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Filling the Ethical Void: Treasury's 1986 Circular 230 Proposal

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I. Introduction

The period between 1980 and 1985 produced tremendous activity over the perceived influence of tax ethics on noncompliance. In 1980 Treasury proposed amendments to Circular 230, attempting to regulate for the first time practice standards for legal opinions used in the promotion of tax shelters.¹ In 1982 the American Bar Association (ABA) promulgated Formal Opinion 346, covering ethical and disciplinary standards for lawyers rendering opinions on tax shelter investments offered to nonclients;² in the same year, Treasury issued modified proposed amendments to Circular 230.³ In 1984 the ABA Section of Taxation concluded a multiyear study of the debased "reasonable basis" standard,⁴ which prompted the ABA Committee on Ethics and Professional Responsibility to promulgate Formal Opinion 85-352 replacing the reasonable basis standard with the realistic possibility

of success standard;⁵ and also in 1984 Treasury issued final Circular 230 regulations.⁶ While Treasury and the ABA attacked noncompliance by addressing practice standards and ethical guidelines, Congress supplied a strengthened penalty regime aimed at both tax practitioners and taxpayers. The Economic Recovery Tax Act of 1981 (ERTA),⁷ the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),⁸ and the Deficit Reduction Act of 1984 (DEFRA)⁹ all added new penalty provisions while fortifying others.

But Treasury wanted more. Responding in large part to the ABA's failure to elevate appreciably ethical standards in Opinion 85-352, Treasury sought to raise practice standards through the Circular 230 regulations and to demonstrate to tax practitioners that they had obligations both to clients and to the government.

In 1986, only two years after finalizing amendments to Circular 230, Treasury issued another round of proposed amendments.¹⁰ While the earlier episode incurred criticism from tax practitioners jealous of their right to self-regulation,¹¹ Treasury's 1986 proposal caused even more commotion among practitioners who thought they were being unfairly targeted by new rules that threatened their livelihood.

The Treasury proposal added two notable elements to the regulations. First, it raised due diligence standards by requiring practitioners to assure themselves that all reporting positions on a tax return comply with the tax law and that the positions were reasonable, meritorious, and made in good faith.¹² Second, the proposed amendments added a new section to Circular 230 that addressed a

¹Proposed Amendments, Tax Shelters; Practice Before the Internal Revenue Service, 45 *Fed. Reg.* 58594 (Sept. 4, 1980). For a recent discussion, see Ventry, "The Reaction to the 1980 Proposed Amendments to Circular 230," *Tax Notes*, June 5, 2006, p. 1141.

²ABA Committee on Ethics and Professional Responsibility, Formal Opinion 346 (Rev.) (Jan. 29, 1982). For a recent discussion, see Ventry, "ABA Formal Opinion 346 and a New Statutory Penalty Regime," *Tax Notes*, June 12, 2006, p. 1269.

³Modified Proposed Regulations, Tax Shelters; Practice Before the Internal Revenue Service, 47 *Fed. Reg.* 56144 (Dec. 15, 1982). For a recent discussion, see Ventry, "No Joke: Circular 230 Is Here to Stay," *Tax Notes*, June 19, 2006, p. 1409.

⁴ABA Tax Section, "Proposed Revision to Formal Opinion 314," May 21, 1984, reprinted in Bernard Wolfman and James P. Holden, *Ethical Problems in Federal Tax Practice*, 2d edition (Charlottesville, Va.: The Michie Company, 1985), at 71-74. For a recent discussion, see Ventry, "Lowering the Bar: ABA Formal Opinion 85-352," *Tax Notes*, July 3, 2006, p. 69.

⁵ABA Committee on Ethics and Professional Responsibility, Formal Opinion 85-352 (July 7, 1985). See Ventry, *supra* note 4, at 73-81.

⁶Final Rule, Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries Before the Internal Revenue Service, 49 *Fed. Reg.* 6719 (Feb. 23, 1984). See Ventry, *supra* note 3, at 1413-1414.

⁷P.L. 97-34 (Aug. 13, 1981). See Ventry, *supra* note 2, at 1273.

⁸P.L. 97-248 (Sept. 3, 1982). See Ventry, *supra* note 2, at 1273-1276.

⁹P.L. 98-369 (July 18, 1984). See Ventry, *supra* note 3, at 1414-1415.

¹⁰Notice of Proposed Rulemaking, Tax Practitioners, 51 *Fed. Reg.* 29113 (Aug. 14, 1986).

¹¹See Ventry, *supra* note 1, at 1142-1149.

¹²*Supra* note 10, at section 10.22(a).

practitioner's responsibilities in situations involving a potential section 6661 substantial understatement penalty.¹³ New section 10.34:

- required the practitioner to advise clients of any potential section 6661 violations;
- prohibited the practitioner from advising or recommending a reporting position unless the practitioner could determine that the section 6661 penalty would not apply; and
- further prohibited the practitioner from preparing or signing a tax return unless the practitioner could determine, again, that the section 6661 penalty would not apply.¹⁴

To many practitioners, it seemed that Treasury was effectively requiring them to underwrite an insurance policy against the possible imposition of the section 6661 penalty for every reporting position on a client's tax return.¹⁵ The proposed rules were "draconian"¹⁶ and a "pernicious attack"¹⁷ on the tax bar. If practitioners did not respond aggressively, the U.S. tax system would soon resemble the legal apparatus of the Soviet Union,¹⁸ with Circular 230 reflecting "the rules of practice of the Czechoslovak bar."¹⁹

Hyperbole aside, the 1986 amendments proposed altering the rules of the tax practice game. In particular, they subjected practitioners to standards of conduct and culpability in section 6661 that heretofore had been applied only to taxpayers. Under that provision's no-fault standard, practitioners — accustomed to fault standards requiring negligence or willful disregard under such sections as 6700 (the promoter penalty), 6701 (the aiding and abetting of understatement penalty), and 6694 (the tax return preparer penalty) — could conceivably be subject to suspension or disbarment after a single transgression of Circular 230 rules.

Miffed that the ABA's recently issued Opinion 85-352 permitted tax lawyers to advise reporting positions subjecting clients to section 6661 penalties,²⁰ Treasury sought

¹³In 1989 Congress replaced former section 6661 with section 6662, the accuracy-related penalty provision, which incorporated all underpayment penalties for taxpayers under a single code section. See P.L. 101-239, Title VII, section 7721(a), Dec. 19, 1989, 103 Stat. 2395.

¹⁴*Supra* note 10, at section 10.34.

¹⁵Herbert J. Lerner and Leonard Podolin, American Institute of Certified Public Accountants, to Leslie S. Shapiro, director of practice, *Doc 87-994*, 87 *TNT* 35-9 (Feb. 13, 1987).

¹⁶David Sachs, chair, Bar Association of the City of New York, to director of practice, *Doc 87-655*, 87 *TNT* 25-44 (Jan. 9, 1987).

¹⁷Doug Briggs, "Tax Attorneys Debate Merits of Amendment to Circular 230," *Tax Notes*, May 18, 1987, p. 635 (quoting Jules Ritholz of Kostelanetz, Ritholz, Tighe & Fink at a meeting of the D.C. Bar Tax Section).

¹⁸*Id.*

¹⁹Joe Spellman, "IRS Director of Practice Urges Stricter Standards at Tar Heel Conference," *Tax Notes*, June 5, 1989, p. 1202 (quoting Ritholz at a tax institute conference presented by the University of North Carolina Law School).

²⁰For a discussion of how Opinion 85-352 allowed tax lawyers to advise reporting positions subjecting clients to the substantial understatement penalty, see Ventry, *supra* note 4.

to align practice standards for tax practitioners with the taxpayer penalty provisions of the code. By tying a practitioner's fate to her client's, Treasury allocated shared stewardship responsibilities for the tax system to practitioners, making them interested parties in the regulatory and legislative effort to curb noncompliance. Indeed, as Treasury explained in 1986, the ability of the IRS "to accomplish its missions efficiently and effectively depends on reliance on tax practitioners to be fair and honest in their dealings with the IRS and to foster confidence by their clients in our tax system and in tax compliance."²¹ Fighting noncompliance required the cooperation of every link in the tax compliance chain: the legislators and policymakers who wrote the nation's tax laws; the agency and its agents charged with regulating and interpreting the tax laws; and the private-sector professionals who assisted taxpayer-citizens in complying with the tax laws and accurately reporting tax liabilities.

