Revised (And Revised Again) Internal Revenue Code Section 6694 And New IRS Guidance

Brian C. Bernhardt
Craig D. Bell
REVISED (AND REVISED AGAIN)
INTERNAL REVENUE CODE SECTION 6694
AND NEW IRS GUIDANCE

PRESENTED BY:

BRIAN C. BERNHARDT
McGuireWoods LLP
One James Center
901 East Cary Street
Richmond, VA 23219
804.775.7819
bbernhardt@mcguirewoods.com

CRAIG D. BELL
McGuireWoods LLP
One James Center
901 East Cary Street
Richmond, VA 23219
804.775.1179
cdbell@mcguirewoods.com

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I. Introduction.

Section 6694 imposes monetary penalties on a variety of tax advisors. Although these rules apply to both returns and claims for refund, for ease of nomenclature this outline will only refer to returns. However, references to returns should be deemed to mean returns and claims for refund.


A. Introduction. Section 6694 imposed a monetary penalty on tax advisors in certain circumstances.

B. Imposition of Penalty. Section 6694 imposed a penalty if four elements were present.

1. An Understatement of Income Tax. There was an understatement of income tax liability on a tax return.

2. By Income Tax Return Preparer. Section 7701(a)(36) defined an "income tax return preparer" as a person who prepared, or employed a person to prepare, all or a substantial portion of an income tax return for compensation.

3. With Respect to a Position Which Failed to Meet the Realistic Possibility of Success Standard. The understatement was due to a position that did not have a "realistic possibility of being sustained on the merits." A position has a "realistic possibility of being sustained on the merits" if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead that person to conclude that the position has at least a 33% chance of being sustained on the merits.

4. Either:
   a. Without Disclosing the Position. The tax return preparer did not disclose the position to the IRS; or
   b. With Disclosing the Position if the Position was Frivolous. The income tax return preparer disclosed the position to the IRS, but the position was a frivolous position, a position with less than a 10% chance of success.

C. Amount of Penalty. $250, unless the income tax return preparer had reasonable cause for the understatement and acted in good faith, in which case the IRS did not impose a penalty.

D. Increased Penalty for Willful or Reckless Conduct. The amount of the penalty increased to $1,000 if the income tax return preparer acted willfully or recklessly.

A. Introduction. Congress revised Section 6694 by enacting Section 8246 of the Small Business and Work Opportunity Tax Act of 2007, Public Law No. 110-28. This law became effective on May 25, 2007. It was one of the methods by which Congress raised revenue to pay for the Iraq war-funding bill.

B. Imposition of Penalty. Section 6694 now imposes a penalty if four different elements are present.

1. An Understatement of Tax. The return understates the tax liability owed by the taxpayer to the IRS.

2. By a Tax Return Preparer. Section 7701(a)(36) now defines a “tax return preparer” as a person who prepares, or who employs a person who prepares, all or a substantial portion of a return for compensation.

3. With Respect to a Position Which Fails the More Likely Than Not Sustained Standard. The tax return preparer does not have a reasonable belief that the position would more likely than not be sustained on its merits. The “more likely than not” standard requires more than a 50% chance of success.

4. Either:
   a. Without Disclosing the Position. The tax return preparer did not disclose the position to the IRS; or
   b. With Disclosing the Position if the Position Does Not Have a Reasonable Basis. The tax return preparer disclosed the position to the IRS, but the position does not have a reasonable basis, a position with less than a 20% chance of success.

C. Amount of Penalty. The penalty is the greater of (a) $1,000 or (b) 50% of the income derived, or to be derived, by the tax return preparer with respect to the tax return. There is no penalty if the tax return preparer has reasonable cause for the understatement and acted in good faith.

D. Increased Penalty for Willful or Reckless Conduct. The new Section 6694 penalty increases if the tax return preparer acted willfully or recklessly.

1. Willful Conduct. If any part of the understatement is due to a willful attempt by a tax return preparer to understate the tax liability, then the penalty increases. Willful conduct occurs when a tax return preparer ignores information provided by the taxpayer in a wrongful attempt to reduce the taxpayer’s tax liability.
2. **Reckless Conduct.** If any part of the understatement is due to a reckless or intentional disregard of rules or regulations by a tax return preparer, then the penalty increases. Reckless conduct occurs when a tax return preparer takes a position on the return that is contrary to a rule or regulation and the tax return preparer knows, or is reckless in not knowing, about the rule or regulation. A tax return preparer is reckless in not knowing about a rule or regulation if he unreasonably makes little or no effort to determine whether one applies.

3. **Increased Amount of Penalty.** The penalty is the greater of (a) $5,000 or 50% of the income derived, or to be derived, by the tax return preparer with respect to the tax return.


A. **Introduction.**

1. **Revision.** Congress revised Section 6694 again by enacting Section 506 of the Emergency Economic Stabilization Act of 2008, H.R. 1424, on October 3, 2008. This law is retroactively effective for returns prepared after May 25, 2007. It was one of the provisions in the financial services bailout/rescue bill.

2. **Effect of New Provision.** The bill reduces the standards for imposition of the tax return preparer penalty for undisclosed positions to "substantial authority, while maintaining the preparer standard for disclosed positions at "reasonable basis." For tax shelters and reportable transactions to which section 6662A applies (reportable transactions), a tax return preparer is still required to have a reasonable belief that such a transaction was more likely than not to be sustained on the merits.

B. **Imposition of Penalty.** Section 6694 now imposes a penalty if there is:

1. **An Understatement of Tax.**

2. **By a Tax Return Preparer.**

3. **With Respect to a Position Without Substantial Authority.** The tax return preparer does not have substantial authority for the position. The substantial authority standard requires a 40% chance of success.

4. **Either: Without Disclosing the Position, or With Disclosing the Position if the Position Does Not Have a Reasonable Basis.**

C. **Amounts of Penalty.** The revised penalty amounts remain the same.

D. **Impact.** We will note, throughout this outline, where this new law may have an impact.

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V. Interim Guidance.

