REPORT #558

TAX SECTION

New York State Bar Association

Comments on Proposed Modification
Of Circular 230

February 13, 1987

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TAX SECTION
EXECUTIVE COMMITTEE
1987-1988

DONALD SCHAPIRO
Chairman
26 Broadway
New York, NY 1004

REPORT # 558

New York State Bar Association

February 18, 1987

BY FEDERAL EXPRESS

The Honorable J. Roger Mentz
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 Main Treasury Building
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Dear Roger:

The enclosed report of the New York State Bar Association Tax Section comments on proposed modifications to Circular 230 published on August 14, 1986 by the Department of the Treasury.

The report recommends that the proposed modifications to Circular 230 be withdrawn. We have suggested that an appropriate fault-based standard be substituted as a basis for suspension or disbarment of tax practitioners.

I hope the report is useful to you.

Sincerely,

Donald Schapiro

Enclosure

TAX SECTION
EXECUTIVE COMMITTEE
1987-1988

DONALD SCHAPIRO
Chairman
26 Broadway
New York, NY 1004

New York State Bar Association

February 18, 1987

BY FEDERAL EXPRESS

The Honorable Laurence B. Gibbs
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, DC 120224

Dear Larry:

The enclosed report of the New York State Bar Association Tax Section comments on proposed modifications to Circular 230 published on August 14, 1986 by the Department of the Treasury.

The report recommends that the proposed modifications to Circular 230 be withdrawn. We have suggested that an appropriate fault-based standard be substituted as a basis for suspension or disbarment of tax practitioners.

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Sincerely,

Donald Schapiro

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EXECUTIVE COMMITTEE
1987-1988

DONALD SCHAPIRO
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26 Broadway
New York, NY 1004

New York State Bar Association

February 18, 1987

BY FEDERAL EXPRESS

William F. Nelson, Esq.
Chief Counsel
1111 Constitution Avenue, N.W.
Washington, DC 140224

Dear Bill:

The enclosed report of the New York State Bar Association Tax Section comments on proposed modifications to Circular 230 published on August 14, 1986 by the Department of the Treasury.

The report recommends that the proposed modifications to Circular 230 be withdrawn. We have suggested that an appropriate fault-based standard be substituted as a basis for suspension or disbarment of tax practitioners.

I hope the report is useful to you.

Sincerely,

Donald Schapiro

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TAX SECTION
EXECUTIVE COMMITTEE
1987-1988

DONALD SCHAPIRO
Chairman
26 Broadway
New York, NY 1004

New York State Bar Association

February 13, 1987

Mr. Leslie S. Shapiro
Director of Practice
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Attn: PM:HRMS:DP

Dear Mr. Shapiro:

The enclosed report of the New York State Bar Association Tax Section comments on proposed modifications to Circular 230 published on August 14, 1986 by the Department of the Treasury.

The report recommends that the proposed modifications to Circular 230 be withdrawn. We have suggested that an appropriate fault-based standard be substituted as a basis for suspension or disbarment of tax practitioners.

I hope the report is useful to you.

Sincerely,

Donald Schapiro
Chairman

Enclosure

REPORT #558

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

Comments on Proposed Modification Of Circular 230

February 13, 1987

This report was written by Sterling L. Weaver and Anne M. Barr. Helpful comments were received from Thomas V. Glynn, James S. Halpern, Sidney I. Roberts, Michael I. Saltzman & David E. Watts.

INTRODUCTION

On August 14, 1986 the Treasury Department published proposed modifications to Circular 230, which governs practice before the Internal Revenue Service. The proposed modifications would make three changes to Circular 230. The first modification is a requirement that tax practitioners exercise due diligence in giving advice regarding positions to be taken on Federal tax returns and other documents relating to the tax system. The second modification provides requirements for practitioners to follow in a situation where the provisions of Section 6661 of the Internal Revenue Code may apply. The third modification makes the duties and restrictions relating to practice before the Internal Revenue Service applicable to practitioners' personal tax matters.