II. The 1986 Proposed Amendments

In 1986, with the ink barely dry on the 1984 final regulations to Circular 230, Treasury issued another round of proposed modifications. Although the final regulations had largely conformed to the noncontroversial due diligence and reporting standards enunciated in ABA Formal Opinion 346, practitioners were still trying to reconcile themselves to the new rules. Some practitioners feared that the IRS would wield a tougher Circular 230 to "tar and feather the average practitioner" and prohibit plain-vanilla tax advice in an attempt to capture abusive and fraudulent shelters.²² Others expressed concern that Treasury would analyze old tax shelter transactions under new Circular 230 rules and recently enacted penalty provisions.²³ At the least, uncertainty remained concerning how the new regulations would be administered, and more generally how the rules of the tax shelter game would change. "The good news is that the IRS wants to take attorneys and accountants out of the process of participating in the abusive tax shelter area," said Steven Salch of Fulbright & Jaworski. "But we don't know if the IRS loosed a monster in our midst that will devour us indiscriminately."²⁴ Into that uncertainty, Treasury unleashed a second monster.

A. The Treasury Proposal

In August 1986 Treasury issued a notice of proposed rulemaking modifying Circular 230. According to Treasury, the notice merely "clarified" existing regulations. According to practitioners, the "clarifications" fundamentally changed the regulations and, consequently, practitioners' obligations under them.

²¹*Supra* note 10, at Supplementary Information.

²²W. John Moore, "IRS Increasing Its Scrutiny of Tax Shelter Professionals," *Legal Times* (June 24, 1985), at 1 (quoting Albert B. Ellentuck of the accounting firm Laventhol & Horwath).

²³*Id.*, at 1 (quoting Paige Marvel, an attorney from Baltimore).

²⁴*Id.*

1. Section 10.22 — due diligence. Under existing regulations, section 10.22 provided that practitioners exercise due diligence in preparing, approving, and filing tax returns, documents, and affidavits related to IRS matters; determining the accuracy of representations (oral and written) made to the Treasury Department; and determining the accuracy of representations (oral and written) made to clients with reference to IRS administration. Treasury proposed adding a fourth requirement: obligating practitioners to exercise due diligence in advising clients on all reporting positions on a return.²⁵ Treasury believed those requirements were already reflected in existing Circular 230 rules, but it wanted 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.”²⁶

Under the proposal, a practitioner could satisfy the new due diligence requirement only if she determined that a reporting position was reasonable, meritorious, and asserted in good faith. The new requirement also prohibited reporting positions advanced principally to exploit the audit selection process, to serve as leverage in settlement negotiations with the IRS, or to forestall a charge that the return was false or fraudulent. Further, a practitioner could not satisfy the new standard if a reporting position had no practical or realistic possibility of being sustained on the merits.²⁷

2. Section 10.34 — applying section 6661 to tax practitioners. While the changes to section 10.22 slightly elevated due diligence standards — particularly the requirement that a position be “meritorious” — new section 10.34 proposed practice standards that no practitioner was prepared to meet.

Section 10.34 required practitioners to advise clients of potential section 6661 violations. More importantly, it prohibited practitioners from advising reporting positions or preparing or signing a tax return unless the practitioner determined that the section 6661 penalty would not apply. In short, the proposal provided that a practitioner could not, in the exercise of due diligence, “place his or her client in a position of being assessed any penalty or addition to tax in connection with section 6661.”²⁸ That requirement contradicted the standard promulgated under Opinion 85-352, which explicitly permitted practitioners to advise positions subjecting clients to the section 6661 penalty.²⁹ More troubling from the perspective of tax practitioners, proposed section 10.34

took a civil penalty provision designed for taxpayers and “expand[ed] its scope by making it a disciplinary provision for tax practitioners.”³⁰

The section 6661 substantial understatement penalty had been enacted in 1982 as part of TEFRA.³¹ Congress’s stated purpose in subjecting taxpayers to a no-fault standard was to create a downside risk for taxpayers asserting aggressive reporting positions and to discourage them from playing the audit lottery. If a taxpayer reported an understatement exceeding 10 percent of tax owed, section 6661 subjected her to a 25 percent penalty (originally set at 5 percent under TEFRA), regardless of her state of mind. She could avoid that no-fault penalty if her reporting position for non-tax-shelter items was supported by “substantial authority” or “adequate disclosure” (more on both terms below, at sections III.B.1 and III.B.2). The penalty could also be waived on a showing of good faith and reasonable cause. Harsher rules applied if the return position related to a tax shelter. In those situations, the taxpayer could avoid the penalty only if she demonstrated substantial authority and she reasonably believed the return treatment was more likely than not correct when she asserted the position.

Explicitly referencing a code section in the Circular 230 regulations was unusual. In fact, it was unprecedented. According to Treasury, however, “because of the importance to our tax system of the compliance principle on which section 6661 is based, we believe it necessary to address section 6661 in Circular 230.”³² Tying tax practice standards to the statutory penalty regime applicable to taxpayers was an overt warning to tax practitioners: Despite your profession’s ethical and disciplinary standards, you are not above the law observed by your taxpayer-clients. The proposed amendments to Circular 230 underscored Treasury’s position that “the role of the practitioner in our tax system requires adherence to the principles of TEFRA as well as to all tax compliance laws.”³³ It emphasized that to avoid disciplinary proceedings under Circular 230 — which could result in suspension or disbarment — the tax practitioner had to assure herself when advising a reporting position to a taxpayer-client that the position was supported by substantial authority or that the relevant facts were otherwise adequately disclosed. In tax shelter situations, disclosure would not cure an insubstantial position. Rather, the position had to be supported by substantial authority as well as a more-likely-than-not belief that the position would be upheld if challenged. Those requirements far exceeded existing practice standards. But according to Treasury, they were necessary to fortify the integrity of the tax system and to rein in abusive tax shelter activity.

B. The Treasury Philosophy

Treasury viewed its 1986 proposal as the latest in an ongoing effort to promote tax compliance. Then-IRS

²⁵Treasury proposed renumbering section 10.22 such that the new due diligence requirement would have become section 10.22(a) with the existing provisions constituting sections 10.22(b)-(d).

²⁶*Supra* note 10, at Supplementary Information.

²⁷*Id.*

²⁸*Id.*

²⁹*See supra* note 20.

³⁰New York State Bar Association (NYSBA) Tax Section, “Comments on Proposed Modification of Circular 230,” *Tax Notes*, Mar. 16, 1987, p. 1113.

³¹*See supra* note 8.

³²*Supra* note 10, at Supplementary Information.

³³*Id.*

Commissioner Lawrence Gibbs placed the proposed amendments squarely in the recent spate of antiavoidance strategies employed not only by Treasury but also by Congress. Speaking to the District of Columbia Bar Taxation Section, Gibbs referred to the tax return preparer penalties enacted in 1976 as well as the highly publicized penalty and compliance provisions created by TEFRA in 1982. Gibbs also noted formal actions taken by professional organizations purporting to raise ethical standards — including the ABA's promulgation of Opinion 346 in 1982 and Opinion 85-352 in 1985 — in addition to the announcement from the AICPA that it was revising its own standards of conduct.³⁴ Treasury's amendments to Circular 230 regulations elevating standards of tax practice — both in 1980 and 1986 — complemented (and in many ways, drove) the antiavoidance movement. Despite the recent activity, Treasury remained concerned that the various standards were neither uniform nor complementary, and in fact resulted in three different standards applying to members of the three major groups practicing before the Treasury Department: enrolled agents, attorneys, and CPAs.³⁵

Also, tax shelters were not going quietly into the good night. Tax shelter cases overburdened the courts, clogged dockets, and constituted nearly 50 percent of all cases in the Tax Court.³⁶ Meanwhile, untold numbers of tax shelter schemes went undetected, as audit coverage hit an all-time low.³⁷ Treasury's philosophy was simple: Attacking tax shelters required attacking the professionals who advised and peddled questionable positions. Taxpayers, despite their insatiable appetite for tax reduction, were largely incapable of entering into tax shelter transactions without the help of tax practitioners; it made sense to go after the enablers. If you wanted to stop a drunk from drinking, you didn't give him \$1,000, a pint of his favorite beverage, and a ticket to Las Vegas. Rather, you intervened and attempted to modify behavior by eliminating the opportunity for a misstep.

