

Raising Penalty Standard “More Likely than Not” Creates Conflict Between Tax Lawyers and Their Clients

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*[S]o few words have created such angst*¹

I. INTRODUCTION

A tax lawyer is analyzing whether a client’s recent sale of real estate resulted in a favorable long-term capital gain or unfavorable ordinary income gain to the client.² The lawyer reads the relevant Internal Revenue Code³ (Code) sections and thoroughly researches the case law on the topic.⁴ Several cases support the client’s position that the gain is capital,⁵ while several contrary cases suggest the taxpayer’s gain is ordinary income.⁶ The authority is split or possibly in favor of treating the gain as ordinary income,⁷ and thus, the lawyer estimates there is a forty

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1. Jeremiah Coder, *Treasury Official, Practitioners Hope for Future Clarification of Preparer Guidance*, TAX NOTES TODAY, Jan. 16, 2008, LEXIS, 2008 TNT 11-3 (quoting Michael Dolan, former Internal Revenue Service (IRS) deputy commissioner and current director at KPMG, speaking at a January 15, 2008, webcast about the amendment to the tax return preparer standard in Internal Revenue Code (Code) § 6694).

2. An in-depth discussion of capital gains versus ordinary income is beyond the scope of this Note. A long-term capital gain results from the sale of a capital asset that a taxpayer has held for more than a year. I.R.C. § 1222(3) (2000); *Womack v. Comm’r*, 510 F.3d 1295, 1298 (11th Cir. 2007). The Code defines ordinary income as “gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b).” I.R.C. § 64 (2000). A taxpayer usually prefers a long-term capital gain to an ordinary income gain because the Code generally taxes long-term capital gains at a favorable rate. See *Womack*, 510 F.3d at 1298; MARVIN A. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 361 (Foundation Press 2005) (1977).

3. Title 26 of the United States Code contains the statutory tax law of the United States—the Code. 26 U.S.C. §§ 1-9833 (2000).

4. This example assumes the lawyer has fulfilled the definition of a non-signing tax return preparer because she prepared a substantial portion of the return. See *infra* note 155 and accompanying text.

5. See, e.g., *Bramblett v. Comm’r*, 960 F.2d 526, 534 (5th Cir. 1992) (granting capital gain treatment to the taxpayer).

6. See, e.g., *Suburban Realty Co. v. United States*, 615 F.2d 171, 187 (5th Cir. 1980) (affirming ordinary income treatment to the taxpayer).

7. The characterization of gain from the sale of real estate is often unclear. See, e.g., *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 414-15 (5th Cir. 1976) (“We have become accustomed to the frequency with which taxpayers litigate [the real estate capital gains versus ordinary income] question. . . . Over the past 40 years, this case by case approach with its concentration on the facts of each suit has resulted in a collection of decisions not always reconcilable.”).

to fifty-five percent chance a court would determine the sale results in a capital gain.

Until recently, this situation posed no problem for either the taxpayer or the lawyer, acting as the tax return preparer. The Code requires both taxpayers and tax return preparers to have a certain level of support before they take a tax position.⁸ If either asserts a position without meeting the requisite standard and there is a tax understatement, the Internal Revenue Service (IRS) can penalize them.⁹ Generally, the tax return preparer could assert a position only if there were a realistic possibility of success on the merits, a one-in-three or greater likelihood.¹⁰ The taxpayer, however, can take a position only if there is substantial authority for the position,¹¹ estimated by commentators to be a forty percent or greater likelihood of success.¹² The capital gain position fulfills both the return preparer and taxpayer requirement because of the forty to fifty-five percent likelihood of success. Therefore, the lawyer would advise the client to take a capital gain, which the client would do without disclosing the issue to the IRS.¹³

A recent change in the Code has created a dilemma. On May 25, 2007, Congress amended the Code section addressing tax return preparer penalties, § 6694.¹⁴ Among other changes, the amendment increased the standard a tax return preparer's position must meet to avoid penalties.¹⁵ Instead of the prior "realistic possibility" standard with its one-in-three or greater likelihood,¹⁶ a return preparer must now reasonably believe a position will more likely than not be sustained on the merits, a greater than one-in-two chance of prevailing.¹⁷ In other words, the amendment increases the likelihood of success required for a return

8. A tax position is "the determination of the existence, characterization, or the amount of an entry on a [tax] return or claim for refund." Treas. Reg. § 301.7701-15(a)(2)(ii) (as amended in 2002). See, e.g., *United States v. Gray*, No. 1:07-CV-42, 2007 WL 851873, at *3 (W.D. Mich. Mar. 19, 2007) (taking a position that wages were not taxable income).

9. See generally I.R.C. § 6662 (2000) (penalizing taxpayers); I.R.C. § 6694 (2000) (penalizing tax return preparers).

10. See I.R.C. § 6694(a)(1) (2000) (penalizing tax return preparers for an undisclosed position unless there was a realistic possibility of success on the merits); Treas. Reg. § 1.6694-2(b)(1) (as amended in 1992). This Note will explain the "realistic possibility" standard in detail below. See *infra* text accompanying note 66.

11. See I.R.C. § 6662(d)(2)(B)(i) (2000) (reducing the understatement penalty for a taxpayer who relied on substantial authority). This Note explains the "substantial authority" standard in detail below. See *infra* text accompanying notes 194-198.

12. See *infra* text accompanying note 198.

13. The Code does not require disclosure because the taxpayer possessed substantial authority and the tax return preparer fulfilled the "realistic possibility" standard. I.R.C. § 6662(d)(1)(B)(i) (2000); I.R.C. § 6694(a)(1) (2000); see *infra* text accompanying notes 63, 193.

14. Small Business and Work Opportunity Act of 2007, Pub. L. No. 110-28, 121 Stat. 201, 203 (codified as amended I.R.C. § 6694). This Note describes the tax return preparer penalties in detail below. See *infra* text accompanying notes 89-90.

15. Compare I.R.C. § 6694(a)(1) (2000) (containing the "realistic possibility" standard), with I.R.C. § 6694(a)(2)(B) (West 2008) (containing the "more likely than not" standard).

16. Treas. Reg. § 1.6694-2(b)(1) (as amended in 1992).

17. I.R.C. § 6694(a)(2)(B) (West 2008).

preparer to take a position from greater than thirty-three and one-third percent to greater than fifty percent. If the position does not fulfill the new "more likely than not" standard, the taxpayer must disclose the position.¹⁸ This amendment creates a conflict of interest between the tax return preparer, with a "more likely than not" standard, and the taxpayer, with a "substantial authority" standard, because in this scenario the return preparer, but not the taxpayer, must disclose the position.¹⁹

In the above situation, the lawyer faces a difficult decision. The lawyer can recommend the taxpayer report the income as a capital gain, but the taxpayer must disclose the position. Disclosing the position is not in the client's best interest because it raises a red flag for the IRS,²⁰ but it is in the lawyer's best interest to avoid the penalty.²¹ Therefore, if the lawyer advises the client to disclose the position, the lawyer may have acted unethically. The lawyer seems to have put her interests ahead of her client's by providing advice that benefits the lawyer and possibly burdens the client.²² The Model Rules of Professional Responsibility prevent a lawyer from representing a client if the representation causes a conflict of interest.²³ In addition, the taxpayer may have been able to take the capital gain position without hiring the lawyer.²⁴ This encourages taxpayers to prepare their tax returns without professional assistance.²⁵

An increase from a "realistic possibility" standard—a one-in-three likelihood or greater—to a "more likely than not" standard may seem like a small change. The increase, however, can make an enormous difference, especially when the position satisfies the taxpayer's "substantial authority" standard but not the preparer's "more likely than not" standard.²⁶ The amendment affects both tax return preparers and the tens of millions of taxpayers who utilize them.²⁷ The definition of a tax re-

18. *Id.* § 6694(a)(2)(C)(i).

19. This situation will arise when a preparer determines the position satisfies the "substantial authority" standard, but not the "more likely than not" standard.

20. See Naomi Snyder, *Uncle Sam Asks Tax Preparers to Tattle*, THE TENNESSEAN, July 15, 2007, available at <http://m.tennessean.com/detail.jsp?key=58150&full=1> (stating that some clients could object to disclosure, "fearing it could raise red flags at the IRS"); Robert W. Wood, *Am I a Return Preparer?*, TAX NOTES TODAY, Oct. 30, 2007, LEXIS, 2007 TNT 210-37 ("Why disclose if I don't have to, a client may ask?").

21. This is because a court does not have greater than a fifty percent chance of sustaining the position on the merits. See I.R.C. § 6694(a)(2)(B) (West 2008). Notice 2008-13 provides temporary guidance on how return preparers can deal with this situation. See I.R.S. Notice 08-13, 2008-3 I.R.B. 282. Nevertheless, the notice is just a short-term solution and does not effectively implement the new standard. See *infra* notes 220-222 and accompanying text.

22. See *infra* text accompanying notes 211-212.

23. See *infra* text accompanying notes 211-212.

24. Diane Freda, *NAEA Assails Stricter Reporting Standards for Preparers on Non-Disclosure Positions*, Tax & Acct. Center (BNA) (Aug. 13, 2007) (interviewing Claudia Hill).

25. See *infra* text accompanying notes 213-217.

26. Wood, *supra* note 20 (stating the increase of "17 percentage points can mean a world of difference").

27. See S. REP. NO. 109-336, at 9 (2006) (estimating in 2003, 60% of the 130 million individually filing taxpayers paid a tax return preparer).

turn preparer is much broader than many realize.²⁸ It obviously includes tax professionals who prepare and sign tax returns.²⁹ The definition may also include any lawyer who provides tax advice.³⁰ The amendment to § 6694 is the biggest topic in tax law today.³¹

Section II.A of this Note provides a background of tax return preparer penalties in the Code. Section II.B discusses other standards that tax lawyers and accountants must follow, along with taxpayer standards and penalties. Next, Section III analyzes the conflict of interest problem created by the amendment, and contends that the standards for a taxpayer and tax return preparer should be similar in order to avoid this conflict. Finally, this Note concludes that Congress should increase the taxpayer standard from “substantial authority” to “more likely than not.” This change would increase the perception of fairness of the United States tax system and align the preparer and taxpayer standard with the taxpayer’s accounting standard for disclosing uncertain tax positions on financial statements.

