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The Preparer Penalty's Realistic Possibility of Success Standard: Its Meaning and Application

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THE PREPARER PENALTY'S REALISTIC POSSIBILITY OF SUCCESS STANDARD: ITS MEANING AND APPLICATION

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I. INTRODUCTION

On March 7, 1988, Congressman Pickle, Chairman of the Subcommittee on Oversight, Committee on Ways and Means of the House of Representatives, announced hearings to review the civil penalties imposed on taxpayers and third persons, such as tax return preparers, information return filers, and tax shelter promoters.[1] In perhaps an unprecedented and certainly a rare cooperative effort, reports critical of the existing penalty structure and recommendations for comprehensive changes were submitted by the Internal Revenue Service (the Service), Treasury Department, professional groups such as the American Bar Association's Tax Section (ABA) and the American Institution

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1. *See Review of the Civil Penalty Provisions Contained in the Internal Revenue Code: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 100th Cong., 2d Sess. 2 (1988) [hereinafter *Civil Penalty Hearings I*].

of Certified Public Accountants (AICPA), and other interested organizations.[2] The result of these hearings was a more coordinated civil penalty structure that became part of the Omnibus Budget Reconciliation Act of 1989, called the Improved Penalty Administration and Compliance Tax Act (IMPACT).[3]

This article discusses the amendment of one of the civil penalties, the penalty on tax return preparers, section 6694 of the Internal Revenue Code (Code),[4] which sets the standard of conduct for return preparation. As will be shown below, although Congress believed it was making the return preparer penalty stricter by replacing the negligence standard with the standard adopted by such professional organizations as the ABA and the AICPA,[5] the professional group standard does not impose a higher standard than the negligence standard did under prior law. The professional group standard requires the return preparer to have sufficient support for a return position so that the position has a realistic possibility of being sustained administratively and judicially on its merits if challenged or litigated.[6] Believing that this standard was a higher standard of return preparation than the negligence standard, Congress assumed that something more than a "reasonable basis" for a return position would be required for a preparer to have a realistic possibility of success for a return position. The Service evidently believes that the realistic possibility standard is a quantitative standard. Under new regulations issued by the Service, a realistic possibility of success exists if there is at least a one in three chance of succeeding on the merits in a proceeding.[7]

Neither the legislative history nor the regulations explains how or why the new standard requires something more than a reasonable basis, or why the new standard should be viewed as a quantitative

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2. *Id.*; *Review of the Civil Penalty Provisions Contained in the Internal Revenue Code: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means, on Recommendations for Civil Tax Penalty Reform and H.R. 2528*, 101th Cong., 1st Sess. 7 (1989) [hereinafter *Civil Penalty Hearings II*].

3. Improved Penalty Administration and Compliance Tax Act, Pub. L. No. 101-239, 103 Stat. 2388 (1989) (codified as amended in scattered sections of 26 U.S.C.) [hereinafter IMPACT].

4. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7732, 103 Stat. 2106 (1989).

5. H.R. REP. NO. 247, 101st Cong., 1st Sess. 1396 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2866.

6. ABA Comm. on Ethics and Professional Responsibility, Formal Op. 352 (1985) [hereinafter ABA Opinion 85-352]; TAX RETURN POSITIONS, Statement on Responsibilities in Tax Practice No. 1, § 7 (Am. Inst. of Certified Pub. Accountants 1988) [hereinafter TAX RETURN POSITIONS].

7. Treas. Reg. § 1.6694-2(b)(1) (1991).

standard if it is supposed to be the same one adopted by the professional organizations. As we shall see, both the legislative history and the regulations reveal some confusion about the professional group standards and civil penalties in general. In attempting to understand what the realistic possibility of success standard means, it is helpful to examine the plain meaning of the new statutory language, as well as the history of the negligence standard (which the new standard was intended to replace) and other sanctions imposed on lawyers and other professionals for taking frivolous positions in litigation (out of which the new realistic possibility standard developed).

II. BACKGROUND

Before IMPACT, a penalty was imposed on the preparer of a taxpayer's return if a deficiency was caused by the preparer's negligent or intentional disregard of rules and regulations.[8] The preparer's negligence had the same meaning as the taxpayer's negligence — that is, "the lack of due care or failing to do what a reasonable and ordinarily prudent person would do under the circumstances."[9] A preparer could avoid the negligence penalty if the preparer could show a "reasonable basis" for the return or that he had acted with "due diligence."[10]

In its congressional testimony, the AICPA recommended that the return preparer penalty be amended to adopt the standards of professional conduct recommended for tax practitioners by the AICPA and the ABA.[11] Under this professional group standard, a tax return position would not be subject to penalty as long as the preparer has a good faith belief that, if challenged, the position has a realistic possibility of being sustained on its merits, administratively and judicially.[12] In a remarkably frank study prepared by the Service, it recommended, among other changes, that the penalty on return preparers be based on the substantial authority standard that applied generally to taxpayers.[13] This standard required substantial authority for undisclosed positions in order to avoid a penalty for large deficiencies. The Service also recommended that Treasury Circular 230, which contains the rules of conduct for practitioners before the Service,[14] be revised to

8. Former I.R.C. § 6694 (prior to amendment by IMPACT).

9. Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967).

10. Former Treas. Reg. § 1.6694-1 (as amended in 1978), *reprinted in* 42 Fed. Reg. 59,968 (1977).

11. *Civil Penalty Hearings II*, *supra* note 2, at 123.

12. *Id.*

13. *Id.* at 38-39.

14. *Id.* Treasury Circular 230 is reprinted at 31 C.F.R. pt. 10 (1991).

provide that a practitioner could not advise the taking of a position unless, in the exercise of reasonable care, the practitioner concluded that the position, if not disclosed, was supported by substantial authority, or, if the position was disclosed, it had a realistic possibility of success if challenged.[15] This recommended standard was an amalgamation of the negligence standard (reasonable care requirement), the substantial authority standard, and the realistic possibility standard used by the professional organizations.