A. Notice 2007-54. In order to have sufficient time to address implementation issues after the original amendment to Section 6694, the IRS issued Notice 2007-54, which provided transitional relief.

1. Transitional Relief for Income Tax Returns and Refund Claims. For income tax returns, the IRS will apply the law in effect prior to the revision of Section 6694 when determining whether a tax return preparer is subject to penalty under Section 6694. If the tax return preparer must make an actual disclosure, he must make the disclosure on a Form 8275.

2. Transitional Relief for Other Returns. For all other returns, the IRS will apply the reasonable basis standard in the Section 6692 regulations (without regard to the disclosure requirements contained therein) in determining whether to impose a penalty under Section 6694.

3. Effective Date. Notice 2007-54 became effective on May 25, 2007. It applies to all returns and amended returns due on or before December 31, 2007 (taking into account any extensions of time for filing); to 2007 estimated tax returns due on or before January 15, 2008; and to 2007 employment and excise tax returns due on or before January 31, 2008. The transition rule will remain relevant for a few years, until the statutes of limitation on these returns have expired.

B. Notice 2008-11. The IRS issued Notice 2008-11 on December 31, 2007 to provide additional guidance regarding the scope of Notice 2007-54.

C. Notice 2008-12. The IRS issued Notice 2008-12 on December 31, 2007 to provide additional guidance regarding the tax return preparer's signature on a tax return.

D. Notice 2008-13 and Notice 2008-46. The IRS issued Notice 2008-13 on December 31, 2007, and supplemented it on April 16, 2008 with Notice 2008-46, to provide additional guidance regarding the implementation of the new rules under Section 6694.

VI. Proposed Regulations.


1. The Proposed Regulations Do Not Specify Which Returns are Subject to Section 6694. Although the Proposed Regulations do not specify which returns are subject to Section 6694, they do provide that the returns subject to Section 6694 will only include those returns specifically identified by the IRS in published guidance. The IRS expects to issue this
guidance at the same time it issues the Final Regulations. The IRS does
not anticipate that this guidance will differ from the guidance in Notice

2. Notice 2008-13 and Notice 2008-46 Specify Which Returns are Subject
to Section 6694. Notice 2008-13, as supplemented by Notice 2008-46,
provides guidance on the types of returns subject to Section 6694.

a. Tax Returns Subject to Section 6694. Exhibit 1 to Notice 2008-
13, as supplemented by Notice 2008-46, provides a list of tax
returns subject to Section 6694 if they are prepared by a tax return
preparer.

i. Exhibit 1 includes, but is not limited to, a variety of income
tax returns, including Forms 1040, Forms 1120, Form
1041, Form 1042, and Form 990T; estate and gift tax
returns, including Forms 706 and Form 709; employment
tax returns, including Form 940, Forms 941, Forms 943,
Forms 944, and Form 945; a variety of excise tax returns,
such as Form 720, Form 990-PF, Form 2290, Form 4720,
and Form 8849; certain alcohol and tobacco forms, such as
Form 8275 and Form 8876; and Form 843.

ii. Notice 2008-46 added additional returns, including, but not
limited to, additional Forms 1040, Forms 1120, and Forms
1041, as well as Form 2438, Form 8288, Form 8752, and
Form 8804.

b. Information Returns Subject to Section 6694 if Advice is a
Substantial Portion of a Return. Exhibit 2 to Notice 2008-13, as
supplemented by Notice 2008-46, provides a list of information
returns subject to Section 6694 if the information on the return
constitutes a substantial portion of a taxpayer’s tax return.

i. Exhibit 2 includes the following information returns: Form
1065 and Form 1120S.

ii. Exhibit 2 also includes the following information returns:
Form 1042-S, Form 550, Form 8038, Form 8038-G, and
Form 8038-GC.

iii. Notice 2008-46 added additional returns to the list of
returns identified on Exhibit 2. These returns include, but
are not limited to, returns in the Form 3520 series, Forms
5471 and 5472, Form 8805, Form 8858, and Form 8865.

c. Information Returns Not Subject to Section 6694. Not all
information returns are subject to Section 6694. Exhibit 3 to
Notice 2008-13, as supplemented by Notice 2008-46, provides a list of information returns to which Section 6694 does not apply, unless the tax return preparer willfully prepares the information return to understate tax or prepares the information return in reckless disregard of rules or regulations, and the information in the return constitutes a substantial portion of the taxpayer’s tax return.

i. Exhibit 3 includes, but is not limited to, the following information returns: Form W-2 and Form 1099.

ii. Exhibit 3 also includes, but is not limited to, the following information returns: Form SS-8, Form 990, Form 1040-ES, Form 1120-W, Form 2350, Form 4768, Form 4868, Form 8809, Form 8868, and Form 8892.

iii. Notice 2008-46 added additional returns to the list of returns identified on Exhibit 3. These returns were Forms 8288-A and 8288-B.

d. Other Documents Which Constitute a Substantial Portion of a Return. Notice 2008-13. Documents that include information which is, or may be, reported on a tax return are treated as returns subject to Section 6694 if the information reported in the document constitutes a substantial portion of the taxpayer’s tax return.

i. In such a case, a preparer, for compensation, of these documents will be a tax return preparer subject to Section 6694.

ii. Notice 2008-13 Example: A person who, for compensation, prepares depreciation schedules, or income or expense allocation studies, is a tax return preparer subject to Section 6694 if the documents affect any entries on a tax return that reports a tax liability and the entries constitute a substantial portion of the tax return, even if the documents themselves do not report a tax liability.

C. Definition of Tax Return Preparer. Prop. Treas. Reg. § 301.7701-15(a). A tax return preparer is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any return of tax.

