FLORIDA TAX REVIEW

VOLUME 3 1996 NUMBER 3

Commentary on Return Preparer Obligations

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I. BACKGROUND

Our income tax system requires that taxpayers report their income annually and assess the correct amount of tax on this income. This self-assessment system, however, depends on taxpayers ferreting out the provisions of the tax law that apply to them and properly applying those provisions to their factual situations. The immensity and complexity of the tax law and the difficulty of applying even apparently clear legal provisions to complex sets of facts (the most difficult lesson in law school for the typical law student) make this process impossible for many taxpayers. As a result, they turn to tax professionals for assistance in preparing tax returns.

These professionals generally fall into one or more of four groups: (1) lawyers licensed to practice law in at least one state or the District of Columbia (licensed lawyers); (2) certified public accountants (CPAs); (3) those admitted to practice before the IRS under the provisions of Circular 230;[1] and (4) "income tax return preparers," as defined in section 7701(a)(36)

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1. The most significant members of this group are enrolled agents, most of whom must take a special examination to qualify to practice before the IRS, and lawyers and CPAs admitted to practice before the IRS. Enrolled actuaries are also eligible to practice before the IRS, but only in particular areas involving employee benefit plans. Treasury Dept. Circular 230, § 10.3(d)(1) (1994), codified in 31 C.F.R. § 10 (1995) [hereinafter Circular 230]. Nothing precludes an enrolled actuary from preparing tax returns. The enrolled actuary might then be subject to the same standards as "enrolled agents" with regard to the preparation of tax returns, although it is not clear that Circular 230 envisions this possibility. A variety of other persons may practice before the IRS in limited circumstances. See Circular 230, § 10.7. The author understands that the Commissioner's Advisory Group has under consideration a recommenda-

(return preparers).[2] Professionals in each category are subject to their own set of practice standards. Many professionals in the tax field are members of more than one group and thus subject to multiple sets of standards. For example, licensed lawyers or CPAs may be subject to their respective state regulatory authorities, Circular 230 (because they are admitted to practice before the IRS), and the statutory provisions affecting return preparers.[3]

Once the taxpayer seeks the help of a professional, several difficulties inevitably mar the return preparation process. First, although the professional should be more skilled at finding the tax law relevant to the taxpayer's situation, the professional's knowledge of the facts underlying the taxpayer's tax situation depends entirely on the information known to and conveyed by the taxpayer. The way in which the professional inquires about the facts may influence how the facts are reported by the taxpayer. Hence, the taxpayer's response is a function of the professional's inquiry. Furthermore, the taxpayer may deliberately slant the facts in the hope of reducing her tax, or simply fail to report all of the relevant facts because of misunderstanding, misperception, forgetfulness, or the like. These considerations raise the prospect that a return prepared by even the most assiduous professional may be less accurate than what a well-informed, well-intentioned taxpayer might have prepared independently.[4]

Inevitably, the return preparation process also suffers because the taxpayer must pay for the professional's services, a factor that significantly limits the amount of time and effort that the professional can commit to the taxpayer's return. While the taxpayer might be willing to spend his own time establishing exact amounts for various return entries and satisfying substantiation requirements, resort to estimates and less rigorous review of supporting

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tion to amend Circular 230 to require registration of "commercial tax return preparers," who would then be subject to Circular 230's standards.

2. The term "income tax return preparer" generally refers to "any person who prepares for compensation, or employs one or more persons to prepare for compensation," any income tax return or claim for an income tax refund. IRC § 7701(a)(36)(A). The definition contains exceptions for, among others, those who prepare returns or refund claims for their employers (or officers or employees of their employers) or as fiduciaries. IRC § 7701(a)(36)(B).

3. The rendering of tax advice in connection with a return may trigger other penalty provisions of the Code, even if the advisor is not a return preparer with respect to the return. See, e.g., IRC § 6701 (relating to penalties for aiding and abetting understatement of tax liability).

4. There is some empirical evidence that noncompliance is greater on returns prepared by return preparers than on returns prepared by taxpayers themselves. See Brian Erard, The Impact of Tax Practitioners on Tax Compliance: A Research Summary, 90 TNT 237-47 (Nov. 21, 1990) (LEXIS, FEDTAX library, TNT file). The reason for this difference is not clear. I am grateful to Professor Gwen Thayer Handelman for calling this interesting report to my attention.

documentation are bound to follow when a professional's time (and fees) are involved. Similarly, the legal research and analysis necessary to determine the proper treatment of various items may prove more costly than is justified by the amount at stake for the taxpayer.

In theory, the taxpayer and the professional are both interested in preparing an accurate return, but in some cases, the taxpayer's interest in reducing the tax shown on the return conflicts with the professional's responsibility to assure that the return meets some minimum standard. The taxpayer may simply fail to cooperate or may refuse to follow the advice of the professional in the preparation of the return. How professionals respond to such taxpayers can have major consequences for the viability of the self-assessment system.

The foregoing issues define the environment in which the practice standards applicable to tax professionals must apply.[5] These standards are designed to assure that returns prepared by tax professionals are basically accurate and complete. The standards may also have the salutary effect of offering the scrupulous tax professional shelter against the entreaties of the unscrupulous taxpayer-client. In general, the standards represent an accommodation between the practical concerns discussed above and the need for integrity in the filing of tax returns.

Given the diverse sources of the standards, it is remarkable how they have evolved so as often to apply similar rules in similar contexts, regardless of the professional status of the practitioner. Indeed, despite differences in wording, emphasis, and, in some cases, important substantive results, it is possible to discuss many aspects of these diverse rules as one whole. In addition to facilitating efficient, intelligent discussion of an otherwise unmanageable morass, this approach offers the additional benefit of suggesting how the morass could be transformed into a body of uniform standards.

