

**TAX PREPARER IRS CIRCULAR 230
WRITTEN TAX ADVICE
And
TAX PREPARER ETHICS CONSIDERATIONS**

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Written Tax Advice

IRS Circular 230, effective June 20, 2005, makes specific requirements for CPA's, attorneys and enrolled agents that give **written** "covered opinions." A practitioner that violates the guidance is subject to reprimand, suspension or disbarment. The rules apply to a Federal tax issue and seem to apply to any written advice regarding income, estate and probably other Federal taxes. "Covered opinions" include the following:

- 1) Tax advice – the **principal purpose** is the **avoidance or evasion** of any tax. **ISSUE:** Many transactions involving tax advice involve business or family purposes and the author is not sure how tax minimization vs. business or family purposes will be weighed by the IRS. **IRS CIRCULAR 230 CLARIFICATION:** For purposes of Reg. §10.35(b)(2)(i)(B), the principal purpose of a partnership or other entity, investment planner arrangement or other plan is tax avoidance or evasion if that purpose exceeds any other purpose. An arrangement may have a significant purpose of avoidance or evasion without having the principal purpose of avoidance or evasion. The principal purpose is not to avoid or evade tax if its purpose is to claim tax benefits in a manner consistent with the statute and congressional purpose. **PRACTICE TIPS:** In giving any written tax advice to the client, the author suggests emphasizing that the advice given (such as a position taken on a tax return or type of trust for estate planning instituted) is for the purpose to claim tax benefits consistent with an Internal Revenue Code section(s) and other tax authorities (such as Regulations and Revenue Rulings), so as to be consistent with congressional purpose, list the supporting tax citations **and** also itemize the client's non-tax motivations for entering into the transaction to which the tax advice relates.
- 2) Any tax advice that has a **significant purpose** of **avoidance or evasion** of any tax, if the written advice is a "reliance opinion." A reliance opinion is a written opinion that concludes that it is more likely than not (greater than 50% likelihood) that one or more **significant** Federal tax issues would be resolved in the taxpayer's favor. Written tax advice other than those with the principal purpose of tax avoidance are **not** treated as a reliance opinion if the tax practitioner prominently discloses in writing that the opinion is not intended to be used for the purpose of avoiding penalties. "Prominently disclosed" means **bold print** larger than any other typeface used in the written opinion, stating it is not intended for the purpose of avoiding penalties. Thus, if the principal purpose of the tax opinion is avoidance of tax, the prominently disclosed statement that the opinion is not for the purpose of avoiding penalties is of no use in avoiding sanctions on the individual giving the opinion. **PROBLEM:** As above, the issue would always be whether or not the **principal** purpose is avoidance of tax vs. business or family purposes. I hope that the IRS will issue guidance, but it is clear that any tax question a client would ask to be answered in writing would relate to minimizing or avoiding tax.

AUTHOR CONCLUSIONS: Simply preparing and signing a tax return is not the issuance of a "covered opinion." However, the author is not sure if checking the box on a tax return authorizing the

tax preparer to discuss the return with the IRS impacts the first conclusion. If the principal purpose is the avoidance or evasion of any tax, providing relevant law summaries (such as tax research copies from tax law treatises, such as published by CCH and RIA) would be a “covered opinion.” However, giving such tax advice orally would not be a “covered opinion.”

The IRS Circular 230 requirements also state that if a written opinion is a **covered opinion**, the tax practitioner **must** use reasonable efforts to identify the underlying facts that the tax preparer must determine to be reasonable and the opinion may not be based on factual representations by the taxpayer that the practitioner knows or should know are incorrect or incomplete. The opinion **must** relate the applicable law to the relevant facts. The opinion **must** consider all significant Federal tax issues and the practitioner **must** provide a conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each significant Federal tax issue (or state that the tax preparer is unable to reach a conclusion). The opinion must state the reasons (generally, in the form of tax law citations, such as an Internal Revenue Code section, IRS Revenue Ruling, tax case decision, etc.) for the conclusions (or describe the reasons why the practitioner fails to conclude that a favorable taxpayer resolution is more likely than not). In addition, if the conclusion is that it is **not** more likely than not the taxpayer would prevail, the prominent disclosures must be made that the opinion cannot be relied upon to avoid penalties. The opinion giver may not take into account the possibility the tax return will not be audited.

The practitioner may rely on the opinion of another competent practitioner if the opinion is identified, but it appears that such tax research resources as provided by CCH and RIA do not qualify. Even if the written opinion satisfies the practitioner’s responsibilities as above, the taxpayer’s good faith reliance on the opinion will be determined under law and regulations (meaning whether or not the taxpayer himself/herself will be subject to penalties).