2. **Nonsigning Tax Return Preparer.** Prop. Treas. Reg. § 301.7701-15(b)(2)(i). A nonsigning tax return preparer is any tax return preparer who is not a signing tax return preparer but who prepares all or a substantial portion of a return with respect to a transaction which occurred before the advice is rendered.

   a. **De Minimus Exception.** Prop. Treas. Reg. § 301.7701-15(b)(2)(i). When determining whether a tax advisor is a nonsigning tax return preparer, the IRS does not take into account (1) time spent providing advice for a position which is given with respect to past events (2) which represents less than 5% of the tax advisor’s aggregate time spent providing advice with respect to the position.

   b. **Determining Whether a Tax Advisor Prepares a Portion of a Return.** Prop. Treas. Reg. § 301.7701-15(b)(3)(i). A tax advisor who renders tax advice on a position that is directly relevant to the determination of the existence, characterization, or amount of an entry on a return has prepared that entry.

   c. **Determining Whether a Portion of a Return is a Substantial Portion of a Return.** Prop. Treas. Reg. § 301.7701-15(b)(3)(i). A schedule, entry, or other portion of a return is a substantial portion of the return if the tax advisor knows or reasonably should know that the tax attributable to the schedule, entry, or other portion of a return is a substantial portion of the tax required to be shown on the return.

      i. **Factors to Consider.** Prop. Treas. Reg. § 301.7701-15(b)(3)(i). The factors to consider when determining whether a schedule, entry, or other portion of a return is a substantial portion include, but are not limited to

         (a) the size and complexity of the item relative to the taxpayer’s gross income; and

         (b) the size of the understatement attributable to the item compared to the taxpayer’s reported tax liability.

      Thus, a single tax entry may constitute a substantial portion of the tax required to be shown on a return.

      ii. **De Minimus Exception.** Prop. Treas. Reg. § 301.7701-15(b)(3)(ii). There is a de minimus exception under which some portions of a return are automatically not a substantial portion of the return.

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(a) A schedule, entry, or other portion of a tax return is not a substantial portion of the return if the gross income, deductions, or amounts upon which credits are determined are (1) less than $10,000 or (2) less than $400,000 and also less than 20% of the gross income shown on the return.

(b) If a tax advisor prepares more than one schedule, entry, or other portion of the return, the tax advisor must aggregate all schedules, entries, or other portions he prepared to determine whether the exception applies.

3. **Information Used on a Second Return.** Prop. Treas. Reg. § 301.7701-15(b)(3)(iii). A tax return preparer for one return is not automatically considered a tax return preparer of a second return simply because one or more entries on the first return affect an entry on the second return. However, if any entries reported on the first return are directly reflected on the second return and constitute a substantial portion of the second return, then the tax return preparer of the first return will be treated as a tax return preparer of the second return.

   For example, the sole preparer of an income tax return for a partnership is considered a tax return preparer of a partner’s income tax return if any of the entries on the partnership return which are reportable on the partner’s income tax return constitute a substantial portion of the partner’s income tax return.

4. **Excluded From Definition of Tax Return Preparers.** Prop. Treas. Reg. § 301.7701-15(f)(1). The definition of tax return preparer does not include, among others:

   a. A person providing tax assistance under a Volunteer Income Tax Assistance (VITA) program established by the IRS.

   b. An organization sponsoring or administering a VITA program established by the IRS.

   c. A person who provides tax assistance as part of a qualified Low-Income Taxpayer Clinic (LITC) or an organization that is a qualified LITC, if the assistance is directly related to a controversy with the IRS for which the qualified LITC is providing assistance, or is an ancillary part of an LITC program to inform individuals for whom English is a second language about their rights and responsibilities under the Code.
d. A person providing only clerical or mechanical assistance in the preparation of a return.

e. A person preparing a return for a trust, estate, or other entity of which the person is either a fiduciary or an officer, general partner, or employee of the fiduciary.

f. A person who prepares a return for no compensation.

D. Determining Which Tax Return Preparer the IRS will Treat as the Tax Return Preparer Subject to Section 6694. Prop. Treas. Reg. § 1.6694-1(b).

1. Prior Rule. Under the current regulations, there is only one tax return preparer in each firm, the so-called “one preparer per firm” rule. Thus, if a signing tax return preparer is associated with a firm, that individual, and no other individual in the firm, is treated as a tax return preparer with respect to the return for purposes of Section 6694. If two or more individuals associated with a firm are tax return preparers with respect to a return and neither is a signing tax return preparer, only one of them can be a nonsigning tax return preparer with respect to that return for purposes of Section 6694. Typically, the individual who is the tax return preparer for purposes of Section 6694 is the individual with overall supervisory responsibility for the advice given by the firm with respect to the return or claim.

2. Decision to Change the Rule. The IRS now believes that reconsideration of the “one preparer per firm” rule is appropriate. The IRS wants to focus on each position within a return, rather than the return as a whole. As a result of this change in focus, the “one preparer per firm” rule no longer applies. Instead, the IRS has created a “one preparer per position per firm” rule.

3. New Rule. Prop. Treas. Reg. § 1.6694-1(b)(1). An individual is a tax return preparer subject to Section 6694 if the individual is primarily responsible for the position on the return giving rise to the understatement.

a. One Person Per Position Per Firm Rule. Prop. Treas. Reg. § 1.6694-1(b)(1). Only one person within a firm will be considered primarily responsible for each position giving rise to an understatement and subject to penalty. In the course of identifying the individual who is primarily responsible for the position, the IRS may advise multiple individuals within the firm that it is considering whether one of them is the individual within the firm primarily responsible for the position. In some circumstances, there may be more than one tax return preparer who is primarily responsible for a position giving rise to an understatement if multiple tax return preparers are with different firms.
b. **Signing Tax Return Preparer.** Prop. Treas. Reg. § 1.6694-1(b)(2). The individual who signs the return as the tax return preparer will generally be considered the person primarily responsible for all of the positions on the return giving rise to an understatement.

