NYSBA

New York State Bar Association

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January 28, 2008

The Honorable Charles B. Rangel
Chairman
House Committee on Ways and Means
2354 Rayburn House Office Building
Washington, D.C. 20515-3215

The Honorable James McCrery
Ranking Member
House Committee on Ways and Means
2354 Rayburn House Office Building
Washington, D.C. 20515-3215

The Honorable Max S. Baucus
Chairman
Senate Committee on Finance
511 Hart Senate Office Bldg
Washington, D.C. 20510

The Honorable Charles E. Grassley
Ranking Member
Senate Committee on Finance
135 Hart Senate Bldg.
Washington, DC 20510-1501

Re: Recent and Proposed Statutory Changes to Tax Return Preparer Penalty Rules of Internal Revenue Code Section 6694 and Related Issues [1]

Dear Sirs:

On behalf of the New York State Bar Association Tax Section, I am writing to express our concern regarding a significant problem that we believe results from the statutory revisions, enacted in May 2007, to the

[1] This letter was prepared by an ad hoc committee of the Tax Section of the New York State Bar Association (the "Tax Section"), consisting of Melissa Blades, Ellen Brody, Peter Connors, Michael Farber, Patrick Gallagher, Lawrence Hill, Liz Kessenides, Stephen Land, David Mayo, William McRae, Elliot Pisem, Joel Scharfstein, Michael Schler, David Sicular, Bryan Skarlatos and Diana Wollman, with input from the Tax Section's Executive Committee. Diana Wollman and Patrick Gallagher were the principal drafters. The comments in this letter are made solely on behalf of the Tax Section and not on behalf of the New York State Bar Association as a whole (which would require approval by its House of Delegates).

Internal Revenue Code's "tax return preparer" rules.[2] The statutory revisions subject tax return preparers to a stricter standard (under Section 6694[3]) than their taxpayer clients are subject to (under Section 6662). That is, preparers need a higher level of substantive support for positions taken on a tax return (to avoid a monetary penalty being imposed on the preparer[4]) than taxpayers need (to avoid a monetary penalty being imposed on the taxpayer). We believe the difference in standards is problematic and undermines fundamental aspects of our Federal tax system and the proper role of tax advisors in that system, as we attempt to set out in this letter.

As we explain in more detail below, the new rules have created a situation in which a tax return that is permissible and appropriate for a taxpayer to file may not be one that a tax return preparer is permitted to prepare for that taxpayer. This creates an inappropriate dilemma for a tax return preparer who wants to avoid having to pay a monetary preparer penalty (and the other possible negative consequences of having been found liable for such a penalty) and who now has a powerful incentive to focus more on his own self-interest than on his taxpayer-client's interests. This conflict of interests creates serious problems for taxpayers and for preparers. In addition, such a conflict cannot be beneficial for a system like ours that relies so heavily on preparers to help taxpayers comply with their obligations under the law.

This letter is divided into the five parts:

I. INTRODUCTION

We recently submitted to the Treasury Department and the Internal Revenue Service (the "IRS") a comprehensive New York State Bar Association Tax Section report (the "Report") on

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2 These changes were contained in §8246 of the *U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007*, Subtitle B Small Business and Work Opportunity Tax Act of 2007 (Pub. L. No. 110-28) ("H.R. 2206").

3 All "Section" references herein are to sections of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise noted.

4 As explained below, the immediate effect of being found in violation of Section 6694 is a monetary fine, but there are secondary or collateral effects that can be far more harmful to a preparer.

the tax return preparer rules,[5] which included our recommendations for how those rules (as amended by H.R. 2206) could be interpreted and applied in administrative guidance to alleviate some of the difficulties caused by the statutory amendments. The Report, together with its "Appendix Describing Rules, Their History and Other Background" (the "Appendix"), contains a detailed discussion of the new standards under Section 6694, the history of the return preparer rules, various other rules applicable to tax advisors, and other related and important matters. We have attached the Report and Appendix to this letter because we believe they provide helpful background to the issues we are addressing here. In addition, we note that many other organizations and individuals have written to you or the Treasury Department and IRS regarding this matter.

On December 31, 2007, the Treasury Department and IRS issued interim guidance relating to the revised tax return preparer rules in the form of three Notices (the "December 2007 Notices").[6] These Notices stated that the Treasury Department and the IRS intend to "revise the regulatory scheme governing tax return preparer penalties" during 2008, thereby replacing the Notices with more permanent rules, and requested further comments to assist in that endeavor. We intend to make ourselves available to provide whatever additional assistance we can to the Treasury Department and the IRS. Nevertheless, the problems we are addressing in this letter emanate from the statute, and we believe that no regulatory guidance could fully resolve them.[7]

II. BACKGROUND ON THE PENALTY RULES AND WHAT WE MEAN BY "STANDARD"

A. Why the Code Imposes Penalties on Taxpayers with Understatements

The Code's penalty rules reflect the fact that the U.S. Federal tax rules are uncertain. A taxpayer who is found to have shown less taxes on his return than were properly due (in Code parlance, the taxpayer had an "understatement") is required to pay the previously-unpaid taxes, interest on those unpaid taxes, and an understatement penalty (usually 20% of the unpaid taxes)[8] *unless* the return position that produced the understatement had at least a specific degree of

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5 New York State Bar Association Tax Section, Report No. 1139, "Report on the Definition of 'Tax Return Preparer' and Other Issues Under Code Sections 6694, 6695 and 7701(a)(36)" (December 20, 2007), available at www.nysba.org /Content/ContentFolders20/TaxLawSection/TaxReports/Report1139.PDF.

6 Notices 2008-11, 2008-12 and 2008-13, available at www.irs.gov/pub/irs-drop/n-08-11.pdf, www.irs.gov/pub/irs-drop/n-08-12.pdf, and www.irs.gov/pub/irs-drop/n-08-13.pdf.

7 As discussed further in IV and V below, a bill that would further modify the Section 6694 return preparer penalty rules (H.R. 4318) was introduced December 6, 2007.

8 The 20% penalty is imposed by Section 6662(a); a 40% penalty applies to some understatements (*see* Section 6662(e)). An even higher penalty applies to civil fraud (*see* Section 6663); we are not addressing that penalty here nor are we addressing the penalties applicable to criminal fraud.

support.[9] Although the position turned out, in the end, to be incorrect, the taxpayer is essentially excused if the position had enough support to be an "acceptable" return filing position.