If written tax advice is given, but is not a “covered opinion,” the practitioner still must not give written tax advice if the advice is based on unreasonable factual or legal assumptions, the practitioner unreasonably relies on representations or other documentation of the taxpayer, the practitioner does not consider all relevant facts that the practitioner knows or should know and/or the practitioner takes into account the possibility that the tax return will not be audited.

The following is prototype “more likely than not” language the author uses on client tax advice letters (such as the letter to the business CPA with the incorporation document portion of the business formation material:

IMPORTANT TAX ADVICE DECLARATIONS: This letter contains tax advice (conclusions) and is in conformance with IRS Circular 230 requirements. Each conclusion is made, as I believe each complies with current Federal tax law (see the citations/authorities set forth below). In addition, I believe it is more likely than not that the taxpayer(s) being provided the conclusions would prevail on the merits with respect to each significant Federal tax issue. I believe that I have identified the relevant underlying facts and related them to the tax law and conclusions set forth. The tax advice given is with the purpose to claim tax benefits consistent with an Internal Revenue Code section(s) and other tax authorities (such as IRS Regulations and Revenue Rulings, etc.), and so be consistent with congressional purposes. **NOTE:** As above, the tax advice should emphasize non-tax motivations for entering into transactions to which the tax advice relates (for example, family or business reasons). The tax advice should also list the reasons (tax citations) for each conclusion (tax advice) given. Additionally, if any tax opinion (conclusion) is not given with “more than likely” client assurance, Circular 230, written tax advice/covered opinion rules would need to be consulted and the declarations above would need to be modified accordingly.

Are You a Tax Preparer And What Tax Return Positions May You Recommend

TAX PREPARER DEFINITION: Tax preparers are accountable under IRS, lawyer and CPA guidelines. The Internal Revenue Code provides penalties applied to tax preparers as well as taxpayers for failure to meet guidelines and standards for tax preparation (positions taken on a tax return). This outline discusses what the author considers to be the most important guidelines and standards under the Internal Revenue Code, IRS regulations, Circular 230 and other authorities and is intended to be a “road map” to meet those various guidelines and standards and avoid penalties. Circular 230 is IRS guidance and regulations relating to the conduct of tax preparation and the giving of tax advice. Circular 230 is discussed throughout this outline; see the Circular 230 rules regarding written tax advice in the topic just above. A practitioner who furnishes tax advice as to positions to be taken on a tax return is an income tax preparer, even though he or she does not prepare the return. Circular 230 §10.22 requires a practitioner to exercise due diligence in preparing or assisting in the preparation of a tax return and in determining the correctness of oral and written representations made to a client to assist in the preparation of an income tax return. As an example, an attorney handling a business sale aiding in the determination of the purchase price allocations under the fair market value/residual requirements of §1060, IRC would be subject to the guidelines of Circular 230 (see the extensive business sale tax considerations topic). In addition, advice given during business formation such as that set forth in the corporate formation CPA letter with the business formation material would subject the attorney to the guidelines of Circular 230, including §10.33 “Best Practices” in providing tax advice, §10.34 “Standards” for advising tax return positions and probably §10.35 “Written Opinion Requirements” (see the topic just above). A person who gives advice that is directly relevant to the determination of the existence, characterization or amount of an entry on a return is regarded as having prepared that entry.

UNDERSTATEMENT OF TAX PENALTIES: §6694(a), IRC provides a \$250 tax preparer penalty if understatement of tax is due to an unrealistic position taken by the tax preparer. For tax preparer penalty purposes, a practitioner who prepares only a portion of a return is not considered a preparer if that portion involves gross income, deductions or the basis for determining a tax credit in the amount of under \$2,000 or under \$100,000 and is also less than 20% of gross income or less than 20% of adjusted gross income on an individual return. Reg. §301.7701-15(b)(2). Income tax preparers are subject to \$250 penalty for understating tax liability attributable to an unrealistic position taken on a return. An unrealistic position is one for which there is not realistic possibility of being sustained on the merits. If a reasonable analysis by a person knowledgeable in tax law would lead to the conclusion the position has approximately a one-in-three or greater, likelihood of being sustained on the merits, the position has a realistic possibility and avoids penalty. Further, the preparer penalty will not be imposed if the position taken is not frivolous and is adequately disclosed. Disclosure is made on Form 8275 (or 8275-R relating to IRS regulations) or on the return. As of the end of May 2005, the author has never prepared and filed Form 8275 or 8275-R. The penalty against the tax preparer is generally a relatively small monetary amount, but the understatement penalties described below as assessed against the taxpayer can be a large amount. The 20% substantial understatement non-deductible penalty against the taxpayer may be avoided if the position on the return has substantial authority or it is disclosed using the required IRS forms and reasonable basis for the position exists (see below).

