Potential Penalties and Ethical Problems in Filing an Amended Return: The Case of the Repentant Sports/Entertainment Figure's Legal Expenses Deduction

John R. Dorocak

Follow this and additional works at: https://digitalcommons.mainelaw.maine.edu/mlr

Part of the Legal Ethics and Professional Responsibility Commons, Taxation-Federal Commons, and the Tax Law Commons

Recommended Citation
John R. Dorocak, Potential Penalties and Ethical Problems in Filing an Amended Return: The Case of the Repentant Sports/Entertainment Figure's Legal Expenses Deduction, 52 Me. L. Rev. 1 (2000).
Available at: https://digitalcommons.mainelaw.maine.edu/mlr/vol52/iss1/2

This Article is brought to you for free and open access by the Journals at University of Maine School of Law Digital Commons. It has been accepted for inclusion in Maine Law Review by an authorized editor of University of Maine School of Law Digital Commons. For more information, please contact mdecrow@maine.edu.
POTENTIAL PENALTIES AND ETHICAL PROBLEMS
IN FILING AN AMENDED RETURN: THE CASE OF
THE REPENTANT SPORTS/ENTERTAINMENT
FIGURE’S LEGAL EXPENSES DEDUCTION

John R. Dorocak

I. INTRODUCTION .............................................................................................................2
II. THE HYPOTHETICAL CASE OF THE ATHLETIC TAXPAYER ................................3
III. AMENDED RETURN OBLIGATION .............................................................................6
IV. POTENTIAL ETHICAL PROBLEMS AND PENALTIES IN NOT FILING AN AMENDED
RETURN ............................................................................................................................7
   A. Ethical Problems ........................................................................................................7
      1. When Error is Discovered ....................................................................................7
      2. When Client Refuses to Amend ..........................................................................8
   B. Potential Penalties ....................................................................................................9
      1. Original Return .....................................................................................................9
      2. Failure to Amend .................................................................................................13
   C. Disclosure .................................................................................................................13
      1. Effect of Disclosure on Taxpayer and Practitioner Penalties .........................13
      2. Likelihood of Taxpayer Disclosure and Potential Exposure .......................14
   D. Audit Lottery ............................................................................................................15
V. HYPOTHETICAL APPLICATIONS ............................................................................16
VI. CONCLUSION .............................................................................................................17
I. INTRODUCTION

A prominent sports/entertainment figure walks into your office (all preparers should be so lucky). He is in a repentant mood—not because he escaped conviction for the murder of his former wife and her friend, but because he deducted his legal expenses in defending against the criminal prosecution and the civil wrongful death suit. This Article discusses the obligation of the taxpayer, even one as nefarious as the athlete posited, and the practitioner to file an amended return.

As one pair of commentators has stated, “How should the amendment be made, and what are the possible consequences of amending a return? Little has been written on this subject and even fewer answers have been provided.”

First, this Article will briefly discuss the suggested hypothetical taxpayer and the rationale for deducting his legal expenses. Second, this Article will discuss the current status of the legal obligation to file an amended return. Third, this Article will discuss (a) the ethical obligations of the practitioner regarding amended returns; (b) the potential penalties against taxpayers and practitioners for not filing an amended return; (c) the effect of disclosure of the potentially questionable deduction on the original return; and (d) the propriety of the taxpayer and the practitioner discussing the audit lottery (the likelihood of being audited by the IRS). Finally, this Article will discuss the application of the legal, ethical, penalty, and disclosure requirements to the hypothetical taxpayer and preparer, and distinguish other hypothetical taxpayers.

* Copyright © 1998 by John R. Dorocak.

** John R. Dorocak, Professor of Accounting, California State University, San Bernadino, Honors A.B., Xavier University; J.D., Case Western Reserve University; LL.M. (Tax), University of Florida; C.P.A., California and Ohio. Companion articles have appeared in the following journals: John R. Dorocak, *Sports and Entertainment Figures (and Others) May Be Able to Deduct Legal Expenses for Criminal Prosecutions (and Wrongful Death Suits)*, 13 AKRON TAX J. 1 (1997); John R. Dorocak, *Potential Penalties and Ethical Problems of a Filing Position: Not Reporting Gain on the Expiration of a SCIN After Frame v. Commissioner*, 23 DAYTON L. REV. 317 (1998); John R. Dorocak, *Save Our SCIN’s: A Defense of the Tax Court Dissent in Frame*, 55 OHIO CPA J. 20 (Nov./Dec. 1996). The author thanks Marion Wiltjer whose invaluable and professional assistance (for the limited compensation of chocolate peanut butter cups and minimal cash) was essential to the production of these pages and many others.

1. “As if the American public has not heard enough about the murder trial of former professional football and entertainment figure Orenthal James (O.J.) Simpson, this article argues that the legal expenses of a taxpayer situated as Mr. Simpson may well be deductible.” John R. Dorocak, *Sports and Entertainment Figures (and Others) May Be Able to Deduct Legal Expenses for Criminal Prosecutions (and Wrongful Death Suits)*, 13 AKRON TAX J. 1, 2 (1997) (footnote omitted).