These penalty rules exist to give taxpayers an incentive to self-assess the correct amount of tax. In a self-assessment system like ours, the government will be unlikely to collect the full amount of taxes that are due if taxpayers do not face a penalty for failing to self-assess correctly. But, because the law is uncertain, it is considered to be unfair to penalize a taxpayer who made an honest attempt to self-assess correctly, but happened to be incorrect. Thus, an understatement is "excused" if the position had a certain degree of substantive support.

B. Summary of the Understatement Penalty Rules Applicable to Taxpayers

The rules establishing how much support a position must have for a taxpayer to avoid an understatement penalty are found in Sections 6662, 6664 and 6662A, and in summary are as follows:

1. Tax avoidance transactions. If the understatement arises from

(i) a "plan or arrangement" that has as "a significant purpose ...the avoidance or evasion of Federal income tax",[10]

(ii) a "listed transaction", or

(iii) a "reportable transaction" that has as "a significant purpose ...the avoidance or evasion of Federal income tax",[11]

then the only possible defense is the "reasonable cause ... and ... good faith" defense found in Sections 6664(c) and (d). For ease of reference, we will refer to these three types of transactions as "tax avoidance transactions".

In the case of a tax avoidance transaction, this reasonable cause and good faith defense generally requires proving, at a minimum, that (i) the position was supported by "substantial authority" and (ii) the taxpayer reasonably believed that the position would more likely than not

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9 For most transactions this understatement penalty does not apply unless the total dollar amount of understatements on the return for which there was not the requisite degree of support exceeds a specified threshold amount (*see* Sections 6662(d)(1) and (2)); and for some transactions a taxpayer also has available a facts-and-circumstances-based "reasonable cause ... and good faith" defense (*see* Section 6664(c)).

10 This is sometimes referred to as "Section 6662(d) tax shelter" because this special rule is found in Section 6662(d)(2)(C).

11 The terms "listed transaction" and "reportable transaction" refer to those transactions that are required to be specially reported by the taxpayer under Section 6011.

be sustained on the merits ("MLTN"); even when these two minimum requirements are met, other factors will be considered as well.[12] Most people refer to this as the "MLTN defense".[13]

2. Non-tax-avoidance transactions. In contrast, in non-tax-avoidance transactions, the taxpayer has two additional defenses, each different from the MLTN defense, which excuse an understatement if the position taken on the return was:

(i) supported by "substantial authority", or

(ii) supported by "a reasonable basis" and was "adequately disclosed" in the tax return.[14]

"Adequate disclosure" generally means that the return includes a special IRS Form 8275, which, the IRS instructions accompanying the Form say, must include "1. A description of the relevant facts and the nature of the controversy affecting the tax treatment of the item," and "2. A concise description of the legal issues presented by these facts."[15] This IRS Form 8275 "flags" or "highlights" the transaction for the IRS. Essentially under these rules, in exchange for including this disclosure, the standard of support required is reduced (from substantial authority to reasonable basis).

The terms "substantial authority", "MLTN", and "reasonable basis" have developed very specific meanings in the tax arena. Generally "reasonable basis" means at least a 20% likelihood of success if challenged; "substantial authority" means at least a 40% likelihood of success if challenged; and "MLTN" means a more than 50% likelihood of success if challenged.[16]

C. Summary of the Section 6694 Penalty Rules Applicable to Tax Return Preparers

A different penalty is provided for a person who is considered a "tax return preparer" of any tax return which contains an understatement. This penalty is imposed by Section 6694. As explained in detail in the Report (Part III.A.1. and 4.), the term "tax return preparer" is generally defined in the applicable Treasury Regulations as including a person who physically prepares the

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12 *See* Treas. Regs. §1.6664-4(f) (applicable to corporate taxpayers for an understatement arising from a Section 6662(d) tax shelter); Section 6664(d)(2) (for an understatement arising from a reportable or listed transaction).

13 For transactions that are not tax avoidance transactions, this reasonable cause and good faith defense can also be used to excuse unintentional errors and mistakes of fact (*i.e.*, as a facts-and-circumstances-based "reasonable cause ... and good faith" defense). That aspect of the defense is not our focus in this letter.

14 Section 6662(d)(2)(B).

15 This is referred to as "Section 6662(d)(2)(B)(ii)(I) disclosure" since this is the Code section that sets out the disclosure requirement.

16 *See, e.g.*, Joint Committee on Taxation, *Comparison of Recommendations of the Joint Committee on Taxation Staff and the Treasury Relating to Interest and Penalties* (JCX-79-99), November 5, 1999, available at http://www.house.gov/jct/x-79-99.pdf.

return *as well as* any person who prepares or reviews only a portion of the return and any person who simply provides post-transaction advice to the taxpayer with respect to a matter that is eventually reflected on the return so long as the portion of the return which was prepared, reviewed or advised on is significant (in amount or complexity).

As is the case with taxpayers, the tax return preparer is excused from the penalty if the position had a certain level of substantive support. Prior to May 2007, the level of support (or the "standard") for preparers under Section 6694 had always been lower than that applicable to taxpayers under Section 6662. The May 2007 amendments changed that, by raising the Section 6694 standard so that it not only is, for the first time, not lower than the taxpayer Section 6662 standard, but instead is even higher than the taxpayer Section 6662 standard.

The Section 6694 standards are now, as follows:

(i) for positions that are not disclosed, there must be "a reasonable belief" of MLTN, and

(ii) for disclosed positions, the position must have had a reasonable basis.[17]

Prior to H.R. 2206, the Section 6694 standards were as follows: (i) for undisclosed positions, the position needed a realistic possibility of being sustained on the merits ("RPSM"), which is generally considered to be a 1/3 chance of success, and (ii) for disclosed positions, the position had to be not "frivolous" (5-10% chance of success).[18]

Section 6694 also contains a "reasonable cause for the understatement and the preparer acted in good faith" defense for the preparer. This defense was not altered by H.R. 2206.

D. Summary Comparison of the Taxpayer vs. Preparer Standards

For positions that do not arise from tax avoidance transactions, the level of support a taxpayer needs to avoid a penalty for an undisclosed transaction (substantial authority) is lower than the level of support a preparer needs to avoid a penalty for the same undisclosed transaction (MLTN).[19] We think this is extremely problematic and we have written this letter to explain why.

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[17] Under the tax return preparer rules, there are no special rules for understatements arising from tax avoidance transactions. For taxpayers, there are special rules for such understatements.

