regulations. The taxpayer needs to use reasonable diligence in determining the correctness of the return.58 As noted in Mortensen, “This Court has defined negligence as lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances.”59

In Marcella,60 the Fifth Circuit held that a taxpayer’s failure to maintain adequate records was sufficient basis, where income was understated, for assessing the negligence penalty. The court also stated that negligence is lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances.61

Reliance on competent tax advisors may provide a defense to claims of negligence, but only if the advisor is informed of all the relevant facts.62 Likewise, negligence may exist if the taxpayer fails to provide the return preparer with all of the facts needed to properly prepare the return.63 Large discrepancies between actual and reported income can indicate negligence and may shift the burden of proof to the taxpayer.

On the other hand, honest mistakes are not negligence. Taxpayers may place reliance on experienced and qualified tax advisors. Honest disagreements as to the effect of a law will not cause a problem, nor will mistakes that a prudent and reasonable person might have made.64

Specific disclosure of an item where reasonable basis exists for the position taken is a statutory defense to the disregard of rules and regulations subcomponent.65 However, adequate disclosure is not a defense to the negligence subcomponent of the accuracy penalty. This seems logical because if the taxpayer has a reasonable basis for the position taken on the return, negligence does not exist.

As noted in H.A. True, Jr. Est., the taxpayer may seek reliance on professional advice, but is not required to do so in order to meet the requirements of reasonable cause and good faith. The court specifically noted that it disagreed with the Tax Court’s prior conclusion that the “taxpayers’ failure to seek legal advice ... precludes their ability to rely on the good faith exception.”66

The penalty is imposed on the taxpayer, and appears to be action driven rather than authority driven; did the taxpayer make a reasonable attempt to comply with the law?

**Substantial Understatement of Income Tax**

The substantial understatement component applies only to the federal income tax, and it comes into play if the understatement exceeds 10 percent of the tax on the return or $5,000, whichever is larger. (For corporations other than S corporations and personal holding companies, $10,000 is substituted for $5,000). As noted earlier, the understatement is the excess of the tax required to be shown on the return over the amount of tax imposed on the return as filed, reduced by any rebate. As with the other components of the accuracy penalty, the applicable rate is 20 percent.69
This component of the accuracy penalty appears to be based on the return, not directly on the acts of the taxpayer; was there substantial authority or reasonable basis (with disclosure) for the position shown on the return? Thus, the penalty is authority oriented. However, since reasonable cause and good faith also are a separate defense to this component, the actions of the taxpayer are important in determining if the taxpayer meets this standard.

The understatement can be reduced by any amount for which there is adequate disclosure of the relevant facts reflecting the tax treatment of an item. This disclosure requirement is specified in the regulations and revenue procedures and is effective only if there is a reasonable basis for the position taken on the return. The disclosure must be made in a manner that may reasonably be expected to inform the IRS of the facts and nature of the potential controversy. The regulations require particularity: disclosure must identify the item in question, show the amount at issue, include all relevant facts, and state the legal issues involved, thus red-flagging any disagreements that the taxpayer has with an IRS position. Any statements must be clearly identified as being made to avoid the substantial understatement penalty. Forms 8275 and 8275-R (if disagreement with a regulation is involved) may be used for this purpose, or the taxpayer may follow the requirements set forth by the IRS in annual revenue procedures.

The understatement also will be reduced by any amount for which there is substantial authority for the position taken by the taxpayer on the return. “Substantial” does not require that the taxpayer have a more likely than not prospect of prevailing on the issue (except for tax shelters), but it does require that the taxpayer have a respectable percentage of the authorities agreeing with the position taken. The IRS has stated in the regulations that substantial authority is a higher standard than reasonable basis, but less than more likely than not. A 35- to 40-percent chance of prevailing based on the authorities, pro and con, has often been thought to be sufficient. Authorities include the Internal Revenue Code, legislative history, court decisions, regulations, revenue rulings, revenue procedures, proposed regulations, the Blue Book that follows and explains legislation, private letter rulings, technical advice memoranda, actions on decision, general counsel memoranda, information or press releases, notices and similar documents published by the IRS in its Internal Revenue Bulletin.