The multiple sets of standards, however, provide little guidance in two major problem areas: (1) the evaluation of facts and the application of the law to the facts, and (2) whether there is an obligation to amend a return subsequently found to be erroneous. In both of these contexts, the role of the taxpayer is preeminent, and the integrity of the return may ultimately be beyond the control of even the most conscientious tax professional.

In addition, once the facts and applicable law have been established, there may be choices about how to report some items on the return. The professional should discuss alternative positions that may be taken on the return (and the disclosures that some positions may require) and explain the

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5. This paper is not intended to be a comprehensive analysis of the ethical principles and law applicable to the various categories of return preparers. For more extensive discussion of some of the issues discussed here, see Bernard Wolfman, James P. Holden & Kenneth L. Harris, Standards of Tax Practice (3d ed. 1995).

risks associated with those positions (including the possibility of a successful challenge by the Service, penalties, and other costs, such as legal and accounting fees, of pursuing a dispute with the Service). Ultimately, however, it is the taxpayer's decision how to report items on the return. Similarly, as discussed below, it is ultimately the taxpayer's decision whether to amend an erroneous return.

Although the taxpayer's greater knowledge of and access to the facts affecting the tax liability has played a major role in the development of the practice standards, the standards also reflect the concerns of those with different stakes in both the tax system and the interests of their clients. Thus, the statutory return preparer rules of section 6694 (including the accompanying regulations) and the provisions of Circular 230 regarding return preparation by those admitted to practice before the IRS (including both general due diligence standards and provisions reflecting the standards of section 6694) all reflect a governmental concern with receiving accurate tax returns. The somewhat lower standards that must be met to avoid the accuracy-related penalties under section 6662 reflect the same concern. To varying degrees, all of these standards limit the aggressive advocate's ability to assist a taxpayer-client in making a nonfrivolous challenge to a government tax position.

Licensed lawyers on the other hand, have always viewed loyalty to the client, who is to be represented zealously within the bounds of the law, as the base line for ethical analysis.[6] That the taxpayer-client may at some point be represented by the lawyer in an adversarial proceeding involving the client's tax return has long colored the development of ethical standards governing the provision of tax advice by lawyers.[7] Even the Supreme Court has drawn a sharp contrast between the lawyer's training as an advocate and the CPA's role in audit and attest functions, where independence from the client is essential.[8] Although the Court noted this distinction in the context of the First Amendment protection accorded commercial speech in the form of in-person uninvited solicitations of business, the distinction must be borne in mind in understanding the historical underpinnings of both professions' approaches to the ethical standards applicable to return preparation. This is true despite the fact that licensed lawyers and CPAs perform essentially the same roles in advising about and preparing tax returns and representing the

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6. See Model Code of Professional Responsibility, EC 7-1 (1986); see also Model Rules of Professional Conduct, Rules 1.3, 3.1 and cmts. (1994).

7. See ABA Comm. on Ethics and Professional Responsibility, Formal Op. 352 (1985), reprinted in 39 Tax Law. 631, 632 (1986) ("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").

8. See Edenfield v. Fane, 507 U.S. 761 (1993) (invalidating Florida's ban on direct, in-person uninvited solicitation of employment by CPAs).

taxpayers on audit, roles which are also performed by other preparers and enrolled agents.

II. PRESENT STANDARDS

A return preparer must, above all, prepare the return in conformity with the law. In general, a return preparer should not recommend a return position unless the preparer has a good faith belief that the position has a realistic possibility of being sustained on the merits.[9] However, even if the preparer concludes that a return position does not meet this "realistic possibility" standard, the preparer may recommend the position and sign the return if the position is not frivolous and is adequately disclosed on the return.[10] The preparer may also recommend a nonfrivolous position if the preparer advises the client of the opportunity to avoid the accuracy-related penalty by adequate disclosure.[11] In addition, return preparers subject to Circular 230 (those admitted to practice before the IRS) must satisfy Circular 230's due diligence requirements,[12] requirements that are similar to those applied in malpractice litigation against professionals and to professional ethical standards. All of these standards use terms of art, the general application of which is discussed below. In addition, the tension between these practitioner standards and the return-filing standards applicable to taxpayers is a source of considerable difficulty for preparers.

III. REALISTIC POSSIBILITY STANDARD

The realistic possibility standard is expressed similarly in the statements and provisions of the ABA, the American Institute of Certified Public Accountants (AICPA), Circular 230, and the Internal Revenue Code.

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9. IRC § 6694(a); Circular 230, supra note 1, § 10.34(a); Tax Return Positions, Statement on Responsibilities in Tax Practice No. 1, § .02 (Am. Inst. of Certified Pub. Accountants Rev. 1991) [hereinafter AICPA Statement No. 1]; ABA Formal Op. 352, supra note 7.

10. AICPA Statement No. 1, supra note 9, § .02; IRC § 6694(a); Circular 230, supra note 1, § 10.34(a)(1). The ethical principles and opinions applicable to licensed lawyers do not address this point and may even be read as not permitting adequate disclosure of a nonfrivolous position that lacks a realistic possibility of success to allow the lawyer to advance the position on the client's return. The better view, however, seems to be that licensed lawyers may participate in advancing such a return position if the position is adequately disclosed. See Wolfman et al., supra note 5, ¶ 204.2.4.2.

11. See Circular 230, supra note 1, § 10.34(a)(1)(ii); Regs. § 1.6694-2(c)(3)(ii)(A). This action appears to be ethical for both licensed lawyers and CPAs, although no authority expressly so provides. What the preparer should do if the taxpayer proceeds to take the return position without adequately disclosing it is discussed below.

