

## **Interpretation No. 1-1, “Reporting and Disclosure Standards,” of Statement on Standards for Tax Services No. 1, *Tax Return Positions***

### **Background**

**1.** Statement on Standards for Tax Services (SSTS) No. 1, *Tax Return Positions* (AICPA, *Professional Standards*), contains the standards a member should follow when recommending tax return positions or preparing or signing tax returns.

**2.** A member should determine and comply with the reporting and disclosure standards, if any, that are imposed by the applicable taxing authority with respect to recommending a tax return position or preparing or signing a tax return.

If the applicable taxing authority has no written standards that apply with respect to recommending a tax return position or preparing or signing a tax return or if its standards are lower than the standards set forth in this paragraph, the following standards will apply:

*a.* A member should not recommend a tax return position or prepare or sign a tax return taking a position unless the member has a good-faith belief that the position has at least a realistic possibility of being sustained administratively or judicially on its merits, if challenged (commonly referred to as the *realistic possibility of success* standard).

*b.* Notwithstanding paragraph 2(a), a member may *recommend a tax return position* if the member (i) concludes that there is a reasonable basis for the position, and (ii) advises the taxpayer to appropriately disclose that position. Notwithstanding paragraph 2(a), a member may *prepare or sign a tax return* that reflects a position if (i) the member concludes there is a reasonable basis for the position, and (ii) the position is appropriately disclosed.

**3.** Federal, state, local, and other taxing authorities may impose specific reporting and disclosure standards with respect to recommending tax return positions or preparing or signing tax returns that apply in addition to the AICPA standards. These standards vary among taxing jurisdictions and by type of tax. A member should refer to the current version of Internal Revenue Code (IRC) Section 6694, “Understatement of Taxpayer’s Liability by Tax Return Preparer,” and the regulations thereunder to determine the reporting and disclosure standards applicable to preparers of federal tax returns.

**4.** When recommending a tax return position, or when preparing or signing a tax return on which a position is taken, a member should, when relevant, advise the taxpayer regarding the potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**5.** A member should not recommend a tax return position or prepare or sign a tax return reflecting a position that the member knows exploits the audit selection process of a taxing authority or serves as a mere arguing position advanced solely to obtain leverage in a negotiation with a taxing authority.

6. When recommending a tax return position, a member has both the right and the responsibility to be an advocate for the taxpayer with respect to any position satisfying the aforementioned standards.

7. A member also should consider SSTS No. 3, *Certain Procedural Aspects of Preparing Returns* (AICPA, *Professional Standards*), regarding the obligation to examine or verify certain supporting data or consider information related to another taxpayer, when preparing a taxpayer's tax return.

### **General Interpretation**

8. As described in the preface, the realistic possibility of success standard is a lower standard than the substantial authority standard and the more likely than not standard, but it is a higher standard than the reasonable basis standard. Therefore, if the standard of the applicable taxing authority is, for example, substantial authority, more likely than not, or some other standard that is higher than the realistic possibility of success standard, then the member should comply with that higher standard. In that case, the member is held to a standard higher than realistic possibility of success.

If the standard of the applicable taxing authority is lower than the realistic possibility of success standard, then the member should comply with the realistic possibility of success standard, which is reflected in paragraph 2(a) of this interpretation, or the reasonable basis standard with appropriate disclosure, which is reflected in paragraph 2(b) of this interpretation.

For purposes of this interpretation, the reporting and disclosure standards that apply in a given situation in accordance with SSTS No. 1 and this interpretation will be referred to as the *required reporting and disclosure standards*.

9. A member should determine and comply with the rules of the applicable taxing authority regarding reliance on authorities (cases, rulings, regulations, treatises, and so forth). However, notwithstanding the rules of the applicable taxing authority, in determining whether a tax return position satisfies the realistic possibility of success standard or the reasonable basis standard with appropriate disclosure for purposes of paragraph 2(a)–(b) of this interpretation, a member may rely on authorities in addition to those evaluated when determining whether substantial authority exists for a return position or whether a position is more likely than not to prevail under IRC Section 6662. For purposes of paragraph 2(a)–(b) of this interpretation, a member may rely on well-reasoned treatises, articles in recognized professional tax publications, and other reference tools and sources of tax analyses commonly used by tax advisers and preparers of returns. A member should exercise caution in relying on materials, such as treatises, that may not be accepted as authorities in all situations, such as under federal tax law.