³⁴IRS Commissioner Lawrence B. Gibbs, before the D.C. Bar Tax Section, 86 *TNT* 202-3 (Oct. 6, 1986).

³⁵*Id.*

³⁶See Mark Uhlfelder, "Interview With Chief Counsel William F. Nelson," *Tax Notes*, Dec. 8, 1986, p. 888 (reporting that tax shelter cases represented 46.5 percent of the Tax Court docket); "American Bar Association Tax Section Kicks Off Spring Meeting With Committee Meetings," 87 *TNT* 96-1 (May 18, 1987) (tax shelter caseload at 45 percent of the Tax Court docket); Kathleen Matthews, "Nelson Discusses Service's Plans on Large Case Litigation," *Tax Notes*, May 2, 1988, p. 553 (tax shelter caseload at 55 percent). See also NYSBA Tax Section, Committee on Practice and Procedure, "Managing the Tax Court Docket," 85 *TNT* 146-93 (July 24, 1985) (reporting that tax shelter cases accounted for more of the increase in the Tax Court docket than any other component in the early 1980s); report to the chief judge, United States Tax Court by the U.S. General Accounting Office GAO/GGD-84-25, May 14, 1984; Lee A. Sheppard, "ABA Tax Section Rails Against Tax Shelters," *Tax Notes*, June 4, 1984, p. 1018.

³⁷See Sheppard, "Unpopular Spending: IRS Budget and Tax Administration," *Tax Notes*, Aug. 19, 1985, p. 821 (reporting audit coverage of 1.2 percent for 1986).

Intervention required the help of tax practitioners. It required altering the perception among the practitioner community of an adversarial relationship with the IRS. And it required getting practitioners to embrace their dual obligation to client and government as well as their multiple roles as advocate, adviser, planner, negotiator, and intermediary. In other words, it required a partnership.

The proposed amendments "highlight[ed] practitioners' dual responsibility — to individual clients and the tax system at large."³⁸ According to Gibbs, "The thrust of the emerging rules," which included Circular 230 as well as the reconsideration of practice standards undertaken by the ABA and the AICPA, "is to define a practitioner not as a go-between for sending tax information to the IRS but as an instrument for the full and accurate reporting of clients' tax information."³⁹ While acknowledging the duty to one's client, Treasury emphasized additional duties to the tax system and to the government. In so doing, it identified multiple roles for tax practitioners. Director of Practice Leslie Shapiro, for example, listed the many elements of tax practice: tax planning, tax advice, tax return preparation, representation before the IRS, and litigation. "Each of these elements brings with it a different dimension of professional responsibility," Shapiro argued.⁴⁰ "At the base of it all is a practitioner's duty to his client of competence, loyalty, and confidentiality. Also present are his or her obligations and responsibilities to the tax system."⁴¹ The tax practitioner was in a unique position, carrying with it unique responsibilities. "If it sounds as though I am asking something special from you, you're absolutely right," then-Commissioner Roscoe Egger told the AICPA Tax Division in 1985.⁴² "People who are engaged in tax practice are in a category all by themselves. No group of people has a more clear-cut double responsibility — to clients and to society at large. You are experienced and professionally trained. We expect good judgment."

Rather than invoke George Gipp, Egger chose Randolph Paul and a bygone generation of tax practitioners. As a "specially qualified person in one of the most important areas of the public interest" with "special

³⁸IRS Commissioner Gibbs, before the North Carolina Association of CPAs, 86 *TNT* 203-3 (Oct. 9, 1986).

³⁹*Id.* See also Briggs, *supra* note 17, at 637 (paraphrasing Shapiro as saying that every practitioner "has an obligation to deal fairly and honestly with the government and to foster client confidence in the system").

⁴⁰Spellman, *supra* note 19, at 1202.

⁴¹*Id.*

⁴²Remarks of IRS Commissioner Roscoe L. Egger Jr. before the AICPA Tax Division meeting, Crystal City, Va., 85 *TNT* 98-5 (May 14, 1985).

qualifications," Paul wrote in 1950, the tax lawyer assumes "special responsibilities which may not be passively discharged."⁴³ Those responsibilities included duties to professionalism, to government, to other taxpayers and society, and to one's own conscience.⁴⁴

None of those additional duties made the tax practitioner an adversary of the IRS. In fact, each of them made her a partner in achieving full compliance. "We are not necessarily adversaries," Gibbs told a roomful of tax practitioners in 1986.⁴⁵ "You have a job to do — represent your clients' best interests. And we have a job to do — be sure that positions taken on tax returns can be supported by the law. The two are not, and should not be, mutually exclusive."⁴⁶ Tax return preparation and advising clients on reporting positions "clearly reflect[ed] a practitioner's dual responsibility."⁴⁷ Notably, the 1986 proposed amendments to Circular 230 stated unequivocally, "A tax return is not a submission in an adversary proceeding." Rather, it served "a disclosure, reporting, and self-assessment function." It was "a citizen's report to the government" of her economic activities for the year. To serve "its disclosure and assessment function," a tax return had to provide "a fair report of matters affecting tax liability." Given the administrative obstacles (low audit rate) and institutional constraints (insufficient appropriations) faced by the IRS, representations made on tax returns "must accurately reflect the facts," and reporting positions "must be supportable by the law." A tax practitioner, Treasury believed, had "an affirmative duty to assure that these occur."

Given Treasury's "partnership" mentality, as well as its long-running antiavoidance efforts, Treasury refused to countenance practitioners advising noncompliance. It opposed existing ethical guidelines of professional organizations that allowed tax practitioners to advise reporting positions subjecting clients to the section 6661 substantial understatement penalty. Shapiro, charged with enforcing the Circular 230 regulations, argued that "the standard of professional responsibility in giving advice relevant to positions to be taken on tax returns and positions on tax returns themselves be consistent with the substantial understatement provision of section 6661."⁴⁸ Tax practitioners were supposed to be the "instrument for the full and accurate reporting of clients' tax information."⁴⁹ That meant subjecting practitioners to the same standards of compliance as taxpayers.

⁴³Randolph E. Paul, "The Responsibilities of the Tax Adviser," 63 *Harvard L. Rev.* 378, 386 (January 1950).

⁴⁴For a fuller discussion of those additional responsibilities and the philosophy of an "older" generation of tax practitioners, see Ventry, "Raising the Ethical Bar for Tax Lawyers: Why We Need Circular 230," *Tax Notes*, May 15, 2006, p. 803.

⁴⁵Gibbs, *supra* note 38.

⁴⁶*Id.*

⁴⁷*Supra* note 10, at Supplementary Information. Remaining citations in this paragraph are from *id.*

⁴⁸Uhlfelder and Sheppard, "Interview: IRS Director of Practice Shapiro Comments on Proposed Changes to Circular 230," *Tax Notes*, Mar. 23, 1987, p. 1150.

⁴⁹Gibbs, *supra* note 38.

