

PARADISE LOST

The Rise, Fall, and Return of MILTON
[the More Likely Than Not (MLTN) Standard]

Tax Positions, Preparer Penalties and Circular 230

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IRS Circular 230 Disclosure

This is a study outline. It's not tax advice. Sorry, but you can't rely on the outline, or the speech, to avoid penalties. They might help suggest when you should go get advice, though. That part is up to you.

This has been your Circular 230 warning.

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I. Preparer Penalties, and related issues.

A. **Taxpayers** – standards for tax positions

1. Generally – 20% accuracy related penalty applies if any of the §6662 categories apply.
 - a. Key categories:
 - i. Negligence or intentional disregard of rules or regulations
 - ii. Substantial understatement of tax
 - iii. Substantial valuation misstatement
 - b. Standards for reporting (“understatement” branch of §6662 penalty):
 - i. Substantial authority = general rule. Code §6662(d)(2)(B)(i)
 - ii. If adequate disclosure = reasonable basis. Code §6662(d)(2)(B)(ii)
 - c. Note – critics of the preparer penalty regime point to the lower taxpayer standard (as compared to the MLTN preparer standard) as pitting the preparer against the taxpayer. Pending legislation (included in the current Extender Bill) would equalize that standard at “substantial authority.”
2. Reasonable cause exception (Code §6664(c))
 - a. Accuracy-related penalty generally does not apply if the taxpayer had reasonable cause and good faith. §6664(c)(1).
 - i. Reasonable cause requires a “reasonable basis” for the position in question.
 - A. “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.” Regs. §1.6662-3(b)(3).
 - B. Considered by many practitioners to be a 1 in 3 chance of success.
 - ii. Substantial or gross valuation overstatements – no reasonable cause exception unless additional requirements are met – §6664(c)(2):
 - A. Claimed value was based on a qualified appraisal made by a qualified appraiser; and

B. Taxpayer also made a good faith investigation of the value of the contributed property.

b. Reportable transactions – §6662A

i. Applicable penalty section becomes §6662A

A. Applies regardless of whether transaction is disclosed; however, if not properly disclosed, penalty increases from 20% to 30%.

B. “Qualified amended return” must be filed before IRS first contacts taxpayer for audit; otherwise amounts disclosed on amended return are not considered disclosed for purposes of 6662A. Final Regs. provide added guidance on requirements. See Regs. §301.6664-2(c).

ii. Different reasonable cause exception for Reportable Transactions (§6664(d)) – requirements:

A. Sufficient disclosure; and

B. Substantial authority.

C. Reasonable belief -- available only as below:

1. "Reasonable belief" only if such belief—

a. Is based on the facts and law that exist at the time the tax return which includes the tax treatment is filed, and

b. Relates solely to the taxpayer's chances of success on the merits of such treatment and does not take into account the possibility that a return will not be audited, such treatment will not be raised on audit, or such treatment will be resolved through settlement if it is raised.

2. Exception - no reliance on “bad” opinion letters (my term).¹ Bad opinion letter if either:

a. Issued by a "disqualified tax advisor" – if a material advisor, paid by one, or is paid

¹ For a discussion of “bad” opinion letters and the judicial consequences thereof, see Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004), affd. 150 Fed. Appx. 40 (2nd Cir. 2005).

contingent on tax results of transaction;
Regulations authorized; or

- b. "Disqualified opinion" - if any of following:
 - i. Based on unreasonable factual or legal assumptions;
 - ii. Unreasonable reliance on taxpayer's (or anyone else's) statement of facts or other items provided;
 - iii. Fails to identify and consider all relevant facts; or
 - iv. Fails any other requirement Treasury comes up with in Regs.

b. Strange extra layer for substantial understatements (Code §6662(d)(2)(B)) – understatement (unless from a “tax shelter” as defined in §6662(d)(2)(C)(ii)) escapes the definition of “substantial understatement” if either:

- i. There was substantial authority for the position resulting in the understatement; or
- ii. There was reasonable cause for the position resulting in the understatement and the position was adequately disclosed.
- iii. [Exception not applicable for multiparty financing transactions that do not clearly reflect income.]

