



Authoritative Support—Getting the Required Support for a Tax Position
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Authorities in Various Situations

There are various times a tax professional is required to have analyzed the support for a position and be ready to prove that the support for the position in question met various required minimum standards. That could be in order for a client to avoid a penalty, for the preparer to avoid sanction under §6694, or to justify recognition of a tax benefit for financial reporting purposes under FIN48, as well as for various other reasons that regulatory agencies or other individuals might decide are applicable.

Given the importance of having that support, we are going to consider the nature of such support, as well as what resources we have to turn to in order to determine our support.

Support Needed

Various levels of support are mentioned in different contexts. While the technical

definition often depends on the exact reason why we are seeking to demonstrate the level of support, we find that (generally moving from the lowest standard to the highest) the following levels of support are mentioned in various contexts:

- **Frivolous**—the lowest level of support, most often reserved for positions mentioned in “tax protestor” style cases (the 16th Amendment was not adopted since Ohio isn't a state, only residents of the District of Columbia are subject to federal income tax, etc.). Suffice it to say that this level of support virtually never works for anyone (taxpayer or tax preparer) to avoid negative consequences.
- **Realistic possibility**—while this appears to rapidly becoming a standard that isn't going to be referenced, it generally is given to be a position that it reasonably believed to have a 1 out of 3 chance of being successful if formally challenged and litigated. Prior to the changes in §6694, this was the level of support that needed to exist for a tax preparer to avoid penalty under §6694(a).
- **Reasonable basis**—a standard that is growing in importance, it is a position for which the support may not rise to the level of substantial authority, but which more authoritative support exists than a merely “arguable” position. It does include a position where it seems significantly less than “even money” the position would be sustained if challenged and fully litigated, but not so far out of the realm of likely that sustaining the position would seem “shocking” (for instance, the original holding in the *Murphy* case by the Federal Circuit panel would be such a “shocking” position—and, it turns out, it didn't stand in the end). This level of support is now needed for preparers to avoid being penalized for *disclosed* positions under §6694(a), as well as for taxpayers under §6662's general substantial understatement rule.
- **Substantial Authority**—a very important standard, as we'll discuss shortly. In this case, there is a substantial body of authority in support of the position, although it may not rise to the “more likely than not” level of assurance for the position. But, certainly, a court ruling in favor of such a position would not be at all surprising. This level of assurance is generally needed for *nondisclosed* positions of a taxpayer potentially subject to the substantial understatement penalty of §6662 (though not for “tax shelters” as defined at §6662(d)(2)(C)(iii) where a higher standard applies). As well, under both interim guidance and proposed regulations under §6694(a) this will be the *practical* level a tax preparer will be able to cite for nondisclosed positions if the preparer can document certain communications with the taxpayer for positions that did not meet the more likely than not level of assurance.
- **More Likely Than Not**—A level of assurance that has grown dramatically in importance, it is most often paired with a “reasonable belief” clause. What it means is that the support indicates that there is a greater than 50% chance if the

matter were fully developed and litigated that the taxpayer's position would prevail. Originally this standard applied to taxpayers under §6662 for tax shelter positions, where the taxpayer needed to demonstrate a reasonable belief that the position met the more likely than not standard. Since opinions from professionals were often used to demonstrate that reasonable level of reliance, the IRS Office of Professional Responsibility in 2005 modified Circular 230 §10.35 to require that professionals reach this level of assurance for “covered opinions” in various circumstances. The Financial Accounting Foundation picked up this issue and incorporated the “more likely than not” standard (with some modifications) in FIN48. Congress, noticing those two changes, then grafted more likely than not onto §6694(a), making it the statutory minimum for *nondisclosed* positions for a preparer to avoid sanction.

In all cases, the tests are run without taking into account “audit lottery” considerations. Nor is it allowed to presume that a matter would be negotiated away at the appellate level—in all cases we presume the case goes to court when testing our level of authority.

But just how do we approach these definitions? That is what we will consider now.

The Key Standard

When we trace the standards, we find that our definitions all tend to point back to a similar starting point—the “substantial authority” standard under §6662, and more particularly the definition for that standard found at Reg. §1.6662-4(d). Other provisions in the regulations constantly refer back to this regulation when noting what can and cannot be considered support.

