Congress Should Not Lower the Standard for Tax Return Preparers

By Donald B. Tobin

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It is rare when Congress is chastised for raising the ethical standards of lawyers and accountants. That, however, is what is happening now as a result of Congress's successful efforts to raise the standards for lawyers and others who prepare or help prepare tax returns. The new standards require tax professionals, who are providing taxpayers with advice on how to treat items on a tax return, to believe that the position is more likely than not correct before advising a taxpayer to take such a position.[1] A preparer can advocate that a taxpayer take a position that may not meet the more likely than not (MLTN) standard if that position is disclosed on the return. In other words, a tax professional must believe a position has at least a 50 percent chance of success before recommending it, or the IRS must be told that the position is questionable. Many tax professionals have argued that Congress went too far and should lower the standard.[2] The higher standard, however, helps ensure a fairer tax system and discourages overly aggressive tax reporting.

Why Is This Important?

The central question here involves the obligations of tax professionals when advising taxpayers regarding return positions. Tax professionals have a duty to both the clients they serve and to the tax system as a whole. There is a tension between the tax professional as an aggressive planner for the client and the professional as a guardian of the law and our system of justice. Recently, the balance has tilted too far toward aggressive advocacy. Tax and accounting malfeasance at Enron, WorldCom, Tyco, and Arthur Andersen, to name just a few, have increased national attention on ethical issues in tax practice and bookkeeping. Lawyers, accountants, and other tax return preparers have played a major role in assisting companies in defrauding consumers, investors, stock holders, and regulators.[3] Tax practitioners have been willing to push the envelope and to make or employ creative and sometimes ludicrous tax avoidance schemes. Because the standards were relatively low, tax practitioners had a strong incentive to be aggressive.[4] The move by Congress to raise the standards for reporting a position helps to reverse this trend.

In many ways, a tax return preparer's role is special in our legal system. Because we have a system of taxation based on voluntary compliance, and because audit rates are low, the system depends on honest reporting. Generally outside the tax context, a lawyer has an obligation not to file a claim or to take a position if the claim or position is frivolous. But if we use a frivolous standard in the tax arena, attorneys and other tax professionals would have every incentive to recommend that their clients take aggressive tax positions. After all, only a few returns are ever audited, and it is easy to justify a position as "not frivolous."

Tax attorneys (and, in some cases, other tax professionals) generally have two different functions, and the ethical standards employed may be different depending on the role they are playing. Sometimes the tax professional acts as an adviser. In this role, she advises her client on a return position in various ways. She may advise a client on whether a position is justified, how to set up a transaction, or how to take advantage of a loophole in the tax law. When she acts as an adviser, the ethical and statutory responsibilities provide a check on abuse. The preparer's involvement provides, in a sense, a seal of approval. In that circumstance, it makes sense to hold the preparer to a higher standard.[5]

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[1]Section 6694.

[2]*See, e.g.*, American Bar Association Section of Taxation, *Legislative Changes Impacting Standards for Imposition of Penalties*, Nov. 25, 2007, *available at* http://abanet.org (last visited July 2, 2008); American Institute of Certified Public Accountants, *Comments on Revisions to Section 6694 Changing Tax Return Reporting Standard for Preparers*, July 10, 2007, *available at* http://tax.aicpa.org (last visited July 2, 2008); New York State Bar Association Tax Section, *Recent and Proposed Statutory Changes to Tax Return Preparer Penalty Rules of Internal Revenue Code Section 6694 and Related Issues*, Jan. 28, 2008, *available at* http://www.nysba.org (last visited July 2, 2008).

[3]*See* Linda M. Beale, "Tax Advice Before the Return: The Case for Raising the Standards and Denying Evidentiary Privileges," 25 *Va. Tax Rev*. 583, 598 (2006) (noting aggressive practices by lawyers and arguing that standard be raised to discourage aggressive tax reporting and planning).

[4]*Id*. at 608 (taxpayers and tax advisers engage in cost-benefit analysis, and the economic model suggests that aggressive tax planning is efficient).