The Supplementary Information section of the proposed modifications to Circular 230 states that a practitioner owes a client confidence, loyalty and confidentiality, but that a practitioner also has responsibilities to the tax system. The Supplementary Information section also sets forth the following positions:

(1) a tax return is not a submission in an adversary proceeding, but is a taxpayer's report to the government of the taxpayer's relevant activities for the year;

(2) to be a fair report, the tax return must accurately reflect the facts and positions taken on the tax return must be supportable by the law; and

(3) a tax practitioner, during an engagement with a client, has an affirmative duty to assure that the tax return accurately reflects the facts and that positions taken on the tax return are supportable by the law.

The Supplementary Information section states that the Internal Revenue Service recognizes that it may be difficult for a practitioner to carry out his responsibilities to the client and the tax system and that in situations in which it is difficult to carry out both of these responsibilities, a practitioner's obligation to the tax system is paramount.

For the reasons set forth below, we recommend that the modifications proposed in Circular 230 not be adopted and that an appropriate fault based standard be substituted as a basis for suspension or disbarment.

DETAILED ANALYSIS OF THE PROPOSED MODIFICATIONS

The first proposed modification of Circular 230 involves Section 10.22, which deals with due diligence.

Section 10.22 currently provides that practitioners shall exercise due diligence:

> (1) in preparing, assisting in the preparation of, approving and filing returns, documents, affidavits and other papers relating to Internal Revenue Service matters;
>
> (2) in determining the correctness of representations, oral or written, made by the practitioner to the Treasury Department; and
>
> (3) in determining the correctness of representations, oral or written, made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service.

The proposed change to Section 10.22 would add a fourth requirement that practitioners exercise due diligence in advising clients about positions taken with respect to the tax treatment of all items on returns. The Internal Revenue Service states that this new requirement may already be required by Circular 230 and states that the change is made to “punctuate the link between a practitioner's responsibility to exercise due diligence and his or her responsibility to adhere to the compliance provisions of the Internal Revenue Code.”

The Supplementary Information section of the proposed modifications to Circular 230 provides that the due diligence requirement will not be met unless a reporting position is reasonable, meritorious, and made in good faith.

The due diligence requirement is not met if a reporting position is advanced principally to exploit the audit selection process, to serve as leverage in a settlement negotiation within the Internal Revenue Service, to avert a successful charge that the return is false and fraudulent, or is a reporting position that has no practical or realistic possibility of being sustained in the courts.

The second proposed modification would add new Section 10.34 to Circular 230 requiring that in advising a taxpayer about the treatment of any item on a return, a practitioner must comply with the following requirements:

(1) a practitioner must advise a client about the Section 6661 penalty if, in the exercise of due diligence, the practitioner determines that the taxpayer may be liable for the Section 6661 penalty as a result of a position taken on the taxpayer's return;

(2) a practitioner may not recommend to a client that a certain position be taken on a tax return unless, in the exercise of due diligence, the practitioner determines that the taxpayer will not be liable for the Section 6661 penalty as a result of the position; and

(3) a practitioner may not prepare or sign a return unless, in the exercise of due diligence, the practitioner determines that the taxpayer will not be liable for the Section 6661 penalty as a result of a position taken on the return.

In summary, proposed Section 10.34 provides that a practitioner should not, in the exercise of due diligence, place his or her client in the position of being assessed a Section 6661 penalty. The Supplementary Information section of the proposed modifications to Circular 230 states that the Internal Revenue Service believes that proposed Section 10.34 is a requirement of current regulations; but due to the importance of the compliance principle on which Section 6661 is based, it is necessary to address this section in Circular 230.

Section 6661 imposes a penalty for a substantial understatement of income tax liability. The penalty does not require the personal fault of the taxpayer. If there is an understatement of tax in excess of 10%, the taxpayer is liable for the penalty, whatever the taxpayer's state of mind; however, the penalty may be waived if the taxpayer can establish that there was reasonable cause for the understatement and that the taxpayer acted in good faith. In the case of a non-tax shelter item, the penalty can be avoided if the underpayment resulted from a reporting position for which the taxpayer had “substantial authority” or the taxpayer “adequately disclosed” the issue to the Internal Revenue Service. In the case of a tax shelter item, the Section 6661 penalty can be avoided if there was

both substantial authority for the position and a reasonable belief that the tax treatment of the item was “more likely than not” correct.