i. However, if the IRS determines that another person within the same firm is primarily responsible for a position giving rise to the understatement, the IRS may determine that person, rather than the signing tax return preparer, is primarily responsible for a position and the IRS may treat that person, rather than the signing tax return preparer, as the tax return preparer for purposes of the position.

ii. This caveat will prevent the IRS from assessing a penalty against a person who may have overall responsibility in terms of signing the return, but who may lack detailed knowledge of, or responsibility for, a problem return position and who reasonably relied on another advisor at the same firm with greater knowledge of, and responsibility for, the accuracy of a position giving rise to the understatement.

c. **Nonsigning Tax Return Preparer.** Prop. Treas. Reg. § 1.6694-1(b)(2). If there are one or more nonsigning tax return preparers at a firm and no signing tax return preparer at the firm, the individual in the firm with overall supervisory responsibility for a position giving rise to the understatement is the tax return preparer primarily responsible for the position for purposes of Section 6694.

i. In addition, if the IRS determines that the signing tax return preparer is not primarily responsible for the position or the IRS cannot determine whether the signing preparer or another person in the firm is primarily responsible for the position, the IRS will treat the individual within the firm with overall supervisory responsibility for the position as the person primarily responsible for the position giving rise to the understatement.

ii. The IRS anticipates that this rule will address problems which arise when it cannot determine the identification of the person primarily responsible for the position and the statute of limitations is about to expire. In such an instance, this rule enables the IRS to impose the Section 6694 penalty on someone, rather than letting the statute of limitations expire.
d. Firm Responsibility. Prop. Treas. Reg. § 1.6694-1(b)(4), -2(a)(2); -3(a)(2). An individual and the firm that employs the individual, or only the firm with which the individual is associated, may be subject to a penalty under Section 6694 if:

i. One or more members of the principal management of the firm or a branch office participated in or knew of the conduct;

ii. The firm failed to provide reasonable and appropriate procedures for review of the position for which the penalty is imposed; or

iii. The review procedures were disregarded through willfulness, recklessness, or gross indifference.

E. Date Return is Prepared. Prop. Treas. Reg. § 1.6694-1(a)(2). There are two rules clarifying when the IRS deems a return prepared.

1. Signing Tax Return Preparers. Signing tax return preparers are deemed to have prepared a return on the date they sign the return. If the signing tax return preparer does not actually sign the return, fails to date the signature, or otherwise fails to note the date, the return is deemed prepared on the date filed.

2. Nonsigning Tax Return Preparers. Nonsigning tax return preparers are deemed to have prepared a return on the date they gave the advice with respect to the position at issue. That date is determined based on the facts and circumstances.

F. Existence of Understatement of Tax. Prop. Treas. Reg. § 1.6694-1(c), (d). An understatement of tax exists if, viewing the return as a whole, there is an understatement of the net amount of tax payable (or an overstatement of the net amount creditable or refundable). For purposes of Section 6694, the net amount payable is not reduced by any carry-back.

1. Determining whether an understatement of tax exists may be made in a proceeding involving the tax return preparer that is separate and apart from any proceeding involving the taxpayer.

2. However, if the IRS or a court later determines that no understatement of tax existed (for instance, the Office of Appeals or Tax Court decides in favor of the taxpayer to whom the return relates), the IRS must abate the Section 6694 assessment and refund any portion of the penalty paid, without regard for the statute of limitations.

1. Please note that the IRS may change these rules in light of the October 3, 2008 amendment to Section 6694.

2. Establishing a Reasonable Belief. Prop. Treas. Reg. § 1.6694-2(b)(1). A tax return preparer reasonably believes that the tax treatment of an item is more likely than not the proper tax treatment if the tax return preparer analyzes the relevant facts and authorities and, in reliance upon that analysis, reasonably concludes in good faith that the tax treatment of the item would more likely than not be sustained on the merits.

   a. May Not Consider Audit Lottery. A tax return preparer may not take into account the possibility that the IRS may not audit the return or that the IRS may not raise the issue on audit.

   b. Facts and Circumstances Test. Whether a tax return preparer has a reasonable belief is determined based upon all facts and circumstances, including the tax return preparer's due diligence. When examining the level of diligence in a particular case, the IRS will take into account the tax return preparer's experience with the area of tax law and familiarity with the taxpayer's affairs, as well as the complexity of the issues and facts in the case.


   a. Substantial Authority. When determining whether a tax return preparer has a reasonable belief that a position will more likely than not be sustained on the merits, the tax return preparer must determine whether there is substantial authority for the position.

      For a fuller discussion of the analysis required and the authorities upon which a tax return preparer may rely, please see Part VI.H.6 and 7 of this outline, below.

   b. Well Reasoned Construction of Law. A tax return preparer may reasonably believe that a position would more likely than not be sustained on its merits if the position is supported by a well-reasoned construction of the applicable statutory provision, despite the absence of other types of authority. This, of course, raises privilege issues, since the preparer would have to disclose the "well reasoned construction" and the taxpayer may not allow the disclosure.

   c. Reliance on Facts Provided by Taxpayer. A tax return preparer may rely in good faith without verification upon information
furnished by the taxpayer, the taxpayer's advisor, or another tax return preparer. Again, however, there are privilege implications.

4. **Reliance on Information Provided By Third Parties.** Prop. Treas. Reg. § 1.6694-2(b)(1). Tax return preparers are allowed, in certain circumstances, to rely on information provided by third parties, without engaging in an independent examination, when determining whether there is a reasonable belief that a position would more likely than not be sustained on its merits. See Part VI.L., below.

5. **Date Required to Meet More Likely Than Not Test.** Prop. Treas. Reg. § 1.6694-1(e)(6). A position must satisfy the more likely than not standard on the date the return was prepared.