Regulation §1.6662-4(d)(2) provides this general outline of the “substantial authority” standard:

(2) Substantial authority standard.

The substantial authority standard is an *objective standard* involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is *less stringent than the more likely than not standard* (the standard that is met when there is a *greater than 50-percent likelihood of the position being upheld*), but more stringent than the *reasonable basis standard* as defined in section 1.6662-3(b)(3). *The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant* in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied.

This paragraph puts substantial authority into context for us, positioning it between “reasonable basis” and “more likely than not” (at least the absolute version of the latter). It also emphasizes that we cannot consider “audit lottery” considerations. As well, the

IRS announces it is an objective standard—that implies that the question of a preparer's experience or expertise would not enter into whether or not substantial authority exists.

The types of authority we can consider are outlined at Reg. §1.6662-4(d)(3)(iii), which lists the following as authorities we can consider:

- Applicable provisions of the Internal Revenue Code and other statutory provisions;
- Proposed, temporary and final regulations construing such statutes;
- Revenue rulings and revenue procedures;
- Tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties;
- Court cases;
- Congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers;
- General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book);
- Private letter rulings and technical advice memoranda issued after October 31, 1976;
- Actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin);
- Internal Revenue Service information or press releases; and
- Notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin.

The regulation notes one thing that doesn't count that many practitioners rely on in practice—editorial content. Reg. §1.6662-4(d)(3)(iii) goes on, following the above list of authorities, to note:

Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority. The authorities underlying such expressions of opinion where applicable to the facts of a particular case, however, may give rise to substantial authority for the tax treatment of an item.

Put simply, a citation from *CCH's Standard Federal Tax Reporter*, *RIA's Federal Tax Coordinator 2d*, a *BNA Portfolio*, or other such documents may not be used, standing alone, to provide support.

The need to determine if the item we are relying on has been overruled is also noted, as the regulation continues:

Notwithstanding the preceding list of authorities, an authority does not continue to be an authority to the extent it is overruled or modified, implicitly or explicitly, by a body with the power to overrule or modify the earlier authority. In the case of court decisions, for example, a district court opinion on an issue is not an authority if overruled or reversed by the United States Court of Appeals for such district.

However, the regulation goes on to note a “special” rule for Tax Court decisions:

However, a Tax Court opinion is not considered to be overruled or modified by a court of appeals to which a taxpayer does not have a right of appeal, unless the Tax Court adopts the holding of the court of appeals.

For instance, the Tax Court might rule in a published opinion in a certain manner, a ruling that is overruled in that case by the Court of Appeals to which that particular taxpayer would appeal. Nevertheless, unless the Tax Court adopts the holding of that Court of Appeals in general (that is, it ceases to treat its own original holding as precedential), the original holding would still constitute authority outside of the particular Court of Appeals.

Private letter rulings are also given special limitations:

Similarly, a private letter ruling is not authority if revoked or if inconsistent with a subsequent proposed regulation, revenue ruling or other administrative pronouncement published in the Internal Revenue Bulletin.

However, the taxpayer's *own* private letter ruling is generally a slam dunk substantial authority support, as noted in Reg. §1.6662-4(d)(iv)(A):

(A) Written determinations.

There is substantial authority for the tax treatment of an item by a taxpayer if the treatment is supported by the conclusion of a ruling or a determination letter (as defined in section 301.6110-2(d) and (e)) issued to the taxpayer, by the conclusion of a technical advice memorandum in which the taxpayer is named, or by an affirmative statement in a revenue agent's report with respect to a prior taxable year of the taxpayer ("written determinations"). The preceding sentence does not apply, however, if --

(1) There was a misstatement or omission of a material fact or the facts that subsequently develop are materially different from the facts on which the written determination was based, or

(2) The written determination was modified or revoked after the date of issuance by --

- (i) A notice to the taxpayer to whom the written determination was issued,
- (ii) The enactment of legislation or ratification of a tax treaty,
- (iii) A decision of the United States Supreme Court,
- (iv) The issuance of temporary or final regulations, or
- (v) The issuance of a revenue ruling, revenue procedure, or other statement published in the Internal Revenue Bulletin.