B. **Preparers** - standards for tax positions

1. Preparer penalties – broadened and deepened. Code §§6694, 6695(b), 7701.

a. Prior law -- Pre- May 26, 2007:

- i. Understatement of Taxpayer Liability by Return Preparer (§6694)
 - A. Applied only to income tax return preparers
 - B. **“Realistic possibility”** standard;
 - C. Prior law penalties:
 - 1. First tier penalty: \$250 (if preparer knew or reasonably should have);
 - 2. Second tier penalty: \$1,000 (if preparer was willful or reckless)
- iii. Failure to sign a return (§6695(b))
 - A. Applied only to income tax return preparers;
 - B. Penalties (still unchanged from prior law):
 - 1. \$50 for each failure
 - 2. \$25,000 maximum per preparer per calendar year

3. Reasonable cause exception applies
- b. Preparer penalties -- new law (effective for returns prepared after May 25, 2007):
- i. See **Appendix A** for full text of Code §6694, and **Appendix B** for changes made in the 2008 Bailout Bill and related effective date.
 - ii. Overview of separate elements of statute (see §6694(a)) (each dealt with in detail below):
 1. “Tax return preparer”
 2. “Who prepares any return or claim for refund”
 3. Understatement of liability.
 4. Due to an “unreasonable position” (includes different standards – MLTN, substantial authority, and reasonable basis)
 5. Amount of penalty
 - iii. **Tax Return Preparer** – Code §7701(a)(36); Regs. §301.7701-15; Prop. Regs. §1.6694-1(b)(1). (See Appendices A and B for full Code text).
 - A. Any person who prepares for compensation, or who employs one or more persons to prepare for compensation
 1. Two categories of preparers:
 - a. Signing preparers, and
 - b. Nonsigning.
 2. Why the distinction matters:
 - a. Many nonsigning preparers are unaware that they fall within the §6694 return – a trap for the unwary.
 - b. Under current regulations, a non-signing preparer can discharge his/her obligations by advising the taxpayer of a duty to disclose. See §1.6694-2(c)(3) and further discussion later in this outline.

3. Regs. §301.7701-15(a)(1) (nonsigning preparer):

“A person who furnishes to a taxpayer or other preparer sufficient information and advice so that completion of the return or claim for refund is largely a mechanical or clerical matter is considered an income tax return preparer, even though that person does not actually place or review placement of information on the return or claim for refund.”

- B. Any return of tax imposed by this title or any claim for refund of tax imposed by this title.
- C. The preparation of a “substantial portion” of a return or claim for refund is treated as if it were the preparation of such return or claim for refund. See further discussion later in outline.
- D. Exceptions:
 - a. Pre-transaction advice. Regs. §301.7701-15(b)(2).
 - a. Advice on specific issues of law is generally not considered return preparation.
 - b. This exception applies unless the advice fails both of the following:
 - i. Post-transaction advice -- the events relating to the advice must not have occurred yet (compare, - “should I do this?” vs. “I did this – did it work?”); and
 - ii. Directly relevant to return – the advice must be “directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund.”

(The example given in the Regs.: “if a lawyer gives an opinion on a transaction which a corporation has consummated, solely to satisfy an

accountant (not at the time a preparer of the corporation's return) who is attempting to determine whether the reserve for taxes set forth in the corporation's financial statement is reasonable, the lawyer shall not be considered a tax return preparer solely by reason of rendering such opinion.”)

- b. Clerical involvement only;
- c. In-house work;
- d. Acting in capacity as fiduciary; or
- e. Claim for refund is in response to a notice of deficiency or certain waivers of restrictions.
- f. For additional regulatory exceptions, see Regs. §301.7701-15.

