THE DISTRICT OF COLUMBIA BAR

SECTION

Taxation

February 13, 1987

BY HAND

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Leslie M. Shapiro, Esq.
Director of Practice
Internal Revenue Service
12th & Constitution, N.W.
Ariel Rios Building
Room 1413
Washington, D.C. 20224

Attention: Pm:Hr:Dp

Re: Proposed Amendments to Circular 230, 31 C.F.R. Part 10

Dear Mr. Shapiro:

On behalf of the Section of Taxation of the District of Columbia Bar, we submit the following comments upon the standard of practice with respect to tax return preparation and advice in response to your notices of proposed rulemaking published November 6, 1986, 51 F.R. 40340 and August 27, 1986, 51 F.R. 30510.*

I. RECOMMENDATIONS

1. The Section of Taxation agrees with the Treasury Department that a revised ethical standard with respect to tax return advice and preparation should be incorporated in

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*The views expressed herein represent only those of Section 16, Taxation, of the District of Columbia Bar and not necessarily those of the entire District of Columbia Bar or its Board of Governors. Section 16 is comprised of approximately 1,200 members. These comments were initially prepared by the Section of Taxation's Standing Committee on Legislation and Regulations, chaired by James E. Merritt, and were revised and approved by the Section of Taxation's Steering Committee.

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Circular 230 and that such a standard should be uniformly applied to all tax practitioners, including lawyers, accountants and enrolled agents.

2. We support the explicit "due diligence" requirement proposed by Treasury relating to practitioners' obligations with respect to return positions.

3. We oppose the stringent standard of tax practice proposed by Treasury in its notice of proposed rulemaking, i.e., that a practitioner may not advise or recommend a return position (or prepare or sign a return) unless he or she determines that the taxpayer filing the return will not be liable for an addition to tax under Section 6661.

4. We recommend that any modification of Circular 230 be based generally upon the American Bar Association's ("ABA") Formal Opinion 85-352. We have reviewed the proposed text for Section 10.34 which we understand that the ABA Tax Section is submitting to Treasury and which is patterned after ABA Formal Opinion 85-352, and we are in agreement with the language expressed in the ABA Tax Sections's draft. The standard expressed in Formal Opinion 85-352 and in the ABA Tax Section's draft of Section 10.34 would require practitioners to exercise "due diligence" in asserting positions and would permit positions to be asserted which were reached in "good faith" with the belief of "some realistic possibility of success."

5. In further agreement with the ABA Tax Section's position, we recommend that, in the context of a return or an amended return that serves as a claim for refund, practitioners be permitted to recommend any position that is not frivolous, provided that such position is recommended in good faith and that such position is adequately disclosed on the return or amended return.

II. THE GOALS OF AN ETHICAL STANDARD OF TAX PRACTICE

As we all know, there has been a dramatic increase in uninterpreted tax law culminating most recently in the revised Internal Revenue Code of 1986. Indeed, if there is a current crisis in tax administration, it is the lack of interpretative guidance in regulations, rulings and written determinations. Tax practitioners, in and out of the government, face a momentous task to develop fair and administrable interpretations of tax statutes that seem to be more complex and incomplete than ever before. This is not to criticize Congress, Treasury or the Service. These

circumstances, however, point to the present need to further interpret the law and to develop a body of authority.

In addition to revisions of the substantive tax law, Congress has enacted many new civil tax penalties which are designed to deter overly aggressive taxpayer behavior. These penalties are themselves complex, overlapping and only in the early state of interpretation and application. 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, are materially affecting the behavior of taxpayers.

In this environment, we believe that it is particularly desirable and necessary to encourage taxpayers and practitioners to participate in a reasoned development of the tax law. We believe that a standard of tax practice should: (1) prohibit conduct which fails to meet a certain level of care (due diligence), whether such failure is due either to neglect or to intentional wrongdoing; (2) permit the fair consideration of differing interpretations of the law essential to a full development of the law; and (3) encourage self-compliance with the system. The standard of tax practice promulgated by Treasury must also be perceived of as fair because disciplinary action (including disbarment and collateral action such as malpractice claims) will be based upon any such standard. To suspend or disbar practitioners under a standard generally perceived of as unfair may result in protests that the Service cannot administer nor the system survive.

III. THE FAILURE OF THE CIRCULAR 230 PROPOSALS TO MEET THE NECESSARY GOALS OF AN ETHICAL STANDARD OF PRACTICE

A regressive standard of practice, such as that incorporated in Treasury's proposed amendments to Circular 230, may discourage taxpayers' expressions of legitimate differences in the interpretation and application of the tax law and, in turn, foreclose the very dialogue necessary for the development of our system of taxation. In our opinion, Treasury's current proposal would undermine the recent movement to increase tax 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.

There are additional reasons why the standards proposed by Treasury in its Notice of Proposed Rulemaking fail to

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achieve the goals discussed above. First, although Treasury's preamble would not require "substantial authority" if a practitioner recommends that a client make "adequate disclosure," the proposed amendment to Circular 230 itself, contains no such safe harbor from the "substantial authority" requirements, particularly in the case of tax shelters. Moreover, administration of this rule necessarily would require examination of privileged communications between a practitioner and his or her client.