III. Tax Practitioners React: All in Favor, Say 'Aye'

The nays far outpaced the ayes. Treasury welcomed the criticism, but wished it were more constructive. "We very much want practitioners to give us more than just a negative reaction to our proposed standards," Gibbs said only months after Treasury issued its amendments.⁵⁰ "If you disagree with what we've said, say so. But at the same time, give us more than that — give us an alternative suggestion as to what the standard ought to be."⁵¹ To practitioners, the proposed new rules were a "harsh response to the perceived erosion of the reasonable-basis standard" and its "cancerous" effect on compliance.⁵² Moreover, the new penalty regime — enacted purposefully between 1981 and 1986 — seemed to be working. "The experience of many practitioners indicates that these penalties, together with changes in interest-rate computations and limitations on the deductibility of the interest expense," were "materially affecting the behavior of taxpayers."⁵³ The proposed amendments, the New York State Bar Association (NYSBA) Tax Section concluded, were "not needed."⁵⁴

Despite the criticism, the tax bar supported the spirit of the amendments. The D.C. Bar Tax Section endorsed Treasury's view that "a revised ethical standard with respect to tax return advice and preparation should be incorporated in Circular 230" and that the standard should be uniformly applied to all tax practitioners — lawyers, accountants, and enrolled agents.⁵⁵ The D.C. Bar

⁵⁰Gibbs, before the 25th Annual Arkansas Federal Tax Institute, 86 *TNT* 242-6 (Dec. 8, 1986).

⁵¹*Id.* Treasury received more than 500 comments in the first six months after issuing the proposed amendments, with only a handful expressing support. "IRS Urged to Rewrite Proposal Tying Ethics Standard for Tax Return Preparers to Taxpayer Understatement Penalty," *Daily Tax Rep.* (BNA) No. 35, at K-2 (Feb. 24, 1987).

⁵²Leonard Podolin, "Treasury Raises the Stakes in Circular 230 Proposal," 165 *J. of Accountancy* 60 (April 1988).

⁵³D.C. Bar Tax Section to Shapiro, *Doc 87-1183*, 87 *TNT* 43-15 (Mar. 5, 1987).

⁵⁴NYSBA Tax Section, *supra* note 30, at 1116. There was some evidence to suggest that the new statutory penalties discouraged litigation and reduced the Tax Court docket. See NYSBA Tax Section, *supra* note 36 ("Beginning in 1982, Tax Court receipts of new cases finally began to level off. Several recent developments may have contributed to this welcome turn of events. That year, Congress took the profit out of deferred payment of deficiencies by enacting new Sections 6621 and 6622. Under these provisions, interest is now charged at an adjusted prime rate, compounded daily. Interest on overpayments was similarly adjusted under Section 6611, thus eliminating the previous strong interest bias favoring deficiency procedures over refund suits.") In 1985, however, it was too early to tell whether the new statutory penalties and other noncompliance efforts had any measurable effect on tax shelter activity. See *id.* (citing sections 6659 (substantial overvaluations), 6661 (substantial understatements), and 7408 (enjoining abusive tax shelter activity), as well as Circular 230 amendments and the promulgation of Opinion 346, and concluding, "Steps also were taken to discourage tax shelters, which may result in a decline in this type of litigation over the long run but could not have contributed to the immediate curtailment of new filings").

⁵⁵D.C. Bar Tax Section, *supra* note 53.

Tax Section even supported Treasury's effort to raise due diligence requirements regarding return positions under amended section 10.22.⁵⁶ More importantly, the tax bar "generally agreed" that practitioners rendering tax advice should be held to the same standards as taxpayer-clients relying on that advice before the IRS.⁵⁷ Less agreement converged around the proper standard. Should it be the negligence and fraud standard of section 6653?⁵⁸ The knowing disregard standard of section 6701? The negligent or intentional disregard standard of section 6694? Or the willful or reckless disregard standard, also in section 6694? Whatever standard prevailed, practitioners agreed that it should not be the section 6661 no-fault standard: "As matters now stand, section 6661 provides the Internal Revenue Service with a powerful statutory weapon to enforce disclosure."⁵⁹ But in enacting that provision, the Bar Association of the City of New York argued, "Congress determined to penalize taxpayers rather than practitioners" for substantial understatements.⁶⁰ Determining what was and what was not a "substantial understatement" under existing section 6661 regulations was risky business because of definitional glitches and inconsistencies (discussed below at sections III.B.1 and III.B.2). If Treasury wanted to subject practitioners to disciplinary action when a section 6661 penalty was imposed on a taxpayer-client, it would have to significantly rework and clarify the provision.

A. No-Fault Standard for Practitioners

Section 6661 was a "no-fault" provision. Taxpayers were subject to the 25 percent penalty if they reported an understatement of tax in excess of the greater of \$5,000 (\$10,000 for corporations) or 10 percent of tax owed. If they met the threshold, they were subject to the penalty. New section 10.34 proposed taking that no-fault civil penalty provision for taxpayers and "expand[ing] its scope by making it a disciplinary provision for tax practitioners."⁶¹ Historically, violations under Circular

230 depended on a tax practitioner willfully or knowingly acting or failing to act.⁶² The proposed amendments, however, tied suspension or disbarment to a taxpayer's understatement of tax, thereby granting the IRS "the power to disbar a tax practitioner without proof of fault. The use of such a no-fault standard . . . to discipline tax practitioners," the NYSBA Tax Section wrote, "is inappropriate."⁶³ Congress had specifically enacted other penalty provisions regarding practitioner behavior, all of which required negligence or knowing disregard.⁶⁴ More problematic was that under proposed section 10.34, a practitioner could, at least in theory, be disbarred for a single violation. Suspension or disbarment for Circular 230 violations, the NYSBA argued, "should be based upon a course of conduct, not an isolated event."⁶⁵ Also, as written, section 6661 failed to provide mitigation or waiver of the penalty for practitioners even though it allowed relief for taxpayers. Without mitigation, the no-fault standard would punish honest mistakes. A practitioner could face a section 6661 penalty under the proposal when a taxpayer inadvertently made an error "even though he or she is trying to comply with every jot and tittle in the tax laws."⁶⁶

Treasury attempted to mollify practitioner concerns. Shapiro indicated that disciplinary action under the new rules would depend on the particular case.⁶⁷ While "in some instances" an infraction evidencing "broad or reckless disregard of the rules and regulations" could precipitate disciplinary action, "in most instances" suspension or disbarment would require an established pattern of behavior.⁶⁸ Shapiro assured practitioners that if an infraction merely indicated "an abuse of diligence that may be equivalent to negligence," they would not be disciplined with suspension or disbarment.⁶⁹ Disciplinary action under those circumstances might include a reprimand, a warning, or perhaps no action at all until additional referrals were made. Practitioners simply had to exercise reasonable care, said Richard Stark, assistant to the commissioner. Mistakes in judgment whether a position was more likely than not to prevail under new section

⁵⁶*Id.*

⁵⁷"American Bar Association Tax Section Kicks Off Spring Meeting With Committee Meetings," *supra* note 36. See also minutes of December 1987 Commissioner's Advisory Group meeting, "Complexity and Change," 88 *TNT* 59-33 (Mar. 16, 1988) ("In general, the Group wanted a reasonable standard that should apply equally to taxpayers and practitioners"). The CAG was composed of IRS executives and tax practitioners.

⁵⁸The Omnibus Budget Reconciliation Act of 1989 significantly altered former section 6653, and replaced "Additions to tax for negligence and fraud" with "Failure to pay stamp tax" in the section catchline. See Dec. 19, 1989, P.L. 101-239, Title VII, section 7721(c)(1), 103 Stat. 2399.

⁵⁹New York City Bar, *supra* note 16.

⁶⁰*Id.*

⁶¹NYSBA Tax Section, *supra* note 30, at 1115. See also AICPA, *supra* note 15 ("Congress chose to apply section 6661, which is a 'no-fault' provision, only to the taxpayer whose return reflects a substantial understatement"); Lin M. Trucksess, "Painting the Gray Zone Grayer: Why Substantial Authority Fails as a Replacement for the Reasonable Basis Standard in Assessing Practitioner Conduct Under Circular 230," 8 *Va. Tax Rev.* 743, 751-757 (Winter 1989) (finding no evidence that Congress intended to extend section 6661 penalty to practitioners).

⁶²NYSBA Tax Section, *supra* note 30, at 1115.

⁶³*Id.* In its 1980 proposed amendments, Treasury had caused a similar practitioner outcry by attempting to lower the *mens rea* required to prosecute violations of Circular 230 from willful or reckless behavior to negligence. See Ventry, *supra* note 1.

