Legislating Morality: The Duty to the Tax System Reconsidered

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Legislating Morality: The Duty to the Tax System Reconsidered

Camilla E. Watson*

I. INTRODUCTION

Four years ago, I presented a paper at a symposium on professionalism jointly sponsored by the University of Kansas Law School and the Kansas Bar Association.¹ That paper espoused the view (contrary to what appears to be the popular view among tax scholars)² that tax lawyers owe no special duty to the "tax system"³ other than to abide by the law and the applicable standards of professional conduct.⁴ During the four-year interim since my last visit to Kansas, however, we have witnessed the deleterious effect of the IRS Restructuring and Reform Act of 1998⁵ (RRA ’98) on IRS enforcement

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* Professor of Law, University of Georgia, School of Law. I thank my friends and colleagues Lorie Johnson, Margaret V. Sachs, Charles R.T. O’Kelley, and Alan Watson for very helpful comments on an earlier version of this paper. This paper also was presented at a faculty colloquium at the University of Georgia. I thank Randy Beck and members of the Faculty Seminars Committee for inviting me to present my research.


2. See, e.g., Mortimer M. Caplin, Responsibilities of the Tax Advisor—A Perspective, 40 TAXES 1030, 1032 (1962) (stating tax practitioners must insure that the system is "functioning honestly, fairly and smoothly"); Frederic G. Cromell, Guidelines to Tax Practice Second, 43 TAX LAW. 297, 301 (1990) (noting that tax lawyers should "contribute to [the] improvement of tax laws and their administration"); Linda Galler, The Tax Lawyer’s Duty to the System, 16 VA. TAX REV. 681, 693–98 (1997) (reviewing BERNARD WOLFMAN ET AL., ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE (1995) (arguing that tax lawyers owe additional duties to the revenue system and to the government)).

3. The definition of the term "tax system" is important because it establishes the context in which "the duty" is owed. Both terms have had a variety of meanings. See Galler, supra note 2, at 687–88 (recommending clarifying the meaning of a lawyer’s "duty to the system"). In my previous article, Watson, supra note 1, and in this one, I use the term "tax system" to mean the federal self-assessment system of taxation in general, of which the IRS and its system of administration that comprise the revenue raising process are paramount. See Galler, supra note 2, at 688 (defining the term "tax system").

4. See Watson, supra note 1, at 909 (arguing the "lawyer’s only duty should be to obey the rules of law and ethics"). In general, the applicable standards of professional conduct are the rules of the various state supreme courts of the jurisdictions in which the lawyers practice and the standards of practice applicable to tax professionals appearing before the IRS. These latter standards are found in regulations promulgated by the IRS, collectively referred to as "Circular 230." See 31 C.F.R. §§ 10.0–10.97 (2002) (setting forth ethical rules specific to practice before the IRS). In addition, the U.S. Tax Court has adopted the ABA Model Rules of Professional Responsibility to which those practicing before it must adhere. TAX CT. R. PRAC. 201.

and collection activities, and consequently on taxpayer compliance. Almost daily, new corporate accounting scandals and abusive tax avoidance transactions are being reported in newspapers across the country. Thus, I have been invited to reconsider my earlier position specifically in light of RRA '98.

The problem with abusive tax schemes lies not with the wage earners and lower income taxpayers, but rather with the upper income individual and corporate taxpayers who have money to shelter and resources to hire the best professional advice on how to avoid paying taxes. The sophistication of these taxpayers and their advisors has enabled them to exploit the tax system through the use of elaborate tax avoidance schemes. These schemes would not have been possible without the help of tax professionals. Yet, these schemes have hurt the professionals' clients, damaged the national economy, and undermined the federal tax system.

What does this say about a duty to the tax system, and what difference does it make whether or not tax practitioners have a discrete duty to the tax system? Should the duty of lawyers practicing tax law be different from the duty of other tax practitioners?

If there is a discrete duty to the tax system, it will affect how tax practitioners interact (or should interact) with the Service. In addition, if there is such a duty, it should be a normative one in which clear expectations are firmly established, and the ability of all tax practitioners to comply is feasible in practice. But this has not been the case, and that has led to our present problems.

II. THE ADVERSARIAL NATURE OF THE INTERACTION BETWEEN TAX PRACTITIONERS AND THE GOVERNMENT

Tax practitioners representing clients before the Service must conform their conduct to the standards of practice embodied in Circular 230. Since these standards were drafted by the government, their principle focus

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6. See David Cay Johnston, Departing Chief Says the IRS Is Losing War on Tax Cheats, N.Y. TIMES, Nov. 5, 2002, at A1 (quoting the statement of outgoing Commissioner Charles O. Rossotti that "[t]he great majority of tax cheats... will be allowed to get away without paying their full share because the IRS lacks the money to enforce the law"); see also Jennifer Corbett Dooren & Mark H. Anderson, IRS Says Cost of Tax Scams Is Getting Higher, WALL ST. J., Apr. 12, 2002, at A4 (stating that the Internal Revenue Service estimates that as much as $40 billion in improper tax avoidance might be going undetected, and the problem could be even worse.); Brant Goldwyn, Congressional Panel Tells IRS of Concerns About Compliance, Modernization Programs, DAILY TAX REP., May 15, 2002, at G-6 (explaining that GAO estimates unpaid taxes at $239 billion but considers only $20 billion of this amount collectible according to James R. White, director of tax issues).

understandably is on the Service and the standards of professional conduct the Service expects from those admitted to practice before it. Lawyers further must conform to the standards of professional conduct of their individual state bar associations, many of which are modeled on the ABA’s Model Rules of Professional Conduct (Model Rules). The principle focus of the Model Rules is on conflict resolution and litigation, and of course, on the client. Thus, important aspects of the Model Rules are that lawyers must represent their clients zealously within the bounds of the law, and that they must preserve the confidences of their clients.

Since the principle focus of the two drafting bodies was different, it is not surprising that there are conflicts between the two standards of professional conduct. These conflicts can cause problems even for those lawyers who wish to behave honorably and ethically. For those who do not, the conflicting standards offer a window of opportunity. Until these conflicts are resolved, there can be no meaningful duty to the tax system.

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8. A variety of professionals may represent clients before the IRS. These include attorneys, certified public accountants, enrolled agents, enrolled actuaries, and others. See id. § 10.3 (explaining who may practice).

9. MODEL RULES OF PROF’L CONDUCT (2002) [hereinafter MODEL RULES]. In 1983, the Model Rules replaced the Model Code of Professional Responsibility, created in 1969. Some states continue to adhere to the Model Code, which has a different format from the Model Rules. Prior to 1969, the ABA standards were encompassed in the Canons of Professional Ethics. For a history of the ABA Rules, see N. Lee Cooper & Stephen F. Humphreys, Beyond the Rules: Lawyer Image and the Scope of Professionalism, 26 CUMB. L. REV. 923, 925–31 (1996) (discussing the history of the ABA Rules). See also Mark Hansen, Hot off the Press, A.B.A. J., June 2002, at 37, 38 (discussing proposed amendments to the Model Rules). The ABA Rules are merely a model and do not apply in themselves unless they have been adopted by state bar associations.

10. See MODEL RULES, supra note 9, R. 1.3 cmt. (“A lawyer must also act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client’s behalf.”).

11. See MODEL RULES, supra note 9, R. 1.6 (stating that “[a] lawyer shall not reveal information relating to the representation of a client” without the client’s informed consent). The ABA’s House of Delegates considered an extensive review of the Model Rules. This review concluded in 2002. One of the recommendations, which was rejected, was an amendment to Rule 1.6 to allow a lawyer to disclose client confidences to “prevent, rectify or mitigate financial losses arising out of crimes or frauds” of the client. See Hansen, supra note 9, at 38. This amendment was proposed in order to align the Model Rules with the vast majority of states that have adopted a more liberal confidentiality rule. See James Podgers, Lawyer Ethics in a State of Flux: Revisions in the ABA Model Rules of Professional Conduct May Soon Be Adopted in Your State, A.B.A. J., Dec. 2002, at 46, 48. It is predicted, however, that the ABA will reconsider this revision in the aftermath of the Enron scandal. See Nancy J. Moore, Revisions, Not Revolution: Targeting Lawyer/Client Relations, Electronic Communications, Conflicts of Interest . . ., A.B.A. J., Dec. 2002, at 48, 50.
A. Is the Filing of a Tax Return an Adversarial Process?

One of the unresolved conflicts between the government and the ABA is whether the filing of a tax return is considered adversarial. The ABA set the stage for this controversy in two formal opinions. Under the Model Rules, a lawyer has a duty to disclose to a tribunal adverse controlling authority, as well as adverse material facts, that have not been disclosed by the opposing party. In Formal Opinion 314, issued in 1965, the ABA concluded that the Service is neither a "true tribunal nor even a quasi-judicial institution," because it is "not designed and does not purport to be unprejudiced and unbiased in the judicial sense."

Therefore, a lawyer owes the IRS no greater deference than the lawyer owes any other adversarial party. The lawyer's duty is to preserve the confidences of the client within the constraints of the rules of professional responsibility. Thus, the confidences of the client remain inviolate.
A shortcoming of the opinion, however, is that it failed to distinguish among the various roles a lawyer plays in representing a client in the tax process. These roles, in general, are advisor, return preparer, and advocate. In her role as an advisor, a lawyer may advise her client on the tax consequences of prospective transactions, as well as on how to treat items on a current tax return. If the lawyer receives compensation for rendering advice that constitutes a substantial portion of the return, she may be considered a return preparer even though she does not physically complete the return or sign it. In fact, she may never see the return, but as a nonsigning return preparer, the lawyer is potentially subject to the liability of a signing preparer, which includes the civil penalty for substantial understatements of tax liability.

17. Watson, supra note 1, at 853–55. In representing a taxpayer/client, these are the three principal roles that a tax lawyer plays, although there have been other roles identified. See Theodore C. Falk, Tax Ethics, Legal Ethics, and Real Ethics: A Critique of ABA Formal Opinion 85-352, 39 TAX LAW. 643, 645–46 (delineating seven different roles that a tax lawyer plays in the tax process).

18. Treas. Reg. § 301.7701-15(a)(1) (as amended in 2002). Whether the advice is substantial is determined by the length, complexity, and the amount of tax liability or refund in that portion of the return compared to the entire return as completed. The advice must be sufficient to make the completion of the return "largely a mechanical or clerical matter." Id. In addition, the advice rendered must relate to a completed transaction, as opposed to one that is contemplated. Id. § 301.7701-15(a)(2)(i).

19. I.R.C. § 6694(a). The preparer's obligations differ depending upon whether the preparer is a signing or a nonsigning preparer. A nonsigning preparer fulfills her duty when she advises the taxpayer or the signing preparer or both (whomever has solicited her advice) that the position lacks substantial authority and that a substantial understatement penalty may apply unless the position is disclosed. Treas. Reg. § 1.6694-2(c)(3)(ii) (as amended in 1992). The form of the statement depends on the form of the advice. If the advice is required to be rendered in writing, the statement must be in writing. Treas. Reg. § 1.6694-2(c)(3)(ii)(A) (as amended in 1992). If the advice is oral, the statement can be oral. Id. In the event of a subsequent question about the role of the preparers, however, the nonsigning preparer should make contemporaneous notes to document the fact that the disclosure was given. Id.

If the taxpayer is required to disclose the position, a Form 8275 Disclosure Statement (or a Form 8275-R if the position is contrary to a rule or regulation) must be attached to the return. Disclosure may be made on the return itself if in accordance with IRS specifications. Treas. Reg. § 1.6694-2(c)(3)(i)–(ii) (as amended in 1992); see also Rev. Proc. 97-56, 1997-2 C.B. 582–83 (disclosure must be specific, monetary amount must be verifiable, and the position must be taken in good faith).

An understatement must be distinguished from an underpayment. Both may result in a deficiency due and owing, but an understatement penalty applies whether or not there has been an underpayment of tax. Carryovers and carrybacks of deductions and credits may reduce the amount of an underpayment, but not the amount of an understatement. Similarly, amounts not shown on the return that were previously assessed or collected without assessment may reduce the amount of an underpayment, but may have no effect on an understatement. See I.R.C. § 6664(a) (noting that the calculations under § 6664(a) only apply to underpayments).