Regulations interpreting the substantial authority standard provide that there is substantial authority for a position only if after a review of all relevant authority, the weight of the authorities that support the treatment given the item on the tax return is substantial in relation to the weight of authority supporting contrary positions. Section 1.6661-3(b)(1), Income Tax Regs. The substantial authority standard is stricter than the “reasonable basis” standard but is less stringent that the “more likely than not” standard (defined as a greater-than-50% likelihood of being sustained in litigation). Section 1.6661-3(a)(2), Income Tax Regs. The following authorities may be relied upon: statutes; temporary and final (but not proposed) regulations; court cases; administrative pronouncements including revenue rulings and revenue procedures; tax treaties, related regulations, and official explanations thereof; and congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, or floor statements of a bill

manager made prior to enactment. The following may not be relied upon: treatises, periodicals, opinions of tax professionals, general counsel memoranda published after 1955, actions on decisions, technical memoranda, written determinations (not issued to the taxpayer), and congressional descriptions of statutes prepared after enactment. Section 1.6661-3(b)(2), Income Tax Regs. The substantial authority must exist at the time the return is filed or at the close of the year to which the return relates. Section 1.6661-3(b)(4)(iii), Income Tax Regs.

For non-tax shelter items, the Section 6661 penalty may also be avoided if there is adequate disclosure of the item. The disclosure may be made on the return or in a statement attached to the return. Section 1.6661-4(a), Income Tax Regs. The Internal Revenue Service may by revenue procedure prescribe the circumstances in which disclosure on the return will be adequate. Section 1.6661-4(c), Income Tax Regs. Statements attached to a tax return must clearly indicate that a Section 6661 disclosure is involved. Section 1.6661-4(b), Income Tax Regs.

To avoid the Section 6661 penalty for t a x shelter items, there must be substantial authority for the treatment of the item and the taxpayer must have a reasonable belief

that the treatment was “more likely than not” the correct tax treatment. Section 6661(b)(2)(C). The more likely than not standard requires that the taxpayer must conclude, based on the substantial authority standard as well as the pertinent facts, that as of the date the return is filed the position stands a better than 50% chance of prevailing if litigated. Section 1.6661-5(a)(1), Income Tax Regs.

The third and final proposed modification involves the title of Subpart B - “Duties and Restrictions Relating to Practice Before the Internal Revenue Service.” This title would be revised to read as follows: “Duties and Restrictions Relating to Those Eligible to Practice Before the Internal Revenue Service.” This change is designed to make it clear that Subpart B of Circular 230 applies to practitioners’ personal tax matters in addition to those of clients.

DISCUSSION

The proposed addition of Section 10.34 (involving the Section 6661 penalty) and the proposed modification of Section 10.22 (involving due diligence) are inappropriate for the purpose to be accomplished. The proposed modification of the

title to Subpart B of Circular 230 (dealing with duties and responsibilities relating to practice before the Internal Revenue Service) is a substantive change and should be implemented, if at all, through an amendment to the body of Circular 230. Each of the proposed modifications will be discussed separately.

A violation of the requirements of Circular 230 has previously depended on a tax practitioner willfully or knowingly acting or failing to act. By tying disbarment of a tax practitioner under proposed Section 10.34 to a taxpayer's understatement of tax, the Internal Revenue Service has assumed the power to disbar a tax practitioner without proof of fault. The use of such a no-fault standard, the Section 6661 penalty, to discipline tax practitioners is inappropriate. Using a no-fault penalty applicable to taxpayers to create standards governing tax practitioners is questionable as a technical matter because the Internal Revenue Code already imposes penalties on return preparers for negligent or fraudulent conduct in return preparation resulting in a taxpayer's understatement of tax (Section 6694) and on any person (including a return preparer) who aids and abets in the understatement of tax liability (Section 6701). Both of these penalties are applicable to return

preparers and require negligence and purposeful conduct or knowledge before the penalties are imposed.