II. BACKGROUND

The civil penalty evolved from nonexistence before 1976 to the recent amendment penalizing preparers for taking positions that do not fulfill the “more likely than not” standard. Throughout the background and the remaining sections, this Note utilizes different standards in the Code that apply or did apply to tax return preparer and taxpayer penalties. The following table defines these standards.

28. See Stanley L. Blend & American Bar Association Section of Taxation, *ABA Tax Section Comments on Changes to Penalties Standards*, TAX NOTES TODAY, Nov. 19, 2007, LEXIS, 2007 TNT 223-56. See Section II.D of this Note for an in-depth discussion of the definition of a tax return preparer.

29. See Treas. Reg. § 1.6694-1(b)(2) (as amended in 1992).

30. See Treas. Reg. § 301.7701-15(a)(2) (as amended in 2002).

31. See Jeremiah Coder & Lee A. Sheppard, *Preparer Penalty Headaches on Full Display at ABA Midyear Meeting*, TAX NOTES TODAY, Jan. 23, 2008, LEXIS, 2008 TNT 15-2 (“The topic of section 6694 preparer penalties was on the mind of pretty much everyone attending the American Bar Association Section of Taxation midyear meeting . . .”).

Table of Relevant Standards

Standard	Likelihood of Success	Use
More Likely Than Not, § 6694	More than 50% ³²	New tax return preparer standard for undisclosed positions
Substantial Authority, § 6662	More than 40% ³³	Taxpayer standard for undisclosed positions
Realistic Possibility of Success, prior version of § 6694	More than 33.33% ³⁴	Prior tax return preparer standard for undisclosed positions
Reasonable Basis, § 6694	More than 20% ³⁵	New tax return preparer standard for disclosed positions
Non-Frivolous, prior version of § 6694	More than 5-10% ³⁶	Prior tax return preparer standard for disclosed positions

A. History of Tax Return Preparer Penalties

1. Return Preparers Penalties Prior to 1976

Before 1976, there was no penalty for return preparers who did not sign tax returns even though the returns required the preparer's signature.³⁷ In fact, the Code imposed no civil penalties on paid return preparers even though it imposed both civil fraud and negligence penalties on taxpayers.³⁸ Paid return preparers only faced criminal fraud charges for willfully preparing a fraudulent return.³⁹

The law in the early 1970s created problems for the IRS. At that

32. I.R.C. § 6694(a)(2)(B) (West 2008). See Treas. Reg. § 1.6662-4(d)(2) (as amended in 2003) (stating the "more likely than not" standard is met when there is more than a fifty percent likelihood the position will be upheld).

33. Most commentators define substantial authority as greater than a forty percent likelihood of success. See *infra* note 198 and accompanying text.

34. Treas. Reg. § 1.6694-2(b)(1) (as amended in 1992).

35. See *infra* note 86 and accompanying text.

36. See *infra* note 83 and accompanying text.

37. *Goulding v. United States*, 957 F.2d 1420, 1424 (7th Cir. 1992) (discussing the congressional reasoning for enactment of § 6694 and penalizing a tax lawyer for negligently preparing a partnership tax return); H.R. REP. NO. 94-658, at 273 (1975), *reprinted in* 1976 U.S.C.C.A.N. 2897, 3169.

38. *Wilfong v. United States*, 991 F.2d 359, 366 n.8 (7th Cir. 1993); *Goulding*, 957 F.2d at 1424. Starting in 1954, the Code imposed understatement penalties of five percent on a negligent taxpayer and fifty percent on a fraudulent taxpayer. See I.R.C. § 6653 (1958); Yoram Keinan, *Playing the Audit Lottery: The Role of Penalties in the U.S. Tax Law in the Aftermath of Long Term Capital Holdings v. United States*, 3 BERKELEY BUS. L.J. 381, 399 n.96 (2006). The Code also imposed criminal fraud penalties on taxpayers who willfully evaded taxes. H.R. REP. NO. 94-658, at 273 (1975), *reprinted in* 1976 U.S.C.C.A.N. 2897, 3169 (referencing I.R.C. § 7201).

39. *Goulding*, 957 F.2d at 1424; H.R. REP. NO. 94-658, at 273 (1975), *reprinted in* 1976 U.S.C.C.A.N. 2897, 3169 (referencing I.R.C. § 7206).

time, the number of return preparers in the marketplace substantially increased,⁴⁰ and the IRS suspected many of them were abusing the system.⁴¹ As previously stated, taxpayers, but not return preparers, could receive civil fines for understating tax liability.⁴² In addition, the Code did not force tax return preparers to sign returns they had prepared.⁴³ Thus, it was difficult for the IRS to determine whether the taxpayer or the return preparer was at fault.⁴⁴ Furthermore, even if the IRS determined fault belonged to the preparer, criminal penalties available at the time proved cumbersome because prosecuting the preparers was costly and time consuming.⁴⁵ The IRS's difficulties lead Congress to pass the 1976 Tax Reform Act.⁴⁶

2. Enactment of Code § 6694

Congress enacted § 6694, as a part of the 1976 Tax Reform Act.⁴⁷ As originally enacted, § 6694 penalized income tax return preparers by fining them \$100 if they had negligently or intentionally disregarded revenue rules and regulations in understating their clients' tax liability.⁴⁸ Section 6694 also penalized tax return preparers who willfully attempted to understate their client's tax liability by fining them \$500.⁴⁹

A preparer acted negligently by lacking due care or by failing to act as a reasonable and ordinarily prudent person.⁵⁰ Examples of taxpayers acting negligently include those who inadvertently make an error⁵¹ or who fail to inquire further when given incorrect or incomplete informa-

40. *Goulding*, 957 F.2d at 1424 (citing H.R. REP. NO. 94-658, at 274 (1975), *reprinted in* 1976 U.S.C.C.A.N. 2897, 3169).

41. H.R. REP. NO. 94-658, at 274 (1975), *reprinted in* 1976 U.S.C.C.A.N. 2897, 3170. Tax return preparers were advising taxpayers to sign blank returns, making guarantees of refunds, and claiming fictitious deductions and exemptions. *Id.*

42. H.R. REP. NO. 94-658, at 273 (1975), *reprinted in* 1976 U.S.C.C.A.N. 2897, 3169.

43. *Id.*

44. *Goulding*, 957 F.2d at 1424.

45. *Id.* (citing Tax Reform Act of 1976, Pub. L. No. 94-455, 1976 U.S.C.C.A.N. 2897, 3170). Section 7206 imposes a felony on any person who willfully aids or assists another in making a tax return that is fraudulent to any material matter. I.R.C. § 7206(a)(2) (2000). The maximum penalty upon enactment was \$5000 and now is \$100,000. *See* I.R.C. § 7206(flush language) (1958); I.R.C. § 7206(flush language) (2000). The crime also carries up to three years in prison. I.R.C. § 7206(flush language) (2000). The misdemeanor tax fraud statute is § 7207. *United States v. Bishop*, 412 U.S. 346, 350 (1973). A misdemeanor is committed by someone who willfully delivers a tax return that is known by him to be false as to any material matter. I.R.C. § 7207 (2000); *Bishop*, 412 U.S. at 350. A tax fraud misdemeanor carries up to a \$10,000 fine and one year in prison. I.R.C. § 7207 (2000).

46. *See Goulding*, 957 F.2d at 1424.

47. *Id.*

48. I.R.C. § 6694(a) (1976).

49. *Id.*

50. *Brockhouse v. United States*, 749 F.2d 1248, 1251 (7th Cir. 1984) (holding that a Certified Public Accountant (CPA) acted negligently by not asking about an obvious source of income to the taxpayer).

51. *Swart v. United States*, 568 F. Supp. 763, 765-66 (C.D. Cal. 1982) (holding that a CPA acted negligently by innocently making an error because he failed to exercise the care of a reasonable person under the circumstances).

tion.⁵² Willful understatements occur when the preparer knowingly disregards information given to him by the taxpayer or intentionally disregards rules and regulations.⁵³ Despite the statute, a regulation under § 6694 allowed a practitioner to take a position contrary to rules or regulations if the practitioner's position was "taken 'in good faith' and supported by a 'reasonable basis' for concluding that the rule or regulation did not accurately reflect the Code."⁵⁴ The Department of the Treasury (Treasury) modeled the regulation⁵⁵ from an American Bar Association (ABA) ethics opinion.⁵⁶

Congress was aware of substantial tax abuse taken by "commercial" preparers, those in the business of doing taxes without formal tax training,⁵⁷ when it enacted the 1976 Tax Reform Act.⁵⁸ Section 6694, however, applied to all paid income tax return preparers, and the Code defined income tax return preparers as anyone who prepared, or employed others to prepare, for compensation any tax return or refund claim.⁵⁹ Thus, § 6694 penalized only return preparers who the taxpayer compensated, not those who prepared income tax returns for themselves or gratuitously for others.⁶⁰

3. 1989 Amendment to § 6694

Congress amended § 6694 in 1989 to apply to tax returns and re-

52. *Brockhouse*, 749 F.2d at 1252. See also Jay R. Beskin et al., *Taxation: Substance v. Form and Other Esoterica*, 62 CHL-KENT L. REV. 657, 668 (1986) (stating Congress, the IRS, and the Department of the Treasury (Treasury) support the holding in *Brockhouse*).

53. *United States v. Ernst & Whinney*, 735 F.2d 1296, 1304 (11th Cir. 1984) (holding that tax return preparers could be enjoined from promoting their services if the allegations are proven); H.R. REP. NO. 94-658, at 279 (1975), *reprinted in* 1976 U.S.C.C.A.N. 2897, 3175.

54. Gwen Thayer Handelman, *Law and Order Comes to "Dodge City": Treasury's New Return Preparer and IRS Practice Standards*, 50 WASH. & LEE L. REV. 631, 633-34 (1993) (citing Treas. Reg. § 1.6694-1(a)(1), (4) (as amended in 1978)).

55. Section 7805(a) provides authority for the Treasury and the IRS to issue "all needful rules and regulations" to enforce the Code. I.R.C. § 7805(a) (2000). Congress has delegated this authority to ensure that in such a complex area, "like cases will be treated alike." *Nat'l Muffler Dealers Ass'n v. United States*, 440 U.S. 472, 477 (1979) (upholding the regulation because the taxpayer failed to prove the regulation did not reasonably implement the Code). The delegation also makes sure the regulations are written by the same group that is responsible for putting them into effect. *Id.* Courts "defer to [tax] regulations as long as they 'implement the congressional mandate in some reasonable manner.'" *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 219 (2001) (quoting *United States v. Correll*, 389 U.S. 299, 307 (1967)).