**H. Substantial Authority for Position.** Treas. Reg. § 1.6662-4(d).

1. **Final Regulation, Not Proposed.** The rules for substantial authority are final, not proposed, as they were in effect prior to the May 25, 2007 amendments to Section 6694. Prior to the October 3, 2008 revision of Section 6694, these provisions were relevant only to the extent they impacted a tax return preparer's analysis of whether the tax return preparer had a reasonable belief that a position would more likely than not be sustained on the merits. Now, however, the substantial authority test is the test for determining whether a tax return preparer must make a disclosure under Section 6694. As a result, these rules are relevant in their own right.

2. **Effect of Substantial Authority.** Treas. Reg. § 1.6662-4(d)(1). If there is substantial authority for the tax treatment of an item, the item is treated as if it were shown properly on the tax return in computing the amount of the tax shown on the return.

3. **Substantial Authority Standard.** Treas. Reg. § 1.6662-4(d)(2). 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 (more than a 50% chance of success) but more stringent than the reasonable basis standard (about a 20% chance of success). It is generally considered to require about a 40% chance of success.

4. **May Not Consider Audit Lottery.** Treas. Reg. § 1.6662-4(d)(2). A tax return preparer may not take into account the possibility that the IRS may not audit the return or that the IRS may not raise the issue on audit.

5. **Facts and Circumstances Test.** Treas. Reg. § 1.6662-4(d)(3)(i). There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. The tax return
preparer must take all relevant authorities into account. The weight of authorities is determined in light of the pertinent facts and circumstances.

6. Objective Test. Treas. Reg. § 1.6662-4(d)(3). The substantial authority standard is an objective standard. Therefore the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment.


8. Authorities Allowed for Consideration. Treas. Reg. § 1.6662-4(d)(3)(iii). The tax return preparer must use authorities such as the Code, regulations, revenue rulings and revenue procedures, treaties, cases, legislative history, private letter rulings, technical advice memoranda, actions on decisions and general counsel memoranda issued after March 12, 1981, IRS information and press releases, notices, announcements, and administrative pronouncements.

I. Reasonable Basis for Position. Prop. Treas. Reg. § 1.6694-2(c)(2). A tax return preparer must have a reasonable basis for a position.

1. Definition of Reasonable Basis. Prop. Treas. Reg. § 1.6694-2(c)(2); Treas. Reg. 1.6662-3(b)(3). A reasonable basis for a position is about a 20% confidence level in the position, or a standard higher than not frivolous (which is approximately 10%). It is not satisfied by a return position that is merely arguable. If a return position is reasonably based on acceptable authorities (code, regulations, rulings, notices, cases, etc.) the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard, or even have a realistic possibility of success (about 33%).

2. Reliance on Information Provided By Third Parties. Prop. Treas. Reg. § 1.6694-2(c)(2); -1(e). Tax return preparers are allowed, in certain circumstances, to rely on information provided by third parties, without engaging in an independent examination, in order to determine whether there is a reasonable basis for the position. See Part V.K., below.

3. Disclosure. Prop. Treas. Reg. § 1.6694-2(c)(3). Please note that the IRS may change these rules in light of the October 3, 2008 amendment to Section 6694. A tax return preparer can avoid the Section 6694 penalty when he has a reasonable basis for a position but does not reasonably believe that the position would more likely than no be sustained on the merits if the position were disclosed. The three sections set forth immediately above discussed when a tax return preparer has a reasonable belief that the position would more likely than not be sustained on its
merits, when there is substantial authority for a position, and when a return preparer has a reasonable basis for a position. The next logical question is: how does a tax return preparer disclose the position?

4. Signing Tax Return Preparers. Prop. Treas. Reg. § 1.6694-2(c)(3)(i). Please note that the IRS may change these rules in light of the October 3, 2008 amendment to Section 6694. A signing tax return preparer meets the disclosure requirements for a position that has a reasonable basis but for which the signing tax return preparer does not have a reasonable belief that the position would more likely than not be sustained on the merits if the signing tax return preparer discloses the position in any one of the following five ways:


b. **Provide the Taxpayer with Ability to Make Actual Disclosure.** Prop. Treas. Reg. § 1.6694-2(c)(3)(i)(B). For income tax returns where the position does not have substantial authority, the signing tax return preparer may provide the taxpayer with a prepared income tax return that includes a disclosure of the position.

c. **Advise the Taxpayer of Penalty Standards.** Prop. Treas. Reg. § 1.6694-2(c)(3)(i)(C). For income tax returns where the position does have substantial authority, the signing tax return preparer may advise the taxpayer of all the Section 6662 penalty standards to which the taxpayer may be subject. The signing tax return preparer must also contemporaneously document this advice in his own files.

d. **Advise the Taxpayer of Penalty Standards for Tax Shelters and Reportable Transactions.** Prop. Treas. Reg. § 1.6694-2(c)(3)(i)(D). For income tax returns where the position is a tax shelter or a reportable transaction, the signing tax return preparer may advise the taxpayer that (1) the position must have substantial authority, (2) the taxpayer must have a reasonable belief that the tax treatment of the position is more likely than not the proper treatment for the position, and (3) disclosure of the position by the taxpayer will not protect the taxpayer from an accuracy-related penalty under Section 6662 or Section 6662A. The signing tax return preparer must also contemporaneously document this advice in his own files.

e. **Advise the Taxpayer of Penalty Standards.** Prop. Treas. Reg. § 1.6694-2(c)(3)(i)(E). For returns subject to accuracy related
penalties under Section 6662 other than the substantial understatement penalty, the signing tax return preparer may advise the taxpayer of all the Section 6662 penalty standards to which the taxpayer may be subject. The signing tax return preparer must also contemporaneously document this advice in his own files. Note that, other than actual disclosure, this is the only disclosure option for signing tax return preparers who have prepared returns other than income tax returns.