12. Circular 230, supra note 1, § 10.22.

However, these various expressions of the standard have not been interpreted in the same way. Indeed, the absence of parallel interpretation seems to be a hallmark of this area. The standard of ABA Opinion 85-352 has been interpreted to be satisfied by a position "closely approaching" a one-third chance of success,[13] similar to the one-in-three standard of Circular 230. Also, section 1.6694-2(b)(1) of the regulations provides:

> 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 (realistic possibility standard).[14]

In contrast, an interpretation of the AICPA Statement on Responsibilities in Tax Practice states that the standard "cannot be expressed in terms of percentage odds."[15]

The AICPA view is more realistic because the probability of a doubtful position being sustained on the merits cannot be determined with any precision. However, it raises an obstacle to any attempt to come up with a uniform interpretation of the realistic possibility standard in its various guises.[16] In any event, the one-in-three standard is probably as good a baseline as any for measuring the viability of a return position under the realistic possibility standard. The likelihood that the return will be audited or that the issue will be detected by the IRS may not be considered as part of this calculus.[17]

If a return contains a position that fails the one-in-three standard of the regulations and results in an understatement of tax liability and if the

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13. Report of the Special Task Force on Formal Opinion 85-352, 39 Tax Law. 635, 638-39 (1986).

14. Regs. § 1.6694-2(b)(1).

15. See Realistic Possibility Standard, Statement on Responsibilities in Tax Practice, Interpretation No. 1-1, § .05 (Am. Inst. of Certified Pub. Accountants Rev. 1991) [hereinafter AICPA Interpretation No. 1-1].

16. Many of the differences between the various forms of the realistic possibility standard are discussed in this commentary. For a more extensive discussion of the variations, see Wolfman et al., supra note 5, ch. 2.

17. See Regs. § 1.6694-2(b)(1); AICPA Statement No. 1, supra note 9, § .03a; AICPA Interpretation No. 1-1, supra note 15, § .05; Report of the Special Task Force on Formal Opinion 85-352, supra note 13, at 638. However, where a CPA has a good faith belief that more than one possible position meets the realistic possibility standard, the CPA may advise "of the likelihood that each such position might or might not cause the client's tax return to be examined and whether the position would be challenged in an examination." AICPA Statement No. 1, supra, § .08.

preparer knew (or reasonably should have known) of the position, section 6694(a) imposes a penalty on the preparer unless (1) the position is not frivolous and is disclosed or (2) it is shown that there is reasonable cause for the understatement and the preparer acted in good faith. AICPA Statement on Responsibilities in Tax Practice No. 1 and ABA Opinion 85-352 set forth similar basic realistic possibility standards, in both cases requiring the professional to have a good faith belief that the position has a ("some" in the ABA Opinion) realistic possibility of being sustained on the merits.[18]

The AICPA statement and the regulations under section 6694 elaborate on the application of their respective formulations of the realistic possibility standard. In both cases, however, most of the elaboration consists of illustrations of how to evaluate and weigh authorities that may be relied upon in determining whether the standard has been met. "CPAs may rely on well-reasoned treatises, articles in recognized professional tax publications, and other reference tools and sources of tax analyses commonly used by tax advisors and preparers of returns."[19] The regulations under section 6694, in contrast, permit consideration of only the kinds of authorities listed in the regulations under section 6662, defining the term "substantial authority" for purposes of the substantial understatement penalty.[20] Such authorities are generally limited to those that are binding on the IRS (such as statutory and regulatory provisions, treaties, and judicial decisions) and a variety of other official documents, such as Blue Books, congressional committee reports, administrative pronouncements, and official explanations of treaties.[21] While this more restrictive list of authorities effectively coordinates the realistic

18. Because the ABA standard appears as part of a formal ethics opinion, rather than as a rule, its formulation is somewhat different, calling for a good faith belief 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." ABA Formal Op. 352, supra note 7. Good faith is defined as requiring that there be "some realistic possibility of success if the matter is litigated." Also, the ABA opinion does not spell out exceptions to the realistic possibility standard of the kind provided in § 6694.

The AICPA standard requires that the CPA have a "good faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits if challenged." This is later explained in language paralleling that of the ABA opinion. Compare AICPA Statement No. 1, supra note 9, §§ .02a and .07.

19. AICPA Interpretation No. 1-1, supra note 15, § .07. ABA Formal Op. 352 is not explicit on this point but probably also permits reliance on this broader range of authorities. See Wolfman et al., supra note 5, ¶ 204.2.2 text accompanying notes 30 and 31.

20. Regs. § 1.6694-2(b)(2). Circular 230 applies the same overall approach as the regulations. Circular 230, supra note 1, § 10.34(a)(4)(i).

21. Regs. § 1.6662-4(d)(3)(iii). A limited special provision allows consideration of certain written determinations issued to or naming the taxpayer, such as private rulings, determination letters, and technical advice memorandums, but it is not likely to be of much help in this context. See Regs. §§ 1.6662-4(d)(3)(iv), 1.6694-2(b)(4).

possibility of success preparer standard with the substantial authority standard applicable to taxpayers, it is not at all clear that this tie-in is justified by the Code.[22] In any event, the wide application of the preparer penalty means that even CPAs should keep the regulatory standards in mind in all but the most unusual cases.

The difficulty is that weighing authorities to evaluate the likelihood of success of a return position on a fairly well-defined legal issue is neither the typical nor the most difficult problem in assisting a client with the preparation of a return. The preparer must first ascertain the facts from a client who may be ignorant, inarticulate, unable or unwilling to cooperate, or lacking the crucial information. Often, the client's ability to substantiate the facts raises questions. Once the facts are ascertained, the preparer must determine how the applicable law applies to the facts. These factors must all be weighed in evaluating whether the return position has a realistic possibility of success on the merits, yet the ability to research, evaluate, and weigh various legal authorities is frequently of little help in dealing with them. Furthermore, how the preparer deals with a particular client's tax return depends in large part on the economics of the situation and the preparer's judgment about the client. What then can be said about such matters by way of guidance?