[5]When a tax professional is acting as an advocate in an adversarial proceeding, the professional has a duty to aggressively defend the client, and the MLTN standard does not apply.

What Is the Dispute About?

A standard that requires a tax professional to believe that the position she advocates has at least a 50 percent chance of success makes perfect sense. Why should tax professionals advise a taxpayer to take a position if they do not believe the position is more likely right than wrong? Lawyers and accountants charge significant fees to make these decisions, and it seems appropriate to require that they have some level of certainty before they advise a taxpayer to take a particular position.

Many in the profession, however, have cried foul. For example, the American Bar Association Section of Taxation and the American Institute of Certified Public Accountants have expressed concern over the higher standard.[6] Both organizations claim that the standard is too high and are advocating that Congress lower the standard.[7] To understand the current controversy, a little background is required.

Before last year's change, section 6694 provided that a return preparer could be charged a penalty if there was an understatement of tax on a return and that understatement was due to a position on the return for which there was not a realistic possibility of success on the merits. The preparer is subject to the penalty only if she knew or had reason to know the taxpayer took such a position and the item was not properly disclosed on the return. This realistic possibility of success idea was included in IRS guidance and created a general obligation that a lawyer, accountant, or other tax adviser not advise a taxpayer to take a position on a return unless there was a realistic possibility of success (defined as a 33 percent chance of success on the merits).[8] Interestingly, taxpayers can be penalized for taking a position on a return without having a substantial basis for that position (defined as about a 40 percent chance of success).[9] So before the recently enacted legislation, tax return preparers actually had a lower standard than taxpayers who acted without professional assistance.

Last year, as part of the Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28), Congress amended section 6694 and subjected tax return preparers to a penalty if there was an understatement of tax liability, the preparer knew or reasonably should have known of the position, and "there was not a reasonable belief that the position would more likely than not be sustained on its merits."[10] A preparer could avoid the penalty if he had a reasonable basis for the position (approximately 20 percent chance) and properly disclosed the position. The substantial authority standard in section 6662 was not changed, so taxpayers now are subject to a lower standard than for hired professionals (40 percent chance of success for taxpayers, and 50 percent for return preparers).

So after 2007, if a preparer believed he had better than a 50-50 chance of winning on a position, he could recommend it without penalty and without being required to disclose it. If he thought he had less than a 50-50 chance, he could recommend the position as long as he had a 20 percent chance and disclosed the position. This regime is perfectly reasonable.

Tax professionals raise several concerns, many of which are technical concerns, about the way the statute might be enforced, but there are two main concerns. First, that taxpayers' standards are lower than professionals' causes ethical problems for the practitioner, because professionals, by having a higher standard, have an incentive to urge taxpayers to disclose even though the taxpayer has no independent obligation to do so. This would occur when the chance of success was between the 40 percent required for the taxpayer to avoid penalties and the 50 percent required for the preparer. Presumably, the higher disclosure requirement for taxpayers is disadvantageous because it would increase the chances the IRS would examine the position. Second, the 50 percent standard is too high a standard.[11]

The commentators are correct that there are problems caused by the differential standards. If the standards are different, a preparer would have an incentive to encourage disclosure or to encourage a taxpayer not to take a position, when the taxpayer would have no such incentive if the taxpayer did not use a preparer. In some circumstances, this might discourage taxpayers from getting competent tax advice. The problem could be addressed through a disclosure by the practitioner to the client regarding the different standards, or by increasing the taxpayer standard to the 50 percent standard that applies to professionals.[12] In general, it makes sense for the standard for tax return preparers and taxpayers to be the same, but the system will be better served if the standard for both preparers and taxpayers is the 50 percent more likely than not standard and not the lower reasonable basis standard. The higher standard will encourage accurate self-reporting and will discourage taxpayers and tax professionals from taking overly aggressive reporting positions.

The underlying question is how much of a burden is this higher standard on taxpayers and preparers, and is that burden correct in a system that depends on voluntary compliance. A large majority of individual taxpayers — more than 60 percent — do not itemize on their income tax returns.[13] These taxpayers have very little difficulty

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[6]*Supra* note 2.