Proposed Section 10.34 would take a civil penalty provision for taxpayers (Section 6661) and expand its scope by making it a disciplinary provision for tax practitioners. A practitioner violating proposed Section 10.34 could be barred from practice before the Internal Revenue Service; conceivably, a tax practitioner could be barred from practicing before the Internal Revenue Service for a single violation of the new section. Although taxpayers can have the Section 6661 penalty waived upon a showing that there was reasonable cause for the understatement and that the taxpayer acted in good faith, there is no such relief provision in Section 10.34 for tax practitioners. The livelihood of tax practitioners would be at risk based upon a standard created only four years ago (Section 6661 was added by the Tax Equity and Fiscal Responsibility Act of 1982), which was enacted to provide an economic deterrent to taxpayers playing the audit lottery, and based upon regulations interpreting this standard that were adopted only two years ago (March 1985). Staff of Joint Committee on Taxation, 97th Cong., 2d Sess., General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982, 216 (1982). In addition,

by incorporating the Section 6661 regulations in Circular 230, the Treasury Department is holding tax practitioners to interpretations of Section 6661 that are not law and are not binding on a court.

Proposed Section 10.34 imposes an unfair and unworkable standard on tax practitioners due to the uncertainties of a constantly changing tax law. Proposed Section 10.34 is unworkable because a tax practitioner cannot know with certainty that a position taken on a tax return will or will not result in a Section 6661 penalty. Often there are conflicting or changing authorities on an issue, or, there is no authority other than the statute on an issue, especially with newly enacted legislation. For example, the new passive loss rules in the Tax Reform Act of 1986 (the “1986 Act”) involves such a substantial authority problem. Presumably the Internal Revenue Service will issue some guidelines regarding the passive loss rules in time to prepare 1987 returns. However, if an issue arises that is not covered in the guidelines, the statute, or the legislative history, how would proposed Section 10.34 be applied in such a situation? Could a tax practitioner be subject to discipline even though the questioned position is upheld by a court? With the large amount of recently enacted legislation and the likely

prospect of additional legislative changes, these are important questions.

Another situation in which it is difficult to apply the substantial authority standard involves technical corrections. For example, the Tax Reform Act of 1984 (the “1984 Act”) contained a provision that prevented taxpayers subject to the alternative minimum tax for carrying forward or back unusable credits to other years. In January 1985, Senate Majority Leader Robert Dole sent a letter to Treasury Secretary Regan referring to this provision as a drafting error and stating that he thought the error was not controversial and would be corrected as part of a technical corrections bill for the 1984 Act. Senator Dole also stated that he hoped the Treasury would administer the law as though the error had not occurred. On March 28, 1985 a technical corrections bill was introduced in the House and Senate which contained a section correcting the alternative minimum tax drafting error. However, the alternative minimum tax drafting error was not corrected until October 22, 1986, when the 1986 Act was enacted. How would proposed Section 10.34 be applied in this type of situation? Would the letter from Senator Dole requesting the Treasury Department to administer the law as though the

drafting error had not occurred and/or the introduction of technical correction bills in the House and Senate provide the certainty required under proposed Section 10.34 that a Section 6661 penalty will not be imposed if a return is filed that ignores the drafting error?

Proposed Section 10.34 would also be difficult to apply when there are changing authorities on an issue. An example of changing authorities can be found in the straddle area. As of August 1984, two Tax Court cases and temporary regulations had firmly established that losses resulting from a straddle were deductible under Section 165(c) only if the taxpayer had a profit motive (a subjective test) for entering into the transaction. Smith v. Commissioner, 78 T.C. 350 (1982); Fox v. Commissioner, 82 T.C. 1001 (1984); Section 1.165-13T, Temporary Income Tax Regulations, T.D. 7968, filed August 21, 1984. However, in May 1985 the Tax Court held that losses from a straddle transaction could be deducted if there was a reasonable prospect of any profit from the transaction (an objective test). Miller v. Commissioner, 84 T.C. 827 (1985). How would proposed Section 10.34 be applied when positions on an issue change?