Since the taxpayer's accuracy related penalty under I.R.C. § 6662(b)(2) applies to an underpayment of tax liability, the preparer may be subject to an understatement penalty even though the taxpayer is not subject to an accuracy-related penalty.
If the taxpayer and the Service disagree on the proper tax treatment or characterization of an item on the return, a lawyer may represent the taxpayer in an administrative appeal before the Service, or in court if the disagreement leads to litigation. In either case, the lawyer serves as an advocate for the client against the government. As an advocate, the lawyer’s relationship with the IRS is clearly adversarial, as it is with any other third party opponent. But the lawyer’s role in representing a client during the examination or audit of a tax return is not as clear.

As an advocate, the lawyer is justified in advising her client against volunteering information to a revenue agent, and the lawyer herself has no obligation to voluntarily disclose weaknesses in the client’s case. In fact, the lawyer is prohibited from disclosing confidences of her client unless she has the express permission of the client, or one of the narrow exceptions to confidentiality applies under the legal rules of professional conduct. On the other hand, if the lawyer is not considered an advocate, she owes a greater duty to the government to cooperate fully and completely in the examination of her client’s return.

Formal Opinion 314 further stated that a lawyer could “freely urge” a return position that was most favorable to the client as long as there was a “reasonable basis” for the position. But over time, this standard gave rise to complaints from both the tax bar and the Service that many lawyers and other tax professionals were interpreting this minimum ethical standard to support the use of any colorable claim to justify the exploitation of the audit lottery. In response to these concerns, the ABA issued Formal Opinion 85-352 in 1985, which restated the governing standard as a “realistic possibility.

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20. Note that non-attorneys may represent taxpayers in the Tax Court provided they file an application and pass an examination administered by the court and they also may practice before the IRS. TAX CT. R. PRAC. 200(a)(3).

21. See Loren D. Prescott, Jr., Challenging the Adversarial Approach to Taxpayer Representation, 30 LOY. L.A. L. REV. 693, 730–31 (1997) (admitting that “the case for partisan advocacy is more persuasive in the context of an audit,” but concluding “[t]he purpose of the internal revenue audit is to confirm compliance, not to resolve disputes”); see also infra notes 96–115 and accompanying text (discussing the posture of an audited taxpayer’s attorney towards the IRS).

22. The lawyer has a duty to avoid giving false or misleading information to a Treasury employee. 31 C.F.R. § 10.51 (2002). Under the ABA’s Model Rules, the lawyer may not advise or assist a client in conduct the lawyer knows is criminal or fraudulent. MODEL RULES, supra note 9, R. 1.2(d). Moreover, a lawyer may not deliberately mislead the IRS, either by misstatement or by silence, and may not permit her client to mislead. Formal Op. 314, supra note 13, at 448.


of success if the matter is litigated." 25 This opinion further clarified that a lawyer has no duty to disclose to the government an aggressive return position that meets the new standard. 26 In reaching this conclusion, the ABA Standing Committee reasoned that the filing of a tax return with an aggressive position "may be the first step in a process that may result in an adversary [sic] relationship between the client and the IRS." 27

While the restated standard was intended to raise the bar on the minimum ethical standard of reporting return positions, 28 nevertheless

25. Id. at 461. A further reason for the restatement was that neither the Model Code nor the Model Rules employed the reasonable basis language in discussing the lawyer's duty in advising or presenting return positions for a client. Thus, the Standing Committee thought it appropriate to conform the standard of Formal Opinion 314 to that of the Model Rules. Id. at 460.

26. Id. at 461.

27. Id. at 460. In addressing this issue, Formal Opinion 85-352 differentiated the roles of the lawyer as return preparer and advisor. As a return preparer, the lawyer may recommend an aggressive return position without disclosure if the lawyer has a "good faith belief in the validity of [the] position." Id. at 461. This means that the position cannot be frivolous and the lawyer must have "a good faith belief that those positions are warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law." Id. The opinion goes on to state: "A lawyer can have a good faith belief in this context even if the lawyer believes the client's position probably will not prevail. However, good faith requires that there be some realistic possibility of success if the matter is litigated." Id.

In the lawyer's role as an advisor, the opinion focuses on the substantial understatement penalty applicable to taxpayers. Id. at 461. Section 6662 of the I.R.C. allows the taxpayer to take an aggressive return position without disclosure if there is substantial authority for the position. If there is no substantial authority, the taxpayer may be liable for a substantial understatement penalty unless there is a reasonable basis for the position and the position is adequately disclosed. I.R.C. § 6662(d)(2)(B). If the position is not disclosed, the taxpayer may avoid the penalty by showing that she acted in good faith and with reasonable cause. I.R.C. § 6664(c).

Under Formal Opinion 85-352, the lawyer should advise the client of the likelihood of success if the position is challenged by the Service, as well as the potential penalties that might apply. The lawyer further must advise the client that the substantial understatement penalty may be avoided by disclosing the position. If the client decides not to disclose, then according to the Opinion, "the lawyer has met his or her ethical responsibility with respect to the advice." Formal Op. 85-352, supra note 24, at 461.

Under Circular 230, a preparer may not sign a return without disclosing a position that she believes does not have a realistic possibility of success. 31 C.F.R. § 10.34(a) (2002). Generally, if a return position does not meet the realistic possibility standard, it also will not meet the substantial authority standard. The converse does not necessarily hold true, however, because a return position may have a realistic possibility of success even though there is no substantial authority in favor of the position. Thus, a position with substantial authority is a stronger position "than one that is arguable but fairly unlikely to prevail in court." 16 Stand. Fed. Tax Rep. (CCH) ¶ 39,652,024 (2003) (discussing Treas. Reg. § 1.6662-4(d)(3)(i) (as amended in 1998)). The difference between the two standards is that a preparer may advocate a position without disclosure if there is a good faith argument for an extension, modification or reversal of existing law and the preparer believes the position has at least a one-in-three chance of success. In that case, the preparer may sign the return even though the taxpayer's standard is not met, provided the preparer has advised the client on avoiding the penalty through disclosure. Circular 230, 31 C.F.R. § 10.34 (2002).

Formal Opinion 85-352 has been heavily criticized, primarily for its characterization of the return process as adversarial. As various commentators have noted, the purpose of filing a tax return "is to fulfill the taxpayer's legal obligation of disclosure, reporting and self-assessment." This is an obligation imposed upon all taxpayers under the voluntary compliance system and it must be taken seriously if the tax system is to operate efficiently. Thus, the duty to pay taxes has been referred to as "a special obligation."

Another criticism of the ABA's stance is that the return preparation process involves very little, if any, interaction with the Service. Indeed, this was intended under the voluntary compliance system. A Special Task Force, appointed by the Tax Section of the ABA to comment on Formal Opinion 85-352, attempted to soften the opinion's adversarial view by noting that the filing of a return is not an adversarial proceeding, but "ethical considerations regarding advocacy" can apply in the reporting process, particularly when a tax return contains an aggressive position.

Most practitioners and tax scholars alike would agree that the filing of a tax return is a duty imposed upon all taxpayers and as such, is not (and should not be considered) adversarial. This begs the question of why is there any controversy over the duty to file a tax return?

LAW. 635, 638 (1986) (noting higher ethical standards for reporting). The Task Force noted that the "reasonable basis" standard was intended "to set a relatively high standard of tax reporting," but that this standard "had become a low one." Id. at 638. The Task Force differentiated the new standard from the old one:

"[T]he new standard requires not only that there be some realistic possibility of success, if litigated, rather than merely a construction that can be argued or that seems reasonable, but also that there be more than just any possibility of success. The possibility of success, if litigated, must be "realistic." A possibility of success cannot be "realistic" if it is only theoretical or impracticable. This clearly implies that there must be a substantial possibility of success, which when taken together with the assumption that the matter will be litigated, measurably elevates what had come to be widely accepted as the minimum ethical standard."

Id. at 638.

29. See, e.g., Falk, supra note 17, at 647 (characterizing the audit, rather than the filing of the return, as the first step in the adversarial process); Gwen Thayer Handelman, Constraining Aggressive Return Advice, 9 VA. TAX REV. 77, 95 (1989) (noting that a tax return should not be filed in an adversarial posture); Prescott, supra note 21, at 693–94 (generally criticizing the legal profession's characterization of the tax professional's interaction with the IRS).

30. Watson, supra note 1, at 854 (citing Sax et al., supra note 28, at 640); see also Falk, supra note 17, at 649 ("[A] tax return is . . . how the taxpayer proposes to comply with tax laws.").


32. Watson, supra note 1, at 853–54.

33. Sax et al., supra note 28, at 640–41.

34. But see Frank J. Gould, Giving Tax Advice—Some Ethical, Professional, and Legal Considerations, 97 TAX NOTES 523, 529–30 (2002) (noting that a taxpayer is permitted to take an aggressive return position, even if the position is unlikely to succeed in court); Joe Thornrike, Civilization at a Discount: The Morality of Tax Avoidance, 95 TAX NOTES 664, 666 (2002) ("Paying taxes has always
1. Aggressive Return Positions

The controversy arises over the tax practitioner’s duty when the client’s tax return contains an item based on an aggressive position. The problem is that the preparer’s legal and ethical standards differ from the taxpayer’s penalty standard. This is one of the factors that has given impetus to those professionals who have aggressively marketed tax sheltered proposals and tax avoidance schemes, many of which are considered abusive.

a. The Preparers’ Standards

Under the Internal Revenue Code, a preparer cannot recommend a frivolous position, defined as “one that is patently improper.” If in good faith the preparer recommends a position that does not have a realistic possibility of success on its merits, the position must be disclosed in accordance with the regulations, or the preparer will be subject to an understatement penalty. A “realistic possibility of success” is defined under the regulations as one that has at least a one-in-three chance of being sustained on its merits.
The amount of this penalty is $250 per return, which is not significant in itself unless the preparer files multiple returns with aggressive, undisclosed positions. But if the Service suspects that the preparer’s returns demonstrate a pattern of noncompliance with the return preparer provisions, it may examine other returns prepared by that preparer to determine whether this is the case. If the preparer can establish that she acted in good faith and that the understatement was due to reasonable cause, the penalty will not apply.

Circular 230 also employs the realistic possibility standard and thus conforms the practitioner’s ethical standard to the preparer’s penalty standard. Under Circular 230, a preparer is ethically obligated to avoid advancing a frivolous position, and to recommend disclosure of a position that does not have a realistic possibility of success. While this is logical on its face, nevertheless, conforming the two standards raises several problems. First, despite an earlier, unsuccessful attempt during the 1980s to re-characterize the return preparation process as non-adversarial, the Treasury Department capitulated to the demands and criticisms of the legal profession by adopting the ABA’s “realistic possibility of success” standard in Circular 230. Since the issue was squarely raised by the Treasury Department, its failure to endorse a non-adversarial view of the return preparation and filing process has given credence to the ABA’s position that the process is adversarial, which is inconsistent with a practitioner’s discrete duty to the tax system.