⁶⁴See *id.* (referring to sections 6694 and 6701); AICPA, *supra* note 15 (referring to sections 6700, 6701, and 6694). See also D.C. Bar Tax Section, *supra* note 53 (recommending as a threshold either gross neglect or a willful failure to attempt to comply with the law and standards of practice).

⁶⁵NYSBA Tax Section, *supra* note 30, at 1117. See also D.C. Bar Tax Section, *supra* note 53 (recommending a pattern of conduct rather than a single incident for suspension or disbarment).

⁶⁶Karin M. Skadden, "Substantial Understatement Penalty Centers Debate on Practitioner's Role in the Tax System," *Tax Notes*, Oct. 17, 1988, p. 233.

⁶⁷*Supra* note 48, at 1153.

⁶⁸*Id.*

⁶⁹*Id.*

10.34 would not subject a practitioner to disciplinary action as long as she could demonstrate diligence and reasonable care.⁷⁰

Much like Treasury's guidance on last year's Circular 230 revisions that said practitioners should "just use common sense," palliatives to "just use reasonable care" were not reassuring.⁷¹ Mixed signals from Treasury contributed to practitioner anxiety. A month before Stark said practitioners were merely being asked to exercise reasonable care, for instance, he told a meeting of the Commissioner's Advisory Group that the section 6661 penalty "judges taxpayers on results rather than on the standard of reasonable care."⁷² Would tax practitioners be subject to the same standard as taxpayers if section 6661 were applied to them? Or would they be afforded a more lax standard, despite Treasury's stated desire to align tax practitioner and taxpayer responsibilities? Justifiably, practitioners were wary.

1. It's the client's tax return. According to most practitioners, the decision to take an aggressive reporting position resulting in a section 6661 penalty was the client's. The imposition of penalties on tax practitioners, therefore, should not depend on taxpayer penalties.⁷³ The taxpayer might opt to pay a section 6661 penalty on the rational judgment that the cost to challenge the issue administratively exceeded the benefits. Under Treasury's proposal, however, that taxpayer's judgment could adversely affect the practitioner.⁷⁴ Disciplinary rules for practitioners, said David Sachs of the New York City Bar, "should depend upon the practitioner's beliefs and conduct rather than upon those of the taxpayer."⁷⁵ In fact, recent social science literature indicated that if Treasury wanted to improve its relationship with practitioners and form an antiavoidance partnership, it would be better off lowering rather than raising penalties on practitioners, and preserving rather than equalizing the disparity in penalties between taxpayers and tax practitioners.⁷⁶

⁷⁰See Skadden, "IRS Penalty Task Force Proposes 'More Likely Than Not' Standard to Replace Substantial Authority," *Tax Notes*, Dec. 8, 1988, p. 1152 (paraphrasing Richard C. Stark, assistant to the commissioner and chair of the Executive Task Force for the Commissioner's Penalty Study).

⁷¹For 2005 "common sense" guidance, see e.g., Sheppard, "Korb Won't Give In on Circular 230," *Tax Notes*, Oct. 24, 2005, p. 432 (quoting Don Korb, chief counsel of the IRS, at a roundtable discussion, "Narrowing the Tax Gap," at Columbia University Law School); Kip Dellinger, "Circ. 230, Estate and Gift Practice: The Common Sense Approach," *Tax Notes*, Nov. 28, 2005, p. 1197 (noting that "representatives of the OPR have repeatedly admonished tax practitioners to use common sense in evaluating, vetting, applying, and implementing the written advice-covered opinion provisions of Circular 230").

⁷²Skadden, "Substantial Understatement Penalty Centers Debate on Role of the Practitioner in the Tax System," 88 *TNT* 209-7 (Oct. 14, 1988). Emphasis added.

⁷³See, e.g., AICPA, *supra* note 15 ("The primary responsibility for a tax return is that of the taxpayer, not the practitioner").

⁷⁴*Id.*

⁷⁵New York City Bar, *supra* note 16.

⁷⁶See Betty R. Jackson and Valerie C. Milliron, "Tax Practitioners and the Government," *Tax Notes*, Oct. 17, 1988, p. 333. The Jackson and Milliron study condemned government regulation
(Footnote continued in next column.)

Those findings reinforced practitioner sentiment that attempting to alter behavior and raise ethical standards as a way to eradicate noncompliance was wrongheaded. "Moral opprobrium couched in the form of a penalty is inappropriate."⁷⁷ Tax ethics "isn't law," wrote Jules Ritholz. "It isn't . . . tax regulations; it isn't morality; it isn't even good taste."⁷⁸ Rather, "ethics" amounted to "a set of rules, created mostly by bar associations, which govern the way you relate to your client, other lawyers and the bench."⁷⁹ Asserting positions most "favorable to your client," even though "an incorrect tax may result," Ritholz suggested somewhat flippantly, "are the breaks of the game . . . played in a free society."⁸⁰

Some practitioners didn't quite get it. Rather than assume the role of protecting the tax system, they abdicated all responsibility for improving compliance. Non-compliance proliferated under that view because taxpayers sought ways to reduce tax liabilities, not because practitioners enabled noncompliant behavior. Ethical and disciplinary standards were the exclusive province of professional associations, whether or not self-interested and whether or not deleterious to the system. And practitioners enjoyed a natural right to advise positions they knew would fail if challenged,⁸¹ just as they enjoyed a natural right to peddle shelter schemes free of regulation or oversight.⁸² Fortunately, those perspectives were

of tax professionals. Using an exchange theory model — which generally holds that in the absence of coercion, exchanges are successful only if elements of value are transferred between parties that enhance mutual utility — Jackson and Milliron concluded that the exchange between the government and tax practitioners would "be enhanced by increasing attention to self-regulation by the professions, by increasing practitioner access to government services, and by halting the tendency to regulate practitioners through penalties." *Id.* at 340. Based on those findings, Jackson and Milliron recommended increased penalties on taxpayers, decreased penalties on practitioners, and self-regulation to improve the government-practitioner relationship. Of course, the partnership that Jackson and Milliron posited would work only if one side did not exploit the relationship for its own gain. Portions of the tax practitioner community, however, had been exploiting the relationship for 20 years by peddling tax shelter transactions that violated the spirit and sometimes the letter of the tax law.

⁷⁷Skadden, *supra* note 72 (quoting Hugh Calkins of Jones Day).

⁷⁸Spellman, *supra* note 19, at 1203.

⁷⁹*Id.*

⁸⁰*Id.*

⁸¹The National Society of Public Accountants (NSPA) expressed mild shock that the 1986 proposed amendments to Circular 230 would prohibit a practitioner from signing a return that might subject a taxpayer-client to the section 6661 penalty. See NSPA President Robert R. Feazell, to Shapiro, 86 *TNT* 227-27 (Nov. 14, 1986). Evidently, the NSPA would have preferred that a tax practitioner sign a return containing reporting positions in contravention of the law.

⁸²Sachs, on behalf of the New York City Bar, objected to the prospect of practitioners having to pay a potential premium in the form of a special penalty for advising tax shelter transactions: "Under the proposed changes, there would be accordingly greater risk to the practitioner who renders advice with respect to reporting a tax shelter item." New York City Bar, *supra*

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in the minority. Most practitioners viewed Treasury's efforts to unify practice standards as beneficial, both to the tax system and the long-run health of tax practice. Even the more sober-minded, however, expressed reservations about tying practitioner penalties to the section 6661 substantial understatement provision.

B. Requiring Certainty in a Sea of Uncertainty

The tax law was complicated. And it was constantly changing. Under those precarious circumstances, prohibiting practitioners from advising or recommending a reporting position or preparing or signing a tax return unless she could determine that a penalty would not apply was an unrealistic imposition. According to the NYSBA Tax Section, the proposed amendments "impose[d] an unfair and unworkable standard on tax practitioners due to the uncertainties of a constantly changing tax law."⁸³ Certainty on reporting positions "is rarely possible."⁸⁴ It was arguably impossible given the structural weaknesses and inconsistencies of section 6661.