[18] "Disclosure" for Section 6694 purposes can be met for some preparers only if a completed IRS Form 8275 is filed with the return; for other preparers, the Regulations and the December 2007 Notices permit the preparer to satisfy the disclosure requirement of Section 6694 by making certain written or oral statements to the taxpayer. We are not addressing those rules in this letter.

[19] For disclosed positions, both the taxpayer and the preparer need reasonable basis.

E. The Consequences of a Section 6694 Violation to the Preparer Can Be Very Serious

The direct consequences of a Section 6694 violation is a monetary penalty.[20] Beyond that, there are numerous other possible consequences to a preparer who is found to violate Section 6694, and these are potentially far more severe.

As explained in the Appendix Part V, under the current regulatory rules if a preparer is found to have violated Section 6694, there is an automatic referral of that practitioner to the Office of Professional Responsibility for a determination of whether the practitioner has violated "Circular 230". The Office of Professional Responsibility (which is part of the Treasury Department and is housed within the IRS) regulates tax practitioner conduct and does this through implementing a set of Regulations which are referred to as "Circular 230". If a practitioner is found to have violated Circular 230, far more serious consequences than a monetary penalty to the IRS for up to 50% of his fees can occur: a practitioner can be censured, suspended or disbarred from practice before Treasury or the IRS, and may face an additional monetary penalty. Each of these penalties (including censure and suspension) can have devastating long-term consequences on a practitioner's ability to continue practicing his profession.[21]

A practitioner who is found to have violated Circular 230 is likely to be investigated by the applicable state licensing board and may face additional penalties and harm to his professional reputation.

A preparer also is required, by Circular 230 and by state licensing board ethical rules, to manage conflicts and potential conflicts with a client in a certain manner, including in certain cases advising the client to retain other counsel. The current Section 6694 rules may make it difficult for a tax practitioner to comply with these conflict rules, a violation of which would have its own potentially serious consequences.

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20 H.R. 2206 significantly increased the amount of this monetary penalty. The enhanced monetary penalty is the greater of (i) $1,000 ($5,000 if the violation is "willful," "reckless" or "with intentional disregard") and (ii) 50% of the income derived by the preparer with respect to the return. Precisely how this amount if computed is not clear.

21 Circular 230 has provisions regulating tax return preparation and the giving of advice on tax return positions. These provisions are the subject of proposed amendments, and we are submitting to the Treasury Department and the IRS a report on those proposed amendments. We are not addressing those rules or proposed amendments here.

III. WHY HAVING A PREPARER STANDARD THAT IS HIGHER THAN THE TAXPAYER STANDARD IS A PROBLEM

A. Form 8275 Disclosure: Good For Preparer/Bad For Taxpayer

Under the new statutory rules (setting aside the December 2007 Notices), there are situations in which a preparer faces a penalty with respect to a taxpayer's return when the taxpayer who filed that return is not subject to any penalty. That in itself is problematic enough, but the situation is then exacerbated by the preparer's ability (under the revised statute) to insure against this by having the return include a IRS Form 8275 disclosure, even though *the taxpayer does not need* and *may not benefit at all* from that Form 8275. Accordingly, a preparer who desires to protect himself from the penalty will have a *personal interest,* and therefore an incentive, in seeing to it that his clients' returns are filed taking the more-conservative, "disclosure" approach, whereas that preparer's *clients's interests* may be entirely different. We believe this conflict of interest between preparers and their clients that is created by the new statute is untenable.

Consider the following Example #1: the taxpayer and the return preparer both believe that the taxpayer does not have a "significant purpose of tax avoidance"[22] and that the position at issue definitely qualifies for the substantial authority defense, but there is not a reasonable belief of MLTN. If the taxpayer files a return that includes this position, but without a Form 8275 disclosure, and the position is not upheld, the taxpayer will have a defense to penalties (*i.e.*, substantial authority), but the preparer will not have any defense (setting aside the "reasonable cause and good faith defense" under Section 6694).[23] The only way this preparer can avoid a preparer penalty is through "disclosure" (which may be satisfied by filing an IRS Form 8275 with the return or, in some cases, through other methods).

In short, the preparer here needs disclosure to avoid a personal penalty, but his client does not need disclosure, and indeed could be harmed by disclosure (because disclosure would highlight the position to the IRS and could indicate that the taxpayer did not think the substantial authority standard was met). The client would, however, need disclosure if there was not substantial authority (and there was only a "reasonable basis" level of support for the position). We question whether this preparer can, with true objectivity, advise and assist the taxpayer as to whether there is substantial authority, when the preparer would be better off if the taxpayer thought there was not substantial authority and therefore that disclosure was required by the taxpayer to avoid a taxpayer penalty.

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22 This is relevant because it means that the Section 6662 defenses of (i) "substantial authority" and (ii) "reasonable basis plus disclosure" are available to the taxpayer.

23 We believe the reasonable cause and good faith defense should not be the preparer's only way to reconcile this conflict, since the application of this defense is uncertain and in any case appears usually to be limited to situations where good faith mistakes are made or there are particular circumstances that warrant a deviation from the general rules.

Consider Example #2: a taxpayer believes that the transaction is a tax avoidance transaction. Therefore, from the taxpayer's perspective the only defense available against the taxpayer penalty is the MLTN defense, and disclosure is not a requirement of or helpful to this defense. The preparer agrees with this. The taxpayer believes the MLTN defense is met and wants to report the tax benefits without disclosure; the preparer is more risk adverse and would prefer to avoid the risk of a Section 6694 preparer penalty.[24] The preparer could avoid the preparer penalty, whether or not the transaction is a tax avoidance transaction, and whether or not MLTN exists, if there was disclosure (and the position had a least a reasonable basis, which they both believe that it does). By contrast, disclosure is of no assistance to the taxpayer if the taxpayer and preparer are correct that the taxpayer will be considered (by a court) to have engaged in a tax avoidance transaction (because, in that case, the taxpayer's only possible defense is the MLTN defense for which disclosure is not relevant).

But how can the preparer objectively advise the taxpayer as to whether a court would find "a significant purpose of tax avoidance" when the preparer would be better off if the taxpayer believed that this was not the case and therefore that disclosure would assist the taxpayer, so that the preparer's and the taxpayer's interests were aligned? How can the preparer proceed with preparing the return in the manner that is best for the taxpayer (no disclosure)?