IMPACT adopted the recommendation that the return preparer penalty incorporate the realistic possibility standard of the AICPA and the ABA in lieu of either the substantial authority standard or the negligence standard of former section 6694.[16] According to the legislative history, the new realistic possibility of success standard was adopted "because it generally reflects the professional conduct standards applicable to lawyers and to certified public accountants [CPAs]."[17] The return preparer penalty, as amended by IMPACT, provides that if any part of an understatement of tax on a return prepared by an income tax return preparer is attributable to an undisclosed position for which there was not a realistic possibility of being sustained on its merits, and the return preparer knew (or reasonably should have known) of such position, then the return preparer is subject to a penalty of $250.[18] The penalty is not imposed if there is reasonable cause for the understatement and the return preparer acted in good faith.[19]

According to the House Reports, when the realistic possibility standard replaced the negligence standard, the standard of conduct for purposes of the penalty was raised, not lowered. "The committee believes that this standard of behavior is stricter than present law so that negligent behavior subject to penalty under present law will continue to be subject to penalty under this new standard."[20]

Recently promulgated regulations explain the Service's understanding of the realistic possibility standard as follows:

> A position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well-informed analysis by a person knowledgeable in the tax law

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15. *Civil Penalty Hearings II*, *supra* note 2, at 38-39.
16. IMPACT, *supra* note 3, at 2402.
17. H.R. REP. NO. 247, *supra* note 5, at 1396.
18. *Id.*
19. I.R.C. § 6664 (1991).
20. H.R. REP. NO. 247, *supra* note 5, at 1396.

> would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits.[21]

In other words, a realistic possibility of success exists if there is at least a 33-1/3% chance of succeeding on the merits in a proceeding.

Consequently, the Service/Treasury interpretation of the revised penalty may be summarized as follows:

(1) The realistic possibility of success standard is a quantitative standard (a position with less than a 50% but at least a 33-1/3% chance of success), rather than a qualitative standard based on the conduct of the preparer;

(2) The chances of success on the merits of a return position can be predicted; and

(3) The standard as thus interpreted is the standard professional organizations would apply to lawyers and to CPAs.

A. *A Plain Meaning Approach*

It is fair to start with the ordinary meaning of a realistic possibility of success. A possibility is "something that may exist or happen."[22] A possibility contrasts with a probability — that is, something which is likely to happen, something which is "supported by evidence strong enough to establish presumption but not proof."[23] "Realistic" means "facing facts, based on facts, not on ideals or illusions."[24] Consequently, a realistic possibility of success is one that is based on facts, not imagination or false beliefs about what may happen. Note that the ordinary meaning of a realistic possibility is qualitative; that is, the basis for the conclusion that success may happen is dispositive.

Does this simple exercise of consulting a dictionary provide some insight into the meaning of "a realistic possibility"? It appears so. A return position is realistic when it is "real world as distinct from imaginary or fantasy . . . ," when it "reflects the realities of the situation."[25] A realistic possibility of success on a return position exists, therefore, when the chance of success on the issue is based on facts and the realities of the situation. It is a genuine real world possibility, not one that is imaginary.

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21. Treas. Reg. § 1.6694-2(b)(1) (1991).
22. OXFORD AMERICAN DICTIONARY 520 (2d ed. 1980).
23. WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 937 (9th ed. 1983).
24. *See* OXFORD AMERICAN DICTIONARY, *supra* note 22, at 559.
25. *Id.*

Let us see how this interpretation might apply in a real world example. Suppose a taxpayer has a return position that is based on a single case and the literal application of a long-standing regulation. On the one hand, some factual distinctions may be drawn between the taxpayer's situation and the case. Assume further, that the regulation does not specifically endorse the taxpayer's position. On the other hand, the basic facts of the taxpayer's situation genuinely correspond to the basic facts of the taxpayer's situation in the case, and the regulations do not disapprove of the position. The Service has announced, however, a policy of looking for litigating vehicles in the general area of the issue involved in our case because the Service believes the case on which the taxpayer relied was wrongly decided. Can we say that a position is realistic if it will provoke litigation by the Service?

The answer under a plain meaning approach would be in the affirmative. The possibility of success is realistic in this situation because it is fact-based. The facts of the supporting case and the generally supportive regulation provide the basis for our position. Furthermore, the common law principle of stare decisis supports our position. A Service litigating position reflected in a notice, or for that matter in a revenue ruling, would not change the factual basis for the position. Accordingly, under a plain meaning approach, the return position would have a realistic possibility of success.

B. *The Tort Law Negligence Standard*

Before the amendment of section 6694 in 1989, return preparers could be penalized for negligence.[26] The negligence penalty applied if a taxpayer's understatement of tax was attributable to the return preparer's negligence or intentional disregard of rules and regulations.[27] Regulations provided that preparers would not be considered to have acted negligently or to have intentionally disregarded a rule or regulation if they exercised "due diligence,"[28] and where a rule or regulation was not followed, if they acted "in good faith and with reasonable basis. . . ."[29] "Negligence," "due diligence," and "reasonable basis" are tort law concepts. Despite the suggestion in the House Report, the amendment of section 6694 did not eliminate the tort law

26. Former I.R.C. § 6694(a)(1).
27. *Id.*
28. Former Treas. Reg. § 1.6694-1(a), *reprinted in* 42 Fed. Reg. 59,968 (1977).
29. *Id.*

concepts from the meaning or the operation of the realistic possibility standard.