Importantly, §6662, IRC and several following sections impose a taxpayer accuracy-related 20% penalty for disregard of rules and regulations and substantial understatement of income tax as well as for other issues such as a substantial valuation misstatement. Adequate disclosure (again, by preparing and filing IRS Form 8275 or 8275-R) under these accuracy related penalties is not sufficient to avoid the taxpayer penalty unless there is also reasonable basis for the taxpayer’s treatment. Reg. §1.6662-7(d) states the reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. The regulations state that a return position would generally satisfy the reasonable basis standard if it is reasonably based on one or more of the authorities (referred to as substantial authorities) set forth below, taking into account the relevance and persuasiveness of the authorities as well as subsequent developments. The regulations further state if a return position does

not satisfy the reasonable basis standard, the reasonable cause and good faith exception may still provide relief from penalties under §6694, IRC. Under certain circumstances, the taxpayer's reliance on tax preparer advice will avoid the 20% penalty. Again, the purpose of this outline is to provide a "road map" to tax preparers, including attorneys that give advice in structuring a business or drafting a contract involving tax considerations, to avoid tax preparer and taxpayer penalties.

Generally, there is a 20% non-deductible penalty for such accuracy-related violations. The 20% penalty is imposed for a substantial understatement of income tax if the amount 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 other than an S corporation). The understatement is the excess of the amount of the tax required to be shown over the amount actually shown on the return. Again, adequate disclosure avoids the penalty only if there is a reasonable basis and it appears a reasonable basis standard is intended to be relatively high and is not satisfied by a return position, which is merely arguable. Disclosure **must** be made on a properly completed IRS Form 8275 (or Form 8275-R relating to an IRS regulation). Reg. §1.6662-4(f)(1). Importantly, the amount of any understatement of tax will be reduced for any tax return position of any undisclosed item (meaning IRS Form 8275 or 8275-R is not prepared and filed) if there is **substantial authority** for the tax return position set forth on the return. The following are accepted authorities (substantial authorities):

1. The Internal Revenue Code and other statutory provisions.
2. Proposed, temporary and final regulations construing the statutes.
3. Revenue rulings and procedures.
4. Court cases.
5. Legislative committee reports and the like setting forth congressional intent.
6. The general explanation of tax legislation (referred to as the Blue Book).
7. Private letter rulings and technical advice memoranda issued after October 31, 1976. **CAUTION:** Keep in mind, a private letter ruling is only binding upon the IRS as to the taxpayer to which it is actually issued.
8. Certain other IRS issued information, including Actions on Decisions, General Counsel Memoranda as well as IRS Press Releases, Notices, Announcements and other pronouncements published in the Internal Revenue Bulletin.

Reg. §1.6661-3(b)(2); Reg. §1.6662-4(d)(3)(iii) and IRS Notice 90-20. Congress has given the IRS the authority to except (delete) certain authorities from the list, but the IRS has yet to publish a register of positions it believes lacks substantial authority.

While the author cites IRS publications throughout this text, such IRS publications (also referred to as pamphlets) are treated like information letters and are not designed to be relied upon by taxpayers in tax planning and preparation and may not be used as an estoppel argument against the IRS nor change the meaning of tax law. Manocchio 83-2 USTC ¶9478.

Conclusions reached in legal periodicals (such as CCH and RIA tax treatises and tax-related articles published by tax practitioners) or opinions rendered by tax professionals such as in this text **are not** considered **substantial authorities**.

There is substantial authority for tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. Reg.

§1.6662-4(d)(3) states there may be substantial authority for more than one position. The weight accorded an authority depends upon relevance and persuasiveness. The regulation states a case or revenue ruling having some facts in common is not particularly relevant if the authority is materially distinguishable on its facts from those of the taxpayer.

The tax preparer is directed to the article entitled “Challenging the Adversarial Approach to Taxpayer Representation,” Loyola of Los Angeles Law Review, page 693, 1997; the article discusses tax preparers and tax advisors in determining tax return positions are guided by loyalty to the client and the likelihood of success in a future dispute with a tax authority. Every taxpayer has a legal obligation to file a correct return. Wisely, 13 TC 253. A return that does not contain required disclosures does not satisfy that requirement. The article discusses the above opinions and focuses on the need for tax preparers and advisors to make adequate disclosures currently encouraged under the substantial understatement penalty discussed above. Under the current standard, the substantial authority test is less than the more likely than not standard (greater than 50% likelihood the position will be upheld if litigated), but more stringent than the reasonable basis standard which will prevent the substantial understatement penalty under the substantial authority test. Reg. §1.6662-4(d)(3)(i) states substantial authority supports a return position only if the weight of authority supporting treatment is substantial in relation to the weight of the authorities supporting a contrary treatment. Allowed authorities are set forth above and are assigned greater or lesser weight based upon the nature of the authority, the date it was issued and the similarity of the facts in the situation at hand to that set forth in the authority. The article focuses on the need for the disclosure standard to include taxpayer disclosure of contrary authorities on the return itself, which reflects a taxpayer favorable position even though contrary authorities exist.