E. Only one §6694 preparer per firm, per tax position.
Prop. Regs. 1.6694-1(b)(1).

- 1. If there is a signing preparer in a firm, that individual, and no other in the firm, is generally treated as the preparer for §6694 purposes. Prop. Regs. 1.6694-1(b)(2).
- 2. However, the real inquiry is -- *who was primarily responsible within the firm for the tax position?*
- 3. Accordingly, the IRS may take a “stakeholder” approach, sending notices to all potential “preparers” that they may be the person who was primarily responsible. It will then investigate all of them, and will narrow it down to the one it deems most responsible for the position.
- 4. Query – if the firm is compensated for the work, could the person primarily responsible be someone who is a specialist in the area who “took a quick phone call” from a partner, but didn’t even put down any time (and therefore in effect wasn’t compensated for it)? Panelists at a July 2008 ALI-ABA program (including an IRS representative) were unsure, other than to say that “all facts and circumstances” would have to be considered.

5. A similar rule applies for nonsigning preparers – there can be only one per firm, per issue.
 6. There can be multiple preparers in a single firm, if they handled different issues.
 7. Similarly, there can be multiple preparers on the same issue, if they are in different firms.
- iv. **Any return or claim for refund.** Returns §§6694 and 6695(b) apply to:
- A. Per statute and committee reports, applies to preparers of:
 1. Income tax returns;
 2. Estate and gift tax returns;
 3. Employment tax returns;
 4. Excise tax returns;
 5. Exempt organization returns.²
 - B. Notice 2008-13, supplemented by Notice 2008-46 (interim guidance pending issuance of Regulations) takes a different approach, dividing returns into three categories for purposes of §6694:
 1. “Exhibit 1” returns are those which report tax liability, and are the ones which primarily can subject the preparer to a §6694 penalty.
 2. “Exhibit 2” returns report information, and “may” subject the preparer to a §6694 penalty if the information reported constitutes a substantial portion of the other tax return.
 3. “Exhibit 3” returns do not subject the preparer to a §6694 penalty unless prepared willfully in a manner to understate the liability of tax on a return or claim for refund, or in reckless or intentional disregard of rules or regulations.
 - C. Notice 2008-12 (also interim guidance pending issuance of Regulations) takes a different approach re- §6695(b) (failure to sign returns).
 1. Certain returns require a signature to avoid the §6695(b) penalty (notably 990-T, 990-PF, most of

² The returns described are taken from the Committee Reports. For the statutory language, see section 7701(a)(36) (Appendix A) – applies to any tax return imposed by this title (the Internal Revenue Code) or to any claim for a refund of tax.

1040 series, 1041, 1065, most of 1120 series (but not 1120-S), and 2438. See Notice 2008-12 for details.

2. Certain other returns do not carry a §6695(b) penalty for failure to sign, at least until the end of 2008 or the issuance of contrary regulations. Notably, Form 706 (Federal Estate Tax Return), Form 709 (Federal Gift Tax Return), Form 720 (Quarterly Excise Tax Returns) and Form 720X (amended 720), Form 940 (Annual FUTA return); Form 941 (Quarterly Federal employment tax return), Form 4720 (Charitable and certain other excise taxes), and Form 5330 (Excise taxes relating to employee benefit plans).

v. **Understatement of liability.**

- A. See §6694(a)(1), which imposes the penalty on “any tax return preparer who prepares any return or claim for refund *with respect to which any part of an understatement of liability* is due to ***.”
- B. Accordingly, if there no understatement of liability on a return, there is no §6694 penalty.
- C. The determination of whether there is an understatement of liability is made by viewing the return as a whole, and not just based on the single issue. Prop. Regs. §1.6694-1(c).
- D. Note -- there does not appear to be an exception (either in the statute or the Prop. Regs.) where the understatement arises from a part of the return unrelated to the issue on which the preparer advised.

vi. **Due to an “Unreasonable Position”.** Decision Tree for determining whether a return position was an “unreasonable position”³:

- (A) Did the preparer know, or should the preparer reasonably have known of the position?
 - (1) If no to both, stop – no §6694 liability.
 - (2) If yes, continue to (B).

³ Includes amendments made by 2008 Bailout Bill (signed October 4, 2008) – see Appendix B.