Substantial authority exists if the weight of authorities supporting the taxpayer’s position is substantial when compared to the weight of authorities supporting the contrary position. The weight given to an authority is dependent on its relevance, persuasiveness and the type of document being used. The taxpayer’s residency generally is not taken into consideration for determining whether there is substantial authority. However, substantial authority exists for the position taken by the taxpayer if the position is consistent with the precedent of a circuit court to which the taxpayer has a right of appeal. Finally, substantial authority can exist either on the last day of the tax year in question or when the return is filed.

If a tax shelter is involved, the requirements are more stringent. Here the taxpayer must establish it was more likely than not that the position taken would have been correct, and disclosure is not a defense.

Substantial authority is not a defense for the negligence component, discussed above, of the accuracy penalty. Nonetheless, if there is substantial authority, the negligence penalty should not apply.

**Reasonable Cause and Good Faith**

In addition to the specific defenses discussed above, both the negligence and the substantial underpayment components of the accuracy penalty can be overcome if the taxpayer can establish the general defense that he or she acted in good faith and had reasonable cause for the position taken. The courts, however, have tended to define “reasonable cause” as the exercise of the prudent care that a reasonable person would use in managing his own affairs. Simply proving a lack of willful neglect on the part of the taxpayer is not sufficient. Prudent care generally implies a taxpayer’s good faith as well.

This defense is subjective and is determined on a case-by-case approach, taking into account all the facts and circumstances. The taxpayer is required to demonstrate ordinary business care and prudence. Ignorance of the law does not support this defense because the exercise of due care implies making a reasonable attempt to ascertain what the law is. However, an honest misunderstanding of the law (or a fact) that is reasonable under the circumstances may constitute reasonable cause. The most important factor may be the extent of the taxpayer’s efforts to determine his or her correct tax liability.

Reliance in good faith on an information return or advice of competent counsel may constitute due care if that reliance is reasonable. Thus, taxpayers must use good judgment in selecting their advisors.
Reliance on advisors who fail to act in a professional manner could prove to be costly.

However, requesting a tax preparer to file a return is not in itself reasonable cause. The Supreme Court held that reliance on an attorney to file an estate tax return was not sufficient grounds to establish reasonable cause for failure to file where the attorney failed to file the return on time. The burden of filing is on the taxpayer, not his agent, and hiring an agent does not relieve the principal of his duty to timely file. One does not have to be a tax expert to know that returns have fixed filing dates and taxes must be paid when due.

If the negligence component of the accuracy penalty is involved, the taxpayer must establish reasonable cause for not exercising due care. Reasonable cause could be established if there were an honest misunderstanding (despite good faith efforts on the part of the taxpayer) of the facts or the law and the misunderstanding were reasonable.

**Taxpayer Civil Fraud Penalty**

Unethical advisors who help taxpayers step far beyond the bounds of ethical behavior may create serious problems for their clients. A significant civil penalty exists for filing fraudulent returns. The taxpayer penalty for fraudulently filed returns is 75 percent of the underpayment attributable to fraud.

The initial burden is on the IRS to establish fraud, however, the burden shifts to the taxpayer once the IRS establishes that any portion of the underpayment is due to fraudulent acts. Then, unless the taxpayer can prove otherwise, the entire underpayment is treated as attributable to fraud.

The IRS must initially establish fraud by clear and convincing evidence. If this burden is met, the taxpayer may overcome the presumption of fraud by a preponderance of the evidence. The latter is a lesser standard than clear and convincing, as it only requires that a majority of the evidence supports the taxpayer’s position for the other items on the return.

“Fraud” is defined as bad faith and intentional wrongdoing with a specific intent to evade a tax. The burden of proof rules require the IRS to establish deception (i.e., a willful intent to evade tax).

The IRS must present sufficient evidence from which fraud can be inferred. Fraud is more than gross negligence. The capabilities and business experience of the taxpayer are important factors. Maintaining false records and making fraudulent statements on the return are examples of actions that can establish fraud. The IRS may use consistent understatements of income, unreported bank deposits, unexplained increases in net worth or taxpayer use of fictitious entities to establish fraud.

The taxpayer fraud and accuracy penalties are coordinated. The accuracy penalty will not be assessed on any portion of the underpayment to which the fraud penalty applies; however, the accuracy penalty may be imposed on any portion of the underpayment that is not due to fraud.