II. THE HYPOTHETICAL CASE OF THE ATHLETIC TAXPAYER

Of course, there is at least one prominent sports/entertainment figure who was criminally charged with the murders of his ex-wife and her friend: O.J. Simpson, charged in the deaths of Nicole Brown Simpson and Ron Goldman. Mr. Simpson was found not guilty of the murders in the criminal trial. He was, however, subsequently held liable for wrongful death in the civil suits filed by Ron Goldman’s father and mother, and Nicole Brown Simpson’s family.

Suppose a taxpayer in Mr. Simpson’s situation had deducted the legal fees for both the criminal prosecution and the civil suits. How likely would it be that Mr. Simpson’s deduction would be sustained on the merits? How likely would it be that the deductions would escape taxpayer or practitioner penalties and avoid running afoul of the practitioner ethical provisions? Finally, and most important for the purposes of this Article, if the taxpayer were to have a change of heart about the deduction, what obligation, be it legal, ethical, and/or penalty avoidance, is there upon the taxpayer or the practitioner to amend his return?

The estimates of Mr. Simpson’s legal fees vary drastically, although commentators seem to concur that they are quite large. Other similarly situated taxpayers have reportedly deducted large amounts; for example, Ivan Boesky and Michael Milken, convicted Wall Street figures from the late 1980s, deducted $50 million and $400 million respectively of restitutionary payments, apart from legal fees.

The Supreme Court in United States v. Gilmore set forth the “origin of the claim” test as the basic test for determining the deductibility of legal expenses. According to the Court, the legal claim must have arisen from the taxpayer’s business or income-seeking activity. Because personal expenses are not deductible, many legal expenses cannot be deducted. In Gilmore, the Court also rejected the theory that legal expenses are deductible when the consequences of the legal claim affect the taxpayer’s business or income-seeking activity (the “consequences”

10. See United States v. Gilmore, 372 U.S. at 44-51; Deductibility of Legal and Accounting Fees, Bribes and Illegal Payments, 523 Tax Mgmt. (BNA) at A-13 (Feb. 2, 1996) (discussing the purpose and creation of the “origin of the claim” test).
test). As this Author has indicated elsewhere, the origin of claim test has often raised the question for taxpayers as to how connected the legal claim and legal expenses must be to the taxpayer's business or income-seeking activity. Commentators have also suggested a third test, apart from the origin of claim and consequences tests, based on the connectedness and/or motive of the taxpayer.

Legal expenses, like those of the hypothetical defendant posited herein, may be deductible under the extended concept of connectedness; that is, those legal expenses connected to the defendant's business or income-seeking activity may be deducted. In two key cases, the courts show how connectedness has been extended. In Jenkins v. Commissioner, the Tax Court, in a memorandum opinion, allowed country-western music singer Conway Twitty to deduct payments made on behalf of Twitty Burger Restaurants, purportedly to protect the singer's music business reputation. In Salt v. Commissioner, the Tax Court also allowed a movie script writer to deduct legal expenses involved in appearing before the House Committee on Un-American Activities which investigated charges of Communist infiltration in the motion picture industry.

Some might posit that expenses incurred in defending a murder charge are almost always personal and not business or income-seeking activity. Many decisions have rejected the deductibility of legal expenses incurred in the defense of murder or other crimes when the taxpayer did not demonstrate connectedness but instead only established certain negative consequences; for example, that he would lose his job if he were convicted.

The court in Salt, however, in discussing one of the leading cases, stated:

Applying here the reasoning and an expression used in the Heininger case . . ., "upon being served" with a subpoena to appear before the Committee, petitioner "was confronted with a new business problem which involved" his present and future business welfare. Ordinary business prudence demanded that petitioner employ counsel to advise with and represent him in such an emergency.

It appears that the "dream team" of legal advisors of the real-life O.J. Simpson did place their client in a position analogous to that of Waldo Salt, the taxpayer in Salt. Those advisors consistently alleged a police "frame up" apparently analogous to the Committee's investigation or "witch hunt" (one's politics determining the terminology) of Mr. Salt. The Simpson defense team argued that the police intentionally framed the successful black defendant to destroy his prosperity. The

14. See Dorocak, supra note 1, at 3 & n.14.
15. See id. at 3 & n.15.
17. See 2764. These payments were to third parties, however, and were not legal expenses.
18. 18 T.C. 182 (1952).
19. See id. at 185.
Supreme Court has even held that legal expenses of an unsuccessful defense of a criminal prosecution are deductible when such expenses are related to business and when allowance of the deduction would not frustrate sharply defined national or state policies.\textsuperscript{25}

If a defendant, such as the hypothetical one herein or O.J. Simpson, can deduct legal expenses incurred in defending against a criminal prosecution for murder, it appears likely that the defendant could deduct legal expenses for a defense against a civil law suit for wrongful death. Based on the court's holding in \textit{Jenkins}, the defendant might be able to deduct legal expenses by arguing that the expenses were necessary to protect his business reputation. Furthermore, the court's holding in \textit{Salt} may provide the defendant with further support. Upon finding his business under investigation, the defendant, like \textit{Salt}, is entitled to mobilize his forces against an attack (although in \textit{Salt} the attack was by the government and in a civil law suit it would not be).