10. If particular facts and circumstances lead a member to believe that a taxpayer penalty could be asserted, then the member should so advise the taxpayer and should discuss with the taxpayer the opportunity, if any, to avoid such penalty by disclosing the position on the tax return. Although a member should so advise the taxpayer with respect to disclosure, it is the taxpayer's responsibility to decide whether and how to disclose.

11. In determining if the required reporting and disclosure standards have been satisfied, a member should do all of the following:

- Establish the relevant background facts.

- Consider the reasonableness of the assumptions and representations.
- Consider applicable regulations and standards regarding reliance on information and advice received from a third party.
- Apply the pertinent authorities to the relevant facts.
- Consider the business purpose and economic substance of the transaction, if relevant to the tax consequences of the transaction. (Mere reliance on a representation that there is a business purpose or economic substance generally is insufficient.)
- Consider whether the issue involves a listed transaction or a reportable transaction (or their equivalents) as defined by the applicable taxing authority.<sup>1</sup>
- Arrive at a conclusion supported by the authorities.

**12.** A member should consider the weight of each authority to determine whether the required reporting and disclosure standards have been satisfied. In determining the weight of an authority, a member should consider its source, relevance, and persuasiveness. Therefore, the type of authority is a significant factor. Other important factors include whether the facts stated by the authority are distinguishable from those of the taxpayer’s situation and whether the authority contains an analysis of the issue or merely states a conclusion.

**13.** A standard may be satisfied despite the absence of certain types of authority. For example, a member may conclude that the substantial authority standard has been satisfied when the position is supported only by a well-reasoned construction of the applicable statutory provision.

**14.** In determining whether the required reporting and disclosure standards have been satisfied, the extent of research required is left to the professional judgment of the member, given the facts and circumstances known to the member. A member may conclude that more than one position satisfies a given reporting standard, such as the substantial authority standard.

### **Specific Illustrations**

**15.** The following illustrations address general fact patterns only. Accordingly, the application of guidance, as discussed in the previous section, “General Interpretation,” to variations in such general fact patterns or to particular facts or circumstances may lead to different conclusions. In each illustration, no authority exists other than that which is indicated. A decision regarding what are the required reporting and disclosure standards for tax return positions should be consistent with the provisions of SSTS No. 1, as explained in the previous section, “Background.”

### ***Determination of the Standards***

**16.** *Illustration 1.* A member is preparing a U.S. income tax return at a time when the federal reporting standard is substantial authority for undisclosed positions and reasonable basis for

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<sup>1</sup> See, for example, Treasury Regulation Section 1.6011-4(b).

disclosed positions.<sup>2</sup> One of the issues the member needs to address in preparing the return is the deductibility of a particular expenditure.

**17. Conclusion.** The federal standard of substantial authority is higher than the realistic possibility of success standard; therefore, the member is required to comply with the federal standard of substantial authority for undisclosed positions on the return. If the member analyzes the law and applicable authorities regarding whether the expenditure is deductible and concludes that there is not substantial authority to support taking a deduction for the expenditure, the member should not prepare the return taking the deduction as an undisclosed position.

If the member concludes that there is sufficient authority to provide a reasonable basis for claiming the deduction, the member may prepare the return claiming the deduction if that position is appropriately disclosed.

**18. Illustration 2.** A member is preparing a state inheritance tax return and needs to address the deductibility of a particular expenditure. The state does not have specific tax return reporting standards that apply.

**19. Conclusion.** Because the applicable taxing authority (the state) does not have written tax return reporting standards that apply, the realistic possibility of success standard for an undisclosed position and the reasonable basis standard for an appropriately disclosed position apply. The member can prepare the return claiming the deduction if either of these is satisfied.

**20. Illustration 3.** A taxpayer wants to take a position that a member has determined does not satisfy the reasonable basis standard. The taxpayer maintains that even if the taxing authority examines the return, the issue will not be raised.

**21. Conclusion.** The member should not consider the likelihood of the issue being raised on examination when determining whether any reporting or disclosure standard has been satisfied. The member should not prepare or sign a return that contains a position that does not satisfy the reasonable basis standard, even if the position is disclosed.

**22. Illustration 4.** A taxpayer wants to take a position on a federal tax return without disclosure; the member concludes that the position satisfies the substantial authority standard provided an assumption regarding an underlying nontax legal issue is appropriate. The member recommends that the taxpayer seek advice from its legal counsel, and the taxpayer's attorney gives an opinion on the nontax legal issue that is consistent with the assumption.