IV. Diligence and Care

Circular 230, the ethical precepts governing CPAs and licensed lawyers, and the principles of tort and contract law provide guidance about the degree of skill, care, and diligence a preparer must exercise in preparing a return. Circular 230 requires those admitted to practice before the IRS to exercise due diligence in preparing, assisting, approving, and filing returns with the IRS.[23] Professionals have similar duties under both tort and contract principles,[24] as well as under professional ethical standards.[25] These standards may at times diverge in practical application, given their varied sources, the parties called upon to apply them (e.g., juries, judges, the IRS

22. The Report of the Special Task Force on ABA Formal Opinion 352 states that "[o]rdinarily, there would be some realistic possibility of success where the position is supported by 'substantial authority,' as that term is used in [the substantial understatement rules]." 39 Tax Law. 635, 639 (1986). This statement is consistent with the possibility that a broader range of authorities may be considered because it does not indicate that support by substantial authority is essential to the conclusion that a realistic possibility of success exists.

23. Circular 230, supra note 1, § 10.22.

24. See Wolfman et al., supra note 5, ch. 6.

25. See, e.g., Model Rules of Professional Conduct, Rules 1.1 and 1.3 (1994); AICPA Code of Professional Conduct, Rule 201 (Am. Inst. of Certified Pub. Accountants 1988).

Director of Practice, AICPA, and state licensing authorities), and the kinds of penalties or other costs occasioned by their breach. Nonetheless, the proper level of practitioner skill, care, and diligence is measured in such terms.

Clearly, the preparer is not required to guarantee every fact underlying the return or to audit the taxpayer's records.[26] This would not be economical or, in some cases, possible. On the other hand, the preparer should make a reasonable effort to obtain all relevant information from the taxpayer. Prior years' returns should be reviewed, where appropriate, because they may be helpful in avoiding omissions or duplications of items and may provide a basis for the treatment of similar or related items in the current return.[27] In gathering information, the preparer may in *good faith* rely on information provided by the taxpayer or third parties.[28] However, the preparer cannot rely on information that appears either on its face or from other facts known to the preparer to be incorrect, incomplete, or inconsistent. In such cases, the preparer must make whatever further inquiry seems reasonable under the circumstances.[29]

Reasonable efforts should be made to confirm the adequacy of the taxpayer's record-keeping procedures and inquire about the adequacy of substantiation where substantiation of return items is an issue. In most cases, it is probably sufficient if, in response to such an inquiry, the taxpayer represents that adequate records or other kinds of sufficient evidence exist.[30] Other facts or the nature of the taxpayer's response may, however, indicate that further inquiry is necessary. For example, if a taxpayer residing in a suburban area tells the preparer that all automobile use is business-related and claims to have adequate records to support the claim, the preparer should probably pursue the issue further. Also, if the preparer knows that the taxpayer could not substantiate similar deductions when audited for a prior tax year, the preparer may have a duty to explore the matter further, despite the taxpayer's statement that he has sufficient records.[31]

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26. See Regs. § 1.6694-1(e)(1).

27. Certain Procedural Aspects of Preparing Returns, Statement on Responsibilities in Tax Practice No. 3, § .09 (Am. Inst. of Certified Pub. Accountants Rev. 1991). The professional's response to the discovery of errors on prior returns is discussed below.

28. See Regs. § 1.6694-1(e)(1); Circular 230, supra note 1, § 10.34(a)(3). Both of these regulations only mention relying on information provided by the taxpayer. It seems clear that in appropriate circumstances, however, the preparer should be able in good faith to rely on information provided by third parties.

29. Regs. § 1.6694-1(e)(1); Circular 230, supra note 1, § 10.34(a)(3).

30. Regs. § 1.6694-1(e)(1), (2) ex. See Rev. Rul. 80-266, 1980-2 C.B. 378 (negligence penalty applies to preparer who fails to ask whether taxpayer has sufficient records to satisfy § 274(d) substantiation requirements for travel and entertainment expenses deducted on return and fails to show adequate normal office practices).

31. Rev. Rul. 80-266, 1980-2 C.B. 378 (indicating such a duty).

The preparer should make a reasonable effort to obtain from the taxpayer appropriate answers to all questions on the return that apply to the taxpayer. Reasonable grounds may exist for the return to omit an answer to a question, such as when the information regarding a relatively insignificant item (in terms of taxable income or loss or in terms of the tax liability shown) is unavailable, when there is genuine uncertainty regarding the meaning of the question, or when the answer is voluminous (although the return should then provide assurance that the information will be supplied upon request).[32]

V. VALUATION AND ESTIMATES

Often, the exact amount to be entered on a return is uncertain because (1) it is impossible or impracticable to obtain all of the data needed to determine the amount or (2) the amount is not susceptible to exact determination. In the first situation, the use of estimates may be necessary; the taxpayer or the tax professional is often in a position to make an estimate that is reasonable under the circumstances. In the second, generally involving a question of valuation, the tax professional should often defer to someone with appropriate expertise. In both situations, the figure entered on the return should not be presented in a manner that is misleading.[33] For example, if the estimated amount is $5,000, it should not be entered on the return as $5,021.43.

The AICPA Statement on Responsibilities in Tax Practice No. 4 provides guidance on the use of estimates.[34] It discusses the appropriateness of using estimates for transactions involving small expenditures, for cases where accuracy in recording data may be difficult to achieve, and when records are missing or precise information is not available on the return's due date. The Statement indicates that although specific disclosure that an estimate has been used is ordinarily not required, disclosure may be necessary

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32. The subject of responding to return questions is addressed by AICPA Statement of Responsibilities in Tax Practice No. 2, which states that while a CPA is not required to explain the reasonable grounds that justify omitting an answer to an applicable question, "the CPA should consider whether the omission of an answer to a question may cause the return to be deemed incomplete." Answers to Questions on Returns, Statement on Responsibilities in Tax Practice No. 2, § .06 (Am. Inst. of Certified Pub. Accountants Rev. 1991). This could prove damaging to the client (e.g., by attracting an audit or by tolling the statute of limitations), a factor that must always be weighed and should be discussed with the client.