Tying the disbarment of a tax practitioner to a taxpayer's understatement of tax could provide the

Internal Revenue Service with additional bargaining power in settlement negotiations at the audit and appeals level. An Internal Revenue Service agent or appeals officer might threaten to make a complaint for a violation of proposed Section 10.34 to force the tax practitioner to advise his client to accept the Internal Revenue Service's determination of the amount due. This would adversely interfere with a tax practitioner's duty of loyalty to his client by encouraging the tax practitioner to act in his own best interest, not the client's best interest.

The Supplementary Information section of the proposed changes to Circular 230 provides that for the due diligence requirement imposed by the proposed modification to Section 10.22 to be satisfied, the practitioner must be assured that a reporting position is in compliance with and supportable by the revenue laws, and that unless the position is reasonable, meritorious and made in good faith, a tax practitioner has not exercised the required due diligence. Thus, the Internal Revenue Service has extended the use of the due diligence standard, which is usually a standard applied to the duty to investigate the accuracy of given facts or the duty to ascertain the relevant law pertaining to an issue, to the process of applying the law to the facts.

Even if the use of a due diligence standard is sometimes appropriate in the context of applying the law to the facts, the Internal Revenue Service's proposed application of the due diligence standard is inappropriate. According to the Internal Revenue Service, the due diligence requirement is not met unless the tax practitioner has assured himself that the reporting position is in compliance with and supportable by the revenue laws. Thus, it appears that a tax practitioner cannot meet the due diligence standard unless he is certain that a reporting position is correct.

The proposed modification to Section 10.22 suffers from the same flaw as proposed Section 10.34; each imposes an unworkable requirement that tax practitioners must be certain to meet. As previously discussed, it is common to have conflicting or changing authority on an issue, or there may be no authority on an issue, especially with newly enacted legislation. Under such circumstances, certainty regarding a reporting position is rarely possible.

In addition to the numerous problems with the application of proposed Section 10.34 and the proposed modification to Section 10.22, these provisions are unlikely to have the desired effect of substantially

discouraging aggressive reporting positions on tax returns. More likely, they will simply encourage taxpayers to find more aggressive advisors. What is more, these provisions are not needed because Congress has enacted various penalties to be imposed upon taxpayers adopting aggressive and inappropriate reporting positions. A Special Committee on the Lawyer's Role in Tax Practice of The Association of the Bar of the City of New York, has stated that it does not believe that the adoption of ethical rules by professional groups will curtail aggressive reporting positions. The Lawyer's Role in Tax Practice, 36 Tax Lawyer 865, 882-883 (1983). Instead, the Special Committee believed that the Congress should enact provisions such as Section 6661 (providing a penalty for substantial understatements of tax) and Sections 6621 and 6622 (providing for interest on tax deficiencies at market rates, determined quarterly, and compounded daily) to discourage taxpayers from taking aggressive reporting positions. Id. With the recent substantial increases in the Section 6661 penalty and the fraud penalty, any need for the proposed changes is eliminated.

The proposed modification of the title of Subpart B of Circular 230 is an attempt to make a substantive change

to the duties and restrictions relating to practice before the Internal Revenue Service. According to the Supplementary Information section of the proposed modifications to Circular 230, this change would apply the regulations under Subpart B to tax practitioners’ personal tax matters. Since Subpart B would contain modified Section 10.22 and proposed Section 10.34, a tax practioner could be disbarred if the requirements of modified Section 10.22 and proposed Section 10.34 are not met with respect to the tax practitioner's personal return. Any addition of such a requirement should be clearly set forth in a regulation, not indirectly added by a title change.

RECOMMENDED ALTERNATIVE APPROACH

Changes to Circular 230 designed to discourage aggressive reporting positions by taxpayers are not needed due to the enactment by Congress of numerous provisions imposing substantial penalties on taxpayers adopting aggressive reporting positions. The proposed modifications to Circular 230 should be withdrawn.