1. "Substantial authority" under section 6661. The plain language of section 6661 granted taxpayers relief from the no-fault penalty if the challenged position regarding non-tax-shelter items was supported by substantial authority or adequate disclosure. Taxpayers could also avoid the penalty on a showing of good faith and reasonable cause. With tax shelter items, taxpayers could avoid the penalty only if they demonstrated substantial authority and a reasonable belief that the position was more likely than not correct when asserted.

Treasury regulations recognized only some authorities. The Treasury definition included the code and other statutory provisions, temporary and final regulations, court cases, revenue rulings and procedures, tax treaties and accompanying regulations and Treasury explanations, and congressional reports reflecting the intent of Congress in enacting legislation.⁸⁵ The regulations did not include other commonly recognized sources of the tax law, such as proposed regulations, letter rulings, and the Joint Committee on Taxation's annual Blue Book.⁸⁶

note 16. One wonders where Sachs had been the previous six years. "Greater risk to the practitioner who renders advice with respect to reporting a tax shelter item" had effectively been the animating force of the antiavoidance movement of the 1980s, from Circular 230 changes to TEFRA and DEFRA penalty provisions to parts of the TRA 1986 to Opinion 346 and even to Opinion 85-352.

⁸³NYSBA Tax Section, *supra* note 30, at 1115.

⁸⁴*Id.* at 1116 (noting that "the question whether the penalty under section 6661 is applicable in a given case is not ordinarily susceptible of easy resolution"); Skadden, "Commissioner's Advisory Group Concentrates on Penalties and IRS Relationships With Practitioners and the States," 88 *TNT* 190-1 (Sept. 16, 1988).

⁸⁵Reg. (former) section 1.6661-3(b).

⁸⁶Skadden, *supra* note 66, at 254. The regulations also excluded treatises and legal periodicals from the definition of authority. The Treasury's somewhat restrictive interpretation derived from its reading of the legislative history of section 6661, which stated that in applying the substantial authority standard, "the courts will not be bound by the conclusions

(Footnote continued in next column.)

Practitioners questioned why an interpretation of the law that provided authority for an IRS position, such as proposed regulations or private letter rulings, could not be cited by the taxpayer or her adviser as sufficient support for a reporting position.⁸⁷ Further, practitioners argued that the definition should be expanded to include tax services from established publishers and other sources: "There is so much in the Code for which there are no regs, no instructions, no guidelines, that some credence should be given to whether or not the taxpayer's position made sense to the taxpayer."⁸⁸

Also, under the proposed amendments, practitioners could face disciplinary action for taking perfectly appropriate positions on factual matters "with respect to which there cannot be 'substantial authority.'"⁸⁹ Positions taken on some issues, for instance, such as an adjustment under section 482 or a deduction for reasonable compensation, could be subject to the penalty, but the practitioner may not have relied on "substantial authority" because the issues were inherently factual in nature. Subjecting practitioners to a penalty under those standards, the D.C. Bar Tax Section argued, "would be draconian."⁹⁰

When coupled with the new due diligence requirements under section 10.22, Treasury's section 6661 proposal required a practitioner "to perform a sufficiently thorough analysis as to the authority" of every reporting position and "to in effect underwrite an insurance policy

reached in law review articles, opinion letters, or private letter rulings . . . but will instead examine the authorities that underlie such expressions of opinion." S. Rep. No. 97-530; H.R. Rep. No. 97-760; 97th Congress, 2d Session; H.R. 4961; Conference Report, "Tax Equity and Fiscal Responsibility Act of 1982" (Aug. 17, 1982). However, as one commentator noted, while a court may not have been bound by any of the excluded materials, "this does not mean that a taxpayer who relies on such materials has engaged in the type of conduct that should be subject to penalty. Indeed, a practitioner who ignores the above government interpretations in rendering tax advice probably fails in his duty of competence to his client." Kenneth L. Harris, "Resolving Questionable Positions on a Client's Federal Tax Return: An Analysis of the Revised Section 6694(a) Standard," *Tax Notes*, May 21, 1990, p. 971.

⁸⁷*See, e.g., id.* (paraphrasing James E. Merritt of Morrison & Foerster).

⁸⁸*Id.* (quoting Patricia Burton of Gales Ferry Tax Service). The NYSBA Tax Section, the New York City Bar, the D.C. Bar Tax Section, and the AICPA all endorsed a more expansive definition of substantial authority. *See* NYSBA Tax Section, *supra* note 30, at 1115-1116; New York City Bar, *supra* note 16; D.C. Bar Tax Section, *supra* note 53; AICPA, *supra* note 15. At least one commentator recommended restricting rather than expanding the definition of substantial authority in the Treasury regulations. *See* Peter A. Appel, "Administrative Procedure and the Internal Revenue Service: Delimiting the Substantial Understatement Penalty," 98 *Yale L.J.* 1435 (May 1989) (noting that the existing definition of substantial authority omitted items widely perceived as authoritative, but also arguing that the definition should not recognize IRS interpretive pronouncements (that is, the Service's litigating position) as equivalent to legislative rules).

⁸⁹D.C. Bar Tax Section, *supra* note 53.

⁹⁰*Id.*

against the possible imposition of the section 6661 penalty.⁹¹ “To impose such a standard on a return preparer is wholly unrealistic,” particularly if the IRS subjected a practitioner’s decisionmaking to an *ex post* analysis.⁹²

2. “Adequate disclosure” under section 6661. Taxpayers could protect a (non-tax-shelter) reporting position under section 6661 with substantial authority or with adequate disclosure. Naturally, taxpayers and their advisers preferred the cover of substantial authority over the naked vulnerability of adequate disclosure. But the uncertainty surrounding what constituted substantial authority, and therefore the applicability of the section 6661 penalty, effectively forced a practitioner to disclose “any item of a return with respect to which there is any question as to the possible imposition of the penalty.”⁹³ Practitioners were concerned that if full disclosure became the norm, it would be tantamount to discharging an obligation that properly belongs to the IRS rather than to a tax adviser.⁹⁴

With practitioners reluctant to lend a hand to the IRS, their definition of what constituted adequate disclosure was naturally more restrictive than Treasury’s. But Treasury’s definition did provide practitioners some flexibility. Treasury regulations allowed disclosure on a properly completed Form 8275, “Disclosure Statement.” They also permitted taxpayers to attach a separate statement identified as a disclosure under section 6661.⁹⁵ Under regulation 1.6661-4(c), disclosure made on a return was considered adequate to the extent described in Rev. Proc. 88-37, which stipulated somewhat generously that additional disclosures were unnecessary for some enumerated items, “provided that the forms and attachments are completed in a clear manner and in accordance with the instructions.”⁹⁶ Treasury’s guidance under Rev. Proc. 88-37 represented a conscious attempt “to provide a structure or a format in response to practitioner questions about what is adequate disclosure.”⁹⁷ The Treasury defi-

nition was adopted by the Tax Court,⁹⁸ indicating to at least one commentator that section 6661 was “working as intended” with “less fun and games on returns.”⁹⁹

In addition to issuing specific guidance on what constituted adequate disclosure and substantial authority, Treasury advised practitioners to use reasonable care, to make well-reasoned judgments, and to operate in good faith at all times.¹⁰⁰ Unsurprisingly, those standards meant very different things to practitioners than to the government. While one group viewed them as words of limitation, the other viewed them as words of opportunity.

C. Threats to the Attorney-Client Relationship

Practitioners argued that the proposed changes to Circular 230 jeopardized the attorney-client relationship. Under Treasury’s proposed modifications, details of advice rendered to clients would determine potential disciplinary action.¹⁰¹ Practitioners could be forced to tell all or face suspension or disbarment. Alternatively, taxpayer-clients could be forced to waive the attorney-client privilege to prevent disciplinary proceedings against their attorneys. Also, holding practitioners to the section 6661 standards would force disclosure of information “that would not be necessary absent the proposed changes.”¹⁰² If that information were otherwise privileged, the disclosure could undermine the taxpayer-client’s position in the event of litigation.¹⁰³ And finally, the proposed amendments would create “serious conflicts in the role of the practitioners” forced to balance risks to their careers because of the threat of disciplinary action against client loyalty.¹⁰⁴

D. Feeding the Beast

The proposed amendments, in the minds of practitioners, gave the IRS too much power: “Tying 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

⁹¹AICPA, *supra* note 15.