33. See Use of Estimates, Statement on Responsibilities in Tax Practice No. 4, § .06 (Am. Inst. of Certified Pub. Accountants Rev. 1991) [hereinafter AICPA Statement No. 4] (estimate should not be presented so as to convey a "misleading impression as to the degree of factual accuracy").

34. AICPA Statement No. 4, supra note 33.

in unusual circumstances to avoid misleading the Service.[35] Examples of such unusual circumstances include the death or illness of the taxpayer, the failure of the taxpayer to receive a Form K-1 from a flow-through entity, pending litigation bearing on the return, or the destruction of relevant records by fire or computer failure.

How a preparer should deal with a valuation issue may depend on the value of the property and the potential tax liability involved as well as what legal provision controls. Often, particularly when relatively small amounts of property are involved, the preparer should be able to rely on the taxpayer's valuation of property. A brief inquiry to be sure that the taxpayer's valuation is not without foundation should suffice. Where the property is more substantial, an appraisal is likely to be necessary, although special factors, such as arm's length bargaining over the property's value, may obviate the need for an appraisal.

In some instances, however, an appraisal is required by law.[36] Also, obtaining a "qualified appraisal" from a "qualified appraiser" may ensure against penalties for overvaluation or undervaluation of property.[37] If the taxpayer does not wish to bear the cost of obtaining an appraisal when an appraisal is appropriate, the preparer has a duty to advise the taxpayer of the operative law and the risks involved in not obtaining the appraisal. If an appraisal required to support particular return items is not obtained, a preparer who nonetheless signs the return subjects himself to penalties. The preparer should assure himself that any valuation, whether by an appraiser, the taxpayer, or another person, is responsibly done, makes sense, is well-reasoned, and internally consistent.[38]

Ordinarily, because of ethical limitations on a lawyer serving as a witness and advocate in the same proceeding, a licensed lawyer who may later represent the taxpayer as an advocate against the IRS should refrain from serving as appraiser of the taxpayer's property.[39] However, following an appropriate explanation of the lawyer's ethical concerns, the lawyer, if qualified, may serve as appraiser, although the lawyer might later be unable to represent the taxpayer as an advocate with respect to the tax issues

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35. Id. § .07.

36. See Regs. § 1.170A-13(c)(2)(i)(A) (requiring a "qualified appraisal" for a charitable gift of more than $5,000 in the form of property other than money or publicly traded securities).

37. See IRC § 6664(c)(2) (allowing the reasonable cause defense to valuation overstatement penalties only if a qualified appraisal is obtained from a qualified appraiser and other requirements are met).

38. See Frederic G. Corneel, Guidelines to Tax Practice Second, 43 Tax Law. 297, 304 (1990).

39. See Model Rules of Professional Conduct, Rule 3.7 (1992); Model Code of Professional Responsibility, DR 5-101(B), 5-102(A) (1981).

involved. Preparers who are not licensed lawyers should consider whether any subsequent representation of the taxpayer before the IRS would lessen the credibility or weight of an appraisal provided by the preparer. The preparer should generally discuss this issue with the taxpayer before agreeing to serve as appraiser.

VI. FAILURE TO MEET REALISTIC POSSIBILITY STANDARD

If a preparer realizes that the taxpayer's return position does not satisfy the realistic possibility standard but is nonetheless not frivolous, the preparer can sign the return without incurring a penalty under section 6694 if the position is adequately disclosed.[40] A nonsigning preparer may advise a taxpayer to take a nonfrivolous position on the return if the preparer advises the taxpayer of any opportunity to avoid the accuracy-related penalty of section 6662 by adequate disclosure.[41] The term "frivolous" has been defined, not very helpfully, as "patently improper."[42] Probably, a position that a person knowledgeable in tax law would conclude had less than a 10% chance of being sustained on the merits is frivolous, but the dividing line between frivolous and nonfrivolous is not clear.

The disclosure requirement is the subject of considerable regulatory gloss.[43] The principal problem with respect to this requirement, however, is its relationship to the return standards applicable to taxpayers. Section 6662(a) imposes a penalty on an underpayment of tax that is attributable to negligence, and the regulations provide that a return position is negligent "if it lacks a reasonable basis."[44] Taxpayers can therefore generally avoid a negligence penalty with respect to a return position if the return position has a reasonable basis. The reasonable basis standard, while clearly higher than the "not frivolous" standard, is probably lower than the realistic possibility of success standard. It is not entirely clear, however, whether the reasonable basis standard may be satisfied by a position with as low as a 15% chance of success or whether the standard requires satisfaction of a somewhat higher, albeit less than a 33-1/3%, threshold.[45]

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40. IRC § 6694(a).

41. Regs. § 1.6694-2(c)(3)(ii)(A); Circular 230, supra note 1, § 10.34(a)(1)(ii) (also requiring the preparer to advise the taxpayer of the requirements for adequate disclosure).

42. Regs. § 1.6694-2(c)(2); Circular 230, supra note 1, § 10.34(a)(4)(ii). See AICPA Statement No. 1, supra note 9, § .09, ("frivolous" position is one "knowingly advanced in bad faith" that is "patently improper").