56. Handelman, *supra* note 54, at 634 (citing ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 314 (1965)). Formal Opinion 314 states, "[W]here the lawyer believes there is a reasonable basis for a position that a particular transaction does not result in taxable income . . . the lawyer has no duty to advise that riders be attached to the client's tax return explaining the circumstances surrounding the transaction." ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 314 (1965).

57. H.R. REP. NO. 94-658, at 274 (1975), *reprinted in* 1976 U.S.C.C.A.N. 2897, 3170. Lawyers and CPAs are "professional" tax return preparers with formal training and are not "commercial" preparers. *Id.*

58. *Brockhouse*, 749 F.2d at 1251.

59. I.R.C. § 7701(a)(36) (1976).

60. *Id.*; *Wilfong v. United States*, 991 F.2d 359, 365 (7th Cir. 1993).

fund claims prepared after December 31, 1989.⁶¹ This amendment conformed § 6694 to professional conduct standards of lawyers and certified public accountants (CPAs).⁶² Section 6694 penalized preparers for taking a position that resulted in an understatement and in which the preparer knew, or should have known, that there was “not a realistic possibility of being sustained on its merits.”⁶³ The penalty was a \$250 fine.⁶⁴ The return preparer avoided the penalty by disclosing the position as long as the position was not frivolous.⁶⁵

A Treasury regulation defines a position as meeting the “realistic possibility” standard “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.”⁶⁶ The regulation states that the authority a return preparer can consider is the same as a taxpayer, and a return preparer is not able to take into account the likelihood of an audit.⁶⁷

The return preparer continued to escape penalty by proving good faith and reasonable cause for any understatement.⁶⁸ Factors the IRS considers when determining if the return preparer acted with good faith and reasonable cause include: (1) the nature, frequency, and materiality of the errors; (2) the preparer’s normal office practice; and (3) the reliance on advice of another preparer.⁶⁹ The 1989 amendment also increased the fine for willful and reckless conduct to \$1000.⁷⁰ Congress left the standard for a willful attempt to understate taxpayer liability substantially the same.⁷¹

B. The May 25, 2007 Amendment

1. The Changes

The Small Business and Work Opportunity Act of 2007, enacted on

61. United States v. Bailey, 789 F. Supp. 788, 812 (N.D. Tex. 1992).

62. Handelman, *supra* note 54, at 636.

63. *Id.* (internal quotations omitted).

64. *Id.*

65. I.R.C. § 6694(a)(3) (2000). Section 6694 fined a return preparer for taking a frivolous position even if disclosed. *Id.*

66. Treas. Reg. § 1.6694-2(b)(1) (as amended in 1992).

67. *Id.* Generally, Code provisions, Treasury regulations, revenue rulings and procedures, court cases, congressional intent, private letter rulings, and information the IRS publishes in the Internal Revenue Bulletin can be used to form a realistic possibility. Treas. Reg. § 1.6694-2(b)(2) (as amended in 1992); *see also* Treas. Reg. § 1.6662-4(d)(3)(iii) (as amended in 2003). “Conclusions reached in treatises, legal periodicals, legal opinions, or opinions rendered by tax professionals are not authority.” Treas. Reg. § 1.6662-4(d)(3)(iii) (as amended in 2003).

68. I.R.C. § 6694(a) (flush language) (2000).

69. Treas. Reg. § 1.6694-2(d)(1) to (5) (as amended in 1992).

70. I.R.C. § 6694(b) (flush language) (2000).

71. *See* § 6694(b).

May 25, 2007, changed the law in four significant ways.⁷² First, Congress broadened the definition of a tax return preparer.⁷³ Section 6694 now applies to all tax return preparers, not just those filing returns or claims for income tax.⁷⁴ Thus, § 6694 penalizes persons preparing estate, gift, employment, and excise tax returns as well as returns for exempt organizations.⁷⁵ Therefore, § 6694 now applies to more lawyers than it did prior to the amendment.

Second, Congress changed the threshold for undisclosed positions in § 6694 from the "realistic possibility" standard to the "more likely than not" standard.⁷⁶ This increased the test from at least a one-in-three possibility of success on the merits⁷⁷ to a greater than one-in-two possibility.⁷⁸ The Act did not substantively alter the test for willful or reckless conduct.⁷⁹ Tax return preparers can continue to avoid penalties for reasonable positions, even if they do not meet the "more likely than not" standard, as long as the position is disclosed to the IRS.⁸⁰

Third, the amendment increased the minimum standard for escaping a penalty on a disclosed position from non-frivolous to a reasonable basis.⁸¹ A frivolous position "is patently improper under the tax law and has been interpreted by the courts to be a position which has no basis in

72. See Richard M. Lipton, *What Hath Congress Wrought? Amended Section 6694 Will Cause Problems for Everyone*, 107 J. TAX'N 68, 71 (2007).

73. See I.R.C. § 7701(a)(36) (West 2008).

74. Compare I.R.C. § 6694(a)(2) (2000) (penalizing income tax preparers), with I.R.C. § 6694(a)(1) (West 2008) (penalizing tax return preparers).

75. Michael R. Schuth, *Scope and Size of Tax Preparer Penalties Increase*, THE TAX ADVISER, Sept. 2007, available at <http://www.aicpa.org/pubs/taxadv/online/sep2007/clinic10.htm>.

76. Compare I.R.C. § 6694(a)(1) (2000) (utilizing the "realistic possibility" standard), with § 6694(a)(2)(B) (West 2008) (utilizing the "more likely than not" standard).

77. Treas. Reg. § 1.6694-2(b)(1) (as amended in 1992).

78. I.R.C. § 6694(a)(2)(B) (West 2008); Treas. Reg. § 1.6662-4(d)(2) (as amended in 2003) (stating the "more likely than not" standard is met when there is more than a fifty percent likelihood the position will be upheld).

79. See I.R.C. § 6694(b)(2) (West 2008).

80. I.R.C. § 6694(a)(2)(C) (West 2008) (referencing I.R.C. § 6662(d)(2)(B)(ii)). Adequate disclosure requirements depend on if the preparer is a signing or non-signing preparer. See Treas. Reg. § 1.6694-2(c)(3) (as amended in 1992). For a signing preparer, disclosure must be made in accordance with section 1.6662-4(f). Treas. Reg. § 1.6694-2(c)(3)(i) (as amended in 1992). Disclosure of a position is made on Form 8275 if the position is not contrary to a regulation, and on Form 8275-R if it is contrary to a regulation. Treas. Reg. § 1.6662-4(f)(1) (as amended in 2003). In addition, the regulations permit disclosure on the return in accordance with an annual revenue procedure. Treas. Reg. § 1.6662-4(f)(2) (as amended in 2003); Rev. Proc. 06-48, 2006-47 I.R.B. 934. A non-signing preparer may satisfy the disclosure requirements in accordance with section 1.6662-4(f). Treas. Reg. § 1.6694-2(c)(3)(ii) (as amended in 1992). The non-signing preparer has two other methods to disclose. *Id.* If the non-signing preparer is offering advice to a taxpayer, the preparer must tell the taxpayer the position is subject to penalty without disclosure. Treas. Reg. § 1.6694-2(c)(3)(ii)(A) (as amended in 1992). If the advice is written, the statement concerning disclosure must be in writing, and if the advice is oral, the statement concerning disclosure can be oral. *Id.* When the non-signing preparer gives advice to another preparer, disclosure "is adequate if the advice includes a statement that disclosure under section 6694(a) is required." Treas. Reg. § 1.6694-2(c)(ii)(B) (as amended in 1992). Again, if the advice is written, the statement must be in writing and if the advice is oral, the regulation allows an oral statement. *Id.*

81. Compare I.R.C. § 6694(a)(3) (2000) (penalizing a disclosed but frivolous position), with I.R.C. § 6694(a)(2)(C)(ii) (West 2008) (penalizing a disclosed but unreasonable position).

law or fact.”⁸² Non-frivolous positions generally entail having greater than a five to ten percent chance of a court sustaining the position on its merits.⁸³ The effect of this change is that the IRS can now penalize a preparer for disclosing an unreasonable, rather than just a frivolous, position.⁸⁴ The Treasury currently defines “reasonable basis” under the provisions for taxpayer penalties as significantly higher than frivolous but lower than substantial authority.⁸⁵ Legal commentators equate a reasonable basis with a twenty percent likelihood of success if the IRS challenged the position.⁸⁶ A taxpayer’s position must be more than just arguable or a colorable claim to meet the reasonable basis test.⁸⁷ A position based on at least one of the authorities listed in regulation 1.6662-4(d)(3)(iii) will usually satisfy the test.⁸⁸

Finally, Congress increased the penalties for violating the “more likely than not” standard from \$250 to the greater of \$1000 or “50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.”⁸⁹ Congress also increased the willful or reckless violations from \$1000 to the greater of \$5000 or “50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.”⁹⁰ The amendment became effective for all tax returns and claims prepared after May 25, 2007.⁹¹

2. Reasons for the Amendment

The changes to § 6694 surprised many people.⁹² The Treasury did not lobby for the change; its only recommendation was to increase the penalty, not to change the tax return preparer standards.⁹³ Further, the

82. Damon M. Fleming et al., *New Law Raises Tax Return Preparer Standard and Penalties*, 79 PRAC. TAX STRATEGIES 132, para. 4 (2007); see also Treas. Reg. § 1.6694-2(c)(2) (as amended in 1992).

83. See Fleming et al., *supra* note 82, para. 4; JOINT COMM. ON TAXATION, COMPARISON OF JOINT COMMITTEE STAFF AND TREASURY RECOMMENDATIONS RELATING TO PENALTY AND INTEREST PROVISIONS OF THE INTERNAL REVENUE CODE 13 (1999), available at <http://www.house.gov/jct/x-79-99.pdf>.

84. I.R.C. § 6694(a)(2)(C)(ii) (West 2008); Lipton, *supra* note 72, at 71.

85. Treas. Reg. § 1.6662-3(b)(3) (as amended in 2003).

86. Timothy F. Malloy, *Corporate Decisionmaking: Disclosure Stories*, 32 FLA. ST. U. L. REV. 617, 641 (2005). But see Damon M. Fleming & Gerald E. Whittenburg, *Accounting for Uncertainty*, J. ACCT., Oct. 2007, at 68. (stating the “reasonable basis” standard is equivalent to about a twenty-five percent likelihood of success).