An alternative to the proposed modifications to Circular 230 which might be considered is the standard adopted by

the American Bar Association Ethics Committee in Formal Opinion 85-352, dated July 7, 1985, modified to reflect that the standards would be applicable to non-lawyers as well as lawyers practicing before the Internal Revenue Service.

Formal Opinion 85-352 provides that a lawyer may advise a reporting position on a tax return so long as the lawyer believes in good faith that the position is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law and there is some realistic possibility of success if the matter is litigated. To provide a meaningful standard for all tax practitioners, not just tax lawyers, the “some realistic possibility of success if the matter is litigated” standard might be modified to provide “some realistic possibility of success upon the final determination of the matter.”

Prior to Formal Opinion 85-352 the ethical obligations of lawyers engaged in tax practice were set forth in Formal Opinion 314, dated April 27, 1965. Formal Opinion 314 established a reasonable basis standard as the minimum standard for advice with respect to a position on a tax return. The reasonable basis standard has been construed by many lawyers to support the use of

any colorable claim on a tax return, which created doubt about the validity of the standard as an ethical guideline, so Formal Opinion 85-352 was issued.

Formal Opinion 85-352 restates a tax lawyer's duty in advising a client as to positions to be taken on a tax return. The principles of Formal Opinion 85-352 also apply to all aspects of tax practice to the extent tax return positions are involved, such as tax advice given when structuring a transaction that will involve a tax return position.

Pursuant to Formal Opinion 85-352, a lawyer may advise taking a position most favorable to the client if the lawyer has 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 a reversal of existing law even though the attorney believes the position taken probably will not prevail. An objective, fault-based standard is used to determine the issue of good faith. Good faith requires that there be some realistic possibility of success if the matter is litigated. The probability of the return being audited is not a factor in determining the presence of good faith. According to a special task force report on Formal Opinion 85-352, a position having only a 5% or 10% likelihood of success if litigated

will not meet the good faith standard, but a position having a likelihood of success approaching 33% should meet the good faith standard. Sax, Report of the Special Task Force on Formal Opinion 85-352, 39 Tax Lawyer 635, 638-639 (1986).

Under Formal Opinion 85-352, the lawyer should advise the client of any potential penalty under Section 6661 and of the opportunity to avoid this penalty by disclosure. Unlike Section 6661, if a position taken on a return meets the good faith standard, the lawyer has no obligation to flag a doubtful position on the return, but the lawyer is under a duty not to mislead the Internal Revenue Service deliberately, either by misstatements, by silence, or by permitting the client to mislead.

Our Executive Committee does not endorse any specific standard to be employed instead of that set forth in the proposed changes to Circular 230. However, we endorse the concept that an appropriate fault based standard be substituted for that contained in the proposed modifications to Circular 230 as a basis for suspension or disbarment.

In addition, it should be made clear in any final version of the proposed modifications to Circular 230 that one violation of the proposed modifications will not

result in the suspension or disbarment of a tax practitioner. Instead, any suspension or disbarment of a tax practitioner for violating the proposed modifications should be based upon a course of conduct, not an isolated event.

As a final matter, whatever modifications to Circular 230 are adopted, we recommend that an independent tribunal with a trial de novo should be utilized to adjudicate complaints of violations of the requirements of Circular 230. Since a violation could result in the tax practitioner being suspended or disbarred from practice before the Internal Revenue Service, a tribunal independent of the Treasury Department is needed to guarantee an impartial decision.

Exhibit F

Section 704(c):

Guidance is needed as to:

Accounting for the difference between basis of property contributed to the partnership and its fair market value at time of contribution (a) when on partner contributes property and another contributes cash and (b) when each of two partners contributes property.

Brief Description of Guidance Suggested:

See May 7, 1985 New York State Bar Association report, copy of which is attached as Exhibit S. These issues have become much more important in practice as more businesses have formed joint ventures; with the repeal of the General Utilities doctrine; and as a result of the 704(b) Regulations' references to Section 704(c).

"Exhibit F"