B. Taxpayers Deprived Of Accurate Advice and Assistance Regarding the Law Applicable to Them

Ideally, the tax law would be simple and clear enough that every taxpayer could complete his or her own return – just as we each complete our own magazine subscription forms. The reality is, however, that the tax law has became so complex that, according to studies, a majority of taxpayers pay preparers to prepare their returns. Given how complicated our law is, taxpayers often need or want professional assistance to determine what the law permits them to do and then to actually do it. A person who prepares a taxpayer's tax return is assisting the taxpayer in preparing the documentation that the law requires the taxpayer to send to the government. The preparer's role is to help their taxpayer clients understand and comply with the law. The law should not, on one hand, impose requirements on taxpayers and, on the other, simultaneously create obstacles to their obtaining objective professional advice regarding those requirements.

A tax preparer or advisor should be providing a taxpayer with complete, clear and accurate information regarding what the law is, how it likely applies to the taxpayer's facts, the options available to the taxpayer, and the potential consequences of each option. The preparer should be helping the taxpayer-client understand the law applicable to the taxpayer and assisting the taxpayer in making his own informed decisions as to how to proceed, based upon what the law permits the taxpayer to do and the possible consequences to the taxpayer in cases where the law is uncertain.

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[24] Alternatively, the taxpayer may believe that the position is supported by MLTN, while the preparer does not believe that. Because the Section 6694 MLTN defense would be available to the preparer only if the preparer reasonably believed the position was MLTN, the preparer is not able to claim the defense but the taxpayer may be eligible for the taxpayer MLTN defense based upon the taxpayer's view.

We believe that the laws should enable preparers to advise taxpayers, assist taxpayers, encourage taxpayers to do what the law reasonably permits the taxpayer to do, and discourage taxpayers from doing what the law would penalize the taxpayer for doing.

The current rules instead potentially result in taxpayers being deprived of the information and assistance they need to comply with the tax rules. For example, as discussed above, taxpayers still have the right under the Code, in non-tax-avoidance transactions, to take undisclosed positions that turn out to be incorrect without facing a penalty for doing so, provided the position had substantial authority. The new statute in many instances impedes the ability of preparers to help clients understand and exercise this right.

C. Granny's Lawyer Goes to Jail Case

Under the new statute a tax return preparer (which includes certain advisors who qualify as "tax return preparers", as noted earlier) now must often face the ethical dilemma of having to choose between, on the one hand, a course of action that protects the advisor but may subject the client to risks the client would not otherwise face, and, on the other hand, a course of action that protects the client in a way that is perfectly legal and appropriate for the client but risks subjecting the practitioner to penalties.

A similar situation arose in 1997 when Congress enacted a law that is often referred to as the "Granny's Lawyer Goes to Jail Act."[25] The year before, in 1996, Congress enacted a law often referred to as the "Granny Goes to Jail Act", which made it a crime for an individual to engage in certain types of asset transfers intended to enhance the individual's qualification for Medicaid. In 1997, Congress repealed that law (thereby making it legal once again for an individual to engage in this type of "Medicaid planning"), but replaced it with a law making it a crime for a lawyer to counsel or assist an individual to engage in Medicaid-planning asset transfers. Thus, it was a crime for a lawyer to counsel a client to engage in conduct or to assist a client in engaging in conduct that was perfectly legal for the client. At least one court found this law to be a violation of the First Amendment rights of the lawyers.[26] While we are not aware of anyone making a similar claim with regard to revised Section 6694, and we do recognize that

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25 Section 4734 of the *Balanced Budget Act of 1997*, Pub. L. No. 105-33 (1997).

26 New York State Bar Association v. Reno, No. 97-CV-1768 (N.D.N.Y. Sept. 15, 1998; *see also* Trial, "Medicaid Counseling Law Doesn't Apply to Lawyers" (Dec. 1998); Note, "After New York State Bar Association v. Reno: Ethical Problems in Limiting Medicaid Estate Planning", Georgetown Journal of Legal Ethics (Summer, 1999); J. Matthew Miller, "Balancing the Budget on the Backs of America's Elderly-Section 4734 of the Balanced Budget Act: Criminalization of the Attorney's Role as Advisor and Counselor", 29 U. Mem. L. Rev. 165 (Fall, 1998) (discussing the First Amendment implications in detail); New York Law Journal, "Medicare Counseling Law Struck – First Lawsuit Filed by State Bar, on Penalty for Lawyers, Is a Winner" (Sept. 23, 1998); New York State Bar Association v. Reno, 999 F. Supp. 710 (N.D.N.Y. 1998)(granting preliminary injunction).

there are some differences in the two situations,[27] we believe that there are important common policy concerns that are worthy of serious consideration.[28]

D. Taxpayers Who Prepare Their Own Returns Are Subject to Different Rules

It is not an overstatement to say that H.R. 2206 has inadvertently created two taxpayer penalty standards for otherwise similarly situated taxpayers: one for taxpayers who prepare their return themselves and another for taxpayers who use outside preparers. This is because taxpayers who prepare their own returns can and will rely upon the substantial authority standard of Section 6662, while taxpayers who use outside preparers will be guided by their preparers. The preparers will have an incentive not to risk preparing returns that rely upon the substantial authority standard, which could in turn have the effect of raising the standards applicable to their taxpayer clients. This is particularly true if those clients do not have access to enough information and objective advice to understand their options.

The de facto existence of two different standards is fundamentally unfair and inappropriate.[29]

E. Harm to the System and Tax Collections

Taxpayers may be less inclined to use the services of paid preparers if they realize the preparers cannot prepare their returns in the way that is the best for the taxpayers. The lack of professional assistance in complying with the complex tax laws may reduce the accuracy of returns and voluntary compliance.

Tax preparers are likely to raise their fees to compensate for the additional risks and the additional work required. The additional work would include the factual and legal research and analysis required to determine whether the client's tax positions satisfy the MLTN (rather than merely substantial authority) standard, and the preparation of Forms 8275, all for the preparer's benefit but not necessarily the taxpayer's. This also may discourage taxpayers from using preparers, or may encourage taxpayers to use the services of less expensive and perhaps less ethical and less qualified preparers.

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27 Perhaps completing a tax return is not "speech", but surely giving written or oral tax advice is.