Finally, the defendant might be able to use the case of \textit{Draper v. Commissioner}.\textsuperscript{26} Draper was a professional dancer. Mrs. Hester McCullough said that the petitioner was pro-Communist and that she wanted "to hit these boys in their box office."\textsuperscript{27} Draper sued for libel, and the Tax Court upheld his deduction of legal expenses even though his libel action resulted in a hung jury.\textsuperscript{28} In \textit{Draper}, as well as in \textit{Salt}, one party in the underlying suit appears to be motivated by an attempt to affect the business income of the other, and the legal expenses arise as a result. As indicated above, Mr. Simpson's legal advisors argued that those prosecuting Mr. Simpson in the criminal case harbored the same motive.

Therefore, there is at least some rational argument that a taxpayer such as the hypothetical one herein or O.J. Simpson might be able to deduct legal expenses in defense of a prosecution for murder and/or a civil suit for wrongful death. If the hypothetical taxpayer were, as suggested at the outset of this Article, to have a change of heart about the previously claimed deductions for legal expenses, what legal, ethical, and penalty obligations would he face? The next section of this Article discusses the legal obligations concerning the filing of an amended return. Subsequent sections discuss the ethical obligations and penalties for the taxpayer and the practitioner regarding the amended return and, to some extent, the original return as it impacts the amended return. Finally, disclosure of the claimed deduction and the audit lottery are discussed.

\textsuperscript{25} \textit{See} Commissioner \textit{v. Tellier}, 383 U.S. 687 (1996). Some commentators have argued for expanded deductibility of legal expenses in order to make legal services more affordable. \textit{See}, e.g., Robert Sklodowski \& Douglas J. Rathe, \textit{Aid For the Middle Class: Deduction of Legal Expenses}, 85 \textit{CASE \& COM} 40 (Mar.-Apr. 1980). Also, the \textit{Model Rules of Professional Conduct} suggest the traditional bromide that every client is entitled to vigorous representation. \textit{See Model Rules of Professional Conduct} Rule 1.3 (1995). There also may be a sliding scale, if legal expenses are more tenuously connected to a taxpayer's business or income-seeking activity, then the taxpayer might need to prevail in litigation, especially criminal litigation, before such expenses were deductible. \textit{See Dorocak, supra} note 1, at 6 \& nn.25-26 (where this Author has previously wrestled with his conscience regarding the deductibility of such criminal legal expenses for perhaps unsavory criminal defendants).

\textsuperscript{26} 26 T.C. 201 (1956).

\textsuperscript{27} \textit{id.} at 203.

\textsuperscript{28} \textit{See id.} at 204.
III. AMENDED RETURN OBLIGATION

Although little has been written on amended return obligations, some commentators have addressed the subject.29 Most of these commentators agree on the legal obligations of filing an amended return.

The Internal Revenue Code and the Treasury Regulations merely allow a taxpayer to file an amended return in certain circumstances and do not require such filing. Treasury Regulation 1.451-1(a) states that, when a taxpayer determines that an item of gross income should have been included in a prior year, the taxpayer should file an amended return and pay any additional tax if within the statute of limitations.30 Treasury Regulation 1.461-1(a)(3) also states that, when a deduction was improperly claimed in a prior year, the taxpayer should file an amended return and pay any additional tax due if the statute of limitations is open.31 One commentator interprets these regulations to mean that "it is probably advisable to file an amended return, but it is not mandatory."32 The Code does require taxpayers to report their true income on their returns and file a return without material falsehood.33 Another commentator has indicated that several statutory revisions refer to amended returns in specific circumstances but none grant any general status to amended returns.34

Form 1040X for filing an amended individual income tax return does not contain information normally present in instructions identifying those who must file.35 Publication 17, Your Federal Income Tax for Individuals, also discusses amended returns stating, "you should correct your return" if improper deductions or credits are claimed or income is not reported.36 No separate publication of the Internal Revenue Service deals with amended tax returns. All of this advisory, rather than mandatory, language by the Service led a commentator to state that "perhaps the Internal Revenue Service has concluded that no one is legally required to file an amended individual income tax return but is making Form 1040X available to those who feel morally compelled to do so."37

In Badaracco v. Commissioner,38 the Supreme Court held that the filing of a nonfraudulent amended return, after the filing of a fraudulent original return, did

---


32. Pollack, supra note 29, at 90.

33. See Comisky & Shepard, supra note 2, at 80 & n.3 (citing §§ 6011(a), 6662 et seq., and 7201-7212).

34. See Individuals Escape Penalties, supra note 29, at 236 n.3.

35. See id. at 237.


37. Individuals Escape Penalties, supra note 29, at 237.

not end the unlimited statute of limitations held open because of fraud under I.R.C. section 6501(c).\(^{39}\) The Court read section 6501 strictly and applied it only to the filing of the original returns.\(^{40}\) The Court stated that the taxpayer had no obligation to file an amended return: "[T]he Internal Revenue Code does not explicitly provide either for a taxpayer's filing, or for the Commissioner's acceptance, of an amended return; instead, an amended return is a creature of administrative origin and grace. . . . None of [the current Regulations'] provisions, however, requires the filing of such a return."\(^{41}\)

In the case of the repentant hypothetical taxpayer, as with other taxpayers (as nearly universally concluded by the commentators), there appears to be no legal obligation to file an amended return.\(^{42}\) The next section of this Article discusses whether, in the absence of legal obligation, there are any potential ethical problems or penalties in not filing an amended return.