**Frivolous Returns**

The Code provides penalties for those who file frivolous returns. These include the civil penalties of 75 percent (for fraud) and 20 percent (for negligence) of the tax underpayment, in addition to a $500 penalty for filing frivolous returns. Taxpayers who pursue these frivolous positions in the courts may have an additional penalty of $15,000 imposed on them.

The IRS now posts a document, “The Truth About Frivolous Tax Arguments,” on its Web site. The document discusses the relevant law related to these fraudulent assertions and addresses the unrealistic argument made by these taxpayers and their advisors. The service has grouped these specious arguments into five categories: (1) the tax laws are voluntary, (2) the tax laws are unconstitutional, (3) income items are not really income, (4) deliberate distortion of the Code, and (5) other fictitious legal arguments.

**Criminal Penalties**

Although (hopefully) most professionals and their clients should not run afoul of criminal sanctions, these penalties do exist in the Code. Most can be found in Code Secs. 7201 and seq. They include, among others, willful attempt to evade or defeat tax, willful failure to pay tax or file returns, fraud and false statements, and fraudulent returns, statements or other documents. These penalties can include substantial prison time as well as large fines. Generally, willfulness is the key here.

**Concluding Remarks**

The ethics environment in which tax professionals operate today is important, and ever changing. Tax professionals must be aware of the various standards and penalties that affect them. Also, they must be aware of potential penalties that might have an effect on their clients. Positions taken on a return must reach the threshold necessary to avoid a potential penalty, or the client must be informed of the neces-
sary disclosure action. As well, the professional must be able to advise the client of the potential implications if neither the threshold nor the required level of disclosure is met. Judicial developments also must be continually monitored, as these items add to the administrative guidance that exists for tax professionals. The promotion of abusive tax shelters (those with too little or no authority for the benefits claimed by those selling the shelters), along with the failure of the advisor to inform the client of the potential risks, have gotten a number of tax, legal and accounting professionals in serious trouble in recent years.

Tax advisors should continue to provide the best services they can for their clients, including the reduction of taxes when it can be done in an ethical and lawful manner and in the best interests of the client. However, tax preparers and advisors must act in a professional and ethical manner when assisting their clients, and not let the bottom line on their income statement be their primary concern.