TAX PREPARER PRACTICE TIPS: As an income tax preparer, the author is not hesitant to have tax return attachments and other explanations (such as the authority for the allowance of a large deduction). As an example, a taxpayer paying for long-term care expenses may have an exceptional high medical deduction total given the monthly cost of long-term care not covered by insurance. On Schedule A, the author will note the authority for the allowance of the large medical deduction (see the long-term care tax topic with the estate planning material). The author oftentimes finds that during tax season, such an unusual and/or unique transaction to a taxpayer involves tax law issues, which the author is not totally familiar with. Obviously, tax research is therefore necessary to locate substantial authority (see above) favorable to the desired taxpayer position. **PRACTICE TIP:** A taxpayer favorable position generally only would be taken if substantial authority exists. While the author understands that occasionally a gray area may exist, complete research will generally reveal substantial authority for or against the taxpayer position, and so thorough research is a must. The author then gives a copy of the research to the client to justify the reasonable position that was taken on the tax return with a copy of the research to the file, in case a taxpayer favorable position taken is challenged later. Keep in mind, such research (such as pages from a CCH or RIA tax publication) may constitute written tax advice under the “covered opinion” rules set forth in the written tax advice topic above.

The reasonable basis standard (if adequate disclosure is made, again using IRS Form 8275 or 8275-R) applies for tax years after 1993 and relates to the taxpayer accuracy related penalties and the penalties against preparers. Of course making the adequate disclosure by utilization of IRS forms is the proverbial red flag. The substantial understatement penalties seem to be the most dangerous, and again a **non-tax shelter item** that has substantial authority will avoid the penalty (without any disclosure). It is unclear how much, if at all, substantial authority is beyond realistic possibility of being sustained (the 1 in 3 or greater test). Reg. §1.6662-4(d)(2) states substantial authority is less stringent than the more likely than not standard but more stringent than a reasonable basis test. That regulation states the reasonable basis standard (again in the event of adequate disclosure) is satisfied if the return position is arguable, but fairly unlikely to prevail in court. The substantial authority standard is intended to be an objective standard by which the weight of all authorities, both favorable and unfavorable, is considered. If after the weighing test, the supporting authorities are substantial in relationship to the opposing authorities, the substantial authority test can be satisfied. These concepts are discussed in the article “New Reasonable Basis Standard For Return Disclosure Likely To Be Troublesome,” The Journal of Taxation, January 1994. If the tax position involves a tax shelter issue, substantial authority will avoid

the penalty only if the taxpayer reasonably believed the tax treatment of such item was more likely than not the proper treatment and adequate disclosure will not avoid the penalty in a tax shelter situation. Under §6662, IRC, a tax shelter means a partnership or other entity or an investment plan or arrangement if the principal purpose is avoidance of Federal income tax. The underlying regulation states a typical tax shelter is a transaction structured with little or no motive for realization of economic gain which is utilized to mismatch income and deductions or over value assets; the regulation states the existence of economic substance does not of itself establish the transaction is not a tax shelter if other characteristics indicate the principal purpose is avoidance of tax. The reasonable belief test is a greater than 50% likelihood that the tax treatment will be upheld if challenged by the IRS.

A tax court and a U.S. District Court (such as the District of Arizona) must follow previous decisions of the particular circuit court (Arizona is located in the 9th Circuit). Circuit court decisions around the country may differ on the same tax issue; in the case circuit courts differ on an issue, it would seem that a tax preparer would have substantial authority to take a tax favorable position, in such a case, only if the decision on the same issue in the controlling circuit court (9th Circuit for Arizona) is consistent with the tax return position to be taken.

See the article entitled "What You Should Know About Obtaining IRS Private Letter Rulings," The Practical Tax Lawyer, Fall 2002, Pg. 49.

FINAL IRS REGULATIONS – REASONABLE BASIS DEFINITION: The substantial understatement penalty is avoided by disclosure (utilizing the required IRS Form 8275 or 8275-R) only if the tax treatment of the item disclosed has a reasonable basis. In 1998, the IRS issued final regulations relating to §6662, IRC which state reasonable basis exists for purposes of accuracy related penalties if the return position is based on one or more certain authorities (see the accepted authorities above); reasonable basis of an authority is determined taking into account the relevance and persuasiveness of an authority as well as subsequent developments. Reg. §1.6662-3(b). The regulation states reasonable basis is a relatively high standard of tax reporting and significantly higher than not frivolous or not patently improper. The reasonable basis standard for avoiding the understatement penalty by disclosure is not satisfied by a return position that is merely arguable. In addition, if the return position does not satisfy the reasonable basis standard, a reasonable cause and good faith exception may still apply (for example, in some instances when the taxpayer has justifiably relied upon advice given by the tax preparer).