**23. Conclusion.** A member may, in general, rely on a legal opinion on a nontax legal issue. A member should use professional judgment when relying on a legal opinion. If, on its face, the opinion of the taxpayer's attorney appears to be unreasonable, unsubstantiated, or unwarranted, the member, with appropriate consents from the taxpayer, should consult the member's attorney before relying on the opinion. A member should also refer to the illustrations in Interpretation No. 1-2, "Tax Planning," of SSTS No. 1, regarding the circumstances in which it is appropriate to rely on an opinion of legal counsel.

**24. Illustration 5.** A taxpayer has obtained from its attorney an opinion on the tax treatment of an item and requests that a member rely on the opinion.

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<sup>2</sup> See the preface for a description of the various reporting standards.

**25.** *Conclusion.* If a member is satisfied about the source (for example, the knowledge and expertise of the issuer), relevance, and persuasiveness of the legal opinion, then the member may rely on that opinion when determining whether the required reporting and disclosure standards have been satisfied. The member should also refer to the illustrations in Interpretation No. 1-2 of SSTS No. 1 regarding the circumstances in which it is appropriate to rely on an opinion of legal counsel.

#### ***Application of the Taxing Authority's Standards***

**26.** As noted previously, SSTS No. 1 requires a member to determine and comply with the required reporting and disclosure standards, if any, that are imposed by the applicable taxing authority with respect to recommending a tax return position or preparing or signing a tax return. These standards, and the methods in which they are to be applied, vary among taxing authorities based on the laws and regulations of the relevant jurisdictions; therefore, illustrating all specific taxing authority standards is beyond the scope of this interpretation. To assist members in their analysis of whether the standards of an applicable taxing authority have been satisfied, the preface contains a description of the most common tax return reporting standards, the nature of the analysis to be applied, and the common requirements for appropriate disclosure.

#### ***Application of the Realistic Possibility of Success and the Reasonable Basis Standards***

**27.** If the applicable taxing authority has no written tax return reporting or disclosure standards that apply or if its standards are lower than the realistic possibility of success standard for undisclosed positions or the reasonable basis standard for appropriately disclosed positions, SSTS No. 1 requires a member to comply with these latter standards, as stated in paragraph 2(a)–(b) of this interpretation.

The following illustrations pertain to situations in which a member is required to comply with these standards because the applicable taxing authority either has no written standards that apply or has standards that are lower than those described in paragraph 2(a)–(b) of this interpretation.

**28.** *Illustration 6.* A taxpayer has engaged in a transaction that is adversely affected by a new statutory provision. Prior law supports a position favorable to the taxpayer. The taxpayer believes, and the member concurs, that the new statute is inequitable as applied to the taxpayer's situation. The statute is constitutional, clearly drafted, and unambiguous. The legislative history discussing the new statute contains general comments that do not specifically address the taxpayer's situation.

**29.** *Conclusion.* The member cannot recommend the return position that is contrary to the new statute. A position contrary to a constitutional, clear, and unambiguous statute would ordinarily be considered a frivolous position and, even if appropriately disclosed, would not satisfy the reasonable basis standard.

**30.** *Illustration 7.* The facts are the same as in illustration 6 except that the legislative history discussing the new statute specifically addresses the taxpayer's situation and supports a position favorable to the taxpayer.

**31.** *Conclusion.* In a case in which the statute is clearly and unambiguously against the taxpayer's position but a contrary position exists based on legislative history specifically

addressing the taxpayer's situation, a return position based either on the statutory language or on the legislative history satisfies the realistic possibility of success standard. (It also may satisfy the substantial authority standard.) A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**32.** *Illustration 8.* The facts are the same as in illustration 6 except that the legislative history can be interpreted to provide some evidence or authority in support of the taxpayer's position; however, the legislative history does not specifically address the taxpayer's situation.

**33.** *Conclusion.* In a case in which the statute is clear and unambiguous, a contrary position based on an interpretation of the legislative history that does not explicitly address the taxpayer's situation does not satisfy the realistic possibility of success standard. However, because the legislative history provides some support or evidence for the taxpayer's position, a member may recommend the position to the taxpayer if the member determines that there is a reasonable basis for the position and advises the taxpayer to appropriately disclose the position. Also, a member may prepare a return for the taxpayer taking such a position if the member determines that there is a reasonable basis for the position, and the position is appropriately disclosed. A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**34.** *Illustration 9.* A taxpayer is faced with an issue involving the interpretation of a new statute. Following its passage, the statute was widely recognized to contain a drafting error, and a technical correction proposal has been introduced. The taxing authority issues a pronouncement indicating how it will administer the provision. The pronouncement interprets the statute in accordance with the proposed technical correction.