IV. POTENTIAL ETHICAL PROBLEMS AND PENALTIES IN NOT FILING AN AMENDED RETURN

A. Ethical Problems

1. When Error is Discovered

Treasury Department Circular 230, governing practice before the IRS by attorneys, CPAs, enrolled agents, and enrolled actuaries, states that the practitioner "shall advise the client promptly of the fact of such noncompliance, error, or omission" appearing on a tax return (among other documents).\(^ {43}\) Circular 230 does not require the practitioner to advise the client that an amended return should be filed.\(^ {44}\)

---

39. See id. at 394-401.
42. Some commentators and practitioners believe that where there is an ongoing IRS audit examination of the taxpayer's return that the taxpayer's representative has an obligation to withdraw from representing the taxpayer if the taxpayer refuses to file an amended return when there is an error discovered by the representative. See Raby & Raby, supra note 29, at 472-473. Raby and Raby's Tax 20 Forum practitioners split 40%/60% in favor of withdrawal under the AICPA's Statements on Responsibilities in Tax Practice, No. 7. That Statement requires the CPA who becomes aware of an error on a previously filed return to inform the client, to request disclosure to the Internal Revenue Service, and to consider withdrawal. However, the majority of the practitioners would not withdraw, some citing the difference between preparation of a return and representation in an advocate's role. Sixty percent of the practitioners believed that the representative could continue even if the position on the return had become frivolous because the position was not frivolous when taken and because there is no continuing affirmation to the IRS. See also Harris, supra note 29, at 525-526. Harris suggests if the error is directly involved in the ongoing audit, the practitioner should withdraw unless to do so would cause undue prejudice. See id. at 525 & n.63. Where the error is not directly involved in the audit, withdrawal is not required unless the representative would be giving false or misleading information, a determination that is based on facts and circumstances. See id. at 525-26.
43. 31 C.F.R. § 10.21 (as amended in 1992).
44. Compare Harris, supra note 29, at 521 & n.42, with Pollack, supra note 29, at 91 & n.5. Pollack appears to read more into the Circular 230 language than is there.
Formal Opinion 314 of the American Bar Association states that the attorney must both advise the client of the existence of the error and advise that the error should be corrected. The opinion does not discuss the attorney’s obligation when the error is intentional so that a criminal prosecution may result.

Statement of Responsibility in Tax Practice, Number 6, Knowledge of Error: Return Preparation, of the American Institute of Certified Public Accountants states “the CPA should inform the client promptly upon becoming aware of an error . . . or failure to file a required return. The CPA should recommend the measures to be taken . . . “ The AICPA’s explanation of the statement says “[i]t is the client’s responsibility to decide whether to correct the error.”

The Guidelines to Tax Practice of the American Bar Association’s Tax Section state that, “in any situation involving potential fraud charges, [the attorney] should carefully explain to the taxpayer the benefits and hazards of the various options available, including any constitutional right [under the Fifth Amendment] not to cooperate with the Service.”

These authorities seem to be in agreement that the practitioner must advise the taxpayer of the error. They disagree, however, on whether the practitioner must advise the client to file an amended return. In the case of the hypothetical taxpayer suggested herein, the taxpayer has approached the practitioner to question whether there is an error on his return. Thus, the cited authorities suggest that the practitioner should advise the taxpayer of the existence of an error, but seem to lack agreement on whether to advise the taxpayer that he should or must file an amended return.

2. When Client Refuses to Amend

Neither Statement of Responsibility in Tax Practice, Number 6: Knowledge of Error: Return Preparation nor Number 7: Knowledge of Error: Administrative Proceedings of the AICPA require or even allow the CPA practitioner to disclose an error on a prior return to the IRS without permission of the client. Both advise that the CPA should consider whether to withdraw and whether to continue a professional relationship with the client. Rule 1.6 of the Model Rules of Professional Conduct of the American Bar Association does not permit a lawyer to reveal confidential client information except when the lawyer believes disclosure is required (1) to prevent commission of a crime likely to result in death or serious bodily harm or (2) to establish a claim or defense of the lawyer. In addition, Model Rule 4.1 requiring disclosure of material facts to third parties to avoid assisting in a crime or fraudulent act is limited if “disclosure is prohibited by rule 1.6.” Withdrawal under the Model Rules, the AICPA Statements, and ABA Feb-

46. See Harris, supra note 29, at 521.
48. Harris, supra note 29, at 521 & n.47 (citing AICPA Prof. Standards, at Tex. § 161.05).
50. See AICPA Prof. Standards, supra note 47, at Tex. §§ 161.03 and 171.03.
51. See Model Rules of Professional Conduct Rule 1.6(b) (1995).
52. Id. at 4.1(b).
mal Opinion 314 is a question of facts and circumstances. One commentator concludes that "when the error is directly involved in the proceedings, it is fairly well established under the above standards that the attorney should withdraw from representation, unless to do so would cause undue prejudice to the taxpayer."54