First, since a "realistic possibility" standard is an objective standard, it is similar to the reasonable person standard in tort law, which is also an objective standard. Second, even under the amended penalty, the preparer is subject to penalty if he knew "or reasonably should have known" that the return position did not have a realistic possibility of being sustained on the merits.[30] This reasonable knowledge requirement is another way of injecting the reasonable person standard of tort law into the realistic possibility standard. Finally, if the preparer has taken an unrealistic and undisclosed position, the penalty still will not be imposed if the preparer can show some "reasonable cause" for taking the return position,[31] again a tort law concept. Thus, the realistic possibility standard has tort law aspects and must be seen in that context.

In the *Restatement (Second) of Torts*, negligence is defined as "conduct which falls below the standard established by law for the protection of others against unreasonable risk of harm."[32] But conduct is not negligent unless the magnitude of the risk involved so outweighs its societal utility as to make the risk unreasonable. As the *Restatement* says:

> Where an act is one which a reasonable man would recognize as involving a risk of harm to another, the risk is unreasonable and the act is negligent if the risk is of such magnitude as to outweigh what the law regards as the utility of the act or of the particular manner in which it is done.[33]

Thus, the actor must recognize the unreasonable character of a risk if a reasonable person would recognize the risk. This standard is an objective or societal standard. As Professors Prosser and Keeton have said:

> The whole theory of negligence presupposes some uniform standard of behavior. Yet the infinite variety of situations which may arise makes it impossible to fix definite rules in advance for all conceivable human conduct. The utmost that can be done is to devise something in the nature of a formula,

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30. *See* I.R.C. § 6694(a)(1) (1991).
31. *See id.*
32. RESTATEMENT (SECOND) OF TORTS § 282 (1965).
33. *Id.* § 291.

> the application of which in each particular case must be left to the jury, or to the court. The standard of conduct which the community demands must be an external and objective one, rather than the individual judgment, good or bad, of the particular actor; and it must be, so far as possible, the same for all persons, since the law can have no favorites. At the same time, it must make proper allowance for the risk apparent to the actor, for his capacity to meet it, and for the circumstances under which he must act.[34]

However, even an objective standard is not meant to present an opportunity for second-guessing or evaluating the actor's conduct with the benefit of hindsight. The idea of risk in this context necessarily involves a recognizable danger, based upon some knowledge of the existing facts, and some reasonable belief that harm may possibly follow. Risk, for this purpose, may then be defined as a danger which is apparent, or should be apparent, to one in the position of the actor. The actor's conduct must be judged in the light of the possibilities apparent to him at the time, and not by looking backward "with the wisdom born of the event." The standard is one of conduct, rather than of consequences. It is not enough that everyone can see now that the risk was great, if it was not apparent when the conduct occurred.[35]

In tort law, if the risk is an appreciable one and the possible consequences are serious, the question is not one of mathematical probability alone. "As the gravity of the possible harm increases, the apparent likelihood of its occurrence need be correspondingly less to generate a duty of precaution."[36] Weighed against the risk of harm is the utility of the conduct in question.

These general principles of tort law provide some guidance in interpreting the realistic possibility of success standard. The tax law recognizes the social utility of the professional return preparers, who provide valuable assistance to taxpayers in complying with complicated tax rules. On the other hand, there is also a recognized risk of harm when return preparers prepare and file returns containing an indefensible position, because return preparers prepare many returns, and relatively few will ever be audited. It is safe to say that Congress believes the harm of unsupported or indefensible return positions is

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34. W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 32, at 173-74 (5th ed. 1984).

35. *Id.* § 31, at 170.

36. *Id.* at 171.

sufficiently grave that it warrants a special civil penalty.[37] Consequently, there is a correspondingly greater duty of precaution on the part of the return preparer.

The realistic possibility of success standard, therefore, recognizes this imbalance between the utility of providing professional advice and the risk posed by indefensible positions. But what is the nature of the standard? Is it one of conduct or of consequences? For tort purposes, an unrealistic possibility of being sustained exists when the adviser knows or reasonably should know that the return position is unwarranted or indefensible as a matter of law. The standard is an objective, external, and uniform standard. The individual judgment of the preparer is not the issue. Rather, the standard focuses on the preparer's conduct in reaching a judgment. At the same time, the standard takes into account the circumstances under which the preparer must act. The conduct of the preparer in concluding that the position was realistic must be judged at the time the preparer acted, not at a later time looking backward. It is not enough that everyone can see after an appeals conference or a Tax Court case that the risk of not being sustained on the merits was great because in fact the taxpayer's was not sustained on the merits. The preparer cannot be faulted so long as the risk was not apparent at the time the return was prepared and the position was taken.

C. *The Tort Law Malpractice Standard*

The standard of care exacted from lawyers and accountants under tort law is not measured by the ordinary reasonable person standard of tort law. Instead, courts employ the more stringent reasonable lawyer or reasonable accountant standard, which is defined by the daily work of actual practitioners.[38] In malpractice cases, expert testimony is ordinarily presented from witnesses who are familiar with the practices of lawyers or accountants and can testify to whether the defendant-tax-professional's performance departed from that of ordinarily competent practitioners.[39] Definition of the applicable standard of care has largely been a process of comparing the defendant's performance with the performance of other tax professionals in similar situations.[40]

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37. *See* H.R. REP. NO. 247, *supra* note 5.
38. CHARLES W. WOLFRAM, MODERN LEGAL ETHICS § 5.6.2, at 211 (1986).
39. *Id.*
40. *See id.* at 212.

Clients reasonably expect that the lawyer's training and skill make the lawyer a valuable source of information about probable outcomes in the legal system. However, "[a] lawyer can act unreasonably in assessing the future just as well as a lawyer can act unreasonably in failing to file a client's claim within the statute of limitations."[41] On the other hand, a lawyer should not be required to guess about what the law is, and if the state of the law is uncertain, the lawyer's informed judgment about the probable resolution of relevant legal propositions should not be the basis for a claim of malpractice. In the final analysis, the question is one of degree — was the advice or other lawyer's conduct reasonable under the circumstances.[42] In general, lawyers and tax professionals are not permitted to produce legal uncertainty themselves by failing to conduct reasonable research. If the tax professional conducts research or the professional is otherwise reasonably aware of the state of the law, the tax professional's advice in light of an uncertain state of the law will normally fully comply with the reasonable-practitioner standard.[43]

Insofar as the realistic possibility of success standard implies some forecast of results, it does so by focusing on the manner in which the forecast of the outcome is made. The question is whether the lawyer or accountant acted reasonably in saying, in effect, that the return position is defensible or warranted in law.