Except in the case of a written determination that is modified or revoked on account of section 1.6662-4(d)(3)(iv)(A)(1), a written determination that is modified or revoked as described in section 1.6662-4(d)(3)(iv)(A)(2) ceases to be authority on the date, and to the extent, it is so modified or revoked. See section 6404(f) for rules which require the Secretary to abate a penalty that is attributable to erroneous written advice furnished to a taxpayer by an officer or employee of the Internal Revenue Service.

The analysis itself is outlined in Reg. §1.6662-4(d)(3)(ii). It starts out by holding:

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.

The mere fact that a case or ruling shares *some* facts with a taxpayers' situation isn't enough—you have to evaluate if the item can otherwise be distinguished from your taxpayers case by looking at what is different, and then evaluating whether those differences will impact the result.

The regulation also notes, indirectly, that some authorities really aren't going to give enough information to enable them to be very useful.

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. The weight of an authority from which information has been deleted, such as a private letter ruling, is diminished to the extent that the deleted information may have affected the authority's conclusions.

We have to consider the type and age of a document as well:

The type of document also must be considered. For example, a *revenue ruling* is accorded greater weight than a private letter ruling addressing the same issue. An *older* private letter ruling, technical advice memorandum, general counsel memorandum or action on decision generally must be accorded less weight than a *more recent one*. Any document described in the preceding sentence that is more than 10 years old generally is accorded very little weight. However, the persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account along with the age of the document.

Note the general presumption that private letter rulings, technical advice memorandum, general counsel memorandum or action on decision that is more than 10 years old is immediately considered suspect by the regulation. From a practical standpoint, right now that means we want any such rulings to be dated after 1998.

But, as well, the fact that the only authority existing is the underlying Code (often the case with new law) doesn't preclude getting to substantial authority:

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.

A taxpayer's jurisdiction generally does not apply—*except* when considering the Court of Appeals:

(B) Taxpayer's jurisdiction.

The applicability of court cases to the taxpayer by reason of the taxpayer's residence in a particular jurisdiction is not taken into account in determining whether there is substantial authority for the tax treatment of an item. Notwithstanding the preceding sentence, there is substantial authority for the tax treatment of an item if the treatment is supported by controlling precedent of a United States Court of Appeals to which the taxpayer has a right of appeal with respect to the item.

In Arizona, we would have special interest in rulings of the Ninth Circuit Court of Appeals in this case. As well, since appeals from the U.S. Court of Claims go to the Federal Circuit, that Circuit's rulings are also of interest to all taxpayers when looking to establish authority.

Finally, since new rulings and cases are issued continuously, we have to worry about the point in time when the level of authority will be determined. Reg. §1.6662-4(d)(3)(iv)(C) gives us a choice of two dates. We have to establish the existence of substantial authority

either on:

- The date the taxpayer files the return containing the item *or*
- The last day of the taxable year to which the return relates

Reasonable Basis

As noted earlier, “reasonable basis” is a standard that applies for disclosed positions for both taxpayers and preparers. The definition of “reasonable basis” is found in Reg. §1.6662-3(b)(3), which begins:

Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim.

The regulation goes on to specifically reference the “substantial authority” list of authorities in explaining how to reach a “reasonable basis” level of authority:

If a return position is reasonably based on one or more of the authorities set forth in section 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in section 1.6662-4(d)(2). (See section 1.6662-4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty.)

As well, we find a “reasonable cause” basis for invoking a defense even in the absence of a “reasonable basis” for the taxpayer:

In addition, the reasonable cause and good faith exception in section 1.6664-4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard.

The standard is also placed in context by Reg. §1.6662-3(b)(3)(ii):

The reasonable basis standard is significantly higher than the not frivolous standard applicable to preparers under section 6694 and defined in section 1.6694-2(c)(2).

Or, in other words, merely being able to say your position is not frivolous (which the above regulations defines as “patently improper”) is not sufficient to claim “reasonable basis” for the position. Generally you will need to be able to cite some authority that has not been overruled and which retains persuasive appeal, even if the overall weight of authorities might suggest you can't make substantial authority (which suggests multiple

authorities are on your side—or the only authority is there).