Second, the definition of "authority" in Treasury Regulations § 1.6661-3(b)(2), under Section 6661 to which the proposed Treasury revision refers, is currently very restrictive. In our opinion, it would be unfair to impose sanctions upon an advisor who recommends that a taxpayer take a position supported only by a proposed regulation or a written determination. Nevertheless, that would be the result under Treasury's proposal.

A better proposal, in our view, is that expressed in both ABA Formal Opinion 85-352 and the ABA Tax Section's proposed draft of an amendment to Section 10.34 of 31 C.F.R., Part 10, i.e., requiring that a position must be asserted in good faith with a belief that there is "some realistic possibility of success" and further allowing any nonfrivolous position to be argued in good faith provided that the "audit lottery" is avoided by requiring adequate disclosure or the use of an amended return which serves as a refund claim. (Both procedures are necessary in order to avoid the absurd results under section 641 of the 1984 Act, DEFRA, which would penalize a taxpayer who relies upon the refund claim or amended-return procedure.) Because reasonable and competent tax practitioners may differ as to what is a realistic possibility of success, we believe that it is essential to expressly permit the assertion of adequately disclosed nonfrivolous return positions. The reasonable-possibility-of-success standard is a reformulation of the "reasonable basis" standard in Opinion No. 314, and we believe that such a standard appropriately fails to incorporate any specific percentage likelihood-of-success.

IV. THE POSSIBILITY OF DISCIPLINARY ACTION AGAINST A PRACTITIONER

An implication of Treasury's August 13, 1986 proposal is that disciplinary proceedings may be considered as to any practitioner if one of his or her clients is assessed the substantial understatement penalty under Section 6661. (No other civil or criminal penalties, including tax return

preparer penalties, were mentioned in the proposal.) Such a position should not, in our opinion, be either expressed or implied by Circular 230.

A further consequence of the standards currently proposed by Treasury is that practitioners will face the possibility of disciplinary action for taking appropriate positions on factual matters with respect to which there cannot be "substantial authority." The Section-6661 penalty is a strict-liability penalty which applies automatically when the statutory understatement threshold amount is exceeded, regardless of whether the issue is a legal or a factual one. Thus, although certain issues, such as a Section-482 adjustment or a deduction for reasonable compensation, may be subject to the penalty, there may not have been reliance on "substantial authority" because of the issues' inherently factual nature. In our opinion, to potentially subject a practitioner to disciplinary action for such matters, as would be the case under the standards currently proposed by Treasury, would be draconian.

In view of the complexity of the tax law, the currently rigid definition of "authority" and the evolving state of standards of practice, all of which we have discussed above, it is our view that disciplinary action should rarely, if ever, be based upon a single assessment by Treasury of the Section-6661 penalty against a client of a practitioner. A single assessment of that penalty is as likely to result from a practitioner's good-faith effort to comply with the law and standards of practice as it is from the negligent or willful disregard for such rules. Instead, we believe that the assessment of civil penalties against a practitioner or his or her clients should be considered as a basis for disciplinary action against such practitioner only if such assessment demonstrates either gross neglect or a willful failure to attempt to comply with the law and standards of practice. A pattern of conduct, rather than a single incident, should be evidence of such neglect or willful failure, and we recommend that, as a general rule, such a pattern be required as a basis for consideration of disciplinary action. Such a pattern, moreover, should encompass all or almost all of the civil tax penalties and should not be be restricted solely to the Section-6661 substantial understatement penalty. For example, a practitioner who advises the filing of frivolous returns or, indeed, fraudulent returns should certainly be as subject to consideration

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for disciplinary action as one who advises positions for which there is less than substantial authority.

V. THE ROLES OF PRACTITIONERS AND TAXPAYERS

Although Treasury's Notice of Proposed Rulemaking expressed the view that some practitioners have contributed to compliance problems by recommending overly aggressive positions, we believe that most practitioners, including our members, are attempting to comply with the tax laws, in order to avoid the imposition of penalties upon their clients and to represent what they believe are valid interpretations of the law, even though their interpretations may at times differ from the government's interpretations. An appropriate standard of the practice should provide a mechanism for practitioners to recommend good-faith positions to their clients without fear of censure. We believe that the ABA Tax Section's proposed draft of an amendment to Section 10.34 of 31 C.F.R., Part 10, provides the reassurance to tax practitioners necessary for them to responsibly carry out their duties.

Lastly, we wish to comment upon the problems of confidentiality and the obligations of practitioners, particularly attorneys, to their clients. We recognize that the application of **any standard** of tax practice may have the necessary effect of requiring an attorney to reveal the advice he or she provided to his or her client in order for that attorney to defend a disciplinary action. Even if an attorney may ultimately be authorized to divulge such advice, judicial proceedings will most likely be necessary to obtain such authorization. Investigations which intrude upon confidential attorney-client relationships may have a harsh impact upon an attorney's ability to practice. Accordingly, in administering **any** standard of tax practice, Treasury and the Service should weigh carefully the need for each inquiry into confidential attorney-client communications before such an inquiry is initiated.

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VI. CONCLUSION

We appreciate this opportunity to submit these comments upon the proposed revision of Circular 230 and are willing to work further with the Service in developing acceptable standards of practice and disciplinary rules.

Respectfully submitted,

STEERING COMMITTEE
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