- (B) Did the return position relate to a “reportable transaction” or a “tax shelter”?
- (1) If yes, go to standards test at (C) below.
 - (2) If no, go to standards test at (D) below.
- (C) **Test for reportable transactions or tax shelters:** did the preparer reasonably believe the position was “more likely than not” (MLTN) the proper treatment?
- (1) If yes, stop. If file is properly documented and verifiable, no §6694 penalty.
 - (2) If no –
 - (a) No disclosure exception applies for reportable transactions or tax shelters;
 - (b) §6694(a)(3) provides an exception where there is reasonable cause for the understatement and the return preparer acted in good faith.
 - (3) Otherwise, the position is an “Unreasonable Position.”
 - (4) Note: until the Prop. Regs. are revised to reflect the Bailout Bill, it is unclear whether a “speech” advising on the penalty and disclosure standards helps for reportable transactions or tax shelters.
- (D) **Test for “regular” tax positions** (other than reportable transaction or tax shelters): did the preparer have a reasonable belief that there was “substantial authority” for the position?
- (1) If yes, stop. If file is properly documented and verifiable, no §6694 penalty.
 - (2) If no, continue to (E).
- (E) Were the required return disclosure requirements met?
- (1) If yes, continue to (F)
 - (2) If no, the position is an “Unreasonable Position.”
- (F) Was there a reasonable basis for the position?
- (1) If yes, stop. If file is properly documented and verifiable, no §6694 penalty.
 - (2) If no, the position is an “Unreasonable Position.”
- vii. Knowledge. Preparer must know (or reasonably should have known) of the position.
- A. Based on facts and circumstances.
 - B. Where an advisor gives post-transactional tax advice, this hurdle is likely to mean little.

- viii. Not Reasonably MILTON. Where the transaction is a “reportable transaction” or a “tax shelter,”⁴ the preparer must have had a *reasonable belief* that the tax position was “more likely than not” (MLTN) the proper treatment. Prop. Regs. §1.6694-2(b)(1).⁵
- A. “Facts and circumstances” test applies. Factors considered include:
1. Extent of preparer’s due diligence;
 2. Preparer’s experience within the area of tax law;
 3. Preparer’s familiarity with the taxpayer’s affairs;
 4. The degree of complexity of the issues and facts in the case.
- B. A position may be supported by nothing more than a statutory provision and a well-reasoned construction of that provision, provided there is no contrary authority, and still be “reasonably MLTN.”
- C. Regs. §1.6662-4(d)(3)(iii) sets forth the authorities to be considered in determining whether a position satisfies the MLTN standard:
1. Applicable provisions of the Internal Revenue Code and other statutory provisions;
 2. Proposed, temporary and final regulations construing those statutes;
 3. Revenue rulings and revenue procedures;
 4. Tax treaties, regulations thereunder, and Treasury Department and other official explanations thereof;
 5. Court cases;
 - a. But generally not if overruled or modified;
 - b. Special rule applies for U.S. Tax Court decisions – the case still constitutes authority unless overruled or modified by the court of appeal to which appeal would lie for the taxpayer in question (or by the U.S. Supreme Court).
 6. Congressional committee reports, statements of managers included in conference committee reports,

⁴ This requirement added by the 2008 Bailout Bill – see Appendix B.

⁵ The Prop. Regs. (approximately 200 pages long) were issued prior to the passage of the 2008 Bailout Bill (see Appendix B). Although the Service was targeting promulgation of Final Regs. by the end of 2008, it is unclear whether that timetable will be changed by the significant changes made by the Bailout Bill. All references to the Prop. Regs. should be read with direct reference to pre-Bailout Bill §6694.