28 While the court struck down the "Granny's Lawyer Goes To Jail Act" on First Amendment grounds, commentators also discussed the fact that a lawyer who "temper[ed]" his speech (so as to avoid violating the Act) would be violating his ethical obligations to "provide complete and competent counsel and to advise his client to the extent necessary to allow the client to make an informed decision". J. Matthew Miller, 29 U. Mem. L. Rev. 165, n. 166.

29 In this respect, businesses that have their returns prepared by their own tax professional employees have an advantage over those that use outside professionals because the "tax return preparer" definition excludes persons employed by the taxpayer.

Taxpayers who do use preparers may be confused and not able to distinguish between advice that is motivated by the preparer's concerns about his own penalty exposure and advice motivated by concern about the taxpayer's exposure to penalties. That also may reduce the accuracy of returns and voluntary compliance.

IV. H.R. 4318 (INTRODUCED DECEMBER 6, 2007) WOULD REVISE SECTION 6694 TO MATCH THE TAXPAYER STANDARDS

On December 6, 2007, H.R. 4318, a bill that would amend Section 6694 again, was introduced by Representatives Crowley and Ramstad. H.R. 4318 would revise Section 6694 to make the following defenses available to a preparer:

(i) if the understatement arose from a tax avoidance transaction (as we defined it in II.B. above), the position must have had MLTN support;

(ii) for any other position, the position must be supported by either

(a) substantial authority or
(b) reasonable basis plus "disclosure"; or

(iii) for any position, there was a reasonable cause for the understatement and the preparer acted in good faith.

Briefly compared to current Section 6694 and the pre-May 2007 version of Section 6694, H.R. 4318 would: (A) introduce the "substantial authority" defense from the Section 6662 taxpayer penalty rules (which is between the MLTN standard of current Section 6694 and the RPSM standard under prior Section 6694), but make this defense available only if the understatement arose from a non-tax avoidance transaction; (B) make the current reasonable-basis-plus-disclosure defense no longer available if the understatement arose from a tax avoidance transaction; (C) retain the May 2007 change of the not-frivolous-plus-disclosure defense to the reasonable-basis-plus-disclosure defense; and (D) retain the reasonable cause and good faith defense that was in the statute prior to May 2007 and was retained by the May 2007 amendments.

H.R. 4318 would essentially make the preparer standards the same as the taxpayer standards. We are not endorsing this, or any other specific approach, in this letter. We do however comment on the H.R. 4318 approach below (see Part V.B.).

V. POSSIBLE APPROACHES TO RESOLVING THE PROBLEM

It is not our intent to recommend any particular course of action to you. Nevertheless, we thought it might be useful to you to hear what we as tax practitioners consider the possible benefits and detriments of various approaches that could be taken to resolving the problems identified above.

To this end, we have presented below four possible options and then discussed some of the significant issues and considerations, including positive and negative consequences, that distinguish these options. Some of the possible consequences most of our Executive Committee

agreed would be positive, and others most agreed would be negative; but there were certain consequences that we could not agree about – specifically, in some cases we could not agree whether that consequence was a likely outcome, and in some cases we agreed that the consequence was likely to occur but we could not agree if that was a positive or negative thing.

Two particular questions that our Executive Committee was evenly divided on were the following:

(i) Should the taxpayer and preparer standards be the same or should preparers always have a slightly lower standard than taxpayers?

(ii) Should the taxpayer standard for undisclosed positions be raised to MLTN (i.e., eliminating the "substantial authority" defense), such that any taxpayer who did not have MLTN support for a position would be required to disclose the position (or face the risk of penalties)?

After describing the four options identified in A. below, we will address competing arguments in respect of these two questions, and other related matters.

A. Four Possible Options

1. Option #1: Modify the taxpayer standards to match the current preparer standards. The concept here would be to make the taxpayer standards the same as what is currently in Section 6694, so that taxpayers and preparers alike would have the identical three defenses:

(i) reasonable basis plus disclosure,

(ii) MLTN,[30] and

(iii) reasonable cause plus good faith.[31]

The essential guiding principle for both taxpayers and preparers would be the following: if you do not have MLTN for your position, you need to disclose it.

Option #1 would affect taxpayers: (i) by taking away one defense (*i.e.*, substantial authority), and (ii) making available for tax avoidance transactions the reasonable basis plus

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[30] Under the current Section 6664(c) regulations, the taxpayer's MLTN defense is met if (i) the taxpayer subjectively and reasonably believed there was MLTN, and (ii) there was substantial authority, objectively determined, whereas the Section 6694 MTLN defense currently requires that there be "a reasonable belief" that the position was MLTN. A true alignment of the two standards would therefore require picking one of these two formulations for the MLTN defense and applying it to both the taxpayer and the preparer.

[31] Conforming the taxpayer and preparer standards in this manner could be accomplished by revising the text of Sections 6662 and 6664.

disclosure defense that is not currently available for those transactions. Currently, the taxpayer's sole available defense for tax avoidance transactions is MLTN.

Giving taxpayers this additional defense for tax-avoidance transactions could lead to an increase in tax avoidance transactions and aggressive tax return positions by taxpayers. Option #1 above could be modified ("Option 1A") to address this by retaining for taxpayers the current rule that permits the reasonable basis plus disclosure defense only for non-tax avoidance transactions. This Option #1A would essentially make a single change (eliminate the taxpayer's current substantial authority defense) and would not achieve a complete "match" of the taxpayer and preparer standards.

Stated more generally, achieving conformity is complicated by the following fact: currently taxpayers who have a tax avoidance transaction, have only one possible defense (*i.e.*, MLTN), and there is no weaker disclosure-based variation. In contrast, preparers have the MLTN defense and the weaker reasonable-basis-plus-disclosure defense and both of these are available for any transaction, including a tax avoidance transaction. So, making the standards strictly identical would require either making two defenses available to taxpayers without any restrictions as to their application to tax avoidance transactions, or providing that both taxpayers and preparers may not use the disclosure-based defense in the case of any tax-avoidance transaction. See the discussion in V.D. and V.E. below.

2. Option #2: Modify the preparer standards to match the current taxpayer standards. This option is what H.R. 4318 would do. Like Option #1, the taxpayer and preparer standards would become the same, but here that would be done by changing Section 6694 so that it would have the same rules that are in Sections 6662, 6662A and 6664 currently.

Under this approach, both taxpayers and preparers would have the same standards, consisting of the following: (i) for non-tax-avoidance transactions, two separate defenses being reasonable basis plus disclosure, and substantial authority, and (ii) for tax avoidance transactions, the one MLTN defense.