39. I.R.C. § 6694(a). This amount increases to $1000 per return for willful or reckless conduct. I.R.C. § 6694(b).
40. This is part of its “Return Preparer’s Program.” See INTERNAL REVENUE MANUAL (CCH) § 20.1.6.3.5 (2002).
41. Treas. Reg. § 1.6694-2(d) (as amended in 1992). Reasonable cause will be determined after considering all facts and circumstances, but specific factors to consider include the nature and complexity of the error causing the understatement, the frequency of errors, the materiality of the errors, the preparer’s normal office practice, and whether the preparer relied on the advice of another preparer. Id. § 1.6694-2(d)(1)–(5).
43. Id.
44. For a discussion of the earlier proposal by the Treasury Department to revise Circular 230 to clarify that a “tax return is not a submission in an adversary [proceeding],” see Michael C. Durst, The Tax Lawyer’s Professional Responsibility, 39 U. FLA. L. REV. 1027, 1051 (1987). See also Prescott, supra note 21, at 721–22 (describing the “realistic probability standard”).
45. As one commentator has stated:

The Rules of Practice make no effort to modify the adversarial approach to taxpayer representation by imposing duties on the lawyer and other tax practitioners that are owed to the government in recognition of their role as members of the tax bar and out of concern over the effects of partisanship on the tax compliance process. Prescott, supra note 21, at 726.
Second, the realistic possibility standard is hardly a model of clarity, despite its attempt to quantify the chance of success. While tax professionals, particularly lawyers, are called upon on a regular basis to render opinions, written and oral, on whether particular return positions have merit, nevertheless, predicting the degree of a position’s success in court is extremely difficult and certainly is not an exact science. If lawyers and other tax professionals owe a duty to the tax system, doubts about aggressive return positions should be resolved in favor of the government and thus disclosed. If there is no such duty, legitimate doubts can be resolved in favor of the client without disclosure.

It has been noted that “our tax system encourages aggressive tax transactions [because] . . . [o]ur tax system does not require that a taxpayer resolve all uncertainties in favor of the government.” In fact, if the client does not object to disclosure, the professional may recommend a position that has less than a one-in-three chance of success, provided the position is not frivolous.

Third, if tax professionals owe a special duty to the tax system, there appears to be considerable disagreement as to what that duty is. A recent Wall Street Journal article noted that there is “little consensus among government officials, consumer advocates, journalists, professional organizations, and tax preparers from both small and large firms, about what the extent and nature of the role of the tax professional is in the voluntary compliance system.”

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46. I. and others. previously have discussed this point. See Watson, supra note 1, at 863–67 (explaining the realistic possibility standard and noting the “vast grey area of uncertainty” it leaves open); Falk, supra note 17, at 654–55 (stating that various committees have “quibbled” over the proper interpretation of the standard); Gould, supra note 34, at 537 (observing that lawyers disagree about the standard’s meaning). Consider the reasoning of Franklin L. Green, Exercising Judgment in the Wonderland Gymnasium, TAX NOTES TODAY, March 19, 2001, LEXIS 2001 TNT 53–98, that most disputes are settled and therefore the reference point for most tax practitioners in determining success is not success in litigation, but rather success in settlement.

47. Gould, supra note 34, at 527.

48. See Gould, supra note 34, at 527 (stating that a taxpayer usually can avoid the assessment of an accuracy-related penalty if the position “has at least a 10 percent or 15 percent likelihood of success and is adequately disclosed.”).

49. I.R.C § 6694(a).

Furthermore, state bar associations, which are the regulatory bodies of practicing lawyers, seem unconcerned about whether lawyers have a duty to the tax system. Instead, they leave the regulation of tax practitioners to the federal government. Apparently, no state bar association has ever disciplined a practitioner or even expressed concern over the conduct of a tax practitioner related to the quality of tax advice.\footnote{1}

The two most important problems for tax practitioners raised by conforming the penalty standard to the ethical standard are (1) that a series of preparer penalties may cause the IRS Director of Practice to conclude that the practitioner has demonstrated a pattern of misconduct that could result in the suspension or disbarment of that practitioner from practicing before the IRS,\footnote{2} and (2) that the practitioner's reporting standard appears to be higher than the taxpayer's reporting standard, which could result in a conflict of interest between the practitioner and the client.

b. The Taxpayers' Standards

The accuracy-related penalty provision under the Internal Revenue Code provides a civil penalty of 20\% of the underpayment of tax required to be shown on the taxpayer's return.\footnote{3} This provision encompasses several specific penalties, including negligence, or disregard of the rules or regulations,\footnote{4} and substantial understatements of income tax.\footnote{5}

The negligence penalty will not apply if the position has at least a reasonable basis.\footnote{6} If the position does not have a reasonable basis,

\footnotesize{\textit{HeinOnline} -- 51 U. Kan. L. Rev. 1208 2002-2003}

\begin{itemize}
\item \footnote{1}{See Watson, supra note 1, at 856 n.44 (citing James P. Holden, \textit{Practitioners' Standard of Practice and the Taxpayer's Reporting Position}, 20 CAP. U. L. REV. 327, 337 (1991)).}
\item \footnote{2}{See 31 C.F.R. § 10.34(b) (2002) (listing the standards for preparing or signing tax returns); see also id. § 10.51(j) (listing conduct for which a tax practitioner can be disciplined). Congress intended the Service to be judicious in its use of the ethical sanctions in connection with the preparer penalty. See H.R. REP. NO. 101-247, at 1396-97 (1989) ("The committee also intends that... the IRS not generally expand its investigations of preparer penalty cases."). This does not appear to have been the Service's policy, however. See Watson, supra note 1, at 862 (stating that "[t]he imposition of the preparer penalty does not necessarily involve the physical filing of a return or refund claim, nor does it necessarily require the individual to sign the return or claim as a preparer."). For a criticism of the policy of imposing ethical sanctions in an area that should be left to the civil penalty provisions, see Handelman, supra note 29, at 84 n.43.}
\item \footnote{3}{I.R.C. § 6662. An underpayment is defined as "the amount by which any tax imposed... exceeds the excess of (1) the sum of (A) the amount shown as tax by the taxpayer on his return, plus (B) amounts not so shown previously assessed (or collected without assessment), over (2) the amount of rebates made." I.R.C. § 6664(a). For a general discussion of civil liability for understatements of tax liability, see also supra note 19.}
\item \footnote{4}{I.R.C. § 6662(b)(1).}
\item \footnote{5}{I.R.C. § 6662(b)(2).}
\item \footnote{6}{I.R.C. § 6662(c); Treas. Reg. § 1.6662-3(b)(1) (as amended in 1998).}
\end{itemize}
Legislating Morality

disclosure of the position will not insulate the taxpayer from the penalty, although disclosure is an exception to the penalty for disregard of the rules and regulations provided that the position represents a good faith challenge to the rule or regulation. Disclosure of the position is only valid, however, if it is made in accordance with the requirements of the regulations. The regulations clarify that the reasonable basis standard is "a relatively high [one], . . . significantly higher than not frivolous or not patently improper." It requires that a position be more than merely arguable or colorable. But the use of the reasonable basis standard has been called "unfortunate" because of its "long and somewhat confusing history in the rules governing the conduct of lawyers." If a taxpayer takes a position on a return that results in a substantial understatement of income tax, the taxpayer will be subject to an understatement penalty of 20% of the amount of the underpayment. The taxpayer has two specific opportunities to avoid the penalty: (1) where the taxpayer can establish that the position is supported by "substantial authority," and (2) where the position has a "reasonable basis," the taxpayer took the position in good faith, and the taxpayer adequately disclosed the position.

If the taxpayer falls short of the standards that would enable her to avoid an accuracy-related penalty, the taxpayer may avoid the penalty nonetheless (either negligence or substantial understatement) if the taxpayer can establish

57. Treas. Reg. § 1.6662-7(c) (as amended in 1998).
58. See supra note 19 and accompanying text.
59. Treas. Reg. § 1.662-3(b)(3).
60. Id.
61. Id.
62. I.R.C. § 6662(b)(2). A substantial understatement is an understatement for a taxable year that exceeds the greater of 10% of the tax required to be shown on the return or $5,000 ($10,000 in the case of a corporation that is not a Subchapter S corporation or personal holding company). Id. § 6662(d)(1). Note that the penalty applies to the underpayment of tax that results from the understatement. See supra note 19.
63. Id. § 6662(d)(2)(B)(i).
64. Id. § 6662(d)(2)(B)(ii). Disclosure will not insulate the taxpayer from the assessment of a negligence penalty, however. Id.
that she acted with "reasonable cause" and in good faith.\textsuperscript{65} The determination of whether the taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking all relevant facts and circumstances into account.\textsuperscript{66} One of the relevant circumstances is reliance on the advice of a competent professional.\textsuperscript{67}

In the case of understatements involving the use of tax shelters,\textsuperscript{68} the penalty is more difficult to avoid. For taxpayers other than corporations, disclosure will not provide insulation against the assessment of the penalty.\textsuperscript{69} Taxpayers other than corporations may rely only on substantial authority,\textsuperscript{70} provided the taxpayer reasonably believed that the tax treatment of the item was more likely than not proper.\textsuperscript{71} Corporate taxpayers may not rely on the substantial authority exception. Instead, the only safe harbor protection available for a corporate taxpayer is that of reasonable cause and good faith.\textsuperscript{72}

c. The Conflict Between the Standards

A practitioner must recommend disclosure of non-frivolous return positions that do not pass the realistic possibility test. Violations of the ethical standard could subject the practitioner to sanction or disbarment by the Service.\textsuperscript{73}

"Realistic possibility of success" generally is regarded as a higher standard than "reasonable basis."\textsuperscript{74} Thus, a tax practitioner who advises her client to disclose a position that is not frivolous, but is questionable as to

\begin{itemize}
\item \textsuperscript{65} Id. § 6664(c)(1).
\item \textsuperscript{66} Treas. Reg. § 1.6664-4(b) (as amended in 1998).
\item \textsuperscript{67} Id. § 1.6664-4(c). This alone will not necessarily protect the taxpayer. Other factors also will be considered, such as the reason(s) for entering into the transaction, and whether the taxpayer gave the professional an accurate and complete statement of the facts. Id.
\item \textsuperscript{68} A tax shelter is defined as "(I) a partnership or other entity, (II) any investment plan or arrangement, or (III) any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax." I.R.C. § 6662(d)(2)(C)(iii).
\item \textsuperscript{69} Id. § 6662(d)(2)(C)(i)(I).
\item \textsuperscript{70} Id. § 6662(d)(2)(C)(i)(II).
\item \textsuperscript{71} Id.
\item \textsuperscript{72} Id. § 6662(d)(2)(C)(ii); Treas. Reg. § 1.6664-4(e) (as amended in 1998).
\item \textsuperscript{73} 31 C.F.R. § 10.34(b), § 10.52 (2002).
\item \textsuperscript{74} Gould, supra note 34, at 536. However, the realistic possibility standard has been criticized as being "functionally... very close to the 'reasonable basis' standard that it replaces." Durst, supra note 44, at 1044; see also Gould, supra note 34, at 533 (discussing concerns raised over Formal Opinion 314 and noting that there have been suggestions that the reasonable basis standard was "simply a restatement of the 'frivolousness' standard."). But, the legislative history of the accuracy-related penalties indicates that the reasonable basis standard is a higher standard than "not frivolous." See H.R. REP. NO. 103-213, at 669 (1993) (stating that "the conferees intend that 'reasonable basis' be a relatively high standard of tax reporting, that is, significantly higher than 'not patently improper.'").
\end{itemize}
whether it has a reasonable basis (i.e., the position is merely arguable or colorable), will be insulating herself from liability, but will be exposing her client to the risk of an accuracy-related penalty. If the position does not have a reasonable basis, the disclosure will highlight the position while insulating the preparer, but will place the client at risk of incurring the penalty.

On the other hand, if the return position has a reasonable basis, (but not a realistic possibility of success) and it is not contrary to a rule or regulation, nor will it result in a substantial understatement of tax, the taxpayer is justified legally in taking the position without disclosure since it will not subject her to an accuracy-related penalty. But according to the preparer’s penalty provision, as well as Circular 230, the preparer will be subject to sanction and fine if she does not recommend that the taxpayer disclose the position.\(^\text{75}\)

Generally, the taxpayer will be unwilling to disclose a position which she is legally entitled to take without disclosure, because the disclosure required by the regulations almost guarantees an audit.\(^\text{76}\) Moreover, if the practitioner estimates wrongly and it is subsequently determined that the position does not have a reasonable basis, the disclosure will not insulate the taxpayer from the negligence penalty.

If the understatement is substantial, the taxpayer may avoid the accuracy-related penalty if the position has a reasonable basis and is adequately disclosed in accordance with the regulations. If the position falls short of the reasonable basis standard, disclosure will not insulate the taxpayer from liability unless the “reasonable cause” defense applies. Again, however, the practitioner is ethically obligated to recommend disclosure.