5. Nonsigning Tax Return Preparers. Prop. Treas. Reg. § 1.6694-2(c)(3)(ii). Please note that the IRS may change these rules in light of the October 3, 2008 amendment to Section 6694. A nonsigning tax return preparer meets the disclosure requirements for a position that has a reasonable basis but for which the nonsigning tax return preparer does not have a reasonable belief that the position would more likely than not be sustained on the merits if the nonsigning tax return preparer discloses the position in any one of the following three ways.


b. Advise the Taxpayer of Penalty Standards. Prop. Treas. Reg. § 1.6694-2(c)(3)(ii)(A). The nonsigning tax return preparer advises the taxpayer of any opportunity to avoid the Section 6662 penalties to which the taxpayer may be subject and the standards for such disclosures. The nonsigning tax return preparer must also contemporaneously document this advice in his own files.

c. Advising Another Tax Return Preparer. Prop. Treas. Reg. § 1.6694-2(c)(3)(ii)(B). The nonsigning tax return preparer advises another tax return preparer with respect to the position that disclosure under Section 6694 may be required. The nonsigning tax return preparer must also contemporaneously document this advice in his own files.

6. Disclosure Requirement is a Position by Position Requirement. Prop. Treas. Reg. § 1.6694-2(c)(3)(iii). To satisfy these disclosure rules, a tax return preparer must satisfy the rules on a position by position basis. The tax return preparer must examine each individual position on the return and make the appropriate disclosure, as needed, for each position for which a disclosure is required.

a. As a result, the disclosure advice to the taxpayer must be particular to the taxpayer, the return, and the position in question, and must be specifically tailored to the taxpayer’s facts and circumstances.
A boilerplate disclosure (see, e.g., Circular 230 disclosures on e-mails) will not satisfy the disclosure requirement.

b. Moreover, in every case where a tax return preparer provides advice to a taxpayer in order to satisfy the disclosure requirement, the tax return preparer must contemporaneously document the fact that he provided the advice – thus, there are substantial privilege issues involved in order for a tax return preparer to establish that he met the disclosure requirements and should not be penalized under Section 6694.

7. **Pass-Through Entities.** Prop. Treas. Reg. § 1.6694-2(c)(3)(iv). When the positions at issue are attributable to a pass-through entity, the tax return preparer may make the disclosure at the entity level on a properly completed and filed Form 8275, Disclosure Statement, a properly completed and filed Form 8275-R, Regulation Disclosure Statement, on the tax return, or by any other means available to tax return preparers.

J. **Reasonable Cause and Good Faith.** Prop. Treas. Reg. § 1.6694-2(d), (e). Just like the prior version of Section 6694, revised Section 6694 includes an exception to the Section 6694 penalty if the tax return preparer acted with reasonable cause and in good faith. The IRS will consider the following factors when determining whether reasonable cause and good faith exist:

1. **The Nature of the Error Causing the Understatement.** Prop. Treas. Reg. § 1.6694-2(d)(1). If the error causing the understatement results from a provision of law that was so complex, uncommon, or highly technical that a competent tax return preparer reasonably could have made the error, there may be reasonable cause and good faith. However, reasonable cause and good faith do not exist if the error causing the understatement is apparent from a general review of the return.

2. **Frequency of Errors.** Prop. Treas. Reg. § 1.6694-2(d)(2). If the error causing the understatement is an isolated error (such as an inadvertent mathematical or clerical error) rather than a number of errors, there may be reasonable cause and good faith. However, even if the error is an isolated error, reasonable cause and good faith do not exist if the error is so obvious, flagrant, or material that it should have been discovered during a review of the return. In addition, reasonable cause and good faith do not exist if there is a pattern of errors on the return, even if any one of the errors, in isolation, would have constituted reasonable cause and good faith.

3. **Materiality of Errors.** Prop. Treas. Reg. § 1.6694-2(d)(3). If the error is of a relatively immaterial amount, there may be reasonable cause and good faith. However, even if the error is of a relatively immaterial
amount, reasonable cause and good faith do not exist if the error or errors creating the understatement are obvious or numerous.

4. Normal Office Practice. Prop. Treas. Reg. § 1.6694-2(d)(4). Reasonable cause and good faith may exist if the tax return preparer’s normal office practice, when considered together with other facts and circumstances, such as the knowledge of the tax return preparer, indicates that the error resulting in the understatement would rarely occur and the normal office practice was followed in preparing the return or claim in question. Normal office practices means a system for promoting accuracy and consistency in the preparation of returns or claims. It must generally include, in the case of a signing tax return preparer, checklists, methods for obtaining necessary information from the taxpayer, a review of the prior year’s return, and review procedures. However, reasonable cause and good faith do not exist if there is a flagrant error on the return, a pattern of errors on the return, or a repetition of the same or similar errors on numerous returns or claims.

5. Reliance on Third Party Information. Prop. Treas. Reg. § 1.6694-2(d)(5). A tax return preparer may establish reasonable cause and good faith by relying, without verification, on the advice and information furnished by the taxpayer or other parties. See Part V.K., below.

6. Industry Practice. Prop. Treas. Reg. § 1.6694-2(d)(6). Reasonable cause and good faith may exist if the error is the result of reasonable reliance on generally accepted administrative or industry practice in taking the position that resulted in the understatement. Good faith reliance does not exist if the tax return preparer knew or should have known, at the time the return was prepared, that the administrative or industry practice was no longer reliable due to developments in the law or IRS administrative practice since the time the practice was developed.

7. Reliance on Third Party Information. Prop. Treas. Reg. §§ 1.6694-2(b)(1); 2(c)(2); -1(e); -2(d)(5). Please note that the IRS may change these rules in light of the October 3, 2008 amendment to Section 6694. For the purpose of determining (1) whether a tax return preparer has a reasonable belief that the position would more likely than not be sustained on the merits, (2) whether there is a reasonable basis for the position, and (3) whether there is reasonable cause and good faith for abating a penalty, a tax return preparer may rely on third party information in certain instances. The general rules for each of these determinations are the same.