ENDNOTES

1 G.A. Mortensen, CA-6, 2006-1 USTC ¶50,194, 440 F3d 375, at 385.
2 The Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28) has made some changes, primarily to Code Sec. 6694. These changes are addressed below in the Statutory Penalties section of this paper.
3 The Statements on Standards for Tax Services are endorsed as a part of the AICPAs Code of Professional Conduct Rule 201, General Standards, and Rule 202, Compliance with Standards. This enforcement characteristic of the Statements on Standards for Tax Services is in contrast to the Statements on Responsibilities in Tax Practice, which they replaced. Although the Statements on Responsibilities in Tax Practice may have become de facto enforceable ethical standards of professional tax practice, as originally issued they were intended to serve only as guidance, and to be educational in nature.
5 The SSTs consist of:
   Statement #1: Tax Return Positions
   Statement #2: Questions to Answers on Returns
   Statement #3: Certain Procedural Aspects of Preparing Returns
   Statement #4: Use of Estimates
   Statement #5: Departure from a Position Previously Concluded in an Administrative Proceeding or Court Decision
   Statement #6: Knowledge of Error: Return Preparation
   Statement #7: Knowledge of Error: Administrative Proceedings
   Statement #8: Form and Content of Advice to Taxpayers
5 We focus on Statement #1 in this article, because of its ethical significance and relation to Circular 230 and tax penalties in the Code.
6 Interpretation No. 1-1: Realistic Possibility Standard.
7 For example, the Fourth Circuit Court of Appeals and a South Carolina taxpayer, or the Ninth Circuit Court of Appeals and a California taxpayer.
8 A key concern is that, if the client does not have a reasonable basis for the position taken, he or she may be subject to the Code Sec. 6662 accuracy penalty. See the Taxpayer Accuracy Penalty section in this article.
9 Reg. §1.6662-4(f).
10 See note 7, supra, and the Taxpayer Accuracy Penalty section in this article.
11 Since the SSTs apply to all tax practice, the applicable tax authority could be state or local government pronouncements, depending upon the type of return in question.
12 Interpretation No. 1-1, Realistic Possibility Standard of Statement on Standards for Tax Services No. 1, Tax Return Positions, Section 7.
13 Section 10.34.
14 Discussed in the Taxpayer Accuracy Penalty section in this article.
15 Discussed in the Statutory Penalty Concerns—Client section in this article.
17 Reg. §1.6662-4(f)(2).
18 Section 10.33(a). These rules are effective after June 20, 2005.
19 Section 10.33(b).
20 Section 10.33(b)(2).
21 Section 10.35(c)(3)(v).
22 For example, Code Secs. 6694 to 6696. Many provisions involve failure to supply required information.
23 For example, Code Secs. 7201 and seq. Penalties can include prison time if criminal fraud is involved. Criminal fraud usually involves a willful attempt to evade the tax. It must be proven beyond a reasonable doubt, a higher standard than the clear preponderance of the evidence standard required for civil fraud.
24 Code Sec. 6694.
25 Code Sec. 6694(a)(1).
26 Code Sec. 6694(a)(3). See the Good Faith and Reasonable Cause section later in this article.
27 Code Sec. 6694(b).
28 Code Sec. 7701(a)(36); Reg. §301.7701-15; Treasury Department Circular No. 230 (Rev. 6-2005), Section 10.34.
29 Reg. §1.6694-2(b)(1). See also standards set forth in Treasury Department Circular 230 (Rev. 6-2005) discussed later in this article.
30 See §1.6694-2(b)(3).
31 See Pan American Life Insurance Co., CA-5, 99-1 USTC ¶50,543, 174 F3d 694 (the court states that even though there was no substantial authority for the tax treatment at issue, adequate disclosure was made and the taxpayer's actions were made in good faith). See R.A. Stanford, CA-5, 98-2 USTC ¶50,696, 152 F3d 450. In Stanford, the court distinguished the defenses as alternates, allowing the taxpayer to prevail on one (in this case, reasonable care and good faith), and to ignore the other (here, substantial authority).
32 Code Sec. 6694(c).
34 The Code Sec. 7701 old definition of an income tax return preparer has likewise been expanded beyond income tax return preparer to tax return preparer. A number of other statutes have been similarly changed. Also, in new Code Sec. 6676 regarding erroneous claims for refunds or credits, the penalty on the person making the erroneous claim, if there is no reasonable basis for the claim, is 20 percent of the excessive amount. “Excessive amount” is defined by Code Sec. 6676(b) as “the amount by which the amount of the claim for refund or credit for any taxable year exceeds the amount of such claim allowable under this title for such taxable year.” The later was at least partly done to eliminate a problem where some taxpayers who overwithheld then claimed questionable credits or refunds with the hope of avoiding the Code Sec. 6662 accuracy penalty.
35 Code Sec. 6694(a). Read literally, the statute may now require only a reasonable basis for an undisclosed position. This, however, is not consistent with the IRS position in Notice 2007-54, IRB 2007-27, 12, or the Joint Committee on Taxation Technical Ex-
The Ethics Environment in Which Tax Professionals Practice

planation (JCX-29-07, May 29, 2007), both of which require a reasonable belief that the position taken be more likely than not the correct one for an undisposed position.  

Notice 2007-54 published by the IRS on June 13, 2007. The statute had provided an effective date for returns prepared after May 25, 2007, the date the bill was signed.  

The IRS states in the notice that no transitional relief is available under Code Sec. 6694(b), noting that transitional relief is not appropriate for return preparers who exhibit willful or reckless conduct, regardless of the type of return that is prepared.

Further, it appears that tax professionals who adhere to SSTS #1 or Section 10.34 of Circular 230 still could have a Code Sec. 6694(a) penalty imposed on them for returns due after December 31, 2007.

Code Sec. 6690.

Code Sec. 6700. “Tax shelter activities” are broadly defined here.

Code Sec. 6701. The penalty is $1,000 ($10,000 for corporations) for those individuals who assist, aid or advise in the preparation of a portion of the return knowing (or having reason to believe) that such advice, etc. if used would result in an understatement of the liability on the return.

For example, see Code Sec. 6695 for other assessable penalties on tax preparers.

Code Sec. 6700(a).

J.M. Noske, DC-MN, 88-2 ustc ¶9582.