Another problem for the taxpayer is that the taxpayer has a right to litigate disputes in the Tax Court prior to assessment or payment of the tax.\(^\text{77}\)

Under the Tax Court Rules, taxpayers have the right to present any non-

\(^{75}\) I.R.C. § 6694(a); 31 C.F.R. § 10.52 (2002).

\(^{76}\) This is because of the type of disclosure required to be made. In general, the taxpayer must attach a disclosure statement (Form 8275 or 8275-R) to the return, or disclose on the return itself according to the applicable IRS specifications. See Treas. Reg. § 1.6662-4(f) (as amended in 1998). The disclosure statement has been referred to as a “Please Audit Me Now” form. Prescott, supra note 21, at 753. The preparer’s disclosure obligations depends upon the status of the preparer as signing or nonsigning preparer. Treas. Reg. § 1.6694-2(c)(3) (as amended in 1992); Watson, supra note 1, at 861 n.70.

\(^{77}\) See I.R.C. § 6213(a) (stating that after a notice of deficiency is mailed to the taxpayer, the taxpayer may file a petition to the Tax Court for a redetermination of the deficiency).
frivolous position for which there is a "good faith argument for the extension, modification, or reversal of existing law."  

If a taxpayer is entitled to litigate a good-faith, non-frivolous return position, is it fair of Congress to impose a penalty on return positions that meet this standard but do not meet the higher "reasonable basis" standard? The discrepancy between the litigation standard and the penalty standard could undermine disclosure, because if the taxpayer's return position is non-frivolous but is determined to fall short of the reasonable basis standard, the understatement penalty may be imposed regardless of whether or not the position is disclosed. Since disclosure theoretically would not insulate the taxpayer from the negligence penalty, the taxpayer may be less inclined toward disclosure and more inclined to play the audit lottery if there is doubt as to whether the reasonable basis standard has been met.  

A problem for the preparer is that the taxpayer will be motivated to seek an opinion against disclosure by a tax practitioner as an insurance policy to establish reasonable cause and good faith in order to avoid the accuracy-related penalty. This presents a dilemma for the practitioner, who must decide whether to risk a preparer's understatement penalty, and possible sanction by the IRS Director of Practice, or to risk losing the client. This can impose tremendous pressure on the practitioner, particularly if the practitioner is a member of a law firm or accounting firm that is exerting pressure on her to generate and maintain a lucrative client base.  

On the other hand, if the practitioner incurs an understatement penalty, this may cause the practitioner to be more risk averse in interpreting the substantial authority standard, and thus to recommend disclosure when other practitioners might not. If so, and the client objects to disclosure, there is a conflict of interest between the client and the practitioner.  

The client also may not agree with the practitioner's quantification of the position's chance of success. Whatever the reason, if the client and the practitioner do not see eye-to-eye on the obligation to disclose an aggressive return position, the client simply will go elsewhere and find a tax practitioner whose view more closely corresponds to her own. The erosion of

78. TAX CT. R. PRAC. 33; see also MODEL RULES OF PROF'L CONDUCT R. 3.1 (2002).  
79. This tactic may not work as well for those taxpayers the Service identifies as at risk of cheating on their taxes, such as those engaged in "abusive tax schemes," and employers who fail to file employment tax returns and pay their employment tax liability. Under the new National Research Program (NRP) audits, the Service hopes to boost the audit rates of these taxpayers by 72%. See Rob Wells, IRS to Boost Audits of Corporate, Individual Tax Cheats, WALL ST. J. ONLINE, Feb. 1, 2003 (on file with author); see also infra notes 131-33, and accompanying text (discussing the NRP audits).  
80. I.R.C. § 6664(c); Treas. Reg. § 1.6664-4(c)(1).  
81. Watson, supra note 1, at 865-67.  
82. Id.
professional ethical standards because of the fear of losing clients or because of the pressure to attract clients has been borne out recently in the highly publicized downfall of one of the oldest and most venerable of the big accounting firms, Arthur Andersen. 83

If there is a discrete duty to the tax system, the public’s interest in ensuring that the federal tax system operates efficiently and fairly should be paramount, and questionable positions ideally should be resolved in favor of the government. Doubtless, there are some practitioners with very high standards who operate under this assumption. But this certainly is not true across the board. 84

B. Do the Accuracy-Related Penalties Establish a Normative Standard?

Do the accuracy-related penalties establish a normative standard to which lawyers and other tax practitioners must adhere, or do they merely constitute the operational cost of risking an undisclosed, aggressive return position? If lawyers and other tax practitioners owe an affirmative duty to the tax system, it should be clear that the civil penalties do indeed establish a normative standard. But this very question has been debated at length among tax scholars with no definitive answer to date. 85

Germane to this discussion is whether the obligation to disclose aggressive return positions, in particular, represents a normative requirement or whether it is simply a means to avoid a public fee designed to limit


84. For example, consider the following statement of the ABA Task Force in commenting on Formal Opinion 85-352:

Doubtless there were some tax practitioners who intended “reasonable basis” to set a relatively high standard of tax reporting. Some have continued to apply such a standard. To more, however, if not most tax practitioners, the ethical standard set by reasonable basis” had become a low one. To many it had come to permit any colorable claim to be put forth; to permit almost any words that could be strung together to be used to support a tax return position.

Sax et al., supra note 28, at 638.

85. See, e.g., Durst, supra note 44, at 1065–75 (discussing the reluctance among practitioners to classify the penalty as a normative standard); Gould, supra note 34, at 532 (“[I]t is far from clear that this penalty establishes a normative standard for taxpayer conduct.”); Prescott, supra note 21, at 751–54 (arguing for a “normative obligation”).
aggressive return positions to "a socially optimal level."\textsuperscript{86} If it is the latter, the taxpayer in her discretion simply may opt for nondisclosure if the benefits of nondisclosure exceed the costs of the penalty.\textsuperscript{87}

If, however, the taxpayer's standard for disclosure is normative, a tax advisor would have a firm duty to recommend disclosure whenever a return position is not supported by substantial authority. But the "realistic possibility" disclosure standard applicable to practitioners, falls somewhere below the substantial authority standard but above the "reasonable basis" standard.\textsuperscript{88} The discrepancy has been explained as necessary to allow the practitioner flexibility in advising a return position that has a feasible chance of success but which cannot meet the substantial authority standard.\textsuperscript{89} The problem, however, is that the Service does not recognize some authority that practitioners may regard as substantial, such as treatises and law review articles. Yet these sources have been and continue to be cited by the courts. For this reason, the ABA, in reconsidering Formal Opinion 314, refused to endorse the use of "substantial authority" as the prevailing ethical disclosure standard for lawyers recommending aggressive return positions.\textsuperscript{90}

The Service also does not regard legal opinions as substantial authority, and one can see why. But if there is no other authority available, the well-reasoned opinion of an independent, competent professional should suffice.\textsuperscript{91}

Civil penalties generally should be regarded as normative and should play an important role in encouraging taxpayers to comply fully with the voluntary compliance system.\textsuperscript{92} But the fact that the practitioner's disclosure standard differs from the taxpayer's disclosure standard, in a manner that

\textsuperscript{86} Durst, \textit{supra} note 44, at 1061.
\textsuperscript{87} \textit{Id.} at 1061-62.
\textsuperscript{88} Arguably, the "realistic possibility" standard does not fall significantly above the "reasonable basis" standard of the former substantial understatement penalty provision. \textit{Id.} at 1044-45. But see Richard C. Stark, \textit{A Principled Approach to Collection and Accuracy-Related Penalties}, \textit{91 TAX NOTES} 115, 144 (2001) (noting that it does not matter what the standard is because the boundaries will be determined by the courts).
\textsuperscript{89} Durst, \textit{supra} note 34, at 1042-43.
\textsuperscript{90} See Durst, \textit{supra} note 34, at 1041-42 (discussing the Tax Section of the ABA's attempt "to establish a standard more demanding than 'reasonable basis' but less demanding than 'substantial authority'"). At the time of the ABA's consideration of the substantial authority standard, the Service did not consider private letter rulings to be substantial authority. The Service since then has changed its position and now includes private letter rulings on its list of what constitutes substantial authority. Treas. Reg. § 1.6662-4(d)(3)(iv) (as amended in 1998).
\textsuperscript{92} Stark, \textit{supra} note 88, at 122.
Legislating Morality raises conflicts of interest between the practitioner and the client, indicates that the standard is not a normative one.

The strongest argument, however, against the accuracy-related penalties establishing a normative standard is that the Service apparently has failed to fully enforce the penalties in the past, despite its successes in court when the penalties have been challenged. While it has been speculated that perhaps few taxpayers meet the criteria for the penalties, recent reports of challenges to overly aggressive tax avoidance schemes that have been reported almost daily in newspapers across the country suggest this is not the case. What is more likely to be the case is that the taxpayers who potentially are subject to these penalties are the more sophisticated, upper-income taxpayers who have more at stake and can better afford to litigate the imprecise boundaries of the standards. Since these penalties are likely to be imposed only after an audit, which itself is resource-intensive, the Service may be more inclined to settle the issue in order to conclude the audit and to avoid protracted litigation.

C. Is a Tax Audit an Adversarial Proceeding?

Since 1985 when Formal Opinion 85-352 was issued, the ABA has neither withdrawn the opinion nor further clarified it. Therefore, the formal position of the ABA is that all dealings between lawyers and the Service are adversarial. If this is the case, what duty, if any, does the lawyer owe to the tax system?

In the preparation and filing of a tax return, a tax practitioner usually will have minimal, if any, direct contact with the government. This is not the case with an audit. Commentators have argued that the voluntary compliance system requires “a cooperative effort between taxpayers and the government” that is seriously undermined when “taxpayers and tax lawyers... treat the return preparation and examination process as an adversarial proceeding in which vigorous advocacy of positions will produce a winner and a loser.”

93. See id., at 138-40 (discussing the sporadic enforcement of accuracy-related penalties).
94. See George Guttman, Rosso\'t\'s Thoughts On the IRS and the Tax System, 96 TAX NOTES 1822, 1823 (2002) (Commissioner Rosso\'t\' notes that “[t]he IRS tends to turn a blind eye to [the exotic tax avoidance schemes of the rich] because the rich have the cream of the tax intelligentsia defending them while most auditors lack the skills to identify complicated tax structures. . . . Historically, the IRS has focused on individual tax returns rather than passthrough entities because the latter pay no taxes.”).
95. Prescott, supra note 21, at 769.
While most tax practitioners and scholars seem to be in agreement that the filing of a tax return should not be regarded as adversarial,96 there remains some disagreement about the status of a tax audit.97 Some commentators have argued that audits are merely measurements of taxpayers' compliance efforts and thus are not adversarial in nature. Other commentators, however, disagree.98

It has been argued further that the Service is not the formidable enforcer of the tax laws that it once was and, therefore, in the interest of the tax system, taxpayers and practitioners alike owe a greater duty of disclosure to the Service.99 This statement is borne out in the audit statistics. While ideally the rate of audit in a voluntary compliance system should be low, nevertheless, the Service's audit statistics have been extremely low, with the audit rates declining each year since 1995.100 The Service primarily blames the low rates on a lack of resources and personnel to devote to compliance enforcement.101 Therefore, it has been argued that the low audit rate indicates that it is no longer a level playing field for the Service.102

On the other side of the coin, though, is the fact that in an audit a revenue agent is representing the government. Given recent publicity about how the Service believes that it has been squandering its scarce resources because a large number of audits have resulted in no changes,103 the implication is that returns will be selected on the basis that they have a greater potential for adjustment. Thus, taxpayers and their representatives

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96. See supra note 29 and accompanying text (citing criticism of the characterization of the return process as adversarial).
97. Falk, supra note 17, at 647; Prescott, supra note 21, at 723–27.
98. See Gould, supra note 34, at 529–30 (discussing the adversarial elements of the self-assessment obligation).
99. See Prescott, supra note 21, at 736–41 (discussing the tax compliance system and the job of the examining agent).
100. In fiscal year 2001, more than 168 million returns were filed, and slightly more than 815,000 returns were examined. This represents an audit rate of 0.48%. INTERNAL REVENUE SERV., INTERNAL REVENUE SERV. DATA BOOK 2001 at http://www.irs.gov/pub/irs-soi/oldatabk.pdf (Mar. 2002). This rate has been relatively steady since 1998. See Stark, supra note 88, at 119 (also noting that in 1965, the audit rate exceeded 6%).
101. See Charles O. Rossotti, Report to the IRS Oversight Board—Assessment of the IRS and the Tax System, TAX NOTES TODAY, Sept. 25, 2002, at ¶ 7, 70, LEXIS 2002 TNT 186–17 (stating that IRS is "winning the battle but losing the war" against tax cheats in part because of "steady decline in IRS resources due to budget constraints").
102. See Prescott, supra note 21, at 736–41 (discussing the adversarial process of the tax compliance system).
know going into the audit that there is a great likelihood that some items on the returns will be challenged.