D. *Unjustifiable Litigating Positions*

Rule 11 of the Federal Rules of Civil Procedure provides the following:

> The signature of an attorney or party constitutes a certificate by the signer that the signer has read the pleading, motion, or other paper; that to the best of the signer's knowledge, information, and belief formed after reasonable inquiry it is well grounded in fact and is warranted by existing Law or a good faith argument for the extension, modification, or reversal of existing law, and that it is not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation.[44]

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41. *Id.* at 214.
42. *Id.*
43. *Id.* at 215.
44. FED. R. CIV. P. 11.

The same kind of obligation is imposed by the Tax Court's rules.[45] Sanctions are also imposed for failure to obey a pretrial scheduling order,[46] for discovery abuse,[47] and for frivolous appeals.[48] An attorney can be held in contempt for any of these improper acts.[49]

Rule 11 sets a standard of conduct expected of attorneys who sign pleadings and motions. It emphasizes the responsibilities of the attorney and reinforces those obligations by the imposition of sanctions. The similarity to section 6694 of the Code is striking. Rule 11 imposes a sanction that can include a monetary penalty,[50] and section 6694 imposes a penalty of $250.[51] As indicated above, both Rule 11 and the return preparer penalty require some support in fact and law.[52]

To satisfy the affirmative duty imposed by Rule 11, an attorney must make a pre-filing inquiry into both the facts and the law of the case.[53] The standard is one of reasonableness under the circumstances,[54] and those circumstances include whether the pleading, motion, or other paper was based on "a plausible view of the law."[55] In general, most courts have held that the standard imposed on lawyers by Rule 11 is an objective one and that subjective bad faith need not be shown.[56] Even so, Rule 11 is not intended to chill a lawyer's enthusiasm or creativity in pursuing factual or legal theories, and the court is expected to avoid using hindsight in applying the Rule.[57] The complexity of the law, the non-frivolous argument of the lawyer, and whether the claim is colorable are all considered in determining whether sanctions are appropriate.[58]

Rule 11 as originally adopted seemed to restate several of the Canons of Professional Ethics adopted by the ABA. For example, Canon 30 was captioned "Justifiable and Unjustifiable Litigation," and stated that:

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45. TAX COURT RULES OF PRACTICE AND PROCEDURE Rule 33(b).
46. FED. R. CIV. P. 16(f).
47. FED. R. CIV. P. 37.
48. FED. R. APP. P. 38.
49. *See* FED. R. CIV. P. 16(f); 37(b)(1).
50. *See* FED. R. CIV. P. 11.
51. I.R.C. § 6694(a) (1991).
52. FED. R. CIV. P. 11; I.R.C. § 6694(a)(1) (1991).
53. *See* FED. R. CIV. P. 11.
54. JAMES W. MOORE, MOORE'S FEDERAL PRACTICE § 11, at 121 (2d ed. 1991).
55. *Id.*
56. *Id.* § 11.4, at 129.
57. *Id.* § 11.2, at 121.
58. *Id.*

> The lawyer must decline to conduct a civil cause or to make a defense when convinced that it is intended merely to harass or to injure the opposite party or to work oppression or wrong . . . . His appearance in court should be deemed equivalent to an assertion on his honor that in his opinion his client's case is one proper for judicial determination.[59]

Similarly, Canon 31, entitled "Responsibility for Litigation," provided that: "The responsibility for advising as to questionable transactions, for bringing questionable suits, for urging questionable defenses, is the lawyer's responsibility. He cannot escape it by urging as an excuse that he is only following his client's instructions."[60] Accordingly, under the ABA Canons of Professional Ethics, a lawyer was responsible for decisions taken in litigation and was required to have some justification for a claim before urging it on behalf of a client.[61]

The Canons of Professional Ethics were eventually replaced by the Model Rules of Professional Conduct, which were adopted by the ABA in August, 1983.[62] Rule 3.1 of the Model Rules, entitled "Meritorious Claims and Contentions," provides the following: "A lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis for doing so that is not frivolous, which includes a good faith argument for an extension, modification or reversal of existing law."[63] Rule 3.1 of the Model Rules thus incorporates the language of Rule 11. A lawyer must take responsibility for ensuring that the client's position in any proceeding is non-frivolous and that it is warranted either in existing law or in a good faith extension, modification, or reversal of existing law.

How does the Rule 11 standard help in analyzing the realistic possibility standard? Rule 11 requires the lawyer to investigate both the facts and the law to have a basis for a client's position in a proceeding,[64] and the position must be non-frivolous.[65] Because a realistic position based on fact is a real world possibility, and also is non-frivolous, in this respect at least, the Rule 11 standard and the preparer

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59. MODEL CODE OF PROFESSIONAL RESPONSIBILITY Canon 30 (1980).

60. *Id.* Canon 31.

61. *See id.*

62. It is noteworthy that Rule 11 was also amended in 1983 and that both the Model Rule and Rule 11 use the same terminology. *See* FED. R. CIV. P. 11; MODEL RULES OF PROFESSIONAL CONDUCT Rule 3.1 (1983).