The practitioner is directed to the decision in Wise, TCM 1997-135, involving the issue of whether or not a guarantee of a loan by an S shareholder increases tax basis for loss deduction purposes; that topic is discussed in the S corporation material. The taxpayer relied on the Selfe decision, which held a guarantee does increase basis, but as the S corporation material indicates at least three other decisions have held to the contrary. However, in Wise it was determined that reliance on that one authority avoided the substantial underpayment penalty as Selfe decision constituted substantial authority. **NOTE:** Since the Wise decision, other case decisions have held that a guarantee of a loan by an S shareholder **does not** increase the tax basis for shareholder loss deduction purposes. The author would not recommend to a client to take a contrary position.

It was held in the 9th Circuit Court of Appeals decision in Henry vs. Commissioner (1999) that a taxpayer could rely on advice of the tax preparer and avoid penalties; the Henry decision involved ordinary income vs. capital gain treatment for stock options with the taxpayer failing to provide the accountant with necessary information. The court in Henry said it was reasonable the taxpayer would not know the relevant information needed. Tax preparation and tax advice involves many legal considerations and as an example, the practitioner is directed to the 1999 9th Circuit case Henry, involving a negligence penalty under §6653 (since repealed). The Henry decision involved stock options and a §83(b), IRC election discussed in the business interest for service topic. The issue was whether the negligence penalty could be avoided because the taxpayer relied on advice from an independent Certified Public Accountant that option proceeds were capital gains as opposed to ordinary income. The 9th Circuit reversed the Tax Court, which found such reliance unreasonable because the

taxpayer had failed to provide the accountant sufficient information to render a determination as to whether income was capital gain or ordinary income. The 9th Circuit found that the petitioners provided the accountant with a W-2 reporting form relating to the sale and told the CPA that he could contact the employer for more information. No evidence was presented that the taxpayer knew or should have known that other information should have been relevant to the analysis of the sale, such as copies of the option contract itself. The 9th Circuit stated that it was reasonable that the taxpayer would not know the relevant information that the accountant would need, unless the accountant requested the information. The Tax Court stated, the taxpayer should independently verify the amount of income tax liability, but the 9th Circuit ruled that was unreasonable and would nullify the very purpose of seeking the advice of a presumed expert in the first place, citing US vs. Boyle 469 US 241 (1985). The issue involved whether the options did not have a readily ascertainable market value as required by the regulations under §83, with a finding the transaction had originally been structured to provide capital gain treatment. The Tax Court in finding against the taxpayer, relied on a letter from an outside auditor to the employer that the IRS could challenge capital gain treatment, but there was no evidence in the record that the taxpayer ever saw the letter. The Appellate Court stated knowing there is a risk of an audit, which could result in a deficiency, did not provide evidence that the taxpayer knew or should have known of the tax regulation and unreasonably disregarded it. Other factual issues were considered, but this negligent penalty case should make tax preparers take care in recognizing taxpayer favorable positions on tax returns if the transaction is unusual or unique to the taxpayer. Obviously, the Henry negligence case involved the taxpayer needing more information, which would have led to the conclusion that ordinary income treatment was proper.

Circular 230, §10.22 requires a tax practitioner/preparer to exercise due diligence, and the tax preparer can generally rely on the work product of others (usually the client), if the tax preparer uses reasonable care in the supervision, training and/or evaluating the person preparing the work product (usually financial statements or other information used to prepare the tax return). Circular 230, §10.34(c) states, a tax preparer may rely in good faith without verification upon information furnished by the client, but the tax preparer may not ignore implications of information furnished if it appears to be incorrect, inconsistent with the factual situation or incomplete. It is to be noted Rev. Proc. 80-40 states a tax preparer is not required to audit or examine books or other evidence in order to independently verify information provided to prepare the income tax return, but a tax preparer may not ignore implications of information furnished. In other words, the preparer must make reasonable inquiries if the information furnished appears to be inaccurate or incomplete. See Pickering, 82-1 USTC, ¶9375 and John Brockhouse 749 F.2d 1248 (1984). The Brockhouse decision involved a tax preparer that prepared the corporate return for a professional corporation and the personal return of the sole shareholder in which the corporate return reflected an interest deduction on a shareholder loan transaction with no interest income being reflected on the personal return of the shareholder, with a finding that the tax preparer was negligent.

The AICPA has set forth Statements on Standards for Tax Services (SSTSs), and SSTS No. 1 sets forth the realistic possibility standard for taking a position on a tax return that is defined as a knowledgeable tax preparer would conclude that the position has approximately one-in-three or greater likelihood being sustained if litigated. Circular 230 §10.21 provides that a tax practitioner becoming aware that a previous tax return contains an error or omission must advise the client of the consequences of such non-compliance, including the possibility of assessment of tax, interest and any relevant penalties (see the topic below entitled Duty to File Amended Returns).