87. Treas. Reg. § 1.6662-3(b)(3) (as amended in 2003).

88. *Id.* See *supra* note 67 for authorities listed in section 1.6662-4(d)(3)(iii).

89. Compare I.R.C. § 6694(a) (flush language) (2000) (containing a \$250 penalty), with I.R.C. § 6694(a)(1)(A)-(B) (West 2008) (containing a greater of \$5000 or fifty percent of income derived penalty).

90. Compare I.R.C. § 6694(b) (flush language) (2000) (containing a \$1000 penalty), with I.R.C. § 6694(b)(1)(A)-(B) (West 2008) (containing a greater of \$1000 or fifty percent of income derived penalty).

91. I.R.S. Notice 08-13, 2008-3 I.R.B. 282.

92. See, e.g., American Institute of Certified Public Accountants, *AICPA Writes Lawmakers on Reporting Standards for Return Preparers*, TAX NOTES TODAY, July 16, 2007, LEXIS, 2007 TNT 136-79.

93. *Id.*

change was not the subject of a congressional hearing.⁹⁴ The amendment also shocked the IRS Chief Counsel, who stated the IRS was not aware of the amendment until after it became law.⁹⁵

Even though the § 6694 amendment surprised many, legislative history shows Congress had previously contemplated such a move.⁹⁶ In 2006, the Senate Finance Committee (Finance Committee) submitted a report to Congress, stating the current preparer penalties were inadequate.⁹⁷ The Finance Committee believed the penalties should deter "preparers of estate and gift tax, employment tax, and excise tax returns, and returns of exempt organizations," not just income tax return preparers.⁹⁸ In addition, it recommended an increase in the penalty amount to deter noncompliance.⁹⁹ It also encouraged Congress to increase the tax return preparer's threshold from the "realistic possibility" standard to discourage scams, schemes, and all other abusive transactions.¹⁰⁰ Seven years before the Finance Committee report in 2006, the Joint Committee on Taxation also recommended the "more likely than not" standard for tax practitioners.¹⁰¹ In conclusion, even though Congress did not thoroughly explain why it amended § 6694, each committees' respective report indicates Congress was concerned with taxpayers engaging in tax-abusive transactions.

Moreover, Congress has been attempting to reduce the sizeable tax gap, the difference between taxes owed and taxes timely paid.¹⁰² The IRS estimates the tax gap exceeds \$300 billion per year.¹⁰³ While Congress has not estimated how much the increased standard will close the

94. *Id.* The American Institute of Certified Public Accountants (AICPA) notes that in contrast there were two years of congressional hearings and extensive reports when Congress amended § 6694 in 1989. *Id.* The explanation of the amendment merely states the changes without commentary. See JOINT COMM. ON TAXATION, TECHNICAL EXPLANATION OF THE "SMALL BUSINESS AND WORK OPPORTUNITY TAX ACT OF 2007" CONTAINED IN H.R. 1591 AS REPORTED BY THE CONFERENCE COMMITTEE 32 (2007), available at <http://www.house.gov/jct/x-24-07.pdf>.

95. American Institute of Certified Public Accountants, *supra* note 92 (stating the IRS was "blindsided" by the amendment).

96. Stephen W. Mazza, *The Interaction Between Tax Practitioner Penalties and Ethical Obligations*, KAN. B. ASS'N CONTINUING LEGAL EDUC. (25th Annual Lights Institute, Kansas City, Mo.), Dec. 7, 2007, at 50-51.

97. S. REP. NO. 109-336, at 51 (2006). See also Ryan H. Pace, *Crackdown on Fraudulent Tax Return Preparers*, J. ACCT., Aug. 2007, at 70 (citing members of the Senate Finance Committee discussing tax compliance problems).

98. S. REP. NO. 109-336, at 51 (2006).

99. *Id.*

100. *Id.*

101. JOINT COMM. ON TAXATION, *supra* note 83, at 14.

102. S. REP. NO. 109-336, at 119 (2006); Snyder, *supra* note 20; see also Roger Russell, *Congress Turns up Heat on Preparers: Iraq Bill Boosts Accountability on Returns*, ACCT. TODAY, Aug. 20, 2007 ("Congress hopes to partially remedy the tax gap by making tax preparers more responsible for the positions their clients take on returns.")

103. See S. REP. NO. 109-336, at 119 (2006) ("The IRS estimates that the gross annual tax gap . . . is \$345 billion."); Snyder, *supra* note 20 (estimating there are \$290 billion in taxes that are not paid every year); Catherine Clifford, *Hot Tips: Avoid the IRS Hot Seat*, CNRMONEY.COM, Mar. 14, 2008, http://money.cnn.com/2008/03/12/pf/taxes/Audit_flags/index.htm?postversion=2008031409 (stating the IRS recently estimated the tax gap to be between \$312 and \$353 billion).

tax gap, the Joint Committee on Taxation estimated the increase in revenue from the enhanced penalties would raise \$82 million from 2007 to 2017.¹⁰⁴ Section II.C will next discuss transitional relief the IRS has issued since the amendment.

C. *Since the Amendment*

1. Transitional Relief Until January 1, 2008

On June 11, 2007, the IRS released Notice 2007-54 in response to the § 6694 amendment.¹⁰⁵ Notices generally announce to the public how the IRS interprets, or intends to enforce, regulations and statutes.¹⁰⁶ Courts do not agree on the amount of deference IRS notices deserve.¹⁰⁷ This Note, however, will assume taxpayers and return preparers can safely rely on these authorities.

Notice 2007-54 provided guidance and transitional relief for tax return preparers.¹⁰⁸ The IRS and Treasury required additional time to address the changed definition of a tax return preparer.¹⁰⁹ The IRS also had to alter existing procedures and forms to apply the new standard to all returns, not just income tax returns.¹¹⁰

The first transitional relief applied to preparers of income tax returns, the group governed under the pre-amendment version of § 6694.¹¹¹ For these preparers of returns due before January 1, 2008, the IRS continued to apply the pre-amendment, “realistic possibility” standard when determining whether penalties were appropriate under § 6694(a).¹¹² The second relief applied to preparers of returns not previously governed by § 6694, preparers of estate, gift, employment, excise tax, and exempt organization returns.¹¹³ For these returns due before January 1, 2008, the IRS applied the “reasonable basis” standard from § 6662 when determining whether penalties were appropriate under § 6694(a).¹¹⁴ Thus, the new “more likely than not” standard, adopted in

104. See Mazza, *supra* note 96, at 51 (citing JOINT COMM. ON TAXATION, ESTIMATED REVENUE EFFECTS OF THE TAX PROVISIONS CONTAINED IN H.R. 1591 (2007)).

105. I.R.S. Notice 07-54, 2007-27 I.R.B. 12.

106. See, e.g., Esden v. Bank of Boston, 229 F.3d 154, 171 (2d Cir. 2000) (stating Notice 96-8 interprets statutes and regulations).

107. Compare Costantino v. TRW, Inc., 13 F.3d 969, 981 (6th Cir. 1994) (stating “IRS rulings do not have the force of law and are merely persuasive authority” while analyzing the lower court’s reliance on Notice 87-20), with Esden, 229 F.3d at 169 (stating Notice 96-8 is entitled to deference because “[i]t represents the agency’s ‘fair and considered judgment on the matter’” (quoting Auer v. Robbins, 519 U.S. 452, 462 (1997))).

108. I.R.S. Notice 07-54, 2007-27 I.R.B. 12.

109. *Id.*

110. *Id.*

111. See I.R.C. § 6694(a)(2) (2000); I.R.S. Notice 07-54, 2007-27 I.R.B. 12.

112. I.R.S. Notice 07-54, 2007-27 I.R.B. 12.

113. *Id.*

114. *Id.* The transitional relief applied to 2007 estimated tax returns due before January 16,

May 2007, applied only to preparers of returns due on or after January 1, 2008. Notice 2007-54, however, did not provide relief for return preparers who displayed willful or reckless conduct.¹¹⁵

2. Transitional Relief After January 1, 2008

On January 2, 2008, the IRS issued Notice 2008-13, which again provided guidance on the amendment to § 6694, including the definition of a tax return preparer.¹¹⁶ Notice 2008-13 states the Treasury and the IRS are intending to revise the regulations on tax return preparer penalties and are seeking public comment on the topic.¹¹⁷ The Notice states that a revision in the regulations is necessary “given the complexities and anomalies” the amendment to § 6694 created.¹¹⁸

Notice 2008-13 provides guidance in many areas.¹¹⁹ The two areas most important to this Note are how a tax return preparer establishes the “more likely than not” standard and how tax return preparers comply with § 6694 even without establishing the “more likely than not” standard.¹²⁰ The Notice also provides examples on the application of § 6694.¹²¹

Notice 2008-13 interprets the new “more likely than not” standard of § 6694.¹²² In determining if the tax treatment of an item will more likely than not be upheld on the merits, the tax return preparer should analyze the facts and authorities as described in the regulations.¹²³ The relevant regulation states the weight of an authority depends upon the

2008, and to 2007 employment and excise tax returns due before February 1, 2008. *Id.*

115. *Id.*

116. I.R.S. Notice 08-13, 2008-3 I.R.B. 282. The IRS also released two other notices on January 2, 2008. Notice 2008-12 provides guidance on return preparer requirements pursuant to § 6695. I.R.S. Notice 08-12, 2008-3 I.R.B. 280. Notice 2008-11 clarifies Notice 2007-54 concerning the filing of and due dates for returns. I.R.S. Notice 08-11, 2008-3 I.R.B. 279.