More Likely Than Not

The level that has become popular (some would say far too popular) in recent years is the “more likely than not” standard. As noted above, it appeared in the IRC as part of the tax shelter provisions of §6662's substantial understatement penalty, where the taxpayer needed a “reasonable belief” that the standard was met for his/her position [§6662(d)(2)(C)(i)(II)].

The standard, absent the “reasonable belief” clause, reappeared in Circular 230 §10.35(b)(4)(i) where it was defined as “a greater than 50 percent likelihood” that the issues would be resolved in the taxpayer's favor. The rules applied to “covered opinions” only, which represented a restricted set of written advice that were generally defined by items that would meet the “tax shelter” definition found in §6662.

Next in line was the Financial Accounting Foundation. Acting in response to disclosures that significant tax liabilities that were assessed had not been reported on financial statements that got lots of attention (Enron for instance), the FAF issued FIN48, requiring that tax benefits only be recognized when it was “more likely than not” that the benefit would be realized. In this case the key issue was an eventual quantitative calculation of a tax provision, but adding some new complexities. For instance

- For FIN48 we have to consider returns that are not filed, but might need to be filed. Obviously in governmental guidance we were only concerned with agencies we had filed with, but now we worry about this for entities that might see a liability
- The statute of limitations comes into play, a matter that is essentially irrelevant in the government guidance since unless the statute was open, the issue didn't matter. Now the expiration of the statute itself is an event that creates a more likely than not situation
- We are allowed to consider “administrative practice” even if a literal interpretation of the law would cause the benefit not to be recognized. Government guidance had generally not recognized such an item (though it is referenced in proposed regulations under §6694)

Finally, we had the Congress modifying the paid preparer penalties under §6694, borrowing the “more likely than not” standard, though again with the “reasonable belief” modifier that had been lost in Circular 230. §6694(a) provides:

(a) Understatements due to unreasonable positions

(1) In general

Any tax return preparer who prepares any return or claim for refund with respect to which any part of an understatement of liability is due to a position described in paragraph (2) shall pay a penalty with respect to each such return or claim in an amount equal to the greater of--

(A) \$1,000, or

(B) 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

(2) Unreasonable position

A position is described in this paragraph if--

(A) the tax return preparer knew (or reasonably should have known) of the position,

(B) there was not a reasonable belief that the position would more likely than not be sustained on its merits, and

(C)

(i) the position was not disclosed as provided in section 6662(d)(2)(B)(ii), or

(ii) there was no reasonable basis for the position. (3) Reasonable cause exception

No penalty shall be imposed under this subsection if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith.

Note that we have two “reasonable” outs where—we can show we had a reasonable belief the position would be sustained on its merits *or* there was a reasonable cause for the understatement and we acted in good faith.

The proposed regulations under §6694 provide us with some “breaks” on this penalty, such as:

- A preparer's experience and general sophistication will be considered in determining if a reasonable belief existed. That's likely good news, but also suggests that CPAs, EAs and attorneys will be held to a higher expectation than will unenrolled preparers.

- If a position has substantial authority, is not a tax shelter but we cannot get to “more likely than not” the preparer can avoid requiring the taxpayer to attach an 8275 or other disclosure if the preparer
 - Informs the client of the different standards applicable (meaning we tell them it fails to meet “more likely than not” and
 - We document that we gave that information to the client (meaning it likely needs to be in writing if we want to rely on it).
- For a position that doesn't meet the substantial authority standard, so long as we give the return to the client with the Form 8275 attached we won't face discipline should the client remove that form from the return prior to filing (though prudence suggests that you need to avoid “suggesting” to the client that they could remove that form).
- If disclosure would do the client no good (a tax shelter) we can again inform the client of the standards and then document that fact.

However, there is one significant change in the proposed regulations—we would go from a situation of “one preparer per firm” to “one preparer per position” on the return. Previously, if someone from the firm signed the return, everyone else in that firm was “off the hook” for the penalty. Now more than one preparer in the firm might find him/herself penalized—and there's incentive for the signing preparer to “turn in” other members of the firm to defend him/herself against the penalty.

As well, even if your firm does not sign the return as a preparer, you may still be subject to penalty as a “nonsigning preparer” if responsible for a significant item on a return. The nonsigning preparer exposure is nothing new—we had that under old §6694.