SSTS No. 3 requires that the tax preparer believe client information is true, correct and complete to the best of the tax preparer's knowledge and as based on all known information with the tax preparer required to not ignore the implication of information known to the tax preparer to the contrary or incorrect (inaccurate). If tax preparation information appears to be incorrect, incomplete or inconsistent, the tax preparer must make reasonable inquiries of the client. SSTS No. 4 allows reasonable estimates of tax preparation information in certain cases (such as in the event records are destroyed), but the tax preparer should keep in mind certain tax statutes require exacting client information to allow a deduction (such as the requirements under §274, IRC), requiring receipts for entertainment deductions

(those requirements are discussed in the business tax deduction topic with the business formation material). The primary tax preparer is required to sign the return; other tax preparer requirements must have compliance (such as, keeping a copy of each return prepared).

The current regulations set forth in Circular 230 reflect more stringent standards advocated by the ABA as well as the AICPA. The regulations provide a practitioner may not advise a client to take a position on a return or prepare the return itself unless the practitioner determines there is a realistic possibility of the position being sustained on the merits or the position is not frivolous and the practitioner advises the client of all opportunities to avoid accuracy related penalties by adequately disclosing the position (see the discussion of §6662, IRC above). A position is considered to have a realistic possibility of being sustained on the merits if a knowledgeable practitioner would determine/conclude that the position has approximately a 1 in 3 or greater chance of prevailing upon litigation. Further, a practitioner who determines a return contains a position that would violate the realistic possibility standard may not sign the return as a preparer unless the position is not frivolous and unless it is adequately disclosed to the IRS. Circular 230 §10.34(a).

ABA Formal Opinion 83-352 states attorneys may advise clients to report positions on tax returns most favorable to the clients if the attorney has a good faith belief these positions are warranted under existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law. The opinion requires an attorney in advising a client as to a position on a tax return to advise the favorable position only if there is some realistic possibility of success if litigated; this test is substituted for the previous reasonable basis test of Formal Opinion 314. The opinion states the ethics standard in an objective way in that a position having only a 5% or 10% likelihood of success fails the standard whereas a likelihood of one-third probably satisfies the test. The opinion states the attorney should withdraw if the client insists on asserting a position that does not have a realistic possibility if litigated. Opinion 85-352 requires the lawyer to advise the client of the potential penalties discussed above.

IRS ALLOWANCE OF TAX ISSUE REQUEST: Rev. Proc. 2002-1 allows the IRS to give guidance by way of an information letter. The tax practitioner should submit facts and the issue in writing to the IRS. The reference line should state, “request for general information about ...” The letter is addressed to the same IRS employee that a request for a private letter ruling would be made. To insure 30-day action, the envelope should reflect, “request for general information.” Oftentimes, the IRS response is with a phone call, and it is to be noted that the response is advisory only and has no binding effect on the IRS.

Therefore, the business attorney must keep in mind advice given in business formation or other situations may result in positions taken on tax returns subject to the above rules. Obviously, tax considerations must not be dealt with lightly. It has been the author’s experience as a CPA and tax preparer that adequate disclosure using the IRS forms is usually not made, and the author always strives to find substantial authority for every position taken on a tax return (the clients are told there is no gray area in the tax law and the client is provided memos reflecting the author’s position that substantial authority exists).

SSTS No. 6 requires a tax preparer that discovers a previously erroneously filed return to inform the client of the error, recommend measures to correct the error and inform the client of the potential of assessment of additional tax, interest and applicable penalties. Additionally, if the prior year error affects the return being prepared (such as a net operating loss carryforward), the prior year error must be corrected by the tax preparer with the appropriate carryforward amount reflected on the current year return. That is similar to Circular 230 §10.21. See the Duty to File Amended Returns topic just below.

TAX PREPARER OBSERVATIONS AND “TO DO’S”:

- 1) While IRS, lawyer and CPA tax preparer requirements/tests are somewhat subjective (such as determining whether or not the one in three or greater realistic possibility of a tax return

position being sustained if litigated), in determining tax advice that may be given and the related tax returns positions the clients may take, the author has found that in most cases, underlying substantial authority(ies) provide adequate guidance to allow the tax preparer to determine if tax advice and tax return positions favorable to the client may be made and taken.