63. MODEL RULES OF PROFESSIONAL CONDUCT Rule 3.1 (1983).

64. FED. R. CIV. P. 11.

65. *Id.*

penalty standard are identical. A position that is not supported by existing law is not sanctionable so long as the position is for an extension, modification, or reversal of existing law and is made in good faith after a reasonable inquiry, as objectively judged.[66] A position that has no realistic possibility of extending, modifying, or reversing existing law would be sanctionable under Rule 11. It would also be subject to penalty under section 6694.[67]

But more may be required under section 6694 than is required under Rule 11. When a lawyer takes a position in a proceeding, that position usually is disclosed in a pleading or another filing in the proceeding, such as a motion or a brief. Pretrial proceedings are designed to disclose the positions of the parties before trial and to avoid surprise at trial. Procedures for the disclosure of positions simply do not exist when a position is taken on a tax return, and a disclosure statement is not filed with the return. It would follow from Rule 11, therefore, that a tax return position based on a good faith argument for the extension of existing law need not be disclosed, but that a position calling for a modification or reversal of existing law must be disclosed.

Apart from these observations, however, it can be seen that the Rule 11 standard, so similar to the realistic possibility standard in its operation, is a standard of conduct, not of consequences. The standard also is not violated simply because the court rejects the lawyer's position, so long as the lawyer has a basis for the position and has acted with reasonable care or due diligence (objective considerations) in investigating the facts and the law.[68]

E. *ABA Opinion 85-352 and AICPA SRTP No. 1*

A little history is necessary to understand the realistic possibility of success standard as it was adopted by the ABA and later the AICPA. Radically abbreviated, the history may be summarized as follows. From 1965 to 1985, ABA Opinion 314 described a lawyer's professional obligation in advising a client in the course of preparing a tax return: "a lawyer who is asked to advise his client in the course of the preparation of the client's tax returns may freely urge the statement of positions most favorable to the client just as long as there is reasonable basis for those positions."[69] ABA Opinion 314's

66. *See* FED. R. CIV. P. 11 & advisory committee notes.
67. *See* I.R.C. § 6694(a) (1991).
68. *See* FED. R. CIV. P. 11.
69. ABA Comm. on Ethics and Professional Responsibility, Formal Op. 314 (1965).

"reasonable basis" standard was coupled with a statement that the Service is "not designed and does not purport to be unprejudiced and unbiased in the judicial sense."[70] This implied that the Service is an adversary in litigation and in negotiations for the settlement of a tax case. In this process, the lawyer owes a duty of candor, may not be associated with perjury, fraud, and deception and is, under certain circumstances, required to withdraw from the matter.[71]

A lawyer who had a "reasonable basis" for a return position presumably had acted after reasonable research. In this sense, the reasonable basis standard was in the mainstream of negligence and malpractice law where the reasonable person and the reasonably competent practitioner are the standard conduct. In other words, the basis for a return position would not be reasonable unless it were considered so by a reasonably competent tax practitioner.

If the reasonable basis standard seems so traditional, how did the standard come to represent a cynical cover for shoddy, if not disreputable, tax advice? The answer is the bogey-man of the 1970s: investments of individual taxpayers, primarily in tax shelters. What made the tax return positions of individual taxpayers flowing from tax shelters so troublesome to the Service was the likelihood that such return positions would go undetected since the Service was examining fewer and fewer individual tax returns.[72] Not only were taxpayers taking what were believed to be aggressive return positions, they and their advisers were suspected of taking advantage of the reality that the taxpayer had less than a three percent chance of being examined.[73]

In a 1980 speech, the then General Counsel of the Treasury warned that the Treasury Department was concerned that lawyers' opinions were being used in tax shelter promotions as selling points and penalty insurance for taxpayers.[74] One of the troublesome tax opinions described in the speech was the "reasonable basis but you'll probably lose" opinion.[75] These opinions (which are also lengthy) point out that there is a reasonable basis for the claimed tax benefits, but warns the taxpayer that if he is audited, his claims would be challenged and

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70. *Id.*

71. *See id.* (discussing MODEL CODE OF PROFESSIONAL RESPONSIBILITY Canons 29, 37, 41 & 44).

72. *See, e.g.*, H. CONF. REP. NO. 760, 97th Cong., 2d Sess. 575 (1982).

73. Robert H. Mundheim, *Remarks on Standards for Tax Attorneys*, DAILY TAX REP., Jan. 22, 1980, at J-1, *reprinted in* BERNARD WOLFMAN & JAMES P. HOLDEN, ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE 175-80 (2d ed. 1985).

74. *Id.* at 177.

75. *Id.*

that under existing law he would probably lose.[76] Following this speech, Treasury proposed amendments to Treasury Circular 230 that generally imposed due diligence requirements on tax practitioners as to the facts disclosed, the issues addressed in the tax opinion, and the probability that the principal tax benefits would be allowed.[77] This same due diligence standard was adopted by the ABA in Formal Opinion 346.[78] Under this standard, the lawyer is obligated not only to investigate the underlying facts to insure their accuracy and completeness, but to relate the law to the actual facts (and to identify any facts assumed).[79]

The Service was moving on another front to deal with the "audit lottery." In response to this problem, then Commissioner of Internal Revenue Kurtz urged that taxpayers and their preparers

> should be required to report on their returns "questionable" positions that have been taken on the return (that is, positions that are) knowingly inconsistent with published regulations, rulings or cases. The kind of position that accountants reserve against — the kind of position lawyers would call to the attention of investors in a public offering.[80]

In 1982, this view bore fruit in the enactment of the substantial understatement penalty.[81] The substantial understatement penalty was imposed if the taxpayer lacked "substantial authority" for a position and the position caused a substantial understatement of tax.[82] However, a taxpayer lacking substantial authority could also avoid the penalty by disclosing the return position.[83] The legislative history of the substantial understatement penalty adopted the view that the authorities relevant to a tax return position included Service administrative pronouncements such as revenue rulings, as well as Code pro-

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76. *Id.*

77. 45 Fed. Reg. 58,594 (1980).