There is no provision that requires a taxpayer to voluntarily disclose information once the return has been filed. Moreover, an attorney representing a taxpayer at an audit may be prohibited from disclosing weaknesses in the client’s case under the rules of professional responsibility of the state bar association in which the attorney is licensed to practice. The practitioner further may be motivated to avoid voluntarily disclosing information in an audit if the practitioner recommended an aggressive return position or tax avoidance scheme that was not disclosed. Thus, if the practitioner is at risk of incurring a preparer penalty or an ethical sanction under Circular 230, the practitioner will have a personal interest in not disclosing information.

Another indication that a tax audit is an adversarial process is that once a return is selected for examination, the deck generally is stacked in favor of the Service. It has specially trained agents, it often has the advantage over the taxpayer of knowing exactly what is in question while the taxpayer does not, and it has a variety of procedural devices that it may use to compel testimony, or production of books and records. In addition, an uncooperative taxpayer is disadvantaged in any subsequent judicial proceeding because the shift in burden of proof from the Service to the taxpayer in civil trials, implemented under RRA ’98, does not apply. The existence of this provision is itself an indication that Congress considered litigation in the post-return filing process a very real possibility.

Most importantly, however, is the fact that a routine examination can become a criminal investigation. While this is rare, the problem is that there is often a very fine line between mere negligence, civil fraud, and criminal fraud. Thus, an agent’s discretion often may be required to discern the difference. In a criminal investigation, the attorney should regard the rights of the taxpayer/client as paramount.

104. See Watson, supra note 1, at 871–91, for a discussion of the obligation of a tax attorney in representing a taxpayer at an audit.
105. See, e.g., I.R.C. § 7602 (providing for administrative summons to examine books and records); I.R.C. § 7609 (providing for third party summons); I.R.C. § 7606 (providing for authority to enter premises).
106. See I.R.C. § 7491 (providing for shifting the burden of proof).
107. See U.S. v. McKee, 192 F.3d 535, 537 (6th Cir. 1999) (discussing the fact that the dividing line between a civil audit and a criminal investigation is not always discernable).
108. This involves the subjective determinations of what constitutes reckless, intentional, and willful disregard of the rules and regulations.
In a routine civil audit, the examination is conducted by a revenue agent. In a criminal investigation, the examination is conducted by a special agent, who must identify himself as such to the target, must explain that his purpose is to investigate crimes, and must give the target a modified Miranda warning. When a revenue agent has a “firm indication” of fraud, he must refer the case to the Criminal Investigation Division. The special agent (and perhaps the revenue agent) is required under the Internal Revenue Manual to give the taxpayer a modified Miranda warning so that the taxpayer may preserve his or her constitutional rights. Relatively recently, however, the Seventh Circuit has held that a criminal tax investigation is not considered custodial, so “the Miranda rule is not in play.” The taxpayers in that case made incriminating statements that were used against them at trial. On appeal, they argued that the statements should have been inadmissible because the IRS agent represented that the audit was civil rather than criminal, and thus their cooperation was obtained by trickery and deceit. Writing for the majority, Judge Posner, dismissed the taxpayer’s argument, stating that “trickery, deceit, even impersonation do not render a confession inadmissible, . . . unless government agents make threats or promises.”

Although at the present time this view is held only by the Seventh Circuit, nevertheless, it has been suggested that if this position is adopted by other courts, taxpayers and tax practitioners will be well advised not to cooperate with the Service if there is “even the slightest possibility of the investigation turning criminal.” So far, the Service has given no indication of changing its manual to reflect the position of the Seventh Circuit. But a general undermining of basic taxpayer rights will be detrimental to the voluntary compliance system in the long run.

109. INTERNAL REVENUE MANUAL (CCH) § 9.4.5.11.3.1.1 (2002).
111. See INTERNAL REVENUE MANUAL (CCH) § 9.4.5.11.3.1.1 (2002); see also Beckwith v. United States, 425 U.S. 341, 345 (1976) (concluding that the special agent must recite administrative warning prior to soliciting information).
113. Id.
114. Id. For a criticism of the Kontny decision, see John A. Townsend, Taxpayer Rights in Criminal Investigations, 90 TAX NOTES 1842, 1844–47 (2001). Townsend also notes that in the Seventh Circuit, at least, it is unclear whether the Service can unreasonably delay referring the case to the DOJ in order to use the administrative summons to collect evidence against the taxpayer. Id. at 1847.
115. Id. at 1846. Townsend notes that this “would be virtually every audit, unless the practitioner has conducted a fraud potential audit prior to undertaking the civil audit representation.” Id. But most clients will not be willing to pay for the extra time involved in conducting the fraud potential audit.
III. THE IRS RESTRUCTURING AND REFORM ACT OF 1998

In the past, taxpayers have complained that the Service has not always been fair and even-handed in exercising its discretion and in enforcing the law. In 1996, the Republican controlled House began holding hearings on IRS abuse of taxpayers. These hearings generated much negative publicity for the Service, painting a picture of a governmental agency out of control. Compounding the negative publicity of the hearings was the further negative publicity over the expensive failure of the Service’s modernization efforts. Without a constituency to support it, and without being able to adequately defend itself in the hearings because of its statutorily imposed duty of confidentiality, the result was the enactment of RRA ’98.

RRA ’98 was not the first reform effort of its kind. In fact, it is the fourth time in 139 years that there has been a powerful, committed reform drive, although in the interim the Service has been renamed, restructured and repeatedly rebuilt. The four major reform efforts have had three factors in common. First, each was instigated by Congress following critical reports from ad hoc commissions. All of the commissions had a common refrain: the Service was beset by administrative inefficiency, corruption, taxpayer abuse, and personnel problems. Second, the reform efforts all came at a time when the political environment was turning more conservative, and more importantly, when public sentiment was turning against progressive taxation. Third, general administrative failures of the Service lent a legitimacy and urgency to the reforms. The first three reform efforts followed on the heels of war, which prompted sweeping changes in the tax system that highlighted collection problems in all of the cases. The fourth and last reform effort in 1998 was prompted in large part by the failures of

117. For a general discussion of the negative publicity problem, as well as a discussion of problems that the failure to modernize is currently causing, see George Guttman, Is the IRS Failing at Modernization, Again?, 87 TAX NOTES 1192 (2000).
118. See I.R.C. § 6103.
121. Id. at 717–19.
122. It was no accident, for example, that the Clinton White House expressed serious concerns about the Restructuring Commission’s report while the Republican controlled House of Representatives enthusiastically embraced it. See id. at 773 (commenting on the Restructuring Commission’s report).
the Service’s modernization efforts. This latest reform effort is interesting because the Service was ordered to restructure itself and to change its ideology from collections to taxpayer service. This was a very tall order for the Service and it has meant that resources previously dedicated to compliance have had to be redirected toward meeting the Congressional restructuring and reform mandate.

Several recent reports have focused on the precipitously sharp declines in IRS compliance and collection programs over the past few years since the passage of RRA ’98. These reports have raised troubling questions about the impact of the declines on the tax system as a whole. In a survey conducted in the summer of 2002, nearly one-fourth of taxpayers (24%) thought it was acceptable to cheat on their income taxes. But in a similar survey conducted in 1999, only 13% of taxpayers indicated that they thought this was acceptable behavior.

Ironically, these figures follow on the heels of the best report card the Service has received in approximately twenty years. What has prompted this shift? Is there truly a decline in enforcement of the tax laws and if so, what has caused it?

A. Compliance and Enforcement Activities

The federal tax system is extremely important to this country because it provides revenues that fund most of the operating budget of the federal government. But paradoxically, while the system operates under the principle of voluntary compliance, the federal tax laws are so complex that even most professionals have trouble comprehending them.

It is no accident that both the current and former National Taxpayer Advocates have identified the complexity of the tax code as the most serious problem facing business and individual taxpayers. This complexity costs

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125. Id.

126. See George Guttman, Taxpayer Satisfaction with the IRS, 90 TAX NOTES 144, 144-45 (2001) (discussing improved taxpayer responses to the IRS).


128. See Joint Comm. on Taxation, JCT Reports on Progress in IRS Reform, TAX NOTES TODAY,
the American public an astonishing amount each year, which includes the amount of the tax gap (the difference between the amount owed if the laws were properly applied and the amount actually collected) and the cost of compliance (i.e., the amount Americans spend yearly on professional advice, tax preparation software, and return preparation).

The complexity of the tax code is a major problem for the Service as well because it imposes a substantial burden upon the government to insure that taxpayers are filing correct returns. Taxpayers have flexibility to resolve issues on their tax returns to their advantage and sophisticated taxpayers are frequently able to devise methods of utilizing ambiguities in the law to their further advantage. In order to keep pace with these increasingly sophisticated taxpayers, as well as increasingly sophisticated technology, revenue agents themselves must become more knowledgeable and sophisticated.

Some of the complexity in the tax code is necessary to promote its varied sociopolitical goals, such as social welfare under the earned income tax credit, retirement savings, and the encouragement of education. But some of the complexity is unwarranted under any set of goals, and all of these


129. The tax gap for 1998 was estimated to be $275 billion attributable to income and employment taxes, of which only $50 billion is considered collectible. This gap amounted to over 15% of the total tax due for that year. IRS Paper on Impact of IRS on Voluntary Tax Compliance, Tax Notes Today, Nov. 20, 2002, at ¶ 4, LEXIS 2002 TNT 224–22. Needless to say, if this amount were collected, our tax rates probably would be lower.

130. The estimated compliance figures vary widely depending upon whose study they are based upon. According to the Cato Institute, the estimated cost to taxpayers of the record-keeping and filing burdens is between $150 billion to $300 billion per year. David R. Burton, Cato Institute Analyzes Reforming Federal Tax Policy Process, Tax Notes Today, Dec. 18, 2002, at 8, LEXIS 2002 TNT 243–45. The government, on the other hand, estimates compliance costs to be over $16 billion annually, with over $3 billion taxpayer hours spent per year on tax compliance. Thomas F. Field, IRS Develops Model to Measure Taxpayer Compliance Burden, Tax Notes Today, Nov. 19, 2002, at 1, LEXIS 2002 TNT 223–25. If the cost in dollars of taxpayer hours spent on compliance were included, however, the two sets of figures may not be very far apart. Conversation with Mark J. Mazur, Director of Research, Analysis, and Statistics, Internal Revenue Service, in Lawrence, Kan. (Mar. 6, 2003).

131. For instance, the complexity of the tax code is exemplified by the current capital gains rate structure with its myriad sets of rates and holding periods. Another example is the phase-out of many tax benefits that affects taxpayers when their income reaches a target level. Benefits such as itemized deductions and personal exemptions are reduced or eliminated after a taxpayer's adjusted gross income exceeds the target level which varies according to the phase-out. Not only do the phase-outs further complicate an already complex set of laws, but it also means that many taxpayers will not be able to easily estimate the effect of their itemized deductions and personal exemptions on their tax liability. This uncertainty ensures that these taxpayers will have to seek professional help in preparing their tax returns.
systems must be overseen by the Service, in addition to its primary responsibility of collecting revenue, ensuring adequate compliance with the tax laws, and increasing taxpayer satisfaction.