[7]*Id. See also* H.R. 6049 (would lower the standard from MLTN to substantial authority).

[8]Reg. section 1.6694-2.

[9]Section 6662.

[10]Section 6694.

[11]ABA tax section, *Legislative Changes Impacting Standards*, *supra* note 2.

[12]Also, the regulations proposed by Treasury provide that when a position satisfies the taxpayer standard but does not satisfy the preparer standard, a preparer may meet the disclosure obligations by disclosing to the taxpayer that the preparer believes the position meets the substantial basis standard (the taxpayer standard) but that it does not meet the MLTN standard. Prop. reg. section 1.6694-2 and -3.

[13]Brian Balkovic, "Individual Income Tax Returns, Preliminary Data, 2006," *Statistics of Income Bulletin*, Spring 2008, *available at* http://www.irs.gov/pub/irs-soi/06inplim.pdf (last visited July 2, 2008).

determining whether they have a 50 percent chance of success on the merits of a position. Even taxpayers who itemize on their returns do not usually take a position unless they believe it is correct. Taxpayers generally know whether their mortgage interest is deductible, or whether they are entitled to a deduction for charitable contributions. The difference between a 40 percent and 50 percent standard will simply not affect them. The standard mainly comes into play when taxpayers are taking aggressive positions or when they have very sophisticated tax returns. So the real burden of this change falls on individuals filing complex returns and business taxpayers.

Some preparers argue that it is often hard to determine whether a position satisfies MLTN standard.[14] Many tax situations involve a balancing of facts and circumstances. They argue that it is often hard to know exactly how the situation will turn out. In those instances, taxpayers routinely take the position most advantageous to them. Because only 1 percent to 2 percent of returns are audited, the odds are strongly in taxpayers' favor. Under the pre-2007 rules, tax return preparers had every incentive to encourage taxpayers to take aggressive positions. But a system that requires voluntary compliance should not also favor aggressive reporting of tax positions. If a tax professional is unsure whether a position meets the MLTN standard, she can either recommend that the taxpayer take the position and disclose the particulars of the situation, or she can recommend that the taxpayer not take the position. It is important to remember that nothing prevents taxpayers from taking positions that do not meet the MLTN as long as they disclose the position. The new rules do not prohibit taxpayers from taking aggressive positions. They just insist that when they do so, they disclose that position.

Disclosure is important because it is often difficult to tell by simply looking at a return the basis on which a taxpayer decided to take a deduction. Without disclosure, the IRS has no way to know that the taxpayer's treatment of an item on the return is at all questionable. Thus, a system that requires a reasonably high level of certainty for blind reporting and a lower level for disclosed positions makes sense.[15]

The proposal moving through Congress would lower the standard for tax professionals to that of taxpayers. This is an improvement from pre-2007 law in that it at least keeps the standard for tax professionals at the same level as that for taxpayers (instead of reducing to pre-2007 levels). It is, however, a step back from current law.

A system that requires voluntary compliance should not reward aggressive taxpayers who hide the ball. It should encourage taxpayers to take positions that they believe are more likely than not correct. If a taxpayer wants to take a position when she is not sure it is correct, she can disclose the position, and the Service, if it chooses, can examine that treatment. The MLTN standard encourages taxpayers and preparers to think twice before taking aggressive positions. Honest, transparent, and accurate reporting is essential for tax administrations and provides for a fairer tax system.

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[14]*See* ABA tax section, *Legislative Changes Impacting Standards*, *supra* note 2.

[15]It is possible that this provision could lead to overreporting and that the IRS could not administratively handle those disclosures. Congress, however, did not mandate the type or method of reporting. If the IRS believes that the increase in disclosure will be an administrative burden on either the Service or on professionals, it can provide for a simpler method of disclosure. The crux of the issue is whether a higher standard is appropriate. The technical concerns of preparers are real and should be addressed, but they do not provide sufficient reasons for lowering the standards.