43. Regs. § 1.6694-2(c)(3).

44. Regs. § 1.6662-3(b)(1).

45. See Regs. § 1.6662-3(b)(3)(ii) (stating that reasonable basis standard "significantly higher than" not frivolous standard); Wolfman et al., supra note 5, ¶ 207.1.1 at 89 (written before the regulation was promulgated and referring principally to authority under prior law). It is possible that the "reasonable basis" standard is not applied in probabilistic

If a preparer concludes that a return position does not satisfy the realistic possibility standard but does meet the reasonable basis threshold, the preparer can sign the return without incurring a preparer penalty only if the position is adequately disclosed. The preparer should advise the taxpayer, however, that disclosure is not required to protect the taxpayer against the negligence penalty, particularly since the taxpayer is acting on the advice of a tax professional.[46] In this circumstance, the preparer's own legal position is untenable. If the taxpayer chooses not to disclose the position on the return, the preparer must either (1) cease participating in preparing the return and not sign it or (2) sign the return and risk a preparer penalty.[47] Strangely, the regulatory gloss on adequate disclosure does not discuss this difficult situation. In addition, the reasonable cause, good faith exception to the preparer penalty provision has not been interpreted in the regulations as covering this situation, but has instead been interpreted as focusing on factors relating to the preparer's overall practice and office procedures.[48] This bizarre discontinuity in the law should be corrected.

If a taxpayer wants to assert a nonfrivolous return position that does not have a reasonable basis, the preparer should advise the taxpayer that the taxpayer is risking imposition of a negligence penalty. If the taxpayer does not want to disclose the position, the preparer must also refuse to sign the return to avoid incurring a preparer penalty.

The preparer must also advise the taxpayer of any other penalties that the taxpayer's return position might trigger. For example, in many cases where the negligence penalty is potentially applicable, the substantial understatement penalty may also apply.[49] The preparer should advise the taxpayer

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terms, but instead reflects a mixture of factors, including whether the taxpayer is acting on the advice of a tax professional.

46. As discussed below, disclosure may be required to protect the taxpayer against the substantial understatement penalty.

47. If the preparer withdraws from the preparation of the return, the preparer may want to consider whether he should refund any compensation received for preparing the return. However, in some cases, it may be possible to view the preparation of the return as consisting of several distinct tasks, in which case compensation could clearly be retained to the extent attributable to tasks not connected to the problematic return position.

48. See Regs. § 1.6694-2(d), discussing five factors: (1) the nature of the error causing the understatement, (2) the frequency of errors, (3) the materiality of errors, (4) the preparer's normal office practice, and (5) reliance on advice of another preparer. See generally James R. Hamill, Proper Procedures Can Help to Avoid Preparer Penalties, 55 Tax'n Acct. 294 (1995).

49. See IRC § 6662(a), (b), (d). Both penalties, however, cannot be applied to the same portion of an underpayment. Regs. § 1.6662-2(c).

Another possible penalty (although only in lieu of the negligence or substantial understatement penalty) is for disregard of rules and regulations. See IRC § 6662(b)(1). Adequate disclosure may prevent application of this penalty. See Regs. § 1.6662-3(c)(1).

that the latter penalty is inapplicable to the extent an understatement is attributable to the tax treatment of an item for which there is or was substantial authority *or* for which there is both adequate disclosure and a reasonable basis. Since the substantial authority standard is generally believed to be higher than the realistic possibility standard,[50] satisfaction of the former implies satisfaction of the realistic possibility standard. If the realistic possibility standard is not satisfied, adequate disclosure and a reasonable basis are required to avoid this penalty. If the taxpayer nonetheless wants to assert the position on the return and risk a penalty, the preparer can avoid the preparer penalty only by refusing to participate further in preparing, and refusing to sign, the return.

In discussing the risks of aggressive return positions with the taxpayer, the preparer should not suggest that the risks are lessened by the improbability of an audit. Nonetheless, if asked directly, many practitioners consider it not inappropriate for the preparer to indicate the likelihood of an audit.[51] In all cases where a preparer has advised taxpayers about the risks of aggressive return positions, the preparer should, for his own protection, maintain records of the advice.[52] A licensed lawyer should take care in maintaining such records to preserve the confidentiality of communications

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50. See Wolfman et al., supra note 5, ¶ 207.1.1 at 89-90.

51. In the case of a licensed lawyer, once the taxpayer-client has decided to file a return asserting a position that the lawyer is not permitted to recommend, the lawyer, in this author's opinion, is obligated to withdraw from the engagement and hence may not subsequently answer questions about the likelihood of an audit. See infra text accompanying note 59. A vigorous discussion at the January 20, 1996 Meeting of the Committee on Standards of Tax Practice of the American Bar Association Section of Taxation indicated that many tax lawyers do not agree with the author's view. Others may agree that responding to such an inquiry is inappropriate, but for different reasons. Professor David M. Richardson argues, for example, that lawyers do not have enough knowledge about the possibility of an audit to answer such a question.

If the client has not yet made a decision about the position to be taken on the return or if the preparer is not a licensed lawyer, the propriety of responding to the client's inquiry about the audit lottery is likely to be even more controversial. Full discussion of this issue is beyond the scope of this paper. For two views, see ALI Restatement of the Law Governing Lawyers § 151, Draft Comments (Preliminary Draft No. 10, 1994); A Gathering of Legal Scholars to Discuss "Professional Responsibility and the Model Rules of Professional Conduct"—Panel Discussion, 35 U. Miami L. Rev. 639, 659 (1981) (statement of Professor Geoffrey Hazard, Jr.). See also AICPA Statement No. 1, supra note 9, § .08, allowing a CPA to discuss the "likelihood that each [of two positions meeting the AICPA realistic possibility standard] might or might not cause the client's tax return to be examined," possibly implying that the likelihood of an audit should not be discussed in other circumstances.