When the complexity of the tax code is combined with taxpayers' general loathing of the Service, this does not bode well for compliance efforts, and no doubt contributes to the widening tax gap. The problem for the Service is primarily one of public perception and this problem is multifaceted. First and foremost is the fact that the Service has no constituency. Despite the “kinder, gentler IRS,” with its focus on taxpayer service, the fact is no one enjoys paying taxes. This duty becomes even more distasteful when it is combined with the fear of a tax audit with its intrusiveness, expense, inconvenience, and the ever-present threat of stiff civil penalties or worse yet, criminal penalties and/or prosecution. The deterrence factor of a potential criminal prosecution may be a double-edged sword for the Service because it reinforces the ABA’s contention that the mere filing of a tax return constitutes “the first step in a process that may result in an adversarial relationship between the client and the IRS.”132 This lends credence to the ABA’s position that the taxpayers’ dealings with the IRS are adversarial.

Second, the complexity of the tax laws exacerbates the high costs of compliance. Many of the public tend to equate compliance (and thus complexity) with the Service. This raises two current problems for the Service. First, in order to measure compliance and adequately enforce the tax laws, it must periodically engage in calibration audits. Previously, these audits were very intrusive, time-consuming, expensive, and stressful for taxpayers. The tax bar had voiced strong objections to them because of their resemblance to criminal investigations without the concomitant constitutional safeguards. Despite assurances that the new National Research Program (NRP) audits will be less intrusive than the former compliance audits, the commencement of these new compliance audits is bound to cause anxiety among taxpayers because the fact is a tax audit is

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This is particularly egregious when one considers that phase-outs are a game that Congress plays to avoid the political suicide of raising tax rates directly.

Another example of the complexity of the tax code is the alternative minimum tax (AMT). This is an additional tax liability that originally was designed to deter high-income individuals from investing most of their income in tax-exempt investments, thereby avoiding their fair share of tax. But recently, the AMT has operated to impose an additional tax on middle-income taxpayers who least suspect the trap. The problem of the unfairness of the AMT has been commented upon at length, but Congress so far has failed to heed the complaints and is unlikely to do so in the near future because there has not been enough of a public outcry about this inequity and because the AMT generates a substantial amount of revenue. See Karen Hube, Tax Trap: More Retirees Are Getting Hit with the Dreaded Alternative Minimum Tax: Here’s How to Soften the Blow, WALL ST. J., Sept. 30, 2002, at R5 (explaining the alternative minimum tax).

unpleasant under any circumstances. Even the chair of the Senate Finance Committee has weighed in on this issue, equating a tax audit to “an accountant’s version of a root canal.”\textsuperscript{133} It remains to be seen what effect the NRP audits will have on the Service’s public image. Second, the alternative minimum tax,\textsuperscript{134} which originally was designed to counteract tax avoidance schemes of the rich, has not been indexed and now affects middle-income taxpayers and retirees. This additional tax may be imposed when taxpayers have no corresponding cash flow with which to pay the tax liability, and this is perceived as extremely unfair. The public perception of the fairness of the tax laws in general, and the Service in particular, is crucial to the voluntary compliance system. This is a phenomenon with which Congress is very familiar, yet it refuses to take action to adjust the alternative minimum tax so that it operates in a fair manner. The public perception problem may exacerbate another large problem facing the Service, which is funding. The Service recently has complained that it has not received sufficient funding to adequately conform to the requirements of RRA ‘98 while simultaneously enforcing the tax laws, and that this has greatly hindered its collection efforts.\textsuperscript{135} Former IRS Commissioner Charles Rossotti said in his departing speech that “the agency is steadily losing the war with tax cheats, especially the wealthiest and most sophisticated among them.”\textsuperscript{136} James White, director of tax issues at the General Accounting Office (GAO), has commented understandably that this “might make the rest of us nervous about whether everyone is paying their fair share.”\textsuperscript{137}

\textsuperscript{133} See Amy Hamilton, ‘Taxpayer Beware’: Grassley to Highlight Rip-Offs, 91 TAX NOTES 27, 27 (2001) (quoting Senator Charles E. Grassley as saying, “I believe it is possible to obtain such taxpayer compliance information without subjecting individual taxpayers to an accountant’s version of root canal.”).

\textsuperscript{134} See I.R.C. §§ 55–59 (explaining alternative minimum tax and its application); see also supra note 131 (discussing the AMT).

\textsuperscript{135} Before Commissioner Rossotti left office, he issued a “grave warning” to lawmakers about the critical need for adequate funding in order to enable the Service to carry out its enforcement activities. Larry Levitan, chair of the IRS Oversight Board, reiterated this warning at a congressional hearing in May 2002, stating that if Congress did not appropriate more money to the IRS than the Bush budget called for, there would be no increase in compliance efforts. Amy Hamilton, IRS’s Budget Tightrope Turns into a Noose, 97 TAX NOTES 1263, 1263 (2002). The Service’s auditing staff has shrunk by 20% since 1995, while the number of tax returns filed has increased by 13%. According to the New York Times, “[T]he Bush administration insists, unconvincingly, that its nominal increases to the I.R.S. budget, coupled with its efforts to simplify the tax code, should enable the agency to carry out its mission.” The Taxman, Outgunned, supra note 123.

\textsuperscript{136} Johnston, supra note 6, at A1.

There is considerable justification for this nervousness since according to a report issued last year by the GAO, the number of non-filers "seems to have increased about three-and-a-half times faster than the tax-filing population as a whole."\textsuperscript{138} Apparently, many taxpayers have concluded that a hobbled IRS cannot catch them, and they may be on to something because the Service has admitted that it has not even tried to collect payment from approximately 1.3 million taxpayers who collectively owe some $16 billion.\textsuperscript{139}

The Bush administration has disputed former Commissioner Rossotti's statement that the Service is underfunded, without offering any data or explanation of how the Service is wasting its resources, not applying these resources adequately, or not doing its job properly.\textsuperscript{140} But then, what political gain does any politician derive from supporting the IRS? If the Bush administration recommended appropriating more money to the Service, and Congress were to act on this recommendation, the upshot would be stronger enforcement efforts by the Service. The taxpayers most likely to be affected by this are the higher-income taxpayers, many of whom supported the current administration.\textsuperscript{141} The increased enforcement efforts would more than likely trigger complaints to Congress once again of further taxpayer abuse. So the funding problem becomes a vicious circle.

But the problem is not solely one of funding. In RRA '98, it is clear that Congress issued a public rebuke to the Service. Maybe this was valid in some respects, but the overall tone of the legislation showed a distinct lack of regard for the agency. For instance, the shift in the burden of proof from the taxpayer to the Service in civil cases,\textsuperscript{142} a new oversight Board of Directors,\textsuperscript{143} and the list of "10 deadly sins," the infraction of any one of which could result in Service employees losing their jobs,\textsuperscript{144} clearly make this point.

\textsuperscript{138} Id.
\textsuperscript{139} McKinnon, supra note 137, at A5.
\textsuperscript{140} The fact that President Bush has selected Mark W. Everson, an accountant and former corporate executive known for improving performance and cutting costs, to succeed Commissioner Rossotti is an indication that the Service is expected to rein in its expenses and become more efficient. See Richard W. Stevenson, Budget Official Is Bush's Choice To Lead an Embattled I.R.S., N.Y. TIMES, Jan. 14, 2003, at C8 (explaining that the Bush administration chose Everson because the Service needs "management help more than tax-policy expertise."). This may not bode well for its funding prospects.
\textsuperscript{141} This is the view of former IRS Commissioner, Donald Alexander. George Guttman, News Analysis: The IRS's Fiscal 2004 Budget: More or Less?, 98 TAX NOTES 486, 487-88 (2003).
\textsuperscript{142} \textsection 101(a), 112 Stat. at 691-97 (creating nine member oversight board).
\textsuperscript{143} See infra notes 145-46 and accompanying text (explaining that the risk of losing their jobs causes Service employees to cool enforcement efforts).
In addition to the lack of resources, another problem that has been raised as contributing to the low audit rate is the list of “10 deadly sins” under RRA ’98. The problem is that the “sins” are ill-conceived and poorly drafted, so that taxpayer complaints could result in a revenue agent losing his job. Thus, some speculate that agents avoid pushing examination issues to the extent that they could for fear of retaliation by the taxpayers under examination, particularly the more sophisticated taxpayers. This may explain why so few accuracy-related penalties have been imposed.

The failure to appoint a replacement for outgoing Commissioner Rossotti until late in the budget process is another example of the political disdain in which the Bush administration holds the Service. When respected public figures call the tax code “a disgrace to the human race,” and conservatives claim that they will “get rid of the IRS,” this undermines public confidence in the Service in particular and the tax system in general.

IV. WHAT HAS CAUSED THE RECENT SPATE OF CORPORATE SCANDALS?

Recently, we have witnessed an explosion of abusive tax avoidance “schemes, scams and cons,” and a corresponding implosion of standards of professional conduct. From Enron to WorldCom to Global Crossing, the abusive transactions in which these companies have engaged, and the public scandals that have resulted have undermined the confidence of investors in the stock market, which in turn has had a devastating effect on the national economy.


146. See supra notes 94–95, and accompanying text (explaining that the more sophisticated taxpayers are better prepared and more likely to litigate).

147. See Amy Hamilton, No Word on New IRS Commissioner, 97 TAX NOTES 732, 732 (2002) (characterizing the situation as “weird” that Commissioner Rosotti left without word of replacement).


149. See Molly Ivins, Rich People and Their Level of Greed, CHI. TRIB., Feb. 13, 2003, at 23 (characterizing the Act as a Republican maneuver to “hamstring the IRS so it can’t make rich people pay what they owe”).

150. The Senate Finance Committee has been holding hearings since Spring 2002 on antitax “schemes, scams, and cons,” in an effort to combat tax evasion which costs the federal government billions of dollars each year. See Finance Staff Memo Outlines Hearing on Tax Scams, 95 TAX NOTES 214, 214 (2002) (describing the Finance Committee’s hearing topic).
Moreover, there appears to be no end to the scandals involving abusive tax avoidance transactions.\textsuperscript{151}

There are several factors that contributed to the current spate of scandals, and with hindsight, the resulting scandals should have been predictable. First, it is no accident that all of the major accounting firms were involved in these transactions. After the merger of the big accounting firms in the 1980s and 1990s, the resulting mega-firms became money "'monster[s] that needed to be fed.'"\textsuperscript{152} The explosion of the Enron scandal and the resulting downfall of the "Big Five" accounting firm, Arthur Andersen, revealed the intense internal pressure generated by the tremendous competition between the auditing group and the consulting group within Andersen to bring in large clients and vast amounts of income to the firm. With the decline in audit rates, the firms began to look to other sources of income, and it found profit in marketing highly aggressive tax avoidance proposals.

Second, in 1991, the American Institute of Certified Public Accountants (AICPA) changed its rules to allow accountants to charge performance-based fees instead of hourly rates and fixed fees.\textsuperscript{153} As a result, the accounting firms have received hundreds of millions of dollars in fees from marketing these aggressive tax avoidance proposals, as have the law firms that provided the necessary opinion letters for the transactions.

The large amount of income generated from these transactions is itself a contributing problem, because other firms (both accounting firms and law firms) that perceived no negative consequences from marketing these abusive tax transactions have been motivated to cash in as well. In doing so, these firms ignored a basic fact, which is that it generally takes several years before the Service discovers aggressive or abusive transactions, particularly where no disclosure is made at the time of the transaction. Thus, there has been a delay in negative consequences from the inception of the abusive transaction to today, when scandals seem to surface on a regular basis.

The third factor is that the transactions occurred during a period of strong economic growth when investors had more income to shelter, and during the downturn immediately following the economic boom when

\textsuperscript{151} For the latest scandal, this one involving the "Final Four" accounting firm Ernst & Young, see Cassell Bryan-Low, Accounting Firms Face Backlash over the Tax Shelters They Sold, WALL ST. J., Feb. 7, 2003, at A1.