Regarding the preparation of a tax return for a year subsequent to the year of the error on the prior tax return, Treasury Department Circular 230 would require that the later return not incorporate the current error. Treasury Department Circular 230 requires due diligence in the preparation and filing of returns and the avoidance of giving false or misleading information.55 Similarly, the Model Rules require that an attorney not make a false statement of material fact or law to a third person, and not engage in fraudulent or dishonest conduct.56 Finally, the AICPA’s professional standards require that “the CPA should take reasonable steps to assure himself that the error is not repeated.”57

B. Potential Penalties

1. Original Return

At least one commentator has suggested that, in order to determine whether there are penalties against the taxpayer or practitioner for failure to amend, it is first necessary to determine whether there would have been any penalties for the position taken on the originally filed return.58 In the case suggested herein, therefore, it will be necessary to determine whether the sports/entertainment figure taxpayer and/or his tax return preparer would have been subject to penalties for the original tax return position of deducting legal expenses for defense of the criminal prosecution and the civil wrongful death suit.

For a preparer to avoid a $250 penalty, I.R.C. section 6694(a) requires either (1) a realistic possibility of prevailing on the merits (i.e., a realistic possibility of success [RPOS]) or (2) a non-frivolous position and disclosure.59 RPOS is a one-
third or greater likelihood of being sustained on the merits.\(^{60}\) A frivolous position is one which is patently improper.\(^ {61}\) This preparer penalty, however, may be excused when both reasonable cause and good faith are present.\(^ {62}\)

For a taxpayer to avoid a substantial understatement penalty, I.R.C. section 6662(d) requires either (1) substantial authority or (2) disclosure and a reasonable basis for a filing position.\(^ {63}\) "Reasonable basis"\(^ {64}\) is a "significantly higher" standard than not frivolous.\(^ {65}\) The taxpayer substantial understatement penalty is twenty percent of the understatement.\(^ {66}\) An understatement is substantial when it exceeds the greater of ten percent of the tax required to be shown or $5000 ($10,000 for corporations).\(^ {67}\)

The IRS has defined reasonable basis at an even higher standard in recently finalized regulations 1.6662-7(d) and 1.6662-3(b)(3), where reasonable basis is

---

60. See Treas. Reg. § 1.6664-2(b)(1) (1997). The regulation states that:

(b) Realistic possibility of being sustained on its merits—

(1) In general. 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 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 (realistic possibility standard). In making this determination, the possibility that the position will not be challenged by the Internal Revenue Service (e.g., because the taxpayer’s return may not be audited or because the issue may not be raised on audit) is not to be taken into account. The analysis prescribed by § 1.6662-4(d)(3)(ii) for purposes of determining whether substantial authority is present applies for purposes of determining whether the realistic possibility standard is satisfied.


63. See I.R.C. § 6662(d)(2)(B) (CCH 1996). The Code states that:

(B) Reduction for understatement due to position of taxpayer or disclosed item.—

The amount of the understatement under subparagraph (A) shall be reduced by that portion of the understatement which is attributable to—

(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

(ii) any item if—

(I) the relevant facts affecting the item’s tax treatment are adequately disclosed in the return or in a statement attached to the return, and

(II) there is a reasonable basis for the tax treatment of such item by the taxpayer.

64. Treas. Reg. § 1.6662-7(d) (1999). The regulation states that, "For purposes of sections 1.6662-3(c) and 1.6662-4(e) and (f) (relating to methods of making adequate disclosure), the provisions of 1.6662-3(b)(3) apply in determining whether a return position has a reasonable basis." Id.

65. Treas. Reg. § 1.6662-3(b)(3) (1999) ("Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper.").


67. See I.R.C. § 6662(d)(1) (CCH 1996). The burden of proof shift in I.R.C. section 7491, as revised by the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3001(a) 112 Stat. 685, 726 (1998), seems to change little with regard to the substantial understatement penalty. See I.R.C. § 7491 (CCH 1998). Specifically, 7491(c) states that "the Secretary shall have the burden of production" with regard to penalties. Id. § 7491(c). Apparently after the Service shows a substantial understatement—that by showing a deficiency of $5000 (or 10% of the tax, whichever is greater) for individual taxpayers—the burden would shift back to the taxpayer to prove an exception to that penalty.
defined as reliance on one or more of the identified authorities which can constitute substantial authority, taken together and weighed against contrary authorities.68

For a taxpayer to avoid the twenty percent penalty for disregard of rules and regulations, similar disclosure of, and reasonable basis for, a filing position are required.69 A taxpayer may avoid all of the twenty percent accuracy-related penalties of section 6662 (including the negligence penalty) by showing reasonable cause and good faith under section 6664(a).

Preparers are also subject to a $1000 penalty for willful, reckless, or intentional disregard of rules and regulations under section 6694(b).70 “Rules and regulations” include Treasury Regulations and Revenue Rulings and IRS Notices, according to the Service’s own regulations.71 The section 6694(b) standard for practitioners does not seem to be that different from the section 6694(a) standard. The Service has stated that a preparer who takes a position contrary to a Revenue Ruling or Notice is considered to have acted recklessly or intentionally if the position does not have a RPOS,72 unless the position is non-frivolous with adequate disclosure and good faith.73 However, disclosure is different for reckless conduct from


(3) Reasonable basis. 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. If a return position is reasonably based on one or more of the authorities set forth in § 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 § 1.6662-4(d)(2). (See 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.) In addition, the reasonable cause and good faith exception in § 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.