Option #2 would affect preparers by making only one defense (MLTN) available to them for tax-avoidance transactions; the reasonable basis plus disclosure defense would never be available for preparers for such transactions (which would be a significant change from both current and prior law).[32] As discussed above, achieving conformity under Options #1 or #2 is complicated by the fact that taxpayers (but not preparers) currently have two separate regimes – one for non-tax-avoidance transactions and one for tax-avoidance transactions.

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32 This issue is further discussed in V.E below.

3. Option #3: Restore Section 6694 to what it was before the May 2007 legislation. This would reinstate the prior preparer standards which gave the preparer three possible defenses under Section 6694: (i) the position had a realistic possibility of being sustained on the merits (RPSM); (ii) the position was not frivolous and was disclosed, or (iii) reasonable cause and good faith.

Under this approach, preparers would have lower standards than taxpayers, as was the case historically.

4. Option #4: Revise both the taxpayer and preparer standards so that the preparer's are lower than the taxpayer's but the taxpayer's are higher than current law. This approach would make the preparer standard lower than the taxpayer standard, but at the same time reflect what might have been the policy behind the May 2007 amendments, which is to raise filing standards generally.

One way of accomplishing this might be to raise taxpayer standards for non-tax-avoidance transactions to (i) MLTN or (ii) RPSM (which is higher than the current reasonable basis standard) plus disclosure, retain the current stricter taxpayer standard for tax avoidance transactions (the MLTN defense), and make preparer standards for all transactions (i) substantial authority or (ii) RPSM plus disclosure.

Other variations of this might extend to preparers a two-tier system of higher standards for tax-avoidance transactions as is currently applicable to taxpayers.

Under this approach, preparers would have standards that are lower than taxpayers but taxpayers would have higher standards than they did up until now.

B. Should the Preparer Standards Be Equal to or Lower than the Taxpayer Standards?

As noted above, our Executive Committee is divided on this question.

1. Arguments made in support of preparer standards being the same as taxpayer standards. Some advance the following arguments in support of their view that the preparer standards should be equivalent to the taxpayer standards:

First, the rules would be simplified (because there would be a single set of standards applicable to both taxpayers and preparers)[33] and thus easier to understand and apply.

Second, if the preparer standard is just as high as the taxpayer standard then preparers will be incentivized to do more due diligence and to develop a thorough understanding of the facts and the law, because they will not have any "cushion" or "margin for error" resulting from

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[33] Further simplification would be achieved by eliminating the two-regime approach of having different standards for tax-avoidance transactions, as is the case currently for taxpayers. See V.D below.

their being subject to a lower standard. While additional costs or burdens to taxpayers and preparers may result, this is justified by the legitimate interest in inducing preparers to do as much work as is required to prepare as accurate a return as they are capable of preparing.

Third, the alignment of standards would greatly reduce any conflicts of interest between the preparer and taxpayer and result in the preparer advising the taxpayer based upon what is best for the taxpayer. The Section 6694 reasonable cause and good faith defense would still be available as a protection for the preparer and might apply, for example, if the taxpayer did not take the preparer's advice as to how the return should be completed.

Fourth, if the preparer does not have lower standards then the taxpayer has, then when faced with a situation where it is uncertain if the taxpayer standard is met, the preparer would be more likely to encourage (or even pressure) the taxpayer to disclose (because the preparer would not have the "cushion" of having a slightly lower standard). If this were to occur, it might benefit the tax system by resulting in more disclosure of uncertain positions.

2. Arguments made in support of preparer standards being somewhat lower than taxpayer standards. Others advance the following arguments to support their view that the preparer standards should be somewhat lower than the taxpayer standards:

First, a serious conflict of interest between the preparer and taxpayer will still exist. Although the preparer and taxpayer would be subject to the same standard, they have such different interests in the outcome that there would still be still be potential conflicts between their interests. The taxpayer may be willing to proceed without disclosure after concluding that the risks of doing so (having to pay the penalty) are worth the potential tax savings. For example, the taxpayer may be willing to proceed because the taxpayer believes there is MLTN support for the position, considers this belief reasonable, and believes the other requirements for the MLTN defense are met; or the taxpayer may believe the likelihood of the return being audited is low and is willing to take the risk; or the taxpayer may have some other reason that the preparer does not share. The taxpayer is choosing between (A) the possibility of not paying the potential taxes at all, and (B) the possibility of having to pay the taxes plus penalties.

The preparer, by contrast, is not facing a choice between (A) saving money by paying less taxes and (B) having to pay a penalty. Instead, the preparer is choosing between a no risk of penalty approach and a risk of penalty approach. The preparer has professional responsibility issues and client relationship issues that will give the preparer some interest in seeing to it that the client taxpayer does not pay more taxes than are necessary, but the preparer may be less willing to take the personal penalty risks (and the risks of the other potential consequences) and therefore may want to take the more conservative no-risk-of-penalty approach – which means including disclosure with the return. If the preparer standard were slightly lower, the preparer might be able to better protect simultaneously both his personal interests and his client's interests.

Second, making the preparer standards somewhat lower than the taxpayer standards would strike an appropriate balance between the preparer's obligations to the system, on the one hand, and to the client, on the other. The argument goes as follows: It is appropriate to impose some standards upon preparers; otherwise preparers might see an incentive to encourage their

clients to take advantage of the audit lottery. Preparers should have some personal stake in seeing to it that client return positions are supportable, in order to increase the chances that the Government is not cheated and that the clients are fully informed by the preparers as to the consequences of their return positions. Making available to the preparer a non-disclosed position standard that is one notch below the taxpayer's standard incentivizes the preparer to protect the system without creating a real conflict between the preparer and the taxpayer.

Third, unless the preparer standards are lower than the taxpayer standards, the taxpayer may rely too much on the preparer's willingness to proceed and cease to make his own independent judgments. This argument is based upon the view that, if a taxpayer is informed of the Section 6694 rules applicable to preparers, the taxpayer may conclude that the preparer's willingness to proceed with the return establishes that the position has the requisite degree of support. That is, the taxpayer would be assuming that the preparer would be unwilling to proceed (and risk preparer penalties) unless there was a reasonable certainty of the requisite support. This dynamic, it is argued, seems inconsistent with a fundamental tenet of our tax system, which is that the laws are intended to make taxpayers ultimately responsible for the accuracy of their own returns and to incentive taxpayers to make their own judgments about their returns.[34]

See also V.E below regarding the question of imposing the MLTN standard on preparers.