8. General Rules. The IRS allows tax return preparers to rely on third party information because the increased complexity of the tax law often requires tax return preparers to rely on the work of others in ensuring tax compliance.
a. **Reliance Allowed. Prop. Treas. Reg. § 1.6694-1(e).** A return preparer may rely in good faith and without verification:

i. On information furnished by the taxpayer.

ii. On information furnished by another advisor, another tax return preparer, or another party within or without the same firm. The tax return preparer is not required to audit, examine or review books and records, business operations, or documents or other evidence to independently verify information provided by the taxpayer, advisor, other tax return preparer, or other party.

iii. On a tax return previously prepared by a taxpayer or another tax return preparer and filed with the IRS. However, the tax return preparer must confirm that the position relied upon has not been adjusted.

b. **Reliance Not Allowed. Prop. Treas. Reg. § 1.6694-1(e).** A tax return preparer may not:

i. Rely on information provided by taxpayers with respect to legal conclusions on Federal tax issues; or

ii. Ignore the implications of information furnished to the tax return preparer or actually known by the tax return preparer, and must make reasonable inquiries if the information furnished appears to be incorrect or incomplete.

c. **Reliance on Assumptions. Prop. Treas. Reg. § 1.6694-2(b)(2).** A tax return preparer may not rely on unreasonable legal or factual assumptions (including assumptions related to future events), such as an assumption or representation the return preparer knows is not true, and cannot unreasonably rely on third party statements or representations.

9. **Additional Rules Within Context of Reasonable Cause and Good Faith Exception to Penalty.** If a tax return preparer is establishing reasonable cause and good faith by relying on the advice and information furnished by the taxpayer or other parties, additional rules apply.

a. **Reliance Allowed if in Good Faith.** A tax return preparer may reasonably rely in good faith on the advice and/or schedules or other documents prepared by the taxpayer, another advisor, another tax return preparer, or another third party if the tax return preparer has reason to believe the third party was competent to render the advice or other information. The advice or information may be
written or oral, but in either case the burden of establishing that the advice or information was received is on the tax return preparer.

b. **Reliance Not in Good Faith.** A tax return preparer has not relied on third party information in good faith if:

i. The advice or information is unreasonable on its face;

ii. The tax return preparer knew or should have known that the third party providing the advice or information was not aware of all relevant facts; or

iii. The tax return preparer knew or should have known, at the time the return was prepared, that the advice or information was no longer reliable due to developments in the law since the time the advice was given.

K. **Burden of Proof.** Prop. Treas. Reg. § 1.6694-2(e). The tax return preparer bears the burden of proving whether:

1. He knew or reasonably should have known that the questioned position was taken on the return;

2. There is reasonable cause and good faith with respect to such position; and

3. The position was adequately disclosed.

L. **Calculating the Amount of the Penalty.** Prop. Treas. Reg. § 1.6694-1(f). The penalty for violating Section 6694 is the greater of $1,000 or 50% of the income derived, or to be derived, by the tax return preparer with respect to the tax return. For willful or reckless conduct, the penalty is the greater of $5,000 or 50% of the income derived, or to be derived, by the tax return preparer with respect to the tax return.

1. **Income Derived (or to be Derived).** Prop. Treas. Reg. § 1.6694-1(f)(1). The term income derived (or to be derived) means all compensation the tax return preparer receives or expects to receive from the engagement of preparing the return or providing tax advice for the position taken on the return that gave rise to the understatement.

a. For tax return preparers who are not compensated directly by the taxpayer, but rather by a firm that employs them or with whom they are associated (such as attorneys or accountants in a firm), income derived (or to be derived) means all compensation the tax return preparer receives from the firm that can be reasonably allocated to the engagement of preparing the return, or providing tax advice with respect to the position taken on the return, that gave rise to the understatement.
b. If the firm that employs the tax return preparer or the firm in which the tax return preparer is associated is subject to a penalty, income derived (or to be derived) means all compensation the firm receives or expects to receive with respect to the engagement of preparing the return or providing tax advice with respect to the position taken on the return that gave rise to the understatement.

2. **Multiple Engagements.** Prop. Treas. Reg. § 1.6694-1(f)(2)(i). If the tax return preparer or the tax return preparer’s firm has multiple engagements related to the same return, only those engagements relating to the position taken on the return that gave rise to the understatement are considered for purposes of calculating the income derived (or to be derived) with respect to the return.

3. **Reasonable Allocation.** Prop. Treas. Reg. § 1.6694-1(f)(2)(ii). The IRS will only take into account compensation for tax advice given with respect to transactions that have already occurred at the time the advice is rendered and that relate to the position giving rise to the understatement for purposes of calculating the penalty. If a lump sum fee includes amounts which should not be taken into account (because, for instance, some part of the fee relates to pre-transaction advice), then the amount of income derived is based on a reasonable allocation of the lump sum fee between the tax advice giving rise to the penalty and the advice that does not give rise to the penalty.

4. **Fee Refunds.** Prop. Treas. Reg. § 1.6694-1(f)(2)(iii). If a tax return preparer issues a refund to the taxpayer for all or part of the amount paid (because, for instance, the fee arrangement is a contingent fee arrangement), the refund will not reduce the amount of the Section 6694 penalty – it will not be taken into account when determining the amount of the income derived from the engagement. However, a fee refund does not include a discounted fee or alternative billing arrangement.

VII. **Circular 230 Revisions and Relationship to Revised Section 6694.**

A. **Introduction.** Circular 230 sets forth regulations governing practice before the IRS.

1. **Recent Revisions Relating to the Scope of Practice.** In February of 2006, the IRS released additional proposed regulations regarding the scope of practice before the IRS. These regulations were finalized on September 26, 2007.