70. See I.R.C. § 6694(b) (CCH 1996). Section 6694(b) provides that:

(b) Willful or reckless conduct.—If any part of an understatement of liability with respect to any return or claim for refund is due—

(1) to a willful attempt in any matter to understate the liability for tax by a person who is an income tax return preparer with respect to such return or claim, or

(2) to any reckless or intentional disregard of rules or regulations by any such person, such person shall pay a penalty of $1,000 with respect to such return or claim. With respect to any return or claim, the amount of the penalty payable by any person by reason of this subsection shall be reduced by the amount of the penalty paid by such person by reason of subsection (a).

Id.


what it is for an unrealistic position: without a Form 8275 or 8275R, disclosure on
the return does not prevent the reckless conduct penalty for a non-frivolous posi-
tion even where there is good faith. Concerning RPOS, the regulations indicate
that several court cases holding that a Revenue Ruling is incorrect meets the rea-
sonable possibility standard, but that one Tax Court case invalidating a regulation
does not.

Would the repentant sports and entertainment figure suggested herein have
had substantial authority for the filing position claiming a deduction of legal ex-
enses in defense of murder and a civil wrongful death suit or even a reasonable
basis for deducting those expenses? Furthermore, would the taxpayer’s return
preparer have at least RPOS or a non-frivolous argument in order for the practitio-
nern to sign that tax return without penalty or ethical violation?

The repentant taxpayer may have substantial authority for his position deduct-
ing the legal fees. Court cases constitute substantial authority. “Conclusions
reached in treatises, legal periodicals, legal opinions or opinions rendered by tax
professionals are not authority.” Thus, this Author’s Article defending the de-
ductibility of such legal expenses would not constitute substantial authority.
However, the Treasury Regulation defining authorities which may constitute sub-
stantial authority continues: “The authorities underlying such expressions of opinion
where applicable to the facts of a particular case, however, may give rise to sub-
stantial authority for the tax treatment of an item.”

The Service might argue, on the other hand, that United States v. Gilmore
and I.R.C. section 262, which denies a deduction for personal expenditures, con-
stitute substantial authority disallowing the deduction of legal expenses by the

follows:

(iii) Types of authority. Except in cases described in paragraph (d)(3)(iv) of this
section concerning written determinations, only the following are authority for
purposes of determining whether there is substantial authority for the tax treatment of an
item: Applicable provisions of the Internal Revenue Code and other statutory provi-
sions; 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 enact-
ment 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 memo-
randa published in pre-1955 volumes of the Cumulative Bulletin); Internal Revenue
Service information or press releases; and notices, announcements and other adminis-
trative pronouncements published by the Service in the Internal Revenue Bulletin.

Id.
77. Id.
78. See Dorocak, supra note 1, at 2-6.
80. 372 U.S. 39 (1963) (requiring that the origin of a legal claim be in a trade or business or
income-seeking activity).
81. See I.R.C. § 262(a) (CCH 1996).
taxpayer suggested herein. If the taxpayer were to lack substantial authority, he would need reasonable basis and disclosure of his return position. The Service defines reasonable basis as a "significantly higher" standard than not frivolous. RPOS is in turn defined as a one-in-three chance of prevailing on the merits. Some commentators have suggested that reasonable basis is, therefore, approximately a forty percent chance of winning in litigation or an administrative proceeding.\(^2\)

The problem then would become whether cases such as *Jenkins v. Commissioner*\(^3\) and *Salt v. Commissioner*\(^4\) would provide the taxpayer with a 40% chance of prevailing.

Additionally, the practitioner, under section 6694(a), requires a one-in-three chance of prevailing to have RPOS to avoid a penalty. Otherwise, the practitioner would need a non-frivolous position and disclosure on the return. Given the *Jenkins* and *Salt* cases, the position is at least non-frivolous and may reach RPOS or reasonable basis or even substantial authority, although the last would admittedly be the most difficult.

### 2. Failure to Amend

As set forth above, at least one commentator has suggested that the original return position must meet the standards required in order to avoid penalties for the failure to amend.\(^5\) To avoid a penalty on the failure to amend, whether on the original return or the amended return, the taxpayer would need either substantial authority or reasonable basis and disclosure. Furthermore, to avoid a preparer penalty, the practitioner would require RPOS or a non-frivolous position and disclosure. Based on the brief discussion above, the authority for deducting the expenses would most likely approach either a thirty or forty percent chance of winning at best. Admittedly, such an assignment of likelihood of success can be very subjective.\(^6\) A thirty to forty percent chance of success could satisfy both RPOS (one-in-three) and reasonable basis (significantly higher than not frivolous).