C. Should the Taxpayer Standards (for Non-Tax-Avoidance Transactions) Be Raised to MLTN Such That Disclosure Is Required For Any Less-Than-MLTN Position?

Our Executive Committee was also divided on this question.

1. Arguments made in support of taxpayer MTLN standard for non-tax-avoidance transactions. Some of us support raising the taxpayer standard for non-tax-avoidance transactions to MLTN, which would match the Section 6694 standard and would also match the standard applicable to taxpayer's tax avoidance transaction understatements.[35] The arguments advanced in favor of this view are the following:

First, taxpayers who did not have MLTN support for a position would either (i) disclose the position or (ii) not take the position on their return (or take the penalty risk). The additional disclosures would assist the IRS in determining who to audit, in conducting an audit once the audit was begun, and in identifying and reacting sooner to problematic positions or transactions.

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[34] Others believe that taxpayers would not necessarily react in this manner and that, even if they did, this would not pose a systemic problem.

[35] A separate question, considered in V.A.1 above and V.D below, is whether, for tax avoidance transactions, taxpayers should continue to have only a single, non-disclosure-based defense (*i.e*, the MLTN defense), or whether, in a step towards conformity with the new Section 6694 preparer standards (which do not distinguish between tax avoidance and non-tax-avoidance transactions) and simplification of the taxpayer penalty structure, taxpayers should be provided with an alternative defense for tax avoidance transactions -- one that requires a lower standard of support plus disclosure.

Second, those who determined to "not take the position" would also benefit the system because a decrease in the number of persons taking less-than-MLTN positions on their returns presumably would lead to an increase in the amount and collection of taxes owed (*i.e.*, a decrease in taxpayers paying less than they owe).

Third, because the heightened standard and disclosure obligation would discourage taxpayers from playing the audit lottery and taking aggressive or "borderline" positions, this could strengthen the perception that all taxpayers are paying their fair share of the tax burden and thereby enhance the integrity of our voluntary tax compliance regime.

Fourth, raising the taxpayer standard for non-tax-avoidance transactions to MLTN would create a uniform penalty standard for taxpayers and preparers that is consistent with Congress's 2007 amendments to Section 6694, and thus would simplify the penalty rules generally. It would also simplify the taxpayer penalty structure by better aligning the standards applicable to tax avoidance transactions (for which taxpayers are already limited to the MLTN defense) and non-tax-avoidance transactions (see V.D below for issues arising from the current dual standard).

Fifth, this single standard applicable to taxpayers for both tax avoidance and non-tax-avoidance transactions would be the same as the standard applicable for financial reporting of tax positions in the case of taxpayers preparing U.S. GAAP financial statements. The U.S. GAAP standard under "FIN 48" for reflecting any portion of a beneficial tax position on a financial statement has a threshold requirement that the position be more likely than not to be sustained on the merits. Thus, simplification and overall efficiency should result from having a single standard. (But see V.C.2 below for counterarguments to this position.)

2. Arguments made in support of less-than-MLTN taxpayer standard for non-tax-avoidance transactions. The arguments from those who oppose raising the taxpayer standards to MLTN are as follows.

First, MLTN is too high a standard given the complexity of our tax system. Raising the standard would deprive taxpayers of their current ability to take a position that is less than MLTN without explicit disclosure, unless they were willing to face penalties in the event that the position turned out to be incorrect. Because of the complexity of our tax system and the endless number of fact patterns presented in everyday life, there are frequently situations where a taxpayer has several options for reporting a transaction, perhaps none of which has MLTN support. This regularly happens in transactions that are *not* tax avoidance transactions, including in situations that arise out of routine business or personal transactions. To take an example: assume a corporation has an expenditure incurred in the ordinary course. It is not clear if the expenditure should be currently deducted, should be amortized over a five-year period, amortized over a 15-year period, or capitalized into the cost of a capital asset. Each position has some support, but none has MLTN. This taxpayer would be forced to file a Form 8275 disclosure in order to follow any route other than the route that results in the payment of the greatest amount of taxes. Other examples are in the financial products area where even the

Treasury and the IRS have conceded that for some transactions there is some much uncertainty that there is no MLTN position.[36]

In other cases, there may be one position that is MLTN, and another that has only substantial authority but which may well be sustained. Limiting the taxpayer to a MLTN defense in the case of tax avoidance transactions is considered by many to be understandable; moreover, if the taxpayer has a tax avoidance motive and less than a 50% chance of success, it seems reasonable to require the taxpayer to highlight this to the IRS by disclosing it. But in other cases, taxpayers arguably should be able to take these less-than-MLTN positions without disclosure, and this is why Section 6662 provides for the substantial authority defense.

A second argument is that requiring disclosure in all such cases would be overly burdensome to taxpayers. The process of preparing a Form 8275 requires taxpayers to spend time and money and can add to the stress of preparing and filing a tax return. For example, a Form 8275 is not complete (and thus does not satisfy the disclosure requirement) unless it contains a detailed description of the facts and the law and some analysis of the issues. Preparing estimated tax payments and the annual tax return are time consuming, expensive and stressful for taxpayers already. Similarly, many taxpayers already consider the preparing and filing of tax returns to be intrusive, particularly when third parties are involved in the process. Requiring Form 8275s in all less-than-MLTN situations would add to the intrusiveness of the filing, particularly where taxpayers require third party assistance to comply. These factors may foster discontent with and skepticism about the tax system among some taxpayers, which may reduce compliance. (In contrast, those who believe a MLTN standard for taxpayers would be appropriate take the view that the cost of preparing tax returns is a necessary burden to place on taxpayers and that the "burden" and "intrusiveness" concerns are overstated and in any event would not lead to a reduction in compliance.)

Third, the legislative history to the taxpayer "substantial authority" standard explains that this standard was intentionally chosen was to provide taxpayers with a necessary degree of flexibility:

> "The conferees did not adopt an absolute standard that a taxpayer may take a position on a return only if, in fact, the position reflects the correct treatment of the item because, in some circumstances, tax advisors may be unable to reach so definitive a conclusion. Rather, the conferees adopted a more flexible standard under which the courts may assure that taxpayers who take highly aggressive filing positions are penalized while those who endeavor in good faith to fairly self-assess are not penalized."[37]

These same considerations, it is argued, are still true today, and apply to both taxpayers and those who advise them or prepare their returns.