117. I.R.S. Notice 08-13, 2008-3 I.R.B. 282.

118. *Id.*

119. *See id.*

120. *Id.* Notice 2008-13 also categorized the types of tax returns and their application to § 6694. *Id.* This categorization is to help practitioners know which returns the IRS is going to focus on this filing season. Coder & Sheppard, *supra* note 31. Exhibit 1 contains returns that report tax liability. I.R.S. Notice 08-13, 2008-3 I.R.B. 282. Compensated preparers are subject to § 6694 liability if they prepare all or a substantial portion of a return Exhibit 1 lists. *Id.* Exhibit 2 contains information returns and other documents that do not report tax liability. *Id.* Section 6694 penalizes compensated preparers who prepare an Exhibit 2 return and the Exhibit 2 return constitutes a substantial portion of the taxpayer’s tax return or claim for refund. *Id.* For example, if a tax lawyer prepares a partnership return, an Exhibit 2 return, and the partnership return represents a substantial portion of the partner’s individual tax return, the tax lawyer is subject to § 6694 liability. *See id.* This Note defines substantial portion below. *See infra* text accompanying notes 146-152. Exhibit 3 includes a list of forms that would not subject a preparer to § 6694 liability unless the preparer willfully understated tax liability with a reckless or intentional disregard for the rules. I.R.S. Notice 08-13, 2008-3 I.R.B. 282. Another effect of Notice 2008-13 was it changed regulations defining an income tax return preparer to a tax return preparer. *Id.* (amending Treas. Reg. §§ 1.6694-1, -3, and 301.7701-15).

121. I.R.S. Notice 08-13, 2008-3 I.R.B. 282. The usefulness of these examples is unclear. *See* Coder & Sheppard, *supra* note 31 (quoting Thomas Kane, special counsel in the IRS Office of Chief Counsel as stating, “These are not regulation examples . . . they’re at the back for a reason.”).

122. I.R.S. Notice 08-13, 2008-3 I.R.B. 282.

123. *Id.*

relevance, persuasiveness, and type of authority.¹²⁴ The more similar the authority to the facts at issue, the more relevant the authority.¹²⁵ An authority thoroughly relating the law to the facts is more persuasive than one simply making a conclusion.¹²⁶ Finally, the IRS grants more weight to certain types of authority.¹²⁷ For example, a revenue ruling receives more weight than a private letter ruling.¹²⁸

Notice 2008-13 describes how tax return preparers can meet the requirements of § 6694 without a reasonable belief that the position will more likely than not be sustained on the merits.¹²⁹ The first requirement for both signing and non-signing preparers is that the position must fulfill the “reasonable basis” standard.¹³⁰ Signing return preparers must also meet one of the following requirements: (1) they must disclose the position; (2) if the position lacks substantial authority, they must provide a disclosure with the prepared return;¹³¹ (3) if the position possesses substantial authority, they must advise the taxpayer on the difference between the taxpayer standards and return preparer standards, and contemporaneously document that such advice was provided; or (4) if the position is for a tax shelter, they must advise the taxpayer of the differences between the taxpayer standards for tax shelters and the standards for return preparers and contemporaneously document that the advice was provided.¹³²

Non-signing preparers can also avoid § 6694 liability without meeting the “more likely than not” standard if they have a reasonable basis for the position. When providing advice to taxpayers, non-signing preparers must provide a statement informing the taxpayer of the taxpayer standards and disclosure requirements.¹³³ When providing advice for another tax return preparer, the non-signing preparer must provide “a statement that disclosure under section 6694(a) may be required.”¹³⁴ If the non-signing preparer provides written advice, the statement must be in writing,¹³⁵ otherwise, the statement may be oral.¹³⁶ Non-signing pre-

124. Treas. Reg. § 1.6662-4(d)(3)(ii) (as amended in 2003).

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.* “Revenue rulings represent the official IRS position on application of tax law to specific facts.” *Salomon Inc. v. United States*, 976 F.2d 837, 841 (2d Cir. 1992). A private letter ruling is “[a] written statement issued to the taxpayer by the [IRS] in which interpretations of the tax laws are made and applied to a specific set of facts.” BLACK’S LAW DICTIONARY 1196 (6th ed. 1990). Even though practitioners can use private letter rulings as an authority to take a position, practitioners cannot use or cite them for precedent. I.R.C. § 6110(k)(3) (2000).

129. I.R.S. Notice 08-13, 2008-3 I.R.B. 282.

130. *Id.*

131. This may relieve the signing preparer of liability even if the taxpayer does not file the disclosure with the return. *See* Coder & Sheppard, *supra* note 31.

132. I.R.S. Notice 08-13, 2008-3 I.R.B. 282.

133. *Id.*

134. *Id.*

135. *Id.*

136. *Id.*

parers can establish they provided the necessary statements to the taxpayer or other preparer by filing contemporaneous documentation.¹³⁷

D. Defining Tax Return Preparer

Prior to the May 2007 amendment, the Code limited the definition of a tax return preparer to someone who prepares or employs another to prepare an income tax return or refund claim for compensation.¹³⁸ With the amendment, the Code broadened the definition to include preparers of all tax returns and refund claims, thus, the definition now includes those who prepare refund claims and also those who prepare estate, gift, excise, or employment tax returns.¹³⁹

A tax return preparer is any person who prepares at least a substantial portion of a tax return or a refund claim for compensation.¹⁴⁰ A tax professional is not a tax return preparer merely for providing mechanical assistance, preparing a claim for an employer or a fiduciary, or preparing a refund claim after a notice of deficiency.¹⁴¹ There is no specialized knowledge requirement for being a tax return preparer.¹⁴² A person is not a preparer without an agreement for compensation, even if the person receives a gift, favor, or other return service.¹⁴³ Furthermore, a person who gives advice on a specific issue of law is not a return preparer unless the advice is on a past event and "[t]he advice is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund."¹⁴⁴ The regulation excludes from the definition of a return preparer persons who provide voluntary tax service.¹⁴⁵

In order to determine whether a person prepares a substantial portion of a return, the IRS compares the entries made with the person's advice to the entire return or claim for refund.¹⁴⁶ A substantial portion of a tax return means a schedule or entry that if the IRS disallowed would result in a deficiency that the preparer knows, or should have known, is a significant portion of the reported tax liability on the return.¹⁴⁷ For example, a tax lawyer advises a client that a \$100,000 cost

137. *Id.*

138. I.R.C. § 7701(a)(36) (2000).

139. I.R.C. § 7701(a)(36)(A) (West 2008); Lipton, *supra* note 72, at 71.

140. I.R.C. § 7701(a)(36)(A).

141. I.R.C. § 7701(a)(36)(B).

142. Treas. Reg. § 301.7701-15(a)(3) (as amended in 2002) (stating a person can be a return preparer "without regard to educational qualifications and professional status requirements").

143. Treas. Reg. § 301.7701-15(a)(4) (as amended in 2002).

144. Treas. Reg. § 301.7701-15(a)(2)(ii) (as amended in 2002).

145. *See* Treas. Reg. § 301.7701-15(a)(7) (as amended in 2002). The regulation excludes individuals who prepare returns in the Volunteer Income Tax Assistance program and the Low-Income Taxpayer Clinic. *Id.*

146. Treas. Reg. § 301.7701-15(b)(1) (as amended in 2002).

147. I.R.S. Notice 08-13, 2008-3 I.R.B. 282.

qualifies as a deductible business expense under § 162.¹⁴⁸ The deduction reduces the taxpayer's tax liability from \$80,000 to \$45,000.¹⁴⁹ Thus, the tax lawyer may have prepared a substantial portion of the return, if the IRS disallowed the deduction and determines the taxpayer owes a significant unreported liability. Notice 2008-13 does not define "significant," and therefore, the definition is open for interpretation.¹⁵⁰

For preparers who do not prepare the entire return, the regulations provide a safe harbor.¹⁵¹ The advised portion is not a substantial portion if the entries the person advised on are: "(i) [l]ess than \$2,000; or (ii) [l]ess than \$100,000, and also less than 20 percent of the gross income . . . as shown on the return or claim for refund."¹⁵² Thus, the IRS will not consider a tax advisor as preparing a substantial portion of a return if the advisor meets the safe harbor.

The definition of a tax return preparer includes both a signing preparer and a non-signing preparer.¹⁵³ As the name implies, a signing preparer is one who signs the tax return or claim.¹⁵⁴ A non-signing preparer does not sign the return or claim but provides enough advice to the taxpayer or another preparer for the IRS to consider the person as having substantially prepared the return or claim.¹⁵⁵

The regulations also contain a "one-preparer-per-firm rule."¹⁵⁶ The IRS will not consider more than one individual associated with a firm as a return preparer.¹⁵⁷ If two individuals from the same accounting or law firm prepare a return and do not sign it, the IRS will generally consider the person with supervisory responsibility as the return preparer.¹⁵⁸

III. OTHER RELEVANT STANDARDS

In addition to § 6694, tax return preparers may also need to adhere to Treasury regulations, ethical rules, and organizational guidelines. Along with the Code's taxpayer penalty section, taxpayers may also need to follow accounting rules. Section III discusses the other standards that could apply to tax return preparers and taxpayers.

148. See I.R.C. § 162(a) (2000) (allowing a deduction for ordinary and necessary expenses incurred for "carrying on any trade or business").

149. This is a simplified example assuming the taxpayer is in a thirty-five percent tax bracket. For actual tax brackets, see I.R.C. § 1 (2000).

150. See I.R.S. Notice 08-13, 2008-3 I.R.B. 282.

151. See Treas. Reg. § 301.7701-15(b)(2) (as amended in 2002).

152. *Id.*

153. Treas. Reg. § 1.6694-1(b)(2) (as amended in 1992).

154. *Id.*

155. *Id.*; Treas. Reg. § 301.7701-15(a) (as amended in 2002). See *supra* notes 146-147 and accompanying text (defining a substantial portion of a return).

156. MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE § 4-71 (rev. 2d ed. 2005).

157. Treas. Reg. § 1.6694-1(b)(1) (as amended in 1992).

158. *Id.*

A. Standards Governing Tax Return Preparers

1. Circular 230: Practicing Before the IRS

Circular 230¹⁵⁹ regulates attorneys, CPAs, enrolled agents, and other persons practicing before the IRS.¹⁶⁰ "Practicing before the IRS" includes not only representing clients before the IRS but also preparing and filing all necessary documents.¹⁶¹ Even though Circular 230 may seem to govern all tax practitioners, hundreds of thousands of individuals filing tax returns for others are not subject to Circular 230 because it does not define them as practicing before the IRS.¹⁶²

Prior to the amendment to § 6694, Circular 230 contained the "realistic possibility" standard when tax advisors render advice on tax return positions.¹⁶³ In September 2007, however, the Treasury redacted the "realistic possibility" standard and released a notice of proposed rule-making stating the proposed standard is the "more likely than not" standard, as in § 6694.¹⁶⁴ As of April 17, 2008, the Treasury has not yet finalized the new standard.¹⁶⁵

Circular 230 also contains different standards for tax practitioners who provide covered opinions, formally referred to as tax-shelter advice.¹⁶⁶ A covered opinion includes written advice concerning a tax issue that arises from a plan that has a significant tax avoidance or evasion purpose.¹⁶⁷ Along with other requirements, if a tax practitioner does not conclude a taxpayer will more likely than not prevail on a significant tax issue, then the covered opinion must disclose that the taxpayer cannot use it to avoid possible taxpayer penalties.¹⁶⁸ In other words, the IRS has determined that a covered opinion "must comply with far greater scrutiny than a tax return position."¹⁶⁹

159. This Note provides only a basic and simplified overview of Circular 230, which is located in Title 31 of the Code of Federal Regulations, Part 10. 31 C.F.R. pt. 10 (2007).