2. **Proposed Regulations for Standards of Practice.** On September 26, 2007 the IRS issued proposed regulations modifying the standards for practice with respect to tax return preparation. See Prop. Cir. 230 Reg. § 10.34(a). These modifications were intended to conform the Circular
230 standards to the modifications to Section 6694 adopted as part of the Small Business and Work Opportunity Act of 2007. However, they no longer conform with the amendment to Section 6694 made as part of the Emergency Economic Stabilization Act of 2008. Thus, the Circular 230 standards are now tougher than the Section 6694 standards.

B. **Standards for Advising on Tax Return Positions.** For many years Section 10.34 of Circular 230 set forth specific standards of practice for providing advice with respect to tax return positions and for preparing or signing returns. These standards have been consistent with the standards required by Section 6694 for avoidance of the penalty on return preparers.

1. **Revision to Circular 230.** When Congress revised Section 6694, Treasury decided to revise the standards of practice set forth in Circular 230. As a result, on September 26, 2007 the IRS issued proposed regulations modifying the standards for practice with respect to tax return preparation in order to conform the Circular 230 standards to the (as-then) revised Section 6694. See Prop. Cir. 230 Reg. § 10.34(a).

2. **Circular 230 Standards.** These revisions increase the chances practitioners will be found to violate Circular 230, just as the revisions to Section 6694 increase the chances that a practitioner may be found in violation of Section 6694. These revisions should not be considered an idle threat since the penalties for violating Circular 230 not only include monetary penalties, but also include disbarment from practice before the IRS, suspension, public censure, or any combination thereof.

   a. **Signing Preparer.** Under the proposed regulations, a practitioner may not sign a return as preparer unless

      i. The practitioner has a reasonable belief that each position on the return will “more likely than not” be sustained on the merits, or

      ii. There is a reasonable basis for each position and each position is adequately disclosed to the IRS.

   b. **Return Advice.** Under the proposed regulations, a practitioner may not advise a client to take a position on a return, or prepare any portion of a tax return for which a position is taken, unless:

      i. The practitioner has a reasonable belief that the position satisfies the “more likely than not” standard, or

      ii. The position has a reasonable basis and is adequately disclosed to the Service.
VIII. Implications and Impact of Changes.

A. Circular 230 Issues.

1. **Higher Standard in Circular 230.** Since Congress lowered the Section 6694 standard on October 3, 2008 effective May 27, 2007, Circular 230’s “more likely than not” standard is higher than Section 6694’s “substantial authority.” Thus a tax return preparer could violate Circular 230 without violating Section 6694.

2. **Requirements of Circular 230.** Although the Section 6694 penalty for nonsigning preparers only applies to post-transaction advice and only if the nonsigning preparer provided advice which constitutes a substantial portion of the return, Section 10.34 of Circular 230 includes neither of those requirements. Thus, a tax return preparer may not be a nonsigning tax return preparer subject to penalties under Section 6694, but could be subject to penalties by the IRS Office of Professional Responsibility (“OPR”) under Section 10.34 of Circular 230.

3. **Timing of Procedures.** None of Circular 230, Section 6694, or the Proposed Regulations indicate whether a Section 6694 proceeding must precede an OPR investigation for violations of Circular 230. Could the IRS engage in both proceedings at the same time? And what if the results are not the same? Section 6694 proceedings are ultimately reviewable by the Tax Court and Circular 230 proceedings are ultimately reviewable by the District Court. Could there be two separate bodies of law on the same issue? At the January 18, 2008 Tax Section EO Committee meeting, Michael Chesman, Director of OPR, stated that an OPR proceeding under Circular 230 would generally only occur after a referral is made from the filed return after imposing a Section 6694 penalty – but there is no law, rule, or regulation actually requiring that sequence or order.

4. **Legend.** To be safe, are practitioners better off adding a tailored legend to every correspondence saying, in essence, “we are not advising you to take this position”?

B. Section 6694 Issues.

1. **Penalty for Preparing a Return that Does Not Exist.** Section 6694 leaves open the possibility that a practitioner could face a penalty for preparing a return, such as a Form 990-T or Form 709 that was not, actually, physically prepared.

2. **Attorney-Client Privilege.** If the IRS tries to impose a Section 6694 penalty on a tax return preparer and the tax return preparer’s defense is that he followed the procedures outlined in the Proposed Regulations for
disclosure, can the tax return preparer disclose the contemporaneous memorandum establishing disclosure to the taxpayer without running afoul of attorney-client privilege or conflict of issue rules? Will the new statutory provision affect this issue?

3. **Risk Management.**
   a. Firms and their tax departments must establish and communicate policies and procedures.
   b. There is a distinct need for reliance on professional judgment.
   c. Firms and their tax departments must monitor and test compliance with these rules.
      i. The policy must be capable of being monitored or tested.
      ii. There must be resources available for monitoring.

IX. **Next Steps.**
   A. **Comments and Hearing.** The IRS received comments on the Proposed Regulations and held a hearing on those comments during the summer of 2008.
   B. **Final Regulations.** The IRS has anticipated that it will issue Final Regulations by December 31, 2008 with a likely effective date of January 1, 2009. The IRS does not expect many referrals for penalties under Section 6694 until the Final Regulations are promulgated.
   C. **Delay in Final Regulations?** It is unclear at this time how the new statutory provision will affect the Final Regulations, either in their substance or their timing.
   D. **New Proposed/Temporary Regulations.** It is also unclear at this time whether Treasury will issue new Proposed and/or Temporary Regulations addressing the new statutory amendment to Section 6694, will revise the Proposed Regulations to address the new statutory amendment to Section 6694, or will simply address the new statutory amendment via Final Regulations.
   E. **In the Meantime.** In an interview with BNA on January 18, 2008, after speaking at a session of the ABA Tax Section before the EO Committee, Michael Chesman, head of the IRS Office of Professional Responsibility, said, “I think one of the things to understand is that this is an evolutionary process, short-term guidance. I don’t think you are going to see very much activity for [Section] 6694 during the coming year because it is a transitional period.”