- and floor statements made prior to enactment by a bill's manager;
7. Blue Book (general explanations of tax legislation prepared by the Joint Committee on Taxation);
 8. Private letter rulings and technical advice memoranda issued after October 31, 1976;
 - a. But generally not if revoked or inconsistent with a subsequent proposed regulation, revenue ruling, or other administrative pronouncement published in the Internal Revenue Bulletin.
 - b. A taxpayer's own PLR should be a "lock" as substantial authority – but see the restrictions at Regs. §1.6662-4(d)(iv)(A).
 9. Actions on decisions and general counsel memoranda issued after March 12, 1981;
 10. General counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin;
 11. IRS information or press releases; and
 12. Notices, announcements or other pronouncements published by the IRS in the Internal Revenue Bulletin.
- D. The following do not count as "authority":
1. Treatises
 2. Legal periodicals
 3. Legal opinions by tax professionals
 4. However, the underlying reasoning for any of those may give rise to substantial authority.
- E. See Prop. Regs. §1.6694-2(b)(4) for MLTN examples. However, they are very clear-cut ones, and not terribly helpful.
- F. Where the position does not relate to a "reportable transaction" or a "tax shelter," the lower "substantial authority" standard takes the place of the MLTN standard. Although the Prop. Regs. are superseded to that extent, presumably subsequent guidance will continue to follow the preceding description, but substituting the lower standard.
- G. "Tax Shelter" – defined in §6662(d)(2)(C) – any of following **if a significant purpose is the avoidance of Federal income tax:**
1. partnership or other entity;

2. investment plan or arrangement; or
3. **any other plan or arrangement.**
4. Query –
 - i. How does an advisor get comfort that any given transaction doesn't have Federal tax avoidance as a significant purpose?
 - ii. Who has the burden of proof on that?
 - iii. Hopefully further guidance will provide safe harbors, given how crucial that issue is, including burden of proof.
 - iv. Note that among other things, the availability of protection via disclosure (and possibly via speech) may hinge on what is a "tax shelter."

- H. "Reportable Transaction" – any one of six categories of transactions (Regs. §1.6011-4(b):
- a. Listed transactions (i.e., §6112);
 - b. Confidential transactions;
 - c. Transactions with contractual protection;
 - d. Loss transactions;
 - e. Transactions with a significant book-tax difference; and
 - f. Transactions involving a brief holding period
 - g. For more on Reportable Transactions, see Matthew Kadish, "Listed Transactions and Tax Shelters," 2003 Cleveland Tax Institute.

- I. Reliance on information provided. Prop. Regs. §1.6694-1(e).
1. For purposes of §6694, preparers generally can rely in good faith on information furnished by the taxpayer without independent verification.
 2. No such reliance is allowed on legal conclusions on Federal tax issues.
 3. Preparer can also rely in good faith and without verification on information provided by another advisor, another preparer or another party.

4. Preparer cannot ignore the implication of information furnished to, or otherwise known by the preparer, and must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete.
5. See Prop. Regs. §1.6695-2(b)(3) for additional requirements, guidance and examples regarding preparers of returns claiming the earned income tax credit.

ix. Amount of §6694 penalty

- A. First tier penalty (knew or had reason to know) increased to greater of:
 1. \$1,000; or
 2. 50% of the income derived (or to be derived) by the return preparer from the preparation of the return
- B. Second tier penalty (reckless or willful) increased to greater of:
 1. \$5,000; or
 2. 50% of the income derived (or to be derived) by the return preparer from the preparation of the return.
- C. Prop. Regs. §1.6694-1(f) provides guidance on what constitutes the “income derived from an engagement.”
 1. Generally means “all compensation the firm receives or expects to receive with respect to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position(s) taken on the return or claim for refund that gave rise to the understatement.” Preamble to the Prop. Regs.
 2. Should not include pre-transactional advice, as that is not considered part of the return preparation.
- D. Possible referral to Office of Professional Responsibility (OPR).
 1. Prior to issuance of the Prop. Regs. on June 16, 2008, the IRS’ position was that an IRS determination that a preparer penalty applied required an automatic referral to OPR.