Code Sec. 6700(a). See also Code Sec. 7408 for possible injunctive relief as well.

Code Sec. 6701(b).  

Code Sec. 6501(c)(1) and (2). See also Code Sec. 6501(c)(10).  

Code Sec. 7216(a). See also Code Sec. 7525 for confidentially privileges regarding taxpayer communications to tax preparers (i.e., the taxpayer confidentially privilege).

Code Sec. 7216(b)(3).  

Reg. §301.7216-2. Of course, tax preparers and members of their firms should always be vigilant in how this information is used as this information is personal to the client, not the preparer, and civil action could be brought by the taxpayer against the firm for improper use of their information.

Code Sec. 6662(b). The penalty amount equals 20 percent times the portion of the tax underpayment to which the accuracy penalty applies.

Code Sec. 6662(b)(1). There are numerous other penalty provisions that affect taxpayers, including the five percent per month failure to file a return penalty and the 0.5 percent per month failure to pay sufficient tax penalty. Code Sec. 6651.

Code Sec. 6662(b)(1).

Code Secs. 6662(c) and 6664(a).

Code Sec. 6662(c).

Reg. §1.6662-3(b)(1).

Reg. §1.6662-3(b)(2).

Mortensen, supra note 1, quoting G. Leuhdorff, CA-6, 92-2 ustc ¶50,374, 953 F2d 907, at 910.


See also Rev. Rul. 80-28, 1980-1 CB 304.

Mortensen, supra note 1, at 392.

Of course, although good faith reliance on professional tax advice—and, in this case, an opinion of the Tax Court—may be a defense to negligence, U. S. v. Boyle (469 U.S. 241, 250-51) “[r]eliance on professional advice, standing alone, is not an absolute defense to negligence, but rather a factor to be considered;” Freytag v. Comm’r, 89 T.C. 849, 888 (1987), aff’d. 904 F.2d 1011 (5th Cir.1990), aff’d. 501 U.S. 868 (1991).

Even reliance on a judicial opinion must be reasonable under the circumstances… Business operations are fluid and a court’s opinion or approval of transactions for a certain period does not stamp them as legitimate for all time. 


S.A. Woods Machine Co., CA-1, 3 ustc ¶924, 52 Fd 635.

“A taxpayer is not negligent if he can demonstrate that the underpayment of tax was due to reasonable cause and that the taxpayer acted in good faith.” G.E. Hurley, TC Summ. Op. 2005-125; A.M. Standish, CA-9, 46-1 ustc ¶9242, 154 F2d 1022.

Reg. §1.6662-3(a).

H.A. True, Jr., Est., CA-10, 2004-2 ustc ¶60,495, 390 F3d 1210, at 1247.

Code Secs. 6662(d), (h).

Code Sec. 6664.


Code Secs. 6662(d)(2)(c). The “more likely than not” standard is also referred to as the “more than 50 percent chance of compliance” threshold. Thus, tax shelters are held to a higher standard.

As stated by the Sixth Circuit: “Even reliance on a judicial opinion must be reasonable under the circumstances … Business operations are fluid and a court’s opinion or approval of transactions for a certain period does not stamp them as legitimate for all time.” Mortensen, supra note 1, at 392.

Reg. §1.6662-4(d)(2).

Reg. §1.6662-4(d)(3). Though private letter rulings and technical advice memoranda may be used as authority to avert application of the substantial understatement penalty, they have no precedential value for overcoming an IRS deficiency as to a tax return position. Code Sec. 6110(k)(3).

Reg. §1.6662-4(d)(3).

Reg. §1.6662-4(d)(3)(B). On the other hand, if the taxpayer’s own circuit court rules, in an earlier case, against the position taken, this ruling is just the opinion of a circuit court and as a precedent does not have any more weight than the opinion of any other circuit court.

Reg. §1.6662-4(d)(3)(C).

Code Sec. 6662(d)(2)(C); Reg. §1.6662-4-(g); Treasury Department Circular 230 (Rev. 6-2005), Section 10.34. If a tax shelter is involved, advisors and their clients also should be concerned with Code Secs. 6700 (promoting tax shelters), 6701 (aiding and abetting), and 7201 (criminal attempt to evade tax). A number of actions involving tax shelters have been brought against CPA firms, including members of the Big Four, and law firms, who appeared to have overstepped the ethical legal boundaries in promoting these shelters. Most of these actions have been settled out of court pending future compliance with the law and cooperation by these firms.