⁹²*Id.*

⁹³New York City Bar, *supra* note 16.

⁹⁴*Id.* Full disclosure could also produce adverse unintended consequences. On one hand, requiring disclosure could reduce the number of questionable positions asserted. But it could also result in greater numbers of superficial disclosures “to mask issues that could not meet the new test.” Skadden, *supra* note 70, at 1152. If successful, full disclosure could also overwhelm the IRS given the agency’s lack of personnel at the audit level and given that taxpayers would be more likely to litigate positions they took care to disclose, thereby increasing the appeals and litigation workload of the Service. See William L. Raby, “The Role of Disclosure in Tax Return Preparation,” 3-89 *The Tax Adviser* 157 (March 1989). Commentators also argued that disclosure of controversial positions was already the norm among practitioners. Raby, for one, considered disclosure “the default standard of the CPA profession for those of us who are interested in risk minimization in this world of penalties.” Nondisclosure, Raby offered, was the position that required justification. Skadden, “Gibbs Outlines Challenges for Tax Administration in 1989; CPAs Respond,” 88 *TNT* 249-1 (Dec. 13, 1988) (quoting Raby).

⁹⁵Reg. (former) section 1.6661-4(b).

⁹⁶Rev. Proc. 88-37 (July 1988).

⁹⁷Skadden, *supra* note 66, at 253.

⁹⁸See *Dolphus E. Schirmer v. Commissioner*, 89 T.C. 277 (1987), in which the Tax Court refused to accept Schedule F and Form 4562, “Depreciation and Amortization,” as adequate disclosure of a hobby loss on the basis that those forms were not included in the enumerated list provided under Rev. Proc. 88-37.

⁹⁹Sheppard, “Section 6661 and Full Disclosure,” *Tax Notes*, Oct. 5, 1987, p. 13.

¹⁰⁰Uhlfelder and Sheppard, *supra* note 48, at 1152.

¹⁰¹See, e.g., New York City Bar, *supra* note 16 (“Indeed, we question whether it is appropriate for taxpayers to be questioned as to whether they received advice as to the applicability of the section 6661 penalty. Such inquiry would subject a taxpayer to the dilemma of waiving his attorney-client privilege or jeopardizing his attorney’s eligibility to practice before the Internal Revenue Service. We do not believe that the taxpayer and his attorney should be potentially placed in adversarial postures”); AICPA, *supra* note 15 (noting that Treasury’s proposal “would potentially cause practitioners to have a conflict between their own interests and those of their clients”).

¹⁰²New York City Bar, *supra* note 16.

¹⁰³“American Bar Association Tax Section Kicks Off Spring Meeting With Committee Meetings,” *supra* note 57.

¹⁰⁴NSPA, *supra* note 81.

audit and appeals level.”¹⁰⁵ The revenue agent could blackmail the practitioner with the threat of discipline, forcing her to advise a taxpayer-client to accept an IRS determination. There were reports that revenue agents were already using the imposition of the section 6661 penalty as a “great bargaining tool” or wedge in negotiations with taxpayers and their representatives.¹⁰⁶ That kind of behavior “adversely interfere[d] with a tax practitioner’s duty of loyalty to his client by encouraging the tax practitioner to act in his own interest, not the client’s interest.”¹⁰⁷ Practitioners feared raising a red flag by drawing attention to questionable positions. Thus, while they reported making more disclosures on returns, practitioners also reported avoiding Form 8275 out of concern that attaching it to the return would trigger an automatic examination.¹⁰⁸

Ultimately, practitioners cried foul. The proposed amendments put too much weight on the government’s side of the scale. “Imposition of a section 6661 standard on practitioners,” the AICPA said indignantly, “while the IRS and its agents are under no such restrictions and are free to (and in some cases do) assert nonsubstantial authority positions, is manifestly unfair.”¹⁰⁹ Nevermind that the IRS was understaffed and underfunded, or that it uncovered abusive transactions only by chance or after practitioners had moved on to more lucrative schemes. Nevermind, too, that it was engaged in a losing battle with practitioners determined to treat the IRS as an adversary rather than as a partner in the fight against noncompliance. Practitioners were right about one thing: The playing field wasn’t level.

E. Client Advocacy and Gresham’s Law

The Treasury proposal would ultimately hurt taxpayers, practitioners warned. Its onerous reporting standards prevented practitioners from asserting positions most favorable to the taxpayer-client. Also, the new requirement that a practitioner be “assured” of the ultimate correctness of a reporting position would have a chilling effect on the competency of tax advice.¹¹⁰ If practitioners were not allowed some level of flexibility in rendering advice, taxpayer-clients would suffer a disservice.¹¹¹ Practitioners would be confined to providing taxpayer-clients with safe and conservative tax advice. As such, they would be reduced to “pseudo-IRS agents,”¹¹² part of

the Service’s “enlisted army,”¹¹³ and viewed by clients “as an enforcement arm of the IRS” rather than a zealous advocate of the taxpayer-client’s interest.¹¹⁴

Worse, the new standards would not appreciably raise compliance.¹¹⁵ And they might have the perverse result of increasing rather than decreasing aggressive shelter transactions. Those practitioners predisposed to advising questionable positions would not be deterred by the section 6661 penalty.¹¹⁶ Meanwhile, practitioners who altered their behavior as a result of the higher reporting standard as well as the threat of disciplinary action would lose clients to “the least competent” practitioners.¹¹⁷ Higher reporting standards would result in less honest reporting, lower compliance, and fewer ethical practitioners.

Treasury was aware of those arguments. It even noted the potentially adverse effects of Gresham’s Law. But it was not about to let self-interest among taxpayers and practitioners scuttle its battle against noncompliance. The only way to move forward was to raise standards for both taxpayers and practitioners, enforce the higher standards, catch the bad guys, and instill a sense of responsibility toward the system. In 1987 *Tax Notes* asked Shapiro how the IRS contended with “whatever tendencies taxpayers have to shop practitioners and the concomitant practitioner tendency to sign whatever the taxpayer wants.”¹¹⁸ “We do what we can,” Shapiro responded, “to assure that those who prepare tax returns, particularly those who are eligible to practice before the Internal Revenue Service, are circumscribed by rules which will foster the integrity of our system.”¹¹⁹ Shapiro and the IRS were fighting an uphill battle, however, which was getting tougher by the day.

F. The Realistic Possibility of Success Standard

While Treasury urged more stringent practice standards, practitioners countered that existing standards

¹¹³Schuyler M. Moore to Shapiro, 86 *TNT* 167-26 (Aug. 21, 1986).

¹¹⁴NSPA, *supra* note 81.

¹¹⁵See, e.g., NYSBA Tax Section, *supra* note 30, at 1116 (positing that the proposed amendments were “unlikely to have the desired effect of substantially discouraging aggressive reporting positions on tax returns”).

¹¹⁶New York City Bar, *supra* note 16 (arguing that imposing a section 6661 penalty on wayward practitioners would not achieve the desired goal of forcing disclosure “insofar as practitioners who are insensitive to the possible importance of the penalty would very likely not alter their conduct in any event”).

¹¹⁷Raby, *supra* note 94. In an odd statement that nonetheless arrived at the same result as other practitioner organizations, the D.C. Bar Tax Section asserted that Treasury’s proposed amendments to Circular 230 would undermine the movement to increase compliance and self-assessment “because it would stifle the right to consideration of one’s views (‘a day in court’), which is, perhaps, our most cherished instrument of fair play.” As far as I can tell, the only way the modifications would decrease compliance by preventing a taxpayer-client’s “day in court” would be if the taxpayer-client chose not to report the position (or sought out a less scrupulous adviser) rather than comply with the proposed regulations.

¹¹⁸Uhlfelder and Sheppard, *supra* note 48, at 1151.

¹¹⁹*Id.*

¹⁰⁵NYSBA Tax Section, *supra* note 30, at 1116.