78. ABA Comm. on Ethics and Professional Responsibility, Formal Op. 346 (1982).

79. *Id.*

80. Jerome Kurtz, *Remarks to the American Institute of Certified Public Accountants*, DAILY TAX REP., May 26, 1977, at J-3, *reprinted in* WOLFMAN & HOLDEN, *supra* note 73, at 60.

81. Former I.R.C. § 6661 (1982) (repealed in 1989 but simultaneously reenacted as a component of § 6662, the accuracy related penalty).

82. Former I.R.C. § 6661(b)(2)(B)(i) (1982).

83. Former I.R.C. § 6661(b)(2)(B)(ii) (1982).

visions, court opinions, Treasury regulations, and committee reports reflecting congressional intent.[84]

Courts were supposed to be free to interpret substantial authority in accordance with the legislative purpose of the penalty and not punish taxpayers who made a good faith effort to self-assess tax.[85] In this spirit, substantial authority existed for a return position even if it would probably not be successful in court so long as it had a substantial, rather than merely a "reasonable" basis.[86] According to the legislative history,

> a taxpayer is required to have more support for his position than it is arguable, but fairly unlikely to prevail in Court upon a complete review of the relevant facts and authorities. Rather, when the relevant facts and authorities are analyzed with respect to the taxpayer's case, the weight of the authorities that support the taxpayer's position should be substantial when compared with those supporting other positions.[87]

In short, to avoid a substantial understatement penalty in the event of a deficiency, the taxpayer was required to have substantial authority for the return position — that is, authority that was at least as likely to be accepted by a court as to be rejected. Provided the authority was "substantial" and not merely "reasonable," acceptance by the court need not have been probable.

Although the substantial authority standard was (and still is) ambiguous, the legislative rejection of the reasonable basis standard was clear enough.[88] Taxpayers willing to play the audit lottery were seen to have been aided by tax advisers who believed that there was a "reasonable basis" for the return position.[89] As a 1984 proposed revision of ABA Opinion 314 stated: "The 'reasonable basis' standard of practice promulgated in Formal Opinion 314 has been the subject of misinterpretation and misapplication, to the extent that it has been con-

84. *See* Staff of the Joint Comm. on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Tax Act of 1982, 97th Cong., 2d Sess. 217-18.

85. *Id.*

86. *Id.*

87. *Id.*

88. *See id.* (stating that the new standard requires a taxpayer to have stronger support for a position than a mere "reasonable basis").

89. *Id.*

strued to support the use of any colorable claim to justify exploitation of the lottery of the tax return audit selection process."[90]

The proposed revision of ABA Opinion 314 required that the return position be a "meritorious one," which meant a position "advanced in good faith, as evidenced by a practical and realistic possibility of success."[91] In addition, the lawyer must have honestly entertained the belief that the position may well "be held to be correct, either on the merits of existing authority or by reversal of existing authority."[92]

What this historical summary shows is that the reasonable basis standard did not change during the 1970s. Return positions reporting deductions or credits from a tax sheltered investment were not necessarily reasonable under the reasonable basis standard. In short, the reasonable basis standard did not make indefensible return positions reasonable. But the prevailing belief, especially in the Treasury and Service, was that lawyers and other tax practitioners were advising clients that they could take return positions even when those positions were unlikely, at least in the Service's view, to prevail in court.[93]

In 1985, the ABA adopted as a standard of return preparation the realistic possibility of success standard to replace the reasonable basis standard.[94] It did so not because it accepted the criticism of the reasonable basis standard, but because it believed it necessary to restate the existing standard so as to avoid its misapplication in practice. Thus, ABA Opinion 85-352 did not disavow the reasonable basis standard,[95] nor did it claim that the realistic possibility standard was a higher standard than the reasonable basis standard.[96] To restate the standard, however, ABA Opinion 85-352 borrowed concepts underlying Rule 11 and the ethical standards applicable to lawyers in other proceedings:

> In summary, a lawyer may advise reporting a position on a return even where the lawyer believes the position probably will not prevail, there is no "substantial authority" in support of the position, and there will be no disclosure of the position in the return. *However, the position to be asserted must be*

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90. ABA Section of Taxation Proposed Revision to Formal Opinion 314, May 21, 1984, *reprinted in* WOLFMAN & HOLDEN, *supra* note 73, at 71.

91. *Id.* at 73.

92. *Id.*

93. *See, e.g.*, Jerome Kurtz, *Penalty Revision and the Case for Section 6661*, 42 TAX NOTES (TAX ANALYSTS) 1617 (1989).

94. ABA Opinion 85-352, *supra* note 6.

95. *Id.*

96. *Id.*

> *one which the lawyer in good faith believes is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law.* This requires that there is some realistic possibility of success if the matter is litigated.[97]

The "warranted in existing law" language and the test itself are derived directly from Rule 11.

While the ABA modified the conduct standard from "reasonable basis" to "realistic possibility of success," the AICPA initially retained the "reasonable basis" standard set forth in its Statement on Responsibilities in Tax Practice No. 10 (1977).[98] In apparent response to the lack of uniformity in the professional organization standards, amendments to section 10.34 of Treasury Circular 230 were proposed on August 14, 1986, and were published in the Federal Register on August 14, 1986.[99] In general, these proposed amendments provided that the statutory requirements of the substantial tax understatement penalty of section 6661 provided guidance on the exercise of due diligence,[100] and that accordingly, a practitioner was prohibited from recommending or advising a taxpayer to adopt a return position if the return position might subject the taxpayer to a penalty for a substantial understatement of tax.[101] For example, in a non-tax-shelter situation, the proposed requirement would not be met unless there was "substantial authority" for the position or, in its absence, the position had been adequately disclosed. These proposed amendments were never adopted,[102] but in 1988, the AICPA followed the ABA Tax Section and adopted the realistic possibility of success standard for return preparation.[103]

Shortly thereafter, both the AICPA and the ABA Tax Section recommended the adoption of a uniform standard for tax return positions as follows:

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97. *Id.*

98. TAX RETURN POSITIONS, Statement on Responsibilities in Tax Practice No. 10 (Am. Inst. of Certified Pub. Accountants 1977).