- a. See IRM 4.11.55.4.2.2.1 Situations Requiring a Mandatory Referral (01-15-2005) (“When the following penalties are asserted against a practitioner a mandatory referral should be prepared: * * * IRC § 6694(a) - when closed agreed, sustained in Appeals, or closed unagreed without Appeals contact.”)
 - b. Per one-on-one discussion in January 2008 with Michael R. Chesman (head of OPR), despite IRM, automatic referral to OPR was to occur immediately upon assertion of §6694 penalty *without even waiting for Appeals*.
 - c. Contacts with experience with OPR indicate it is staffed with very young attorneys with little or no experience, leading to unpredictable results.
2. The preamble to the Prop. Regs. indicates the IRS has eased off this position:
- a. “In keeping with a balanced enforcement program for tax return preparers, the IRS intends to modify its internal guidance so that a referral by revenue agents to the IRS Office of Professional Responsibility (OPR) will not be per se mandatory when the IRS assesses a tax return preparer penalty under section 6694(a) * * * .”
 - b. “In matters involving non-willful conduct, the IRS will generally look for a pattern of failing to meet the required penalty standards under section 6694(a) before making a referral to OPR, although an egregious conduct subjecting a tax return preparer may also form a basis for a referral to OPR.”
3. Where the §6694 penalty is imposed, OPR is not intended to “stack” monetary penalties on top of that. Preamble to Prop. Regs. (stating that Circular

230 is to be amended accordingly). Query – does this help or hurt practitioners? By taking that option away from OPR, it may increase the likelihood that it will seek a suspension remedy, which practitioners generally would not prefer.

4. OPR plans to publish specific violations of Circular 230. Announcement 2008-50. The publication will be more frequent (than the traditional quarterly format) and will be in both the Internal Revenue Bulletin and Cumulative Bulletin.
- x. Definition of Nonsigning Preparer. A “Nonsigning Preparer” is any preparer who is not a signing preparer but who prepares all or a *substantial portion* of a return or claim for refund *with respect to events that have occurred at the time the advice is rendered.* Prop. Regs. §301.7701-15(b)(2) (emphasis added).
- xi. Substantial Portion.
- A. General rule – facts and circumstances. Whether a schedule, entry, or other portion of a return or claim for refund is a *substantial portion* is determined by comparing the length and complexity of, and the tax liability or refund involved in, that portion to the length and complexity of, and tax liability or refund involved in, the return or claim for refund as a whole. Prop. Regs. §301.7701-15(b)(2) and (3) (emphasis added).
 - B. De minimus exception. Prop. Regs. §301.7701-15(b)(3)(ii). Not a “substantial portion” if the item giving rise to the understatement is less than:
 1. \$10,000; or
 2. \$400,000 – if
 - a. The item is also less than 20% of the taxpayer’s gross income; or
 - b. Where the taxpayer is an individual, where the item is less than the individual’s entire adjusted gross income.
 3. The de minimus exception does not apply for signing tax return preparers.
 - C. Five Percent Solution. Prop. Regs. §301.7701-15(b)(2).

1. “[T]ime spent on advice that is given after events have occurred that represents less than 5 percent of the aggregate time incurred by such individual with respect to the position(s) giving rise to the understatement shall not be taken into account.”
 2. Per the preamble to the Prop. Regs.: “The Treasury Department and IRS believe that this less than 5 percent test will encourage tax professionals who principally rendered advice regarding events that had not yet occurred to provide follow-up advice requested by a taxpayer without the concern that, by providing such advice to a taxpayer, the advisor would become a tax return preparer.”
 3. Effect – if more than 95% of the advisor’s work was pre-closing transactional work (and not on how it was to be reported, or other post-closing advice), then the Five Percent Solution applies.
- D. Nonsigning preparers are generally subject to the preparer penalty regime – see below re- exception where adequate warning is provided to taxpayer of obligation to disclose.
- xii. Exceptions to the Preparer Penalty -- §6694(a)(2)(C), §6694(a)(3)
- A. Disclosure.
1. Prop. Regs. §1.6694-2(c)(3) -- no First Tier preparer penalty (knew or had reason to know) if BOTH:
 - a. the position is disclosed as provided in §6662(d)(2)(B)(ii);
 - b. the position has a reasonable basis.
 - c. **Note – the Bailout Bill removes the disclosure alternative for tax shelters and reportable transactions.**
 2. **Required disclosure to protect signing preparer.** Prop. Regs. §1.6694-2(c)(3) – Where MLTN standard not otherwise met (substantial authority if

not a tax shelter or reportable transaction)⁶, five alternatives:

- a. Actual filed disclosure on Form 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement), or on tax return but only if compliant with Regs. §1.6662-4(f)(2).⁷
- b. For income tax returns, if preparer provides taxpayer with prepared return containing disclosure satisfying 2.a. above.⁸
 - i. Note: this solves the “rogue taxpayer” concern that pre-dated Notice 2008-13 (what if the taxpayer doesn’t follow advice to disclose, and pockets the provided disclosure?)
 - ii. However, there cannot be a “winky wink” understanding between the preparer and taxpayer that the disclosure will not be submitted – that implicates willfulness (and possibly worse).
- c. For income tax returns, if the position (other than tax shelter or reportable transaction) has substantial authority, if the preparer:
 - i. “[A]dvises the taxpayer of all the penalty standards applicable to the taxpayer under section 6662.”
 - ii. The “preparer must also contemporaneously document the advice in the tax return preparer’s files.”

⁶ As noted earlier, the Prop. Regs. predate the lowering of the preparer standard from MLTN to substantial authority in the 2008 Bailout Bill. Presumably updated guidance will make the corresponding change for these disclosure rules.

⁷ As noted above – no longer available for tax shelters or reportable transactions.

⁸ As noted above – no longer available for tax shelters or reportable transactions.

- d. If the position is a tax shelter or a reportable transaction:
 - i. Preparer must have a reasonable belief that the treatment was MLTN.
 - iii. Disclosure will not protect the preparer from a §6694 penalty, absent any post-Bailout Bill technical corrections.
 - iv. Until further guidance, it is unclear whether a “speech” to the taxpayer helps.
 - v. The only other “out” left is §6694(a)(3) (reasonable cause – see later in outline).
 - e. For returns or claims potentially subject to the §6662 penalties (other than substantial understatement), the preparer advises the taxpayer of the penalty standards applicable under §6662, and contemporaneously documents the advice in the preparer’s files.
 - f. Query – because the “speech” defenses require contemporaneous documentation:
 - i. How does preparer provide those to IRS if they assert preparer penalty? Can the client block that release under the attorney-client (or other) privilege?
 - ii. To what extent does this approach create an implicit conflict between advisor and client?
 - iii. Practitioners differ on whether this forces preparers into conservative positions to avoid that conflict.
3. Sufficient disclosure to protect **nonsigning** preparers. Prop. Regs. §1.6694-2(c)(3)(ii). Where MLTN standard (substantial authority if not a tax

shelter or reportable transaction) not otherwise met, three alternatives:

- a. Actual filed disclosure on Form 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement), or on tax return but only if compliant with Regs. §1.6662-4(f)(2).⁹
 - b. Where advice is to taxpayers, preparer advises taxpayer “of any opportunity to avoid penalties under section 6662 that could apply to the position, if relevant, and of the standards for disclosure to the extent applicable.”¹⁰ The preparer must also contemporaneously document the advice in their files. Prop. Regs. §1.6694-2(c)(3)(ii)(A).
 - c. Where advice is to another preparer, the nonsigning preparer “advises the other tax return preparer that disclosure under section 6694(a) may be required.”¹¹ The preparer must also contemporaneously document the advice in their files. Prop. Regs. §1.6694-2(c)(3)(ii)(B).
4. Requirements for advice. Prop. Regs. §1.6694-2(c)(3)(iii). The “speech” (advice) disclosure exceptions must meet certain requirements.
- a. “The advice to the taxpayer with respect to each position * * * must be particular to the taxpayer and tailored to the taxpayer’s facts and circumstances.”
 - b. “There is no general pro forma language or special format required for a tax return preparer to comply with these rules. No form of a general boilerplate disclaimer,

⁹ Disclosure is no longer an “out” for tax shelters or reportable transactions, barring any post-Bailout Bill technical corrections.