Code Sec. 6664(c)(1). The reasonable cause and good faith defense also is applicable to the tax preparer penalty under Code Sec. 6694(a).

According to the statute, it also applies to the taxpayer civil fraud penalty (Code Sec. 6663), but it is difficult to see where good faith exists if the taxpayer intentionally attempts to evade the tax. The regulations under Code Sec. 6664 do not give any examples of the latter.


K.D. Irving, 92 TCM 126, Dec. 56,590(M), T.C. Memo. 2006-169.

G.W. McDonough, 93 TCM 1145, Dec. 56,912(M), T.C. Memo. 2007-212 (filed Apr. 27, 2007).


Where a taxpayer chooses a competent tax advisor and supplies him or her with all relevant information, it is consistent with ordinary business care and prudence to rely on the advisor’s professional judgment as to the taxpayer’s tax obligations. The taxpayer must show that the advisor was a competent professional with significant expertise to justify reliance. K.L. Hargrove, 92 TCM 90, Dec. 56,580(M); TC Memo. 2006-159; Neo-

Reasonable cause has been found when a taxpayer selects a competent tax advisor, supplies the advisor with all relevant information, and consistent with ordinary business care and prudence, relies on the advisor’s professional judgment as to the taxpayer’s tax obligations. R.A. Leherer, 92 TCM 81, Dec. 56,577(M), TC Memo. 2006-156; R.W. Boyle, SCT, 85-1 ustc ¶13,602, 469 US 241; W. Young Est., 110 TC 297, Dec. 52,691, at 317 (1998). Subsequent to Boyle, a district court did not uphold a penalty where the taxpayer, who relied on an attorney to file, possessed only a high school diploma and was in poor health (C. Brown, DC-TN, 86-1 ustc ¶13,656, 630 FSupp 57). Thus, the question of reasonable reliance where an attorney is expected to file may still be valid depending on all the facts and circumstances.

“While a taxpayer cannot hide behind a tax preparer or advisor, we have often held that a taxpayer who supplies his preparer with accurate information relating to the return is not negligent in relying upon the preparer’s advice.” R. Cox, 90 TCM 599, Dec. 56,221(M), TC Memo. 2005-288. See also, V.E. Reinhardt, 69 TC 1954, Dec. 50,491(M), TC Memo. 1993-397 (no negligence when an incorrect return is the result of the preparer’s mistakes).

Reg. §1.6661-6(a).

Code Sec. 6663. There also are statutory penalties for criminal fraud. Code Sec. 7201 and seq. As with tax preparer fraud, the main difference between criminal fraud and it appears to be the burden of proof placed on the government—proof beyond a reasonable doubt rather than the lesser standard of clear and convincing evidence required in civil cases.

Code Sec. 6663(b).

Code Sec. 7454(a).

M.J. Davis, CA-10, 50-2 ustc ¶9427, 184 F2d 86; B.B. Carter v. Campbell, CA-5, 59-1 ustc ¶9306, 264 F2d 930.

As stated in J.P. McGraw, CA-8, 2005-1 ustc ¶50,358, 384 F3d 965, at 971: Because fraudulent intent is rarely established by direct evidence, it may be established through circumstantial evidence. Accordingly, we look for “badges of fraud” to determine whether there is substantial circumstantial evidence to support a finding of specific intent to evade taxes. ... Such intent may be inferred from conduct such as keeping a double set of books, making false entries of alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one’s affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or to conceal. (Spries v. U.S., 317 U.S. 492 (1942)). Our court has said that a consistent pattern of sizeable underreporting of income, inadequate records, and unsatisfactory explanations for such underreporting also can establish fraud. ... (T)he Ninth Circuit also recognized failing to cooperate with tax authorities and using cash to avoid scrutiny of finances as additional “badges of fraud. (Bradford v. Comm’t, 796 F.2d 303, 307-08 (9th Cir. 1986)).


Code Sec. 6662(b).

Code Sec. 6702. Criminal penalties may apply as well.


Code Sec. 7201.

Code Sec. 7203.

Code Sec. 7206.

Code Sec. 7707.

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