¹⁰⁶Skadden, *supra* note 66, at 255.

¹⁰⁷NYSBA Tax Section, *supra* note 30, at 1116.

¹⁰⁸Skadden, *supra* note 66, at 253-254. The IRS denied that it was screening returns for section 6661 disclosures. According to IRS Assistant Commissioner (Examination) David Blattner, the Service did not pick up that disclosure until the return had been selected under the discriminant information function. *Id.* at 254.

¹⁰⁹AICPA, *supra* note 15.

¹¹⁰NSPA, *supra* note 81.

¹¹¹*Id.*

¹¹²Skadden, “Circular 230 Revisions, CP-2000 Program Changes, and Year-End Conformity Legislation Discussed at AICPA Tax Division Meeting,” 87 *TNT* 236-5 (Dec. 8, 1987) (paraphrasing Leonard Podolin, chair, AICPA Subcommittee on Responsibilities in Tax Practice).

were high enough. The ABA had ostensibly raised practice standards with Formal Opinion 85-352, issued in 1985.¹²⁰ Also, the AICPA was reworking its own practice standards, an effort that would result in revised Statements on Responsibilities in Tax Practice, released in 1988.¹²¹ The guidelines enunciated by the two major organizations of tax professionals contained nearly identical “realistic possibility of success” standards grounded in a practitioner’s “good faith.”¹²² Also, both the ABA and the AICPA allowed their members to assert any nonfrivolous position.¹²³ And they recognized an inherent right of their members to recommend positions most favorable to the taxpayer-client.

Tax lawyers were particularly strident in preserving their right to seek advantageous results for clients. “It is the time-honored rule of attorneys,” Sachs argued, “to render advice that may be contrary to existing authority if the attorney believes in good faith that the position may prevail in a court of law.”¹²⁴ Opinion 85-352 merely

required the attorney to advise her taxpayer-client as to the possible application of the section 6661 penalty. If, after receiving that advice, the taxpayer-client decided to risk the penalty by making no disclosure and taking the position advised by the lawyer in accordance with Opinion 85-352’s realistic possibility of success standard, the lawyer had satisfied her ethical and professional responsibilities.

Only two short years after its release, Opinion 85-352 had seemingly become the bible for attorneys.¹²⁵ In commenting on Treasury’s proposed amendments to Circular 230, the NYSBA Tax Section recommended that Treasury substitute the standards of Opinion 85-352, modified so they could apply to lawyers and nonlawyers alike. Thus, “some realistic possibility of success if the matter is litigated” could be made more inclusive to read “some realistic possibility of success upon the final determination of the matter.”¹²⁶ Independently, the AICPA aligned its guidelines with those of the ABA in 1988 while Treasury’s amendments were still in proposed form, making realistic possibility of success the industry standard.

Treasury recognized that its proposal went beyond existing guidelines embraced by practitioners. For instance, Shapiro noted in March 1987 that practice standards reflected in Opinion 85-352 were “at variance” with the proposed modifications to Circular 230.¹²⁷ Shapiro elaborated at a December 1987 meeting of the CAG, pointing out that the prevailing practitioner view was that advice rendered in good faith evidenced by a realistic possibility of success if litigated equated with good tax practice.¹²⁸ For its part, Treasury wanted to move tax practice standards closer toward “more likely than not” on the continuum of professional guidelines.

IV. Conclusion

By the end of 1988, two years had elapsed since Treasury issued proposed modifications to Circular 230. At that point, Treasury was no closer to finalizing the amendments than it was in 1986. During the intervening period, practitioner groups strongly objected to the prospect of new practice standards that prohibited advising or recommending a reporting position or preparing or signing a return unless the practitioner could determine that the section 6661 penalty would not apply. Lawyers rallied around the ABA’s recently promulgated Opinion 85-352, while nonlawyers adopted the realistic possibility of success standard as their own, unifying practice standards among the major professional tax organizations. In response to practitioner criticism and solidarity, Treasury twice extended the comment period for its proposed

¹²⁰ABA Comm. on Ethics and Professional Responsibility, *supra* note 5.

¹²¹AICPA Federal Taxation Executive Committee, Statements on Responsibilities in Tax Practice (SRTP) (1988 Rev.). Between 1964 and 1977, the AICPA had issued 10 consecutively numbered SRTPs. Between 1985 and 1988, the AICPA Tax Division’s Federal Taxation Executive Committee (now called the Tax Executive Committee) revised and renumbered the SRTPs. Original Statement No. 10, issued in 1977, “Positions Contrary to Treasury Department or Internal Revenue Service Interpretations of the Code,” became SRTP No. 1, “Tax Return Positions,” and contained the AICPA’s version of the realistic possibility of success standard.

¹²²Opinion 85-352 permitted an attorney to advise a reporting position as long as she had a good-faith belief evidenced by some realistic possibility of success if the matter is litigated, while SRTP No. 1 allowed a CPA to recommend a position as long as she had a good-faith belief that it had a realistic possibility of being sustained administratively or judicially on its merits if challenged. While the AICPA standard recognizes two potential forums for determining the realistic possibility of success of a reporting position (that is, an IRS appellate conference or a court proceeding), the ABA guidelines reflect a pure litigation standard and ignore the potentially conclusive effect of administrative proceedings. See John C. Gardner, Susan L. Willey, and James A. Woehlke, “The Realistic Possibility of Success Standard,” 5-91 *The Tax Adviser* 279 (May 1991). The ABA approach comports with its historic refusal to recognize the IRS as a tribunal or even a pseudo-tribunal.

¹²³Opinion 85-352 required attorneys to evidence an objective good-faith belief in the position, while SRTP No. 1 seemed to permit CPAs to assert nonfrivolous positions without an objective good-faith belief as long as the position was adequately disclosed. For a position to be frivolous it had to be “knowingly advanced in bad faith” and “patently improper.” The tax bar also endorsed a nonfrivolous view. See, e.g., NYSBA Tax Section, *supra* note 30; D.C. Bar Tax Section, *supra* note 53. Before issuing SRTP No. 1, the AICPA demonstrated a reluctance to abandon the much-maligned reasonable basis standard. While commenting on the 1986 proposed amendments to Circular 230, the AICPA wrote that “‘reasonable basis’ or ‘reasonable support’ has always been an appropriate standard with respect to tax return preparation or advice to clients.” AICPA, *supra* note 15.

¹²⁴New York City Bar, *supra* note 16.

¹²⁵Briggs, *supra* note 17, at 635 (quoting Ritholz).

¹²⁶NYSBA Tax Section, *supra* note 30, at 1117. See also D.C. Bar Tax Section, *supra* note 53 (recommending that “any modification of Circular 230 be based generally upon” Opinion 85-352); AICPA, *supra* note 15 (endorsing realistic possibility of success standard).

¹²⁷Uhlfelder and Sheppard, *supra* note 48, at 1151.

¹²⁸CAG, *supra* note 57.

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amendments, providing opportunity for additional feedback and potential reconciliation of differing viewpoints.¹²⁹

The reality was that the two sides were worlds apart. Tax practitioners continued to view the IRS as an adversary and the rendering of tax advice as largely an adversarial act. Tax lawyers were especially displeased,

¹²⁹See Department of the Treasury, Tax Practitioners; Extension of Comment Period, 51 *Fed. Reg.* 30510 (Aug. 27, 1986); Department of the Treasury, Tax Practitioners; Solicitation for Extended Comments, 51 *Fed. Reg.* 40340 (Nov. 6, 1986).

wedded to professional standards that reflected litigation norms. Treasury, on the other hand, thought controversy norms inapposite for tax practice. The preparation and submission of a tax return was not an adversarial act. Nor was the planning and advising that informed a taxpayer-client's various reporting positions. Tax practitioners had an obligation both to clients and the tax system. By the late 1980s, the two sides had reached an impasse. Ultimately, Congress would break the stalemate with a new round of penalty reform, just as it had earlier in the decade. Only this time Congress would thwart rather than promote Treasury's effort to equate practice standards for practitioners with legal obligations for taxpayers under the tax law.