**35.** *Conclusion.* A return position based on either the existing statutory language or the taxing authority's pronouncement satisfies the realistic possibility of success standard. (It also may satisfy the substantial authority standard.) A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**36.** *Illustration 10.* The facts are the same as in illustration 9 except that no taxing authority pronouncement has been issued.

**37.** *Conclusion.* In the absence of a taxing authority pronouncement interpreting the statute in accordance with the proposed technical correction, only a return position based on the existing statutory language will satisfy the realistic possibility of success standard. A member may recommend the position to the taxpayer if, based on the facts and circumstances, the member determines that a reasonable basis exists for the position and advises the taxpayer to appropriately disclose the position. Also, a member may prepare a return for the taxpayer taking such a position if, based on the facts and circumstances, the member determines that there is a reasonable basis for the position, and the position is appropriately disclosed. A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**38.** *Illustration 11.* A taxpayer is seeking advice from a member regarding a recently amended statute. The member has reviewed the statute, the legislative history that specifically addresses the issue, and a recently published notice issued by the taxing authority. No cases,

rulings, or other pronouncements exist regarding the statute. The member has concluded in good faith that, based on the statute and the legislative history, the taxing authority's position as stated in the notice does not reflect legislative intent.

**39.** *Conclusion.* A return position supported by the statute and the legislative history satisfies the realistic possibility of success standard. (It also may satisfy the substantial authority standard.) A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**40.** *Illustration 12.* The facts are the same as in illustration 11 except that the taxing authority's pronouncement is a temporary regulation.

**41.** *Conclusion.* In determining whether a tax return position satisfies the realistic possibility of success standard, a member should determine the weight to be given the temporary regulation by analyzing factors, such as whether the regulation is legislative or interpretative and if it is consistent with the statute. If the member concludes that the position does not satisfy the realistic possibility of success standard, the member may still recommend the position if the member determines that it satisfies the reasonable basis standard, and the member advises the taxpayer to appropriately disclose the position. The member may prepare a return for the taxpayer taking that position if the member determines that the position satisfies the reasonable basis standard, and the position is adequately disclosed. A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**42.** *Illustration 13.* A statute is passed requiring the capitalization of certain expenditures. The taxpayer believes, and the member concurs, that to comply fully, the taxpayer will have to acquire new computer hardware and software and implement a number of new accounting procedures. The taxpayer and member agree that the costs of full compliance will be significantly greater than the resulting increase in tax due under the new provision. Because of these cost considerations, the taxpayer makes no effort to comply. The taxpayer wants the member to prepare and sign a return on which the new requirement is simply ignored.

**43.** *Conclusion.* The return position desired by the taxpayer is frivolous, a standard below reasonable basis. The member should not prepare or sign the return.

**44.** *Illustration 14.* The facts are the same as in illustration 13 except that the taxpayer has made a good-faith effort to comply with the law by calculating an estimate of expenditures to be capitalized under the new provision.

**45.** *Conclusion.* In this situation, assuming the taxpayer complied with the statutory and regulatory provisions classifying expenditures to be capitalized and those to be expensed and made a good-faith effort to determine the appropriate amounts to be capitalized and expensed, the realistic possibility of success standard would be satisfied for the return positions. (The substantial authority standard also may be satisfied.) When using estimates in the preparation of a return, a member should refer to SSTS No. 4, *Use of Estimates* (AICPA, *Professional Standards*). A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**46.** *Illustration 15.* On a given issue, a member has located and weighed two authorities concerning the treatment of a particular expenditure. The taxing authority has issued an administrative ruling that requires the expenditure to be capitalized and amortized over several years. On the other hand, a court opinion permits the current deduction of the expenditure. The member has concluded that these are the relevant authorities, considered the source of both authorities, and concluded that both are persuasive and relevant.

**47.** *Conclusion.* The realistic possibility of success standard is met by either position. (Either or both also may satisfy the substantial authority standard.) A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

**48.** *Illustration 16.* A tax statute is silent on the treatment of an item. However, the legislative history explaining the statute directs the taxing authority to issue regulations that will require a specific treatment of the item. No regulations have been issued at the time the member must recommend a position on the tax treatment of the item.

**49.** *Conclusion.* The position supported by the legislative history satisfies the realistic possibility of success standard. A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.