- 2) If the taxpayer client insists upon taking an improper tax return position (such as a deduction that is clearly disallowed), the tax preparer needs to disengage client representation without completing an improperly prepared tax return for the client. In doing so, the tax preparer must take care, as best possible, to disengage in such a way as to allow the client to make other arrangements to file a timely tax return and immediately return all client information whether or not there is a fee dispute with the tax preparer retaining copies of relevant client records at no charge. See Circular 230 §10.28.
- 3) If a tax client insists upon taking a tax return position that does not meet the above ethical standards of the tax preparer and/or presents facts that do not allow a favorable tax return position (including informing the tax preparer that not all income has been declared), either the client must accept an adverse tax return position and/or provide correct information to the tax preparer.
- 4) The author, as a tax preparer, strongly suggests attaching tax return explanations with substantial authority citations to support and/or explain complex and/or unusual tax return entries (positions), such as the basis for allowing a large deduction or loss.
- 5) The standards require a tax preparer to use best efforts **and** due diligence in reviewing client statements and information for determination that there is no inherent reason for the tax preparer to dispute the accuracy of such, in completing underlying tax research of substantial authorities and completion of tax advice and/or tax preparation in accordance with the standards.
- 6) The topics regarding written tax advice and tax preparer standards are not a complete discussion of all considerations. For example, penalties for blatantly disregarding tax law (substantial authorities) are not discussed.

Duty to File Amended Tax Returns

IRS Circular 230, §10.21 requires the tax preparer to notify the client of any error in or omission from a return that has been filed with a duty to advise the client of consequences, but there is a requirement that the client be told of alternatives open for dealing with the situation. The AICPA tax standards require that the client be told of alternatives with a duty of the CPA to consider withdrawing from the representation depending upon what the client proposes to do about correcting the error. Regarding the definition of an error, see the tax position outline above discussing ABA Opinion 85-352 and other authorities regarding the realistic possibility of success if the matter is litigated.

Occasionally, a tax preparer will be faced with a situation in which a return has been filed and an error in favor of the taxpayer will be discovered after filing, and the issue becomes whether the duty exists to file an amended return and pay additional taxes. There is no general Internal Revenue Code requirement. IRS regulations seem to encourage a taxpayer to file an amended return if errors are discovered while the statute of limitations is open; the regulation states, for example, if a taxpayer determines a deduction was improperly claimed, the taxpayer **should** file an amended return and pay additional tax. Reg. §1.461-1(a)(3)(i). The decision in Unvert, 72 TC 807 (1979), appears to require the taxpayer to file an amended return if the original deduction is later believed to be improper. On the other hand, it was stated in Broadhead, 14 TCM 1284 (1955) that a taxpayer has no duty to file an amended return; the court stated the IRS could have declined to accept the position taken on the return. Another decision seeming to state no statutory requirement for the filing of an amended return is had in

Badaracco, 464 US 386 (1984). IRS Circular 230 §10.21 requires an attorney who knows a client has made an error is required to advise the client of the error. The attorney and/or CPA should advise the client that the client/taxpayer **should** file an amended return and pay tax due. Ethically, it appears as if the CPA or attorney having prepared the original return should not prepare a subsequent return if the taxpayer refuses to correct the prior error – at least if the error has a carryover effect on subsequent returns. On the other hand, IRS Circular 230 does not seem to indicate there is a duty to withdraw. See the article entitled “Do Clients Have A Duty To File Amended Tax Returns?” page 25, The Practical Lawyer, March 1987, as well as “What Obligations Do Taxpayers and Preparers Have To Correct Errors On Returns?” page 90, The Journal Of Taxation, February 1990. It is clear from ABA Opinion 85-352 it is a lawyer’s responsibility to advise a taxpayer with respect to reporting a position on a return, and so the attorney may not thereafter report the position differently on the return to the taxpayer’s advantage. On the other hand, if the taxpayer discovers income has been overstated or deductions understated, the taxpayer will have incentive to file an amended return to obtain a refund. Individuals generally must file amended returns within three years after the date the original return was filed or within two years after the date tax was paid, whichever was later. A return before the due date of the return is deemed to have been filed on the due date. Different Federal and Arizona rules apply to different situations. Individual Federal refund requests or any amended return is made utilizing IRS Form 1040X.

IMPORTANT TAX CONSIDERATIONS ***IRS Regulations and Revenue Rulings/Form vs. Substance Doctrine***