160. 31 C.F.R. § 10.0 (2007).

161. 31 C.F.R. § 10.2(d) (2007).

162. Susanne Pagano, *Tax Practice: Treasury, IRS Continuing Focus on Circular 230*, *Desmond Says*, Tax & Acct. Center (BNA), Nov. 5, 2007; see also S. REP. NO. 109-336, at 9 (2006) ("The Committee understands that many tax return preparers are not regulated by any licensing entity or subject to minimum competency requirements."); Lee A. Sheppard, *New Preparer Penalties Sweep Away Circular 230*, TAX NOTES TODAY, Feb. 5, 2008, LEXIS, 2008 TNT 24-8.

163. 31 C.F.R. § 10.34(a) (2007); David L. Click, *Taxing Standards: Recent Changes in the Practice of Tax Law*, TAX NOTES TODAY, Jan. 15, 2008, LEXIS, 2008 TNT 10-25.

164. Click, *supra* note 163.

165. See 31 C.F.R. § 10.34(a) (Apr. 17, 2008) (reserving the subsection where the "realistic possibility" standard previously existed).

166. See 31 C.F.R. § 10.35(a) (2007). Circular 230 currently uses the phrase "covered opinions" instead of "tax shelter opinions." See 31 C.F.R. § 10.35; Isaac J. Roang, Note, *To Disclaim or Not to Disclaim: IRS Circular 230 Requirements for Written Advice*, 19 GEO. J. LEGAL ETHICS 937, 941 (2006) (stating the Treasury deleted the phrase "tax shelter opinions" in 2004).

167. 31 C.F.R. § 10.35(b)(2)(i)(B) (2007).

168. 31 C.F.R. § 10.35(e)(4) (2007).

169. Harold S. Peckron, *Watchdogs That Failed to Bark: Standards of Tax Review After Enron*, 5 FLA. TAX REV. 851, 872 (2002).

2. Ethical Considerations for Tax Lawyers

Along with § 6694 and Circular 230, tax lawyers must also fulfill ethical obligations to both the tax system and to clients.¹⁷⁰ Just like other lawyers, tax lawyers must be committed to their clients' interests and act as zealous advocates.¹⁷¹ On the other hand, tax lawyers must assert only good faith arguments in litigation.¹⁷² The ABA Model Rules of Professional Responsibility allow a lawyer to assert a non-frivolous claim, even if the lawyer does not believe the client's position will prevail.¹⁷³

More specifically, two ABA opinions address the ethical obligations of tax lawyers.¹⁷⁴ ABA opinion 85-352 reiterates Model Rule 3.1 and states a tax lawyer may advise reporting a position on a tax return in "which the lawyer in good faith believes is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law."¹⁷⁵ This position does not require tax lawyers to have substantial authority; they just need to meet the "realistic possibility of success" standard that was the same as the § 6694 standard before the May 2007 amendment.¹⁷⁶

ABA opinion 346 covers the ethical obligations of lawyers giving "tax shelter opinions."¹⁷⁷ In giving the opinion, the lawyer should state whether "the significant tax benefits, in the aggregate, probably will be realized or probably will not be realized, or that the probabilities of realization and nonrealization of the significant tax benefits are evenly di-

170. See Camilla E. Watson, *Tax Lawyers, Ethical Obligations, and the Duty to the System*, 47 U. KAN. L. REV. 847, 850 (1999) (noting that some commentators state a tax lawyer owes a duty to the system). The American Bar Association (ABA) does not have any disciplinary authority over its members. James P. Holden, *New Professional Standards in the Tax Marketplace: Opinions 314, 346 and Circular 230*, 4 VA. TAX REV. 209, 211 (1985). Forty-seven states, the District of Columbia, and the Virgin Islands, however, have enacted a version of the ABA's Model Rules of Professional Conduct (Model Rules). ABA CTR. FOR PROF'L RESP., MODEL RULES OF PROF'L CONDUCT, http://www.abanet.org/cpr/mrpc/alpha_states.html (last visited Apr. 5, 2008). Violation of a Model Rule does not necessarily create a cause of action against a lawyer. Charles E. McCallum & Bruce C. Young, *Ethics Issues in Opinion Practice*, 62 BUS. LAW. 417, 418 (2007). "However, evidence of a violation is admissible and unfavorable evidence against a lawyer defending a claim of malpractice." *Id.*

171. MODEL RULES OF PROF'L CONDUCT R. 1.3 cmt. 1 (2007).

172. See MODEL RULES OF PROF'L CONDUCT R. 3.1 (2007) ("A lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis in law and fact for doing so that is not frivolous, which includes a good faith argument for an extension, modification, or reversal of existing law.").

173. MODEL RULES OF PROF'L CONDUCT R. 3.1 cmt. 2 (2007).

174. See ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 85-352 (1985); ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 346 (1982). An older ABA opinion also addresses tax practice. See ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 314 (1965). The ABA has restated Formal Opinion 314's standard in Formal Opinion 85-352. See ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 85-352 (1985).

175. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 85-352 (1985).

176. *Id.*

177. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 346 (1982). A tax shelter opinion "is advice by a lawyer concerning the federal tax law applicable to a tax shelter if the advice is referred to either in offering materials or in connection with sales promotion efforts directed to persons other than the client who engages the lawyer to give the advice." *Id.*

vided.”¹⁷⁸ Thus, when giving a tax shelter opinion, a tax lawyer must utilize a standard similar to the “more likely than not” standard.¹⁷⁹

3. AICPA Statements on Responsibilities in Tax Practice

The American Institute of Certified Public Accountants (AICPA) is a voluntary professional organization of CPAs and has over 350,000 members.¹⁸⁰ Among other functions, the organization publishes ethical tax standards for its members.¹⁸¹ If a member fails to follow the ethical standards, the AICPA may expel or suspend the member from the organization.¹⁸²

The AICPA adopts the “realistic possibility” standard, just like § 6694 pre-amendment.¹⁸³ Furthermore, the AICPA allows the return preparer to use all of the authorities that § 6694 allows.¹⁸⁴ Nevertheless, there is one small difference between the standards. AICPA members can rely on treatises and articles of tax professionals—items that the regulations specifically exclude from consideration for return preparer penalties in the Code.¹⁸⁵ Therefore, a return preparer can meet the “realistic possibility” standard for the AICPA by relying on a tax treatise, without fulfilling the prior “realistic possibility” standard in § 6694. The AICPA has asked Congress to reduce the tax preparer standard to equal the taxpayer “substantial authority” standard.¹⁸⁶ As of March 2008, the AICPA has not altered its standard.¹⁸⁷

B. Taxpayer Standards

1. Penalty Standard for Taxpayers in the Code

The Code also imposes a penalty on taxpayers for underpaying

178. *Id.*

179. “Probably” is equivalent to more likely than not. *State v. Maxfield*, 891 P.2d 1342, 1344 (Or. Ct. App. 1995) (discussing the sufficiency of an affidavit).

180. American Institute of Certified Public Accountants, AICPA Media Center - Frequently Asked Questions, http://www.aicpa.org/MediaCenter/FAQs.htm#aicpa_answer1 (last visited Apr. 8, 2008).

181. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, STATEMENTS ON STANDARDS FOR TAX SERVICES 5 (2000), <http://www.aicpa.org/download/tax/SSTfinal.pdf>.

182. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, JOINT ETHICS ENFORCEMENT PROGRAM (JEEP) MANUAL OF PROCEDURES 28 (2006), http://www.aicpa.org/NR/rdonlyres/4E2729C5-6B1A-47A5-9D57-64D8CBDEDE6F/0/Dec_2006_JEEP_Manual.pdf.

183. American Institute of Certified Public Accountants, *supra* note 181, at 9 (“In general, a member should have a “good-faith belief that the [tax return] position [being recommended] has a realistic possibility of being sustained administratively or judicially on its merits if challenged.”).

184. *Id.* at 13.

185. *Id.*; Treas. Reg. § 1.6662-4(d)(iii) (as amended in 2003).

186. See American Institute of Certified Public Accountants, *supra* note 92.

187. American Institute of Certified Public Accountants, Standards That Apply to Tax Preparers, <http://tax.aicpa.org/Resources/Professional+Standards+and+Ethics/Standards+That+Apply+to+Tax+Preparers.htm> (last visited Apr. 8, 2008).

their tax liability.¹⁸⁸ An overview of taxpayer penalties is important to understanding the later comparison of taxpayer standards to tax return preparer standards.¹⁸⁹ Section 6662 penalizes a taxpayer for making a substantial understatement of income tax.¹⁹⁰ Generally, an understatement is the amount the taxpayer should have paid over the amount the taxpayer actually paid.¹⁹¹ A substantial understatement occurs if the understatement exceeds the greater of ten percent of the correct tax amount or \$5000.¹⁹² Section 6662, however, reduces an understatement by the portion that is attributable to the taxpayer relying on substantial authority.¹⁹³

A bright-line test for substantial authority does not exist, but the regulations define it as an objective standard determined by analyzing the law and applying the law to all relevant facts.¹⁹⁴ According to a Treasury regulation, substantial authority exists “for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment.”¹⁹⁵ A tax lawyer judges the weight of an authority by its type and by evaluating its relevance and persuasiveness.¹⁹⁶ Substantial authority is a higher threshold than reasonable basis.¹⁹⁷ Most legal commentators define the “substantial authority” threshold at around a forty percent likelihood of success on the merits.¹⁹⁸

Taxpayers who do not meet the “substantial authority” standard may still escape penalty. Section 6662 reduces the understatement if the facts were adequately disclosed and the treatment for the item had a reasonable basis.¹⁹⁹ On the other hand, to reduce the understatement that is attributable to a tax shelter, the tax item must fulfill the “more likely than not” standard as opposed to the “substantial authority” threshold.²⁰⁰

2. Accounting Standard for Taxpayers

The Financial Accounting Standards Board (FASB) is the recog-

188. See I.R.C. § 6662 (2000).

189. See *infra* note 209 and accompanying text.

190. I.R.C. § 6662(b)(2) (2000).

191. I.R.C. § 6662(d) (2000).

192. I.R.C. § 6662(d)(1)(A) (2000).

193. See I.R.C. § 6662(d)(2)(B)(i) (2000).

194. Treas. Reg. § 1.6662-4(d)(2) (as amended in 2003).

195. Treas. Reg. § 1.6662-4(d)(3)(i) (as amended in 2003).

196. Treas. Reg. § 1.6662-4(d)(3)(ii) (as amended in 2003).

197. See Treas. Reg. § 1.6662-3(b)(3) (as amended in 2003).

198. See Malloy, *supra* note 86, at 641; J. Timothy Philipps, *It's Not Easy Being Easy: Advising Tax Return Positions*, 50 WASH. & LEE L. REV. 589, 606 (1993). But see Sheppard, *supra* note 162 (“[S]ubstantial authority is about 33 percent.”).