52. Cf. Regs. § 1.6694-2(c)(3)(ii)(A) (with respect to a nonsigning preparer, disclosure requirement is satisfied with respect to a return position only if the preparer's advice informs the client that the position lacks substantial authority and may therefore subject the client to the substantial understatement penalty unless it is adequately disclosed on the return).

with a taxpayer whose relationship with the lawyer is a lawyer-client relationship.[53]

When a CPA concludes that a position does not meet the AICPA version of the realistic possibility standard, the CPA may prepare and sign a return including the position if the position is not frivolous and is adequately disclosed on the return.[54] If these requirements are not met, the CPA is apparently not supposed to prepare or sign the return, although the AICPA Statement on Responsibilities in Tax Practice No. 1 does not explicitly so state. In recommending certain tax return positions and signing a return, the CPA should, where relevant, advise the client of potential penalty consequences of the recommended positions and the opportunities, if any, to avoid penalties through disclosure.[55] Whether and how to disclose is the client's decision.[56]

The ethical obligations imposed on licensed lawyers who prepare returns are not as clearly defined as one might hope, in part because return preparation may be a small part of the lawyer's representation of the client. If a position on the taxpayer's return does not meet the realistic possibility standard of ABA Opinion 85-352, the lawyer may generally not prepare the return, regardless of whether the lawyer signs the return or simply forwards it (without his signature) to the taxpayer.[57] This general rule raises two major questions: (1) Can a lawyer recommend a nonfrivolous, or perhaps somewhat more promising, return position that does not satisfy the realistic possibility standard without risking professional discipline? (2) If the client insists on asserting a return position that the lawyer is ethically precluded from recommending, must the lawyer withdraw from representing the client?

ABA Opinion 85-352 does not expressly provide a disclosure exception for return positions that do not meet the realistic possibility standard. Nonetheless, the leading treatise in this area, after a full canvas of the issue, concludes that lawyers should be permitted to recommend a disclosed nonfrivolous return position.[58] The authors note both that the adequate disclosure puts the IRS on notice of the position (thus preventing

53. See Corneel, supra note 38, at 306.

54. AICPA Statement No. 1, supra note 9, § .02c. The AICPA, as noted above, takes the rather lenient view that a "frivolous" position is one that is "knowingly advanced in bad faith and is patently improper." Id. § .09.

55. Id. § .02d.

56. For purposes of the preparer penalty, however, "adequate disclosure" is defined by Regs. § 1.6694-2(c)(3).

57. See Wolfman et al., supra note 5, ¶ 207.2.1 at 97 ("inappropriate" for lawyer to prepare return and send it to client with "note attached indicating that the position should not be taken," referring to Paul J. Sax, Ethics in Tax Practice: Current Issues, 38 Tul. Tax Inst. ch. 18 (1988)).

58. Wolfman et al., supra note 5, ¶ 204.2.4.2 at 80-81.

the taxpayer from playing the audit lottery with the issue) and that the section 6694(a) penalty on preparers for substandard return positions does not apply to a nonfrivolous position that is adequately disclosed.

If a client insists on asserting a return position that a lawyer is not permitted to recommend (such as a nonfrivolous, but substandard position as to which the client refuses to make adequate disclosure), the lawyer must withdraw from "the engagement, at least to the extent that it involves advice as to the position taken on the return."[59] This clearly means that the lawyer must withdraw from any involvement in preparing the return. The lawyer could presumably continue to represent the client in other matters, such as a child custody dispute.

Suppose, however, the return is part of an "engagement" involving a larger transaction. Must the lawyer withdraw from the entire "engagement"? Notwithstanding the somewhat inflexible language of the ABA Task Force Report, this seems to depend on the circumstances. The lawyer should weigh a variety of factors, including the importance of the return position to the overall transaction (for example, whether the transaction's viability depends on the questionable return position or the position is a peripheral matter), the proportion of the lawyer's work on the engagement represented by the return, and the potential harm to the client that the lawyer's withdrawal might occasion. Even if the lawyer does withdraw, the lawyer does not appear to be precluded from representing the client subsequently when the return position is raised on audit.[60]

VII. DISCOVERY OF ERROR ON FILED RETURN

When a return preparer discovers an error in a previously filed return for a year not barred by the statute of limitations, the preparer should advise the taxpayer of the error.[61] The preparer should advise the taxpayer that the law does not require the filing of an amended return to correct the error,[62]

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59. Report of the Special Task Force Report on Formal Opinion 85-352, supra note 13, at 635, 639.

60. For other thoughts on this subject, see Wolfman et al., supra note 5, ¶ 204.2.4.1 at 80.

61. Circular 230, supra note 1, § 10.21 (those admitted to practice before the Service); Knowledge of Error: Return Preparation, Statement on Responsibilities in Tax Practice No. 6, § .03 (Am. Inst. of Certified Pub. Accountants Rev. 1991) [hereinafter AICPA Statement No. 6].

62. See, e.g., Badaracco v. Commissioner, 464 US 386, 393 (1984) ("Internal Revenue Code does not explicitly provide either for a taxpayer's filing, or for the Commissioner's acceptance, of an amended return"). Whether an amended return should be required in at least some situations has been a matter of considerable discussion in the literature. See Wolfman et al., supra note 5, ¶ 207.4.4; Kenneth L. Harris, On Requiring the Correction of

but that if the error has a significant effect on the taxpayer's tax liability, the taxpayer should consider filing an amended return to correct the error.[63] Correction of the error is the proper ethical action as a citizen taxpayer and is often the most practical action. In explaining this to the taxpayer, the preparer should note why it may be important to correct the return because of future return-filing requirements, the possibility of an audit, or any possible inquiry to the taxpayer's attorney from an independent auditor about the presence of contingent liabilities that should be disclosed on a financial statement.

The taxpayer should also be advised of any risk that filing an amended return might lead to the imposition of penalties or charges of fraud or criminal misconduct.[64] If the preparer is not a licensed lawyer, the taxpayer should be advised to consult experienced legal counsel before acting, particularly in situations presenting a risk of criminal charges. Such counsel (or the lawyer-preparer) should fully apprise the client of the various options in the face of a potential criminal indictment, including assertion of any applicable constitutional rights.[65]

When the error is on a return prepared by the preparer, particularly if the error is the preparer's fault, the preparer's interest in having the error corrected may conflict with the taxpayer's interest in not filing an amended return. Accordingly, in such cases, the preparer—after explaining this potential conflict—should advise the taxpayer to seek other advice about correcting the error.[66] If the preparer was responsible for the error, the preparer should prepare the amended return at no expense to the taxpayer and should pay any interest or penalties that resulted from the error.