Throughout the material, IRS regulations and revenue rulings are cited. A distinction must be made between regulations, which have become designated final, temporary or proposed regulations. Regulations, when they become final and so effective, have the force and effect of the Internal Revenue Code itself. Marilyn Casualty Co. vs. U.S., 251 U.S. 342 (1920). There are two types of IRS tax regulations – legislative (substantive) and interpretive (procedural). Legislative regulations follow a delegation by Congress to the IRS to write detailed rules, which in essence complete the scope of a particular Internal Revenue Code section; legislative regulations have the force and effect of law. Interpretive regulations give IRS opinions as to the proper application of the code, and do not have the force of law (but courts often accord substantial weight to them). Unless provided otherwise, regulations ordinarily apply retroactively to the effective date of the applicable law. Regulations designated as temporary are binding immediately; §7805(e)(2) states the IRS has three years to finalize a temporary regulation after issuance, or the regulation will expire (that statute applies to regulations issued after November 20, 1988). Proposed regulations generally set the date they become effective, final and therefore binding. It has been held in Zinniel, 89 TC 357 (1987) that proposed regulations are merely suggestions made for comment. However, proposed regulations must always be considered even though not final as they oftentimes provide the practitioner excellent guidance. It is to be noted final, temporary and proposed regulations are considered substantial authority for the understatement penalty purposes (see the tax preparer outline just above). See the articles “What Is The Legal Effect Of Proposed Regulations,” page 279, The Journal of Taxation, October 1988 and “Tax Court Upholds Taxpayer’s Reliance On Proposed Regulations,” page 424, The Journal of Taxation, December 1983. In addition, importantly, keep in mind regulations may not reflect subsequent changes in the Internal Revenue Code, and so many regulations may be partially or totally outdated. Although regulations are presumed to be valid, they may be challenged by a taxpayer as being invalid and having no force and effect. When a regulation is challenged, the court determines whether the regulation is consistent with the statute, expresses the intent of Congress, and is reasonable as applied. Manhattan General Equipment, 36-1 USTC ¶9105.

Proposed regulations are entitled to no more weight than the position of a legal brief of the IRS. Laglia, 88 TC 894 (1997), Freesen, 84 TC 920 (1985). Thus, when only proposed regulations are involved, the issue is not whether the regulations apply retroactively or only prospectively, but the issue is only a proper interpretation of the application of an Internal Revenue Code section. Pagel, Inc., 91 TC (1990), Affd. 905 F.2d 1190. On the other hand, temporary regulations are entitled to weight in interpretation of

a statute, and it was stated in Zinniel, 89 TC 357 (1987), if the IRS wanted a proposed regulation to have more weight it would have issued it as a temporary regulation.

IRS revenue rulings are not binding in court, as they are merely an opinion of a lawyer of the IRS. Stubbs, Overbeck & Associates vs. U.S., 71-2 USTC, ¶9520. In addition to regular revenue rulings, the IRS also issues private letter rulings, which are generated by way of a taxpayer request for advice, or by way of advice requested during a tax audit. §6110(j)(3), IRC. Private letter rulings (as are regular revenue rulings) are now accepted authority under the substantial authority test discussed with this material; private letter rulings are oftentimes cited in this book as LTR

It is to be noted Rev. Proc. 89-14 warns against the use of revenue rulings and revenue procedures as precedents unless the facts and circumstances of a taxpayer's particular situation are substantially the same. See the article "To What Extent Can Taxpayers Rely On IRS Regulations And Rulings To Predict Future IRS Conduct," Gonzaga Law Review, Volume 25, No. 2, page 281, 1990; the article discusses retroactive and prospective application of IRS pronouncements.

The IRS has a number of doctrines, which are used as tools to recharacterize tax transactions, such that the actual substance is controlling and not the form. As an example, a taxpayer may not merely have an actual employee sign an independent contractor agreement and treat that person as an independent contractor if that person is an employee under law; see the topic entitled Tax Distinction Between an Employee Vs. an Independent Contractor with the employment agreement material. It was stated as early as 1873 in Isham, 84 U.S. 496 that tax liability is to be measured by the reality of the transaction and not the mere form of bringing it about. The characterization of a transaction for Federal tax purposes is controlled by the substantive provisions of the agreement and the parties' conduct, rather than by particular terminology used in the agreement. Frank Lyon, 435 U.S. 570. The IRS may also attack a transaction as a sham and recharacterize the transaction to conform to the economic reality of it. See L. Lesser, 47 TC 564 and Peter Pan Seafoods, Inc., 69-2 USTC, ¶9683. Also keep in mind under the Step Transaction Doctrine, where interrelated series of steps are taken pursuant to a plan to achieve an intended result, the tax consequences are determined not by viewing each step in isolation, but by considering all of them as an integrated whole. D'Angelo Associates, Inc., 70 TC 121. TAM 9748006 held that related parties could not avoid recognition of income following a like-kind exchange between related parties who used an intermediary (third party middle man) as the transaction was a sham as well as a step transaction; see the discussion of §1031, IRC like-kind related party rules at the beginning of the non-taxable exchange topic with the real estate material. See the articles "Form vs. Substance: When Will Courts Respect The Form Of The Transaction," page 66, The Journal of Taxation, February, 1987 and "Is The Step Transaction Doctrine Still A Threat For Taxpayers," page 269, The Journal of Taxation, May, 1990.

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