\textsuperscript{152} Id. at A6 (statement of Donald M. Griswold, former KPMG tax partner).

\textsuperscript{153} 2 AICPA PROF’L STANDARDS, Responsibilities to Client, § 302, at 4681 (American Inst. of Certified Pub. Accountants 1998). This change gave accountants an economic interest in the outcome of the client’s transactions, which is inconsistent with the AICPA’s Auditing Standard that requires accountants performing auditing services to maintain “an independence in mental attitude” and to “be without bias with respect to the client.” 1 AICPA PROF’L STANDARDS, The General Standards, § 220.03, at 161.
companies were struggling to meet their earnings estimates. The complexity of the tax laws made these investors an easy target for the aggressive marketing tactics of the big accounting firms. Many of these investors claimed they did not understand the transactions but instead relied on the blue-chip reputations of the large accounting and law firms that backed them.\textsuperscript{154}

A fourth contributing factor is that the standards of professional conduct, as well as the tax laws themselves, allowed these transactions to proliferate. In particular, the lawyers involved in these transactions were able to hide behind imprecise standards of professional conduct in order to issue questionable legal opinions on the legitimacy of the transactions.

Fifth, the Private Securities Litigation Reform Act of 1995\textsuperscript{155} made it much more difficult to bring private suits for violations of the securities laws.\textsuperscript{156} Because the legislation is regarded as pro-defendant, many believe this legislation has contributed to a general climate of fraud.\textsuperscript{157}

Lastly, the Service has been ineffective in policing these aggressive tax avoidance transactions because it has been an agency under siege since the beginning of the congressional hearings in 1996. The resulting 1998 reform legislation and the diversion of the Service's resources to fulfill its congressional mandate have kept it distracted from more aggressively pursuing these abusive transactions.

V. WHAT IS CURRENTLY BEING DONE?

The government announced that it plans to aggressively pursue tax-motivated transactions, and working toward this goal, Congress has proposed changes to the accuracy-related penalty regulations. In addition, the Treasury Department recently issued final regulations limiting the defenses to the accuracy-related penalties. One commentator has remarked that the proposed regulations represent the first step toward “shutting down

\textsuperscript{154} See Cassell Bryan-Low, supra note 151, at A1 (giving an example of one such investor).


\textsuperscript{156} See generally Ann Morales Olazabal, The Search for “Middle Ground”: Towards a Harmonized Interpretation of the Private Securities Litigation Reform Act’s New Pleading Standard, 6 STAN. J. LAW, BUS. & FIN. 153, 155 (2001) (discussing the impact of the increased pleading requirement of the Private Securities Litigation Reform Act).

\textsuperscript{157} See DONNA M. NAGY, ET. AL, SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS, 419 (2003) (“some observers have blamed the PSLRA for precipitating Enron, World Com and other recent securities frauds.”).
the ‘tax shelter’ industry.” The Service is working on three fronts to attack abusive tax avoidance schemes: (1) it is pursuing promoters and other professionals involved in these schemes with criminal penalties and prosecutions, (2) it is requiring greatly increased disclosure of tax motivated transactions at a much earlier point, and (3) it is pressuring Congress to greatly increase the civil penalties for failure to comply with the disclosure and reporting provisions.

A. Proposed Legislation

Under two bills currently pending before the Senate, Congress has proposed several new accuracy-related penalty provisions, as well as significant amendments to the existing penalty provisions. Together with the new reportable transaction regulations, these measures reflect the government’s frustration with the current lapse in disclosure standards. The new provisions require greater disclosure for tax avoidance transactions while greatly increasing the ante for failure to comply.

Under the new accuracy-related provisions, a failure to disclose a listed or reportable transaction having a significant tax avoidance purpose will result in an increased penalty rate of 30% of the understatement. This is a strict liability penalty with no applicable exception.

If the transaction is disclosed, the usual 20% penalty applies to any understatement, and a “strengthened reasonable cause exception” is available. In order for the new reasonable cause exception to apply, the taxpayer must adequately disclose the relevant facts affecting the tax treatment, there must be substantial authority for the treatment, and the

159. Under the U.S. Constitution, tax legislation must originate in the House of Representatives. Thus, the Senate bill cannot go forward until the House reports a comparable bill. So far, the House has not exhibited the eagerness of the Senate to address the problems that have allowed tax avoidance transactions to proliferate.
160. A listed transaction generally is one that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance. A reportable transaction is one that is required to be disclosed under § 6011. It includes listed transactions and five other categories of tax avoidance transactions. See Treas. Reg. § 1.6011-4(b) (as amended in 2003).
161. See J. COMM. ON TAXATION, DESCRIPTION OF THE “CARE ACT OF 2003,” NO. JCX-04-03, Feb. 3, 2003, at 79–88, at http://www.house.gov/jct/x-4-03.pdf (Feb. 3, 2003) (proposing new I.R.C. § 6662A pertaining to listed and reportable avoidance transactions). A public entity that is subject to the penalty must report the penalty to the SEC when it has exhausted its administrative and judicial remedies, or earlier if the penalty is paid before then. Id. at 80–81.
162. Id. at 82.
163. Id. Adequate disclosure is determined in accordance with the reportable and listed transaction regulations under I.R.C. § 6011, as well as under § 6662 regulations. Thus, there may be two disclosures
taxpayer must reasonably believe that the claimed tax treatment is "more likely than not" the proper treatment. In determining "reasonable belief," the taxpayer may rely on an opinion of a tax advisor provided neither the advisor nor the opinion are "disqualified." Because the substantial authority standard is a higher reporting standard than the realistic possibility standard, there will be less "wiggle room" than under the former realistic possibility standard. The higher standard combined with increased penalties should result in greater disclosure of aggressive return positions.

A new 40% penalty (20% if adequate disclosure is made) applies to understatements attributable to any transaction that "lacks economic substance." This penalty also is a no-fault penalty, which is interesting because the economic substance doctrine is very subjective and in fact, has been inconsistently interpreted by the courts. There is likely to be much required, although the Service has indicated that it may consider allowing taxpayers to use a single disclosure document provided it contains all relevant information and is submitted to the Office of Tax Shelter Analysis. See 67 Fed. Reg. 79894.

164. J. COMM. ON TAXATION, supra note 161, at 82.
165. Id. A disqualified advisor under the Joint Committee Proposal is,

[A]ny advisor who (1) is a material advisor [defined in terms of participation in the transaction and in terms of income derived] and who participates in the organization, management, promotion or sale of the transaction or is related . . . to any person who so participates, (2) is compensated directly or indirectly by a material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, or (4) as determined under regulations prescribed by the Secretary, has a continuing financial interest with respect to the transaction.

Id. at 84 (footnotes omitted).

A disqualified opinion is one that is,

(1) based on unreasonable factual or legal assumptions (including assumptions as to future events), (2) unreasonably relies upon representations, statements, finding or agreements of the taxpayer or any other person, (3) does not identify and consider all relevant facts, or (4) fails to meet any other requirement prescribed by the Secretary.

Id. at 85.

166. For a discussion and analysis of the various reporting standards, see Jasper L. Cummings, Jr., The Range of Legal Tax Opinions, with Emphasis on the 'Should' Opinion, 98 TAX NOTES 1125 (2003).
167. J. COMM. ON TAXATION, supra note 161, at 86. A transaction has economic substance if it changes the taxpayer's economic position in a meaningful way, and has a substantial non-tax purpose, and the transaction is a reasonable means of accomplishing that purpose. Id. at 86 n.159. A transaction that is determined to be a sham does not have economic purpose and neither does one in which the present value of the tax consequences exceed the present value of the economic benefits to a tax-indifferent party. See id. at 86. A tax-indifferent party is defined as one who is "not subject to Federal income tax or . . . to whom an item would have no substantial impact on its income tax liability." Id. at 77.
litigation over this provision if it should be enacted, because the parameters of the economic substance doctrine are unclear and the penalty is draconian. Therefore, taxpayers subject to this penalty will be motivated to litigate.

The new provisions also make it more difficult to compromise the imposition of the penalty. The latter provision obviously reflects Congress's dissatisfaction with the high rate of compromise and settlement previously seen with the accuracy-related penalties.

Also, a public entity that is required to pay a penalty under the pending legislation will be mandated to disclose the penalty to the SEC, regardless of whether the taxpayer considers the penalty to be material. Failure to disclose the penalty will be regarded as a failure to disclose a listed transaction.

Congress also has proposed changes to the existing accuracy-related provisions. For corporate taxpayers, there is a new, higher threshold of “substantiality.” The substantial authority standard is increased to “reasonable belief that the tax treatment was more likely than not the proper treatment.” The preparer’s penalty standard is altered to conform to the taxpayer's standard. In addition, the “not frivolous” standard is replaced with the “reasonable basis” standard, and the penalty is increased from $250 to $1000 ($5000 in the case of willful or reckless conduct). Thus, a return that contains an understatement of tax attributable to an undisclosed position, for which there is not a reasonable belief that the tax treatment is more likely than not proper will result in an increased penalty for the

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169. In specific, once the penalty has been included in the Revenue Agent’s Report, it cannot be compromised for purposes of a settlement without the personal approval of the Commissioner or the head of the Office of Tax Shelter Analysis. J. COMM. ON TAXATION, supra note 161, at 82–83. Also, the Service is required to report to Congress the penalty application, each penalty compromised, and the reasons for the compromise. Id. at 83.

170. Id. at 87.

171. Id. The penalty must be disclosed at the earlier of (1) the time the penalty is paid, or (2) the point at which the taxpayer has exhausted all administrative and judicial remedies in contesting the penalty. Id. This provision, if enacted, is likely to have a beneficial effect on compliance because companies care about their reputation, and the effect that a decline in stock prices associated with fines and negative governmental action will have on their public image. See Ehsan H. Feroz, et al., The Financial and Market Effects of the SEC’s Accounting and Auditing Enforcement Releases, 29 J. ACCT. RES. 107, 122–25 (1991) (documenting the impact of SEC investigations and enforcement actions on companies’ stock).

172. Under the proposal, an understatement is substantial if its amount “exceeds the lesser of (1) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or (2) $10 million.” J. COMM. ON TAXATION, supra note 161, at 88. The former threshold was viewed as too low for multi-million dollar corporations.

173. Id. (amending I.R.C. § 6662(d)(2)(B)).

174. Id. at 95.

175. Id.

176. Id. at 96.
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preparer. If the position does not have a reasonable basis, the penalty will be imposed regardless of disclosure.

Some tax practitioners (in particular promoters of aggressive avoidance proposals) have refused to cooperate with the Service by failing to turn over material they claimed is privileged. Under the federally authorized tax practitioner privilege, enacted under RRA '98, communications between a taxpayer and a federally authorized tax practitioner are privileged to the extent that the communication otherwise would be considered privileged under the attorney-client privilege, subject to certain specific exceptions. This privilege does not apply, however, with respect to corporate tax shelters.

The Service has been frustrated by what it calls "unmerited claims of privilege" and the significant obstacles that these claims have posed to its enforcement efforts. Under the new proposals, the corporate tax shelter exclusion is extended to all tax shelters, whether the parties are corporations, partnerships, individuals, tax-exempt entities or other entities. While the parameters of the federally authorized tax practitioner privilege have yet to be fully defined, and in fact, have been called "a trap for the unwary," the problem with the proposed legislation is that it evidences a troubling shift in how the Service will regard the attorney-client privilege. The problem is that this legislation may encourage clients to be less forthcoming with their attorneys.

The pending legislation also proposes to extend the statute of limitations for the entire return from three years to six years if the taxpayer fails to disclose a listed transaction, which is a transaction the Service identifies as tax motivated. Further, any interest attributable to these penalties will not be deductible.