99. 51 Fed. Reg. 29,113-15 (1986).

100. *Id.* at 29,113-14.

101. *Id.* at 29,114.

102. Both the AICPA and ABA Tax Section submitted comments opposing adoption of the proposed standard (AICPA Letter, dated Feb. 13, 1987, from Herbert Lerner and Leonard Podolin and ABA Tax Section Letter, dated Feb. 12, 1987, from John B. Jones, Jr.).

103. TAX RETURN POSITIONS, *supra* note 6.

> A practitioner may not advise or recommend to a client that a position be taken with respect to the tax treatment of any item or a return unless the practitioner has a good faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits if challenged.[104]

Nevertheless under this standard,

> the practitioner may advise or recommend that a position be presented in the context of either: (1) a return on which a position is adequately disclosed, or (2) an amended return that serves as a claim for refund (e.g., a Form 1040X or 1120X), in either case so long as the practitioner concludes that there is a basis for doing so that is not frivolous.[105]

From this history, it is clear that ABA Opinion 85-352 adopted the same standard of conduct for the preparation of tax returns that applied to lawyers under Rule 11 when they take positions for clients in proceedings. Both Rule 11 and the ethical standard require no more than due diligence and reasonable investigation before taking a position.

Consequently, if, as the House Report states,[106] the ethical standard of the ABA and the AICPA was adopted by section 6694, a realistic possibility of success standard requires the same conduct on the part of return preparers as is required under the professional group standards. Interpreting the realistic possibility of success standard in light of Rule 11 means that a return preparer has a duty to make a legal and factual inquiry to ensure that the return position is warranted in existing law. It also requires an inquiry to make certain that the position is not taken for some improper purpose, such as exploiting the likelihood that the return will not be audited by the Service. The standard does not require calculation of the chances of success. It does require reasonable investigation of both the facts and the applicable law *before* taking a position that is not sustained on the merits.

F. *The Realistic Possibility Standard Reinterpreted — Summary of Analysis*

With this background, we can summarize what is required by a realistic possibility standard. If a return preparer has (1) made a good

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104. *Id.*
105. *Id.*
106. H.R. REP. NO. 247, *supra* note 5, at 1396.

faith attempt to determine the correct return position (due diligence), (2) found at least some support for the position (reasonable support), and (3) after reasonably competent research, found no contrary authority demonstrating that a court could not practically (*i.e.*, realistically) be expected to sustain the position, then the preparer will have satisfied the realistic possibility standard. The statement in the regulations that the standard means "a one in three, or greater, likelihood of being sustained on its merits,"[107] is inconsistent with the background of the ABA standard, which section 6694 incorporates, and, which, in turn, was derived from the Model Code and Rule 11.

The realistic possibility of success standard is a standard of conduct, not of speculation about, or correct prediction of, the chances that the position can be successfully defended. Rule 11 does not require a lawyer to calculate the chances of winning on a litigating position. Practically speaking, that sort of calculation is not possible. It is true that some reasonable assessment of the likelihood of success may be required of professionals, but this assessment is simply the kind of service a professional is reasonably expected to provide so that a client is not committed to frivolous litigation. Thus, although some forecasting of results can be expected by professionals, the question under the realistic possibility standard should be whether the preparer acted reasonably in saying that the return position is defensible in fact and warranted in law.

G. *Relevance of the Substantial Authority Analysis to the Realistic Possibility Analysis*

Regulations interpreting section 6694 provide that "[t]he analysis prescribed under [the substantial authority regulations] for purposes of determining whether substantial authority is present applies for purposes of determining whether the realistic possibility standard is satisfied."[108] But is it appropriate to use a taxpayer penalty analysis to describe the preparer's analysis of a realistic possibility of success? As we shall see, in some respects, the analysis of substantial authority is no different from the due diligence expected of the preparer. In other ways, however, by requiring preparers to meet a substantial authority standard, the regulations confuse the process, and seem not to have followed the intention of Congress.

It is fairly obvious that, in performing a due diligence search for legal support for a return position, a preparer will look for, and hope

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107. Treas. Reg. § 1.6694-2(b)(1) (1991).
108. *Id.*

to find, authority to support that position. Finding commonly accepted authorities, the preparer will weigh them. The process is virtually the same for both the AICPA and the penalty regulations interpreting "substantial authority." The AICPA's interpretation of the realistic possibility standard set forth in its Statement on Responsibilities in Tax Practice No. 1 describes the process this way:

> The CPA should consider the weight of each authority in order to conclude whether a position meets the realistic possibility standard. In determining the weight of an authority, the CPA should consider its persuasiveness, relevance, and source. Thus, the type of authority is a significant factor. Other important factors include whether the facts stated in the authority are distinguishable from those of the client and whether the authority contains an analysis of the issue or merely states a conclusion.[109]

The substantial authority regulations contain language that is quite similar to the language used by the AICPA:

> The weight of authorities is determined in light of the pertinent facts and circumstances in the manner described [below]. . . .
>
> The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. . . . There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.[110]

Thus, the research *processes* described in the professional group standard and under the substantial authority regulations are the same. But, the standards do not quite require the same kind of analysis.

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109. SRTP Interpretation No. 1-1.09 (1990).
110. Treas. Reg. § 1.6662-4(d)(3)(i)-(ii) (1991).

It is worth noting that when Congress was considering changes to the preparer penalty, one of the recommendations was that the substantial authority standard be used.[111] Instead of the substantial authority standard, however, the realistic possibility of success standard used by professional organizations was chosen. This suggests that Congress chose not to incorporate the substantial authority standard into a preparer's analysis. At any rate, by incorporating the "substantial authority" analysis, the regulations add elements of uncertainty as well as controversy to a preparer's attempt to determine whether the realistic possibility of success standard is satisfied.