### C. Disclosure

#### 1. Effect of Disclosure on Taxpayer and Practitioner Penalties

The taxpayer, under I.R.C. section 6662, as revised by the Revenue Reconciliation Act of 1993,\(^7\) must have substantial authority or reasonable basis and dis-
closure to avoid a substantial understatement penalty, reasonable cause and good faith (or reasonable basis) to avoid a negligence penalty, or reasonable basis and disclosure to avoid a disregard of rules and regulations penalty. A preparer under section 6694, as revised by the Revenue Reconciliation Act of 1993, need only have RPOS or a non-frivolous position and disclosure to avoid a penalty.

2. Likelihood of Taxpayer Disclosure and Potential Exposure

At least one commentator, Professor Philipps, argues against this dichotomy for taxpayers and practitioners in penalty standards: “The new standard may result in the opposite of its intended effect—less disclosure rather than more—because taxpayers (if not practitioners) may be more willing to take their chances on nondisclosure in such situations.” Anecdotal experience of this Author with clients indicates that Professor Philipps may be close to the mark. Because the old non-frivolous standard for taxpayers was lower than the current reasonable basis (and RPOS for preparers), a taxpayer might have been more willing to take the risk of disclosure to avoid a penalty. Taxpayers who might have chosen to disclose in the past may choose not to do so currently, with a higher reasonable basis standard, to avoid scrutiny because of the more difficult proof of reasonable basis. If the new regulation 1.6662-3(b)(3) interprets reasonable basis as nearly substantial authority, there would seem to be even fewer taxpayers who would want to invite scrutiny.

The disclosure issue in the case suggested here of the repentant sports/entertainment figure is whether there was disclosure on the original return so that the penalties might be avoided as well on an amended return. With an adequate disclosure, the taxpayer would need reasonable basis for the original position of deducting the legal fees and the practitioner would need only meet a non-frivolous standard. However, for adequate disclosure, the original return would need to provide more facts than merely stating the deductions were for legal fees. In Accardo v. Commissioner, the court held that there was not “adequate disclosure” where the taxpayer stated his deduction was for “[l]egal fees [regarding] conservation of property held for production of income.” The court reasoned that the taxpayer did not provide relevant facts on his tax return sufficient for adequate disclosure. Moreover, the court stated, “Particularly where taxpayer lacked substantial authority for his position and where he appeared to think that his deduction presented a novel legal issue, the mere declaration of a deduction did not entitle taxpayer to a reduced penalty for understatement of tax.” Thus, in the hypothetical case at hand, the extent of the disclosure on the original return would clearly need to be examined.

89. See I.R.C. § 6664(c) (CCH 1996).
91. See 26 C.F.R. § 6694(a) (CCH 1996).
92. Philipps, supra note 86, at 1189.
93. 942 F.2d 444 (7th Cir. 1991).
94. Id. at 453. The taxpayer had been acquitted in a criminal prosecution under the Racketeer Influenced and Corrupt Organizations Act (RICO). The taxpayer had argued that his legal expenses were incurred in order to prevent seizure of income-producing property, but he could not connect his legal expenses to the purportedly nonexistent illegal business. See id. at 446-48.
95. Id.
The questions of an amended return and disclosure also raise Fifth Amendment problems. An amended return might result in self-incrimination for a tax crime by revealing that the original return was false. One set of commentators has cautioned that "Accountants often are not comfortable providing such advice, so the prudent approach may be to refer the client to legal counsel."96 In the instant case, if, as suggested above, the chance of prevailing on the merits is approximately thirty to forty percent, then disclosure on the original return would be significant both for the practitioner (RPOS is approximately one-in-three) and the taxpayer (reasonable basis is likely about forty percent).

D. Audit Lottery

The Internal Revenue Service, the American Bar Association, and the American Institute of Certified Public Accountants all prohibit the practitioner from considering the audit lottery in calculating whether there is a one-in-three chance of prevailing on the merits. In Treasury Regulation 1.6694-2(b)(1), the Service states, "[T]he possibility that the position will not be challenged by the Internal Revenue Service (e.g., because the taxpayer's return may not be audited or because the issue may not be raised on audit) is not to be taken into account."97 In Treasury Department Circular 230, the Service again explains that the possibility of not being audited "may not be taken into account."98 The Report of the Special Task Force on the ABA Formal Opinion 85-352 states, "The standard adopted ... does not permit taking into account the likelihood of audit or detection ... ."99 The AICPA's Interpretation of Statements on Responsibilities in Tax Practice, Section 112, Tax Return Positions, states that "[A] CPA should not take into account the likelihood of audit or detection in determining whether [the] standard has been met."100

In January 1996, at the ABA mid-year meeting in New Orleans, Louisiana, the Standards of Tax Practice Committee hosted a panel debating whether the audit lottery might be discussed with a client.101 Mr. James Holden, an advocate of openness in discussing the audit lottery with clients, did, however, acknowledge that it is more problematic for a practitioner to volunteer information about the likelihood of an audit when explaining to a client that an amended return should be filed. Presumably, the situation is problematic because it might influence the client to conclude that he or she should not file an amended return. However, Mr. Holden also cited ABA Model Rules of Professional Conduct Rule 1.2, which states that a client sets the objectives of representation.102 This Author would question whether, in the representation of a client, it is permissible for the practitioner to withhold relevant information from that client.