199. I.R.C. § 6662(d)(2)(B)(ii) (2000).

200. I.R.C. § 6662(d)(2)(C) (2000).

nized organization that establishes accounting standards.²⁰¹ In June 2006, FASB issued Interpretation No. 48 (FIN 48).²⁰² FIN 48 clarifies the accounting for uncertainty in income taxes.²⁰³ It is applicable to tax-paying entities that must issue financial statements in accordance with generally accepted accounting principles (GAAP).²⁰⁴ FIN 48 “sets the threshold for recognizing the benefits of tax return positions in financial statements as ‘more likely than not’ to be sustained by the relevant taxing authority.”²⁰⁵ Thus, an entity can only report the tax benefits of a position that meets the “more likely than not” standard.²⁰⁶ If the position does not meet the standard, the entity cannot take the benefit until the position is resolved.²⁰⁷ A position becomes resolved in one of three ways: (1) the law or circumstances change so the position fulfills the “more likely than not” standard, (2) the taxing authority favorably resolves a position, or (3) the statute of limitations on the position expires.²⁰⁸ The amendment to § 6694 brought the threshold for tax return preparers into alignment with the taxpayer standard for dealing with uncertain tax benefits while releasing financial statements.

IV. ANALYSIS

A. Effects of the Amendment to § 6694

As previously discussed in Section I, the amendment to § 6694 creates a problem for tax return preparers. Preparers and taxpayers are now subject to different standards.²⁰⁹ This conflict will create situations in which a preparer has an obligation to disclose a position, but the taxpayer does not.²¹⁰ This conflict of interest creates a possible ethical dilemma for tax lawyers. The ABA Model Rules of Professional Responsibility state a lawyer shall not represent a client if the representation

201. See Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, 68 Fed. Reg. 23,333 (May 1, 2003) (stating that the Financial Accounting Standards Board’s (FASB) accounting and reporting standards are recognized as “generally accepted” for U.S. security laws).

202. FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109*, FIN48-1 (2006), available at http://72.3.243.42/pdf/aop_FIN48.pdf.

203. *Id.*

204. Jack B. Siegel, *Applying FIN 48 to Tax-Exempt Organizations: Too Much of Nothing or It’s All Too Much?*, TAX NOTES TODAY, May 11, 2007, LEXIS, 2007 TNT 92-37. FIN 48 is a requirement for taxpayers, not return preparers, to fulfill. Kip Dellinger, *FIN 48 and Preparer Penalty: Incongruity to Be Expected*, TAX NOTES TODAY, Feb. 25, 2008, LEXIS, 2008 TNT 38-23.

205. Fleming & Whittenberg, *supra* note 86.

206. Click, *supra* note 163.

207. *Id.*

208. *Id.*

209. Compare I.R.C. § 6662(d)(2)(B)(i) (2000) (utilizing the “substantial authority” standard), with I.R.C. § 6694(a)(2)(B) (West 2008) (utilizing the “more likely than not” standard).

210. Alison Bennett, *Tax Practice: Guidance Under Way on New Standards for Return Preparer Penalties*, *Soucy Says*, Tax & Acct. Center (BNA) (Nov. 12, 2007) (citing Treasury attorney-adviser Anita Soucy).

involves a conflict of interest.²¹¹ A conflict of interest exists if there is a significant risk that a personal interest of the lawyer will materially limit representation of a client.²¹² When a lawyer advises a client to disclose a position not for the client's good, but for the lawyer's, a tax lawyer has probably acted unethically.

This conflict of interest also hinders the lawyer-client relationship.²¹³ The Code should not penalize taxpayers by hiring a lawyer for advice.²¹⁴ Clients will likely become discouraged from seeking tax advice if they are in a worse position by hiring a return preparer than had they prepared their taxes themselves.²¹⁵ Discouraging taxpayers from seeking tax advice is troublesome because the tax system is complicated, and taxpayers oftentimes need professional assistance to determine their correct tax amount.²¹⁶ Thus, the amendment to § 6694 may decrease the accuracy of tax returns, having an opposite effect of what Congress intended.²¹⁷

IRS Notice 2008-13 has temporarily halted the conflict of interest problem by providing tax return preparers options to fulfill § 6694 requirements when a tax position has substantial authority but does not fulfill the "more likely than not" standard.²¹⁸ Some may argue the temporary relief provided by Notice 2008-13 solves the conflict of interest problem created by the amendment to § 6694.²¹⁹ Notice 2008-13, however, is just a temporary band-aid and does not effectively implement the "more likely than not" standard.²²⁰ If a signing tax return preparer reasonably believes a position has substantial authority but fails the "more likely than not" standard, the signing tax preparer need only advise the taxpayer about the different standards.²²¹ Further, if a non-signing tax preparer is in that same situation, the non-signing preparer need only advise the taxpayer on taxpayer penalties and disclosure re-

211. MODEL RULES OF PROF'L CONDUCT R. 1.7(a) (2007).

212. *Id.* R. 1.7(a)(2).

213. See American Institute of Certified Public Accountants, *supra* note 92.

214. See Gwen Thayer Handelman, *Constraining Aggressive Return Advice*, 9 VA. TAX REV. 77, 89 (1989) ("[T]axpayer's rights and duties are neither expanded nor contracted by retaining a lawyer.").

215. N. Y. STATE BAR ASS'N, LETTER TO CONGRESS 9-10, Jan. 28, 2008, <http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1146Report.pdf>.

216. *Id.* at 9.

217. See *id.* at 9-10.

218. See *supra* text accompanying notes 129-137.

219. See American Institute of Certified Public Accountants, *AICPA Task Force Addresses Interim Guidance Under Preparer Penalty Provisions*, TAX NOTES TODAY, Mar. 21, 2008, LEXIS, 2008 TNT 56-22 ("In adopting the interim rules for tax return preparer disclosure in *Notice 2008-13*, Treasury and the Internal Revenue Service have established a sound framework for implementing Congress's objectives in amending *section 6694*.").

220. See Coder, *supra* note 1. "'The rules are interim in nature and we need to do more thinking' about them." *Id.* (quoting Anita Soucy).

221. I.R.S. Notice 08-13, 2008-3 I.R.B. 282. The preparer also contemporaneously needs to document and file that the preparer provided this advice. *Id.*

quirements.²²² With these safe harbors in play, a return preparer or taxpayer would not disclose and call the IRS's attention to the position. In reality, Notice 2008-13 has created more work for tax attorneys through the speech and document requirements but has made the "more likely than not" standard irrelevant.

B. Solution

1. Make the Return Preparer and Taxpayer Standards the Same

One way to avoid the conflict of interest between the taxpayer and the tax return preparer is to have identical standards for each.²²³ Many tax professionals agree that this is the correct approach to solving the conflict of interest problem.²²⁴ Following this notion, there are two options to reconcile the standards: (1) Congress could reduce the tax return preparer standards to the taxpayer standards, or (2) Congress could increase the taxpayer standards to the tax return preparer standards.²²⁵ Along with eliminating the conflict of interest problem, making the two standards the same also has a simplification benefit.²²⁶

2. Congress Should Increase the Taxpayer Standard

Congress should increase the taxpayer standard from substantial authority to "more likely than not," instead of reducing the tax return

222. See *supra* notes 133-134 and accompanying text.

223. The Code used different terms for the pre-amendment standards of taxpayers and return preparers. The tax return preparer needed a realistic possibility of success and the taxpayer's standard was reliance on substantial authority. Compare I.R.C. § 6694(a)(1) (2000) (utilizing the "realistic possibility" standard), with I.R.C. § 6662(d)(2)(B)(i) (2000) (utilizing the "substantial authority" standard). Some legal commentators state the two standards are essentially the same. See Handelman, *supra* note 54, at 637 ("The regulations define the statutory 'realistic possibility' standard as essentially equivalent to 'substantial authority' . . ."); Watson, *supra* note 170, at 865 ("In general, the substantial authority standard corresponds to the preparer's realistic possibility standard."). Other legal commentators, however, state the "substantial authority" standard is more stringent. See James J. Holden, *Constraining Aggressive Return Advice: A Commentary*, 9 VA. TAX REV. 771, 772 (1990) (listing "substantial authority" as a higher threshold than "realistic possibility"); Philipps, *supra* note 198, at 606 ("General agreement exists that substantial authority is a more stringent standard than the one-in-three realistic possibility of success standard."). Another view on the juxtaposition of the terms is that they are not comparable because the "substantial authority" standard is a qualitative standard while the "realistic possibility" standard is quantitative. *Id.*; Michael I. Saltzman, *The Preparer Penalty's Realistic Possibility of Success Standard: Its Meaning and Application*, 43 FLA. L. REV. 915, 936 (1991).

224. See, e.g., ABA SECTION OF TAXATION, LETTER TO CONGRESS 2, Nov. 15, 2007, <http://www.abanet.org/tax/pubpolicy/2007/071115legislativechangesimpactingstandardsforimpositionofpenalties.pdf> (recommending both standards be "substantial authority"). *But see* N.Y. ST. B.A., *supra* note 215, at 15 (discussing the options of restoring § 6694 back to the "realistic possibility" standard or revising both taxpayer and return preparer standards so the return preparer's are less than the taxpayer's but the taxpayer's are higher than "substantial authority").