Once the preparer has advised the taxpayer about any error that ought to be corrected by an amended return, any consequences of amending the

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Error Under the Federal Tax Law, 42 Tax Law. 515 (1989); Joseph E. Ronan, Jr., Do Clients Have a Duty to File Amended Tax Returns, 33 Prac. Law., Mar. 1987, at 25. A proposal to require the filing of amended returns in some cases, prepared by Frederic G. Corneel, was recently discussed by the ABA Section of Taxation Committee on Standards of Tax Practice.

63. In determining whether the error has a significant effect, the possible effect of the error on both the tax year in question and future tax years should be considered. See AICPA Statement No. 6, supra note 61, § .07.

64. See Badaracco v. Commissioner, supra note 62 (filing an amended return does not start the running of the statute of limitations where the earlier return was fraudulent).

65. See Corneel, supra note 38, at 307; AICPA Statement No. 6, supra note 61, § .05.

66. Corneel, supra note 38, at 307. In most cases, simply advising the taxpayer of the conflict of interest should suffice. The taxpayer should be free to decide not to seek other advice. In some cases, however, the conflict of interest may be such that the client must seek independent advice. Although this analysis derives from the conflict of interest rules applicable to licensed lawyers, the practical conclusions should apply with equal force to other preparers.

return, and any circumstances suggesting that the taxpayer should seek other advice or consult legal counsel, the final decision whether to amend the return is the taxpayer's alone. Nonetheless, if the taxpayer chooses not to amend the return, the preparer must consider whether to continue the professional relationship with the taxpayer. Each category of professional must make this decision in light of the factual situation at hand and any relevant ethical principles. Clearly, the professional should not represent the taxpayer in an audit of the uncorrected return if the taxpayer refuses to have the error disclosed on audit.[67] Some degree of withdrawal from the relationship with the taxpayer is also likely to be appropriate where the return was prepared by the preparer and contains a "clear and material" error.[68] If the preparer chooses to continue the professional relationship with a noncorrecting taxpayer, the preparer should take reasonable steps to assure that the error is not repeated or compounded in a return for a subsequent year.[69]

VIII. FINAL THOUGHTS

A complex web of overlapping rules of law and professional ethics regulates the work of return preparers. Some of this complexity reflects the overall complexity of the tax system and the transactional activity to which it applies. Some of the complexity occurs because returns are prepared by members of different professions. The fact that preparers, depending on their professional status, are subject to discipline by the Director of Practice of the Internal Revenue Service, by the AICPA, by state bar and accounting regulatory authorities, under the penalty provisions of the Code, and perhaps through malpractice and contract law, is nonetheless not sufficient justification for all of the complexity. The definition of appropriate conduct in preparing returns does not truly vary with the professional status of the preparer, even if the sanction for improper action varies. Furthermore, the preparer penalty structure of the Code should be more closely coordinated with the taxpayer penalty structure.

In light of these considerations, the following reforms should be pursued:

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67. See ABA Formal Op. 352, supra note 7, at 633 (referring to Model Rules of Professional Conduct, Rules 4.1, 8.4(c) (1983), and Model Code of Professional Responsibility, DR 1-102(A)(4), 7-102(A)(3) and (5) (1969)); Knowledge of Error: Administrative Proceedings, Statement on Responsibilities in Tax Practice No. 7, § .04 (Am. Inst. of Certified Pub. Accountants Rev. 1991).

68. See Corneel, supra note 38, at 307 (noting that an attorney may be required to insist that the client seek other counsel if attorney's "own interest is sufficiently disparate from that of the client"). The attorney, however, may not need to withdraw completely. For example, the attorney might choose to discontinue representing the client in tax matters, but continue to handle the client's child custody dispute.

69. AICPA Statement No. 6, supra note 61, § .06.

1. The various formulations of the realistic possibility standard should be replaced with one standard. The standard in section 6694 was enacted in part to reflect the professional conduct standards developed by the AICPA and the ABA, but the three versions of the standard have not been normalized under one formulation. It is time to undertake this effort.[70] In connection with this effort, the AICPA may want to reconsider its definition of a "frivolous" position, and the ABA should make clear that a lawyer may ethically recommend an adequately disclosed nonfrivolous position. The ABA and the Code standards should reflect the non-adversarial nature of return preparation.
2. The regulations under section 6694 should be amended to expand the kinds of authorities that may be considered in evaluating whether the realistic possibility standard is met. Presently, the regulations do not seem to reflect the legislative intent to have the statutory standard reflect the professional conduct standards of lawyers and accountants. Nor do they reflect the realities of tax practice. The list of authorities that may be considered under AICPA Statement on Responsibilities in Tax Practice No. 1 is much more realistic.
3. The preparer penalty rules under section 6694 should be coordinated with the taxpayer penalty provisions to eliminate the present discontinuities. Either the taxpayer standards could be stiffened or the preparer standards could be liberalized.
4. Serious consideration should be given to requiring the filing of amended returns to correct at least the most material errors.
5. The standards, as reformed, should not attach any significance to the fact that the taxpayer may obtain prepayment judicial review of a return position in the Tax Court.

These reforms would substantially improve the functioning of the return preparer part of the tax-filing system.

70. There are areas of tax practice, however, where the roles of different groups of professionals may justify different regulatory rules. For example, the attorney-client privilege and lawyers' role as advocates may call for special regulatory rules for lawyers engaged in tax practice in some contexts. Return preparation, however, does not seem to be such a context.