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[36] *See, e.g.*, Notice 2004-52 (credit default swaps), Notice 2001-44 (swaps with contingent nonperiodic payments), Notice 2008-2 (structured notes); see also Announcement 99-76 (foreign currency contingent notes).

[37] Conf. Rep. No. 97-760 (1982), reprinted in 1982-2 C.B. 600.

Fourth, another concern is that the Form 8275 might be used during an audit by the IRS agent to argue that the taxpayer knew the position was incorrect, or that the legal analysis included on the Form 8275 are the sole arguments in support of the position. (These concerns might be ameloriated by changing what Form 8275 requires so that, for example, instead of requiring a statement of *all the facts, and the relevant law and issues*, the Form only had to identify the tax return item.)

Fifth, some are concerned that the number of disclosures will be so great that the value of the disclosures to the Government declines. The counterargument is that only experience will tell and the IRS will surely react if this is the case.

Sixth, because the U.S. GAAP FIN 48 rules use a MLTN standard, there could be confusion and an unintended and harmful impact on the accuracy of financial reporting. The confusion could arise because the FIN 48 MLTN determination is not identical to the U.S. Federal tax MLTN determination: different legal authorities and facts are permitted to be considered for FIN 48 purposes than for tax purposes, and the subjective element of the determination may be different.[38] Accuracy could be affected if a preparer who is risk adverse, or does not have enough information to determine whether a Section 6694 reasonable belief of MLTN exists, proceeds under Section 6694 as if MLTN is not present. That fact by itself may affect whether the taxpayer is comfortable reporting the tax results for FIN 48 purposes, even if the preparer's view is based upon lack of information and not a reasoned analysis and conclusion.

D. Should a Separate Standard Apply to Tax Avoidance Transactions?

One complication of our current taxpayer standards are the separate rules for tax avoidance transactions. We thought it was useful to ask whether these rules should be retained for taxpayers, eliminated entirely, or extended to preparers?

The principal argument in favor of retaining the separate, higher standard for taxpayers in the case of tax avoidance transactions is that the strict MLTN defense, with no disclosure alternative, is an appropriate deterrent against such transactions. This is the rationale behind Option #1A discussed in V.A.1 above.

Some arguments in favor of eliminating the two standards for taxpayers are that (1) the system of penalties is so complex that few truly understand it, and (2) the meaning of the "tax avoidance transaction" definition (*i.e.*, a "plan or arrangement" that has as "a significant purpose ... the avoidance or evasion of Federal income tax") is sufficiently unclear that it does not necessarily draw a fair line.

The arguments in favor of extending the two standards to preparers include the arguments listed above in favor of having a uniform standard for taxpayers and preparers (V.B.1. above)

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38 *See* Treas. Reg. §1.6662-4(d) for authorities and methodology permitted under the taxpayer penalty rules.

and the argument stated above in favor of having a separate standard for taxpayers for tax avoidance transactions.

Some arguments against extending the two standards to preparers (so that both taxpayers and preparers would be subject to dual standards), as H.R. 4318 would do, are the following:

First, it could generate additional preparer-client conflicts. If a preparer had a different standard for a tax avoidance transaction, a preparer who was not certain whether there was "a significant purpose of tax avoidance" would need to either (i) assume there was such a purpose or (ii) interrogate a taxpayer to determine whether there was such a purpose. A preparer who assumes there is "a significant purpose of tax avoidance" would necessarily be assuming that the only possible defense to the preparer penalty is MLTN. This would present the same conflict issues as exist under current law, because the preparer would be ignoring the possibility of the substantial authority defense being available.

If instead the preparer tries to determine from the client whether there is a significant purpose of tax avoidance, the conflict arises here as well. Assume a client tells the preparer that there is not such a purpose and the client is comfortable that a court would agree. The preparer may insist on more proof so that the preparer himself is himself convinced. At some point the preparer is seeking more proof not to protect the taxpayer, but instead to protect the preparer. Someone would have to bear the cost of the preparer's additional work – either the preparer or the taxpayer – and neither one may feel that he should have to.

Even assuming complete knowledge of all facts by all parties, preparers and taxpayers may have different views or risk tolerance as to whether a transaction will be viewed as one that has a significant purpose of tax avoidance.

E. Additional Preparer-Specific Considerations

Some are of the view that imposing a MLTN standard on preparers is unfair, because once it has been established that there was an understatement, *i.e.*, that the taxpayer's position was incorrect, the preparer may have difficulty demonstrating in hindsight (e.g., to a court) that there was "a reasonable belief" that the taxpayer's position was MLTN correct. The current taxpayer MLTN defense requires that the taxpayer subjectively had a reasonable belief that the position was MLTN correct, whereas the revised Section 6694 ambiguously refers to the existence of "a reasonable belief". Absent clarification to the contrary, a court could interpret this to mean that the preparer's subjective state of mind is not relevant, and thus it might be difficult for a trier of fact to reconcile the reality of the position turning out to be wrong with an assertion by the preparer that there was a reasonable belief the position was correct.

In addition, regardless of the substantive level of the requisite preparer standard, preparers should have some alternative relief in addition to the normal taxpayer defenses, such as the facts-and-circumstances-based reasonable cause and disclosure defenses currently available to preparers. Consider, for example, the strict MLTN defense imposed on taxpayers for tax avoidance transactions, which has no weaker, disclosure-based alternative. This rule could not be extended to preparers without some other relief to protect the preparer in situations such as the following: (1) the preparer believes a particular transaction, which is supported by substantial

authority but not MLTN, is a tax avoidance transaction and therefore would attract a penalty, but the taxpayer is less risk averse and chooses to proceed on the basis that the transaction is not a tax avoidance transaction; or (2) the preparer and taxpayer agree that a transaction is a tax avoidance transaction and the taxpayer concludes that the MLTN standard is satisfied and proceeds on that basis, but the preparer believes the MLTN standard is not satisfied. In each of these cases, some form of penalty relief for the preparer is needed.

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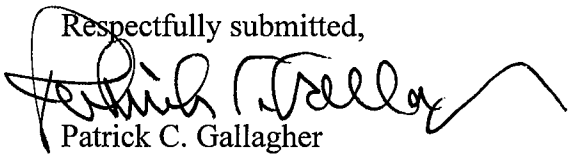
We appreciate your consideration of our comments. Please let us know if you would like to discuss these matters further or if we can assist you in any other way.

Respectfully submitted,



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