225. This Note assumes it would make an easier transition for Congress to make one of these two changes as opposed to setting a new standard for both taxpayer and return preparer.

226. Linda M. Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 VA. TAX REV. 583, 641 (2006).

preparer standard. This change would improve the perception of fairness in the tax system and align the tax penalty threshold for taxpayers with the accounting standard for disclosing uncertain tax positions in financial statements.

Increasing the standard would strengthen the fairness perception of the tax system in the United States.²²⁷ When a tax professional or taxpayer concludes there is substantial authority for taking a deduction, there may be a greater than fifty percent chance that a court will reverse the decision.²²⁸ If there is a greater than fifty percent chance a court will disapprove of a deduction, it seems most taxpayers would disapprove of others taking the deduction. The fact that a majority of Americans pay their taxes on time and in the correct amount supports this conclusion.²²⁹ This majority would likely consider those taking deductions that would more likely than not be reversed by a court, without disclosing it to the IRS, as cheating the system. When people think others are improperly avoiding taxes, they are likely to lose their confidence in the system.²³⁰ Therefore, forbidding taxpayers and tax return preparers from taking positions in which there is a greater than fifty percent likelihood of reversal would increase the perception of fairness of the U.S. tax system.

Another reason to increase the taxpayer standard to “more likely than not” is to align the standard with FIN 48, the accounting rule for taxpayers recognizing uncertain tax positions on financial statements.²³¹ Consistent tax and financial accounting standards would be beneficial for taxpayers in this situation.²³² Taxpayers could hire a tax lawyer to

227. N.Y. ST. B.A., *supra* note 215, at 18.

228. A tax position can meet the “realistic possibility” standard and tax lawyers still believe the position will not prevail. Beale, *supra* note 226, at 639. *See also* ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 85-352 (1985) (allowing a tax lawyer to recommend a position under the “realistic possibility” standard even if the lawyer believes a court will reverse the position). Therefore, a position can meet the “substantial authority” standard and tax lawyers and taxpayers still believe the position will not prevail. Thus, the tax position can still be supported by substantial authority, a forty percent likelihood of success.

229. Danshera Cords, *Tax Protestors and Penalties: Ensuring Perceived Fairness and Mitigating Systemic Costs*, 2005 BYU L. REV. 1515, 1516 (2005).

230. *Id.* at 1517.

231. *See supra* Section III.B.2. There is disagreement over whether § 6662 with a “more likely than not” standard would be equivalent to FIN 48. N.Y. ST. B.A., *supra* note 215, at 18. *See also* Coder, *supra* note 1 (discussing how FIN 48 and § 6694 may not be totally congruent); Dellinger, *supra* note 204 (stating FIN 48 more closely resembles § 6662 than § 6694).

232. N.Y. ST. B.A., *supra* note 215, at 18. This Note does not argue that tax accounting and book, or financial, accounting rules should always be the same. Legal commentators refer to having similar tax and financial accounting rules as “book-tax conformity.” Linda M. Beale, *Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-to-Market Safe Harbor*, 24 VA. TAX REV. 301, 305 (2004). Tax professionals have heavily debated the merits of book-tax conformity. *See, e.g.*, Anthony J. Luppino, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L. REV. 35, 108-37 (2003) (discussing a history of the book-tax conformity debate from a tax law perspective); Dustin Stamper, *Increased Transparency Still Falling Short, Everson Says*, TAX NOTES TODAY, Feb. 2, 2007, LEXIS, 2007 TNT 23-2. The Supreme Court has stated that equivalency between tax and financial accounting is inappropriate because each have different objectives. *Thor Power Tool Co. v. Comm'r*, 439

perform analysis that the taxpayer could utilize for both tax and financial accounting purposes.²³³ Currently, if a taxpayer takes a position supported by "substantial authority," then it must determine if the position also fulfills the "more likely than not" standard. Thus, the congruent standards would lead to greater efficiency for taxpayers that must comply with FIN 48.

3. Overcoming Objections

Some tax practitioners may argue there are problems with increasing the taxpayer standard to "more likely than not." They contend the amendment to § 6694 created these problems. Under the proposal, the taxpayer standard would also be "more likely than not." These potential problems include: (1) difficulty in determining whether a position fulfills the "more likely than not" standard, (2) administrative burden from the likely increased number of disclosures, and (3) courts construing disclosure as a concession on the merits. In the following paragraphs, this Note discusses and then rebuts these contentions.

Some tax lawyers opine the most significant problem with the amendment to § 6694 is that practitioners will have difficulty deciding whether a court will more likely than not sustain the position on the merits.²³⁴ Tax lawyers argue there are not clear answers to many issues facing tax return preparers.²³⁵ Thus, under the proposal, some tax lawyers may argue both the taxpayer and tax return preparer standards are difficult to determine.

Return preparers needed to determine whether the position had substantial authority or a realistic possibility before the amendment to § 6694.²³⁶ In most situations, it is unclear why it is more difficult for return preparers to determine whether a position has more than a fifty percent likelihood of success as opposed to meeting the thirty-three and one third percent or forty percent likelihood. A return preparer would have difficulty determining if the "more likely than not" standard is fulfilled in several instances. One example occurs when there is exactly a fifty percent likelihood of success on the merits. This could arise with a circuit split, which commonly occurs in tax law.²³⁷ In this scenario, a po-

U.S. 522, 542-43 (1979). Financial accounting's purpose is to provide information to investors, creditors, and other interested parties. *Id.* at 542. The purpose of the tax system "is the equitable collection of revenue." *Id.* Legal commentators, however, do argue for more book-tax conformity in the U.S. tax system. See Celia Whitaker, Comment, *Bridging the Book-Tax Accounting Gap*, 115 *YALE L.J.* 680, 714 (2005); Dustin Stamper, *supra*.

233. Companies hire tax lawyers to prepare tax opinions that satisfy FIN 48. Click, *supra* note 163.

234. Lipton, *supra* note 72, at 72; Blend & American Bar Association, *supra* note 28.

235. Lipton, *supra* note 72, at 72.

236. See I.R.C. § 6662(d)(2)(B)(i) (2000); I.R.C. § 6694(a)(1) (2000).

237. Jeffrey S. Kinsler, *Circuit-Specific Application of the Internal Revenue Code: An Unconstitutional Tax*, 81 *DENV. U. L. REV.* 113, 137 n.197 (2003).

sition would not meet “the more likely than not” standard but would meet the “substantial authority” or “realistic possibility” standards. When the authority is equal, tax return preparers would likely have to disclose the position.

Another example of when tax practitioners would have difficulty determining whether a position satisfies the “more likely than not” standard is when there are three equally possible treatments of an item. This situation could arise when a tax return preparer cannot determine whether an expense should be deducted, capitalized, or neither.²³⁸ In this circumstance, none of the three positions would fulfill the “more likely than not” standard or the “substantial authority” standard. On the other hand, the positions would meet the “realistic possibility” threshold. As a result, tax return preparers may have difficulty, in some situations, determining whether a position has fulfilled the “more likely than not” standard as opposed to the other standards. Although this may lead to more disclosed positions, it should not prevent the standard from being “more likely than not.”

The increased standard to “more likely than not” may lead to increased disclosed positions. Increased disclosures results from the difficulty in determining whether the “more likely than not” standard is satisfied. Tax return preparers are likely to disclose many positions on the returns rather than face penalties, thus flooding the IRS with disclosures.²³⁹ The current system is incapable of processing a huge increase in disclosures.²⁴⁰ As a result, the excessive disclosures would “defeat[] the purpose of the disclosure system.”²⁴¹

Even though it may be costly, the IRS could adopt measures to allow it to handle more disclosures. The increased disclosures may also be beneficial to the IRS. They may supply a good source of information from which the IRS could determine where it needs to provide additional guidance.²⁴² Therefore, increased disclosures may be more beneficial than burdensome.

Some tax professionals are concerned that a disclosure under the new “more likely than not” standard is a concession on the merits.²⁴³ This problem arises when the IRS disagrees with a position that the taxpayer has disclosed after the taxpayer sought advice from a return preparer. While advocating for the client, the tax lawyer may have to admit the weight of authority is with the IRS. If there is authority on a posi-

238. See I.R.C. § 162 (2000) (allowing deductions); I.R.C. § 263 (2000) (allowing capitalization of expenses).

239. Lipton, *supra* note 72, at 73.

240. American Institute of Certified Public Accountants, *supra* note 92; Russell, *supra* note 102 (quoting Tom Ochenschlager, the AICPA’s vice president of taxation).

241. American Institute of Certified Public Accountants, *supra* note 92.

242. See N.Y. ST. B.A., *supra* note 215, at 17.

243. See American Institute of Certified Public Accountants, *supra* note 92.

tion and it is on the side of the taxpayer, the taxpayer would not likely have disclosed the position.

To remedy this problem, Congress could adopt a rule preventing the IRS from using the disclosure for evidence. This would allow a tax return preparer to argue the weight of authority supports the tax position taken even though the taxpayer disclosed the position on the tax return. This proposed rule serves a similar rationale as Federal Rule of Evidence (FRE) 408, which prohibits a party from admitting evidence of a compromise offer to prove liability.²⁴⁴ FRE 408’s purpose is to facilitate compromise and the settlement of disputes.²⁴⁵ Likewise, the proposed rule would facilitate full disclosure of the position on the return, but would not prevent a taxpayer from stating that the weight of authority supports the position at trial.

In summary, there are potential drawbacks to increasing the taxpayer standard to “more likely than not.” These possible problems include the difficulty in determining whether a position fulfills the “more likely than not” standard, the administrative burden from the likely increased number of disclosures, and courts construing a disclosure as a concession on the merits. The benefits of reducing the negative perception of the tax system and aligning the tax penalty standards with the accounting standard for uncertain tax positions, however, outweigh any disadvantages.

IV. CONCLUSION

The IRS, the Treasury, academia, and private practice have all acknowledged the huge impact of the § 6694 amendment. The most significant problem of the amendment is that it created a conflict of interest between a tax return preparer and a taxpayer. To resolve this problem, tax return preparer and taxpayer standards should be the same. Congress should increase the taxpayer standard to “more likely than not” to equal the amended § 6694 tax return preparer standard. This would increase the perception of the fairness of the U.S. tax system. It would also make the tax penalty sections parallel with the accounting standard for uncertain tax positions.

244. See FED. R. EVID. 408.

245. FED. R. EVID. 408 advisory committee’s note.