The uncertainty and controversy exist because the AICPA does not consider the realistic possibility of success standard and substantial authority standard to be the same standard. The AICPA considers the realistic possibility of success standard to be less stringent than the substantial authority.[112] Using the Service's view that a realistic possibility of success is a one in three chance of success, this could mean that substantial authority is something less than a probability (more than 50%) and something more than a realistic possibility (33%).

This percentage view of the standards assumes a quantitative analysis, and it is not at all certain that a quantitative analysis is appropriate for the realistic possibility of success standard. As discussed above, the realistic possibility of success standard properly understood is a qualitative standard. It does not require a professional to calculate the odds of success with precision. Rather, it is directed at measuring the conduct and the result of reasonably competent research against the conduct of the reasonable return preparer. By contrast, the substantial authority regulations imply a quantitative analysis insofar as they provide that a return position that is "arguable, but fairly unlikely to prevail in court," does not satisfy the substantial authority standard.[113] Quantitative judgment is also implied by the statement that substantial authority is something less than a probability and more than a reasonable basis.[114]

A quantitative approach to the realistic possibility of success standard not only is inconsistent with its origin, it is also impractical to achieve. Unless the facts pertaining to the return issue are certain, any quantitative calculation of the chances of success will be a guess. As Judge Jerome Frank pointed out in *Courts on Trial*,[115] a prediction of the

111. *Civil Penalty Hearings II*, *supra* note 2, at 37-38.
112. SRTP Interpretation No. 1.06 (1990).
113. Treas. Reg. § 1.6662-4(d)(2) (1991).
114. *Id.*
115. JEROME FRANK, COURTS ON TRIAL (1949).

outcome of a contest before a trial and a decision will be so full of "if's" as to be of little practical value. Consider the uncertainties of witness credibility, the bias or prejudice of the finder of facts, and other factors in the trial of a case. Even after a trial and before a decision, guessing at the result is difficult. Only after a trial and a decision settling what the facts of the case are, can a competent and trained lawyer predict the result with accuracy (and even then not always) because the only question is the legal rule the appellate court will apply to the facts as already found.

Seen against this description of what lawyers can actually predict, the use of a one in three chance of success requirement to define the realistic possibility of success standard is more of a metaphor than a useful guide. To the extent that "substantial authority" purports to carryover a quantitative analysis to the preparer's analysis, therefore, it collides with the professional interpretation of the realistic possibility of success standard.

It thus appears that while "substantial authority" has some relevance to the realistic possibility of success standard, the weighing process but not the analysis is the same. It must have seemed that incorporating the substantial authority analysis into the preparer analysis achieved some goal of simplicity. But the approach is more likely to cause confusion and uncertainty for preparers and the courts.

There is another respect in which the AICPA's interpretation of the realistic possibility of success standard differs from the substantial authority regulations. The AICPA interpretation of the realistic possibility of success standard permits a wider range of authorities to be considered than do the regulations governing the substantial authority and realistic possibility of success standards. The AICPA's interpretation permits CPAs to "rely on well-reasoned treatises, articles in recognized professional tax publications, and other reference tools and sources of tax analyses commonly used by tax advisors and return preparers."[116] The substantial authority regulations contain a list of acceptable authorities, which explicitly excludes such commonly used sources as treatises and articles.[117] Also, the AICPA permits reliance on private letter rulings and general counsel memoranda more than ten years old.[118] The substantial authority regulations provide that such documents are entitled to very little weight.[119] This broader range

116. SRTP Interpretation No. 1-1.07 (1990).
117. Treas. Reg. § 1.6662-4(d)(3)(iii) (1991).
118. SRTP Interpretation No. 1-1.07 (1990).
119. Treas. Reg. § 1.6662-4(d)(3)(ii) (1991).

of permitted authorities shows that the AICPA's criterion is whether the tools and sources are those commonly used by tax professionals. Consequently, the substantial authority regulations are contrary to the very professional standard the penalty statute incorporated.

The preparer should be able to consult any source so long as it is one that a reasonable preparer would rely on in practice, not only those authorities that are considered in a "substantial authority" analysis for purposes of the substantial understatement accuracy-related penalty context. For this reason, a date limitation on authoritative rulings, for example, is unacceptable because such a limitation fails to credit the normative nature of the realistic possibility of success standard. Consequently, by coordinating substantial authority and the realistic possibility analysis, the Regulations have created differences between the realistic possibility of success standard, as interpreted in the Regulations, and the realistic possibility of success standard as interpreted by the AICPA.

III. CONCLUSION

The Service's attempt to focus on the odds of success creates a standard contrary to common practice. Neither attorneys nor accountants can or should be asked to prognosticate how a court or the Service will decide an issue. In practical terms, the Service's focus on the odds of success would limit the standard to issues of law, not of fact. Only in areas where the facts are clear can results begin to be predictable. In addition, limiting the scope of acceptable authorities could lead to a situation where a practitioner has acted professionally under the realistic possibility of success standard, as interpreted by the AICPA, but is subject to penalty under the same standard, as interpreted by the Service. Obviously, if this can occur, section 6694 cannot be said to have adopted the standard of return preparation utilized by professional groups, as Congress intended.

In the end, general statements do not resolve the specific situations facing return preparers. In most cases, there is either clear support for a position or clear authority against it. For those cases in the middle ground, the return preparer must engage in research and analysis to develop a position before the return is filed. In this middle ground, the realistic possibility of success standard requires a preparer to make a reasonable inquiry of the facts and to conduct reasonable research of the applicable law to determine whether there is support for the return position that stands a practical chance of being accepted in an administrative or judicial proceeding. The tax return preparer is obligated to do no less, but the preparer certainly is obligated to do no more.