96. Comisky & Shepard, supra note 2, at 80.
100. AICPA Prof. Standards, supra note 43, at Tx. § 9112.05.
101. Panel Discussion, American Bar Association Mid-Year meeting, Section of Taxation, Standards of Tax Practice Committee, New Orleans, Louisiana (Jan., 1996) (available from ADC Services, 69013 River Bend Drive, Covington, Louisiana 70433, (504) 892-1157).
In the case of the repentant taxpayer, the likelihood of audit could not be considered when determining the likelihood of success. It may well be appropriate, however, for the practitioner to discuss the likelihood of audit with the client in order to enable the client to make a fully informed decision about whether to file an amended return or not.

V. HYPOTHETICAL APPLICATIONS

This Article has focused on the responsibilities of a repentant taxpayer and his preparer to file an amended return when the taxpayer has previously deducted legal expenses. Other hypotheticals, of course, raise these same issues.

For example, a prominent government official takes a filing position on his original joint return claiming deductions that properly belong to an entity in which he and his wife have made an investment. Here the original position was obviously wrong and continues to be so. Even absent bad intent, both the taxpayer and practitioner penalty standards are violated. Still, the taxpayer only needs to be told by the practitioner that the taxpayer “should” file an amended return. The likelihood of not being audited might sway this taxpayer not to amend—at least until elected to a higher office.

Or, what about the case of a chief financial officer with limited tax experience whose business is suffering? He brings to the attention of the outside CPA that an honest mistake was made on a prior return (e.g., prepaid rent was not reported as income on the tax return by the accrual basis taxpayer, an oversight in converting from financial to tax accounting). The CFO honestly asks the CPA whether an amended return is needed. The CPA is aware of the somewhat precarious situation of the business and the possibly precarious situation of the CFO. In response to a question from a client, the CPA states, “My ethical responsibility requires me to tell you that you should file an amended return.” The client asks again, “What should I do?” The CPA repeats his same statement word for word. The CFO responds, “I get it.” Is there anything unethical in this exchange or has the CPA merely met the letter of the law and at the same time intimated the existence of audit lottery to the client? Again the question arises, as discussed above by the ABA panel, as to whether the audit lottery may be discussed, particularly with regard to an amended return.

A taxpayer, in a jurisdiction that has not yet faced this question, allocates taxes and interest on his mixed-use (both rental and personal) vacation home between the Schedule A and the Schedule E by using a fraction in which the numerator represents days used personally and the denominator is 365. The IRS maintains that the denominator should be the sum of personal and business-use days. The Service has not won this issue in any jurisdiction as yet, but vows to continue to litigate. The taxpayer may have substantial authority based on the cases from other jurisdictions or at least a reasonable basis. If he had already taken the position on an original return, there would seem to be no likelihood or compunction for filing an amended return.


104. See Panek, supra note 103.
These three examples illustrate the continuum from obviously wrong to honest mistake to highly supportable position. The chief example posited herein—that of the athlete deducting legal expenses—is most likely toward the supportable position end of the spectrum. An individual taxpayer may also face an additional hurdle regarding the deduction of legal expenses. If the expenses are employee-business expenses or income-seeking expenses, they may be deductible only as miscellaneous itemized deductions that are not deductible for AMT (Alternative Minimum Tax). 105

VI. CONCLUSION

The taxpayer suggested herein, the repentant sports/entertainment figure who has deducted legal expenses, may even have a reasonable basis to support his original filing position. As suggested, the legal expenses were incurred in defending a criminal prosecution for murder and a civil wrongful death suit. There may be a connection between those legal expenses and the taxpayer’s trade or business based on the Jenkins 106 case, where the taxpayer expended funds to protect his reputation, or the Salti 107 case, where the taxpayer paid for a legal defense against the government assault.

Normally there is no legal obligation to file an amended return. The IRS, in regulations and a publication, states only that the taxpayer should file an amended return. Regarding the ethical and penalty obligations to file an amended return, one commentator has suggested that if the penalty rules are met regarding the original return filing position, then there should be no penalty for not filing an amended return. 108 The taxpayer penalty provisions would require that there be at least a reasonable basis for the original return filing position with a disclosure of the taxpayer’s position. The practitioner penalty rules would require either a reasonable possibility of success or a non-frivolous position with disclosure.

If the taxpayer suggested herein would have about a one-in-three chance of winning (the standard for RPOS) or a forty percent chance of winning (likely standard for reasonable basis), then the taxpayer and practitioner could both avoid penalties if there is adequate disclosure of the filing position. Admittedly, assigning a percentage to the likelihood of prevailing is difficult at best.

The practitioner ethical rules mirror the penalty rules, so that if the practitioner could avoid a penalty regarding the amended return there would likely be no ethical violation. Furthermore, because the practitioner is only required to advise the taxpayer that an amended return should be filed, there is likely no ethical violation for the practitioner if the taxpayer decides not to amend. Also, although the likelihood of being audited cannot be used as the basis for a filing position, there does not seem to be any legal penalty or even ethical impediment for the practitioner to discuss the audit lottery with the taxpayer when the taxpayer is considering whether to amend.

105. See Alexander v. Commissioner, 69 T.C.M. (CCH) 1792, 1797 (1st Cir. 1995).
107. 18 T.C. 182 (1952).
108. See Pollack, supra note 29, at 91.