177. I.R.C. § 7525.
178. I.R.C. § 7525(a).
179. I.R.C. § 7525(b).
181. J. COMM. ON TAXATION, supra note 161, at 89.
184. Id. at 253.
185. J. COMM. ON TAXATION, supra note 161, at 100 (proposing an amendment to I.R.C. § 6501).
186. Id. at 100–01 (proposing an amendment to I.R.C. § 163).
Finally, the Senate demonstrates its seriousness in eradicating abusive tax avoidance schemes by recommending that the Service be given an additional $300 million per year dedicated to combating abusive tax avoidance transactions.\textsuperscript{187}

In addition to the new reforms, the Service is stepping up its enforcement efforts by pursuing criminal penalties against some of the promoters of the more aggressive tax avoidance schemes.\textsuperscript{188} Until the new disclosure provisions take effect, the Service is likely to prosecute those who promoted or marketed aggressive tax avoidance schemes.

\subsection*{B. Accuracy-Related Penalty Regulations}

The Service was not content to wait for the proposed legislation to be enacted by Congress. At the end of December 2002, the Treasury Department released proposed regulations, now released as final regulations, that limit defenses to the accuracy-related penalties when taxpayers fail to disclose reportable transactions or take positions without disclosure based on the invalidity of a regulation.\textsuperscript{189} In specific, the proposed regulations provide that taxpayers may no longer rely on the advice or opinions of tax advisors to establish reasonable cause and good faith as a basis for avoiding the accuracy-related penalty in these cases.\textsuperscript{190} The rationale is that the failure to disclose a reportable transaction or a position contrary to a regulation is itself indicative of bad faith. Thus, a taxpayer may not rely upon the bad faith of a tax preparer or advisor to establish good faith sufficient to avoid the accuracy-related penalty.\textsuperscript{191} This amendment should reap a benefit to the Service in the form of increased compliance because it will help to prevent the coercion of tax practitioners by greedy, unscrupulous clients. In addition, if a position relates to a reportable transaction,\textsuperscript{192} and is contrary to

\textsuperscript{187}. \textit{Id.} at 101.

\textsuperscript{188}. \textit{See}, e.g., David L. Lupi-Sher, \textit{Tax Attorney Pleads Guilty in Tax Shelter Fraud}, 95 TAX NOTES 989, 989–90 (2002) (providing the example of a Philadelphia attorney who pled guilty to charges of conspiracy to defraud the IRS based on the creation of a bogus tax shelter, and to corruptly endeavoring to obstruct or impede the due administration of the Internal Revenue laws); David L. Lupi-Sher, \textit{Tax Attorney’s Indictment Raises Shelter Litigation Questions}, 94 TAX NOTES 1582, 1583–84 (2002) (same).


\textsuperscript{190}. \textit{Id.}

\textsuperscript{191}. \textit{See} id.

\textsuperscript{192}. \textit{See} I.R.C. § 6011. Reportable transactions are those in which the transaction affects the taxpayer’s tax liability. They fall into two general categories: (1) those that the Service has determined constitute tax avoidance transactions and (2) other reportable transactions. The latter category includes (a) transactions offered under conditions of confidentiality, (b) transactions offering contractual protections against loss of tax benefits, (c) transactions involving SEC-reporting companies and other large businesses with a book-tax difference of greater than $10 million in any taxable year, (d) transactions producing
a revenue ruling or IRS notice (other than a notice of proposed rulemaking), the taxpayer cannot rely on the realistic possibility standard as a defense to the accuracy-related penalty.

Instead, the taxpayer would have to satisfy the adequate disclosure requirement. Under the newly finalized regulations, the adequate disclosure standard must be met under both the accuracy-related penalty provisions and the reportable transaction provisions. Thus, the taxpayer may be required to file more than one disclosure form for the same transaction.

The regulations further clarify that disclosure and reliance on the advice of a professional will not necessarily insulate the taxpayer from the accuracy-related penalty. The taxpayer must have reasonably relied in good faith on the advice of the professional. In determining reasonable reliance and good faith, the Service will consider all facts and circumstances, including the taxpayer’s “education, sophistication and business experience.” The Service warns that it will rigorously apply the facts and circumstances test in determining good faith and reasonable reliance on professional advice.

losses in excess of specified thresholds and (e) transactions involving short holding periods and generating tax credits in excess of $250,000. Treas. Reg. § 1.6011-4(b) (as amended in 2003). Previously, there was no specific penalty for failing to disclose, although a nondisclosure was likely to jeopardize the taxpayer’s chances of using the reasonable cause and good faith defense under I.R.C. § 6664(c). Under the CARE Act of 2003, Congress proposes a minimum penalty of $50,000, ($100,000 for listed transactions), which doubles the penalty for high net worth individuals and large entities. It applies in addition to the accuracy-related penalties. J. COMM. ON TAXATION, supra note 161, at 80.

193. Treas. Reg. § 1.6011-4(a), (d).
195. See Treas. Reg. § 1.6011-4. The list of reportable transactions has been expanded under the new regulation that became effective on February 28, 2003. Treas. Reg. § 1.6011-4(b).
196. See supra note 163 and accompanying text. The explanation of the provisions states that the Treasury Department and the IRS may consider allowing taxpayers to use a single disclosure form provided the form contains all the required information and a copy of the form is submitted to the Office of Tax Shelter Analysis. See IRS Proposed Regulations (REG-126016-01) Limiting Accuracy Penalty Defenses for Failing to Disclose Reportable Transactions, Positions Conflicting with Rules, 250 DAILY TAX REP., Dec. 31, 2002, at L-1.
198. Id.
199. Id. The proposed effective date of these regulations is December 30, 2002, and will apply to returns filed after that date, with respect to transactions entered into on or after January 1, 2003. Id. at 79896.
C. Will This Work?

The imprecise accuracy-related penalty and ethical reporting standards of the current law have allowed the proliferation of abusive tax avoidance schemes. The pending legislation will “cure” this problem by elevating and equating the taxpayers’ standards and the preparers’ standards while requiring greater disclosure. The higher “more likely than not” standard combined with the increased penalty for noncompliance should establish a normative standard.

The pending legislation is interesting because when Congress attacked tax shelters in the 1980s, it was through the enactment of substantive provisions such as the passive activity loss and the at risk rules. The pending provisions, however, attack tax avoidance transactions, through procedural rules requiring greater disclosure and greatly increased penalties for failure to comply, that are likely to prove more resilient than the substantive rules.

The pending legislation, if enacted, does present several problems, however. First, there is a danger that it could create an unworkable morass of rules, penalties and regulations. Second, the bills require a tremendous amount of disclosure by taxpayers. This will further increase compliance costs, but more importantly, the amount of disclosure required may be too great to be meaningful to the Service. If so, the new penalties could be as ineffective as the current ones. Third, the pending legislation has the potential to stymie legitimate tax avoidance transactions. Fourth, the Service’s list of substantial authority does not include some authority that courts often consider in making their determinations, such as treatises and law review articles. Since the reporting standard has been elevated and the penalties have been greatly increased, the Service should expand its list of authorities that it considers substantial. Also, the Service should consider allowing well-reasoned professional opinions to constitute substantial authority in the absence of other authority.

If the legislation is enacted, a further problem facing the Service is whether the increased penalties and reduced practitioner discretion will promote even further the adversarial view of the tax system, and further encourage noncompliance. We as tax professionals must work to prevent this by encouraging a climate of cooperation and collegiality with the Service, because it is only through such a climate of mutual respect and
cooperation that our system of voluntary compliance can effectively function.

We also must take steps to ensure that ethical standards are properly enforced. On November 18, 2002, IRS Chief Counsel B. John Williams urged attendees at the University of Chicago’s 55th Annual Federal Tax Conference “to observe the highest ethical and professional standards as they advise clients and transact business.” He further urged tax professionals to “embrace ethical reform regardless of the specific parameters of the [pending] Circular 230 revisions.” In return, he promised that his office would try to ease taxpayers’ burden, with respect to the complexity of the tax laws, by doing a better job of communicating with the public through published guidance.

As tax professionals in a voluntary compliance system, the buck starts with us, but it stops with Service. The Service must continue to indicate clearly to the public that it is concerned about taxpayer rights and fair treatment, and that it will deal harshly with those who violate standards of ethics and fairness. In short, it must restore taxpayer confidence in the system, and it must develop and maintain a good relationship with the tax bar and other tax professionals.

In her remarks in the proceedings of this conference, Nina Olson said that the IRS must learn to “stand in the shoes of the taxpayer.” So too must taxpayers learn to stand in the shoes of the IRS. The public must recognize that the tax code serves sociopolitical objectives other than raising revenue, and that the Service administers not only the federal tax system, but also a retirement system, a system of educational credits, and a social welfare system. This is a tremendous job for a single, overburdened, underfunded federal agency. These other objectives should be shifted to other federal agencies to administer so that the Service can do the job it was created to do. We, as tax professionals, should lobby for tax laws that are less complex,

204. Id. In addition to the federal reforms, the states should amend their rules of professional responsibility to provide uniformity with the federal rules on exceptions to confidentiality. In particular, states must provide an exception to allow attorneys to prevent and rectify corporate fraud. This was initially suggested by Roger Cramton at the midyear meeting of the ABA. See Patti Mohr, ABA Tax Section Midyear Meeting: Tax Lawyers Seek Clarity on Economic Substance, 98 TAX NOTES 669, 669-70 (2003) (discussing efforts to codify the economic substance doctrine).
and for adequate funding for the Service so that it can deal effectively with the problems it faces.

The concern, however, is that the Service lacks the resources to deal adequately with the increased disclosure and with the increased caseload of litigating the parameters of the new standards under the pending legislation. The legislation will not solve the Service’s problems of the growing sophistication of taxpayers and new technology. The Service must keep pace in order to deal effectively with the problem of widespread noncompliance.

How does the Service do this in view of its dwindling resources? There are four possible ways: (1) become more efficient at eradicating noncompliance, which it is trying to do by requiring more disclosure and higher penalties for noncompliance, (2) provide better education to taxpayers and tax professionals on reporting and payment obligations, (3) establish better relations with the public, and (4) prosecute to the fullest extent those persons (taxpayers, promoters, other tax professionals, and IRS agents) who persist in illegal and unethical behavior, particularly those who conceive of and market abusive tax shelters.

In addition, the Service must work on its public image by demonstrating that it is pursuing not just the lower income taxpayers, but also the higher income individual and corporate taxpayers who attempt to avoid paying their fair share of taxes. It must maintain consistency in its positions and it must respect the rights of taxpayers. Otherwise, it will not earn the confidence of the taxpaying public and this will be detrimental to the voluntary compliance system.

VI. CONCLUSION

To return to the initial question: in a time of reduced IRS enforcement activities, which in turn leads to reduced taxpayer compliance, do tax professionals owe a duty (or a greater duty) to the tax system?

The issue of reduced taxpayer compliance is an important issue and one in which we all have a considerable stake. The subject of the duty of tax professionals to the tax system has been a matter of discussion for the past forty years. While various reforms to the practitioner’s standard have been suggested in an effort to improve taxpayer compliance, the fact is that very little has been done. Time has taught us that the debate and discussion have focused on the wrong issue. The issue is not whether lawyers and other tax professionals have a separate duty to the tax system, but whether there is an enforceable or normative standard to which tax professionals must adhere. Hopefully, this debate will conclude if the pending legislation is enacted.
because it is now painfully clear that relying on an ideological “duty to the system” has not worked. Moreover, under the proposed legislation there will be fewer opportunities for tax practitioners to use their discretion with respect to aggressive return positions.

While it has been proposed that changes in the penalty provisions will not have much effect on the conduct of those who seek to avoid paying their fair share of tax liability, the pending legislation goes far beyond merely tinkering with the penalty provisions. Enactment of this legislation should give the Service a tremendous weapon in fighting abusive tax avoidance schemes and outright tax evasion.

Will enactment of the legislation signal the end of aggressive tax avoidance schemes? Probably not. Such schemes are as old as the tax system itself. In fact, the remarks of Martin Ginsberg, testifying before the House Ways and Means Committee on tax shelter legislation in the early 1980s remain applicable today: “The tax bar is the repository of the greatest ingenuity in America, and given the chance, those people will do you in.”