¹⁰ Post-Bailout Bill, it is unclear if “speeches” to taxpayers or advisors is any help in avoiding the preparer penalties, if the position relates to a “tax shelter” or reportable transaction.

¹¹ Post-Bailout Bill, it is unclear if “speeches” to taxpayers or advisors is any help in avoiding the preparer penalties, if the position relates to a “tax shelter” or reportable transaction.

however, is sufficient to satisfy these standards.”

- c. Pass-through entities – Prop. Regs. §1.6694-2(c)(3)(iv). Disclosure given to the entity (e.g., partnership) is sufficient – it need not be given to each flow-through owner.

C. Reasonable cause exception - §6694(a)(3) – facts and circumstances test. Prop. Regs. §1.6694-2(d). Factors include:

- (1) Nature of the error causing the understatement. Whether the error resulted from a provision that was so complex, uncommon, or highly technical that a competent preparer of returns or claims of the type at issue reasonably could have made the error.
- (2) Frequency of errors.
- (3) Materiality of errors. Whether the understatement was material in relation to the correct tax liability.
- (4) Preparer's normal office practice. Whether the preparer's normal office practice, when considered together with other facts and circumstances such as the knowledge of the preparer, indicates that the error in question would rarely occur and the normal office practice was followed in preparing the return or claim in question.
- (5) Reliance on advice of another preparer. Whether the preparer relied on the advice of or schedules prepared by (“advice”) another preparer.

A. Advice must be from

- i. 3rd party not from the same firm as the preparer, and

- ii. Someone who the preparer had reason to believe was competent to provide the advice
- iii. Someone preparer has reason to believe has all relevant facts

- B. The advice can be written or oral;
- C. However, preparer has the burden of proving the advice was received.
- D. Note – 3rd party advisor *does* become a nonsigning preparer by virtue of providing this advice, apparently even if to another nonsigning preparer.

- (6) Reliance on generally accepted administrative or industry practice.
Whether the preparer reasonably relied in good faith on generally accepted IRS administrative or industry practices in taking the position.

xi. Miscellaneous observations:

- A. Is there any conflict of interest having return preparer represent taxpayer on audit when IRS challenges the return? If past performance is any indication, IRS will over-assert the penalty, and let it be bargained away (despite contrary pronouncements). Will IRS threaten to uphold penalty against preparer if he/she doesn't concede some/all of taxpayer's case?
- B. One commentator suggested the following language be included in all correspondence to clients, to help avoid non-signing preparer liability: *"if any advice is below the "more likely than not" standard, the taxpayer should disclose the position on a Form 8275."* Lipton, "What Hath Congress Wrought? Amended Section 6694 Will Cause Problems for Everyone," J. Tax (RIA Aug. 2007). Note – the Prop. Regs. respond to this with the "no boilerplate" rule.

C. Remaining issues:

1. Once the dust settles from the 2008 Bailout Bill (less than a week old as this outline is being finalized), there will be considerable concern and focus about how to determine whether a transaction is a “tax shelter” or “reportable transaction.”
2. If there is any uncertainty in a given case as to whether a transaction is either, prudence dictates that a preparer/advisor follow the pre-2008 Bailout Bill approach (either reach a reasonable belief of MLTN, or give disclosure or speeches).
3. The standard of conduct in Circular 230 (which provides the rules governing practice before IRS) remains at the pre-Bailout Bill MLTN standard. Hopefully that will be changed to match §6694 – otherwise the same concerns remain that caused the Bailout Bill amendment – taxpayers have a lower standard of conduct than practitioners do to avoid sanctions under Circular 230. The Taxpayer’s Advocate’s Report (IR 2008-4) concludes that this inconsistency creates potential confusion.

xii. **Summary -- “How to” avoid preparer penalty (§6694):**

A. **Signing Preparers** – alternatives (post-Bailout Bill):

1. Substantial authority determination by preparer (if not a “tax shelter” or “reportable transaction”) or MLTN determination by preparer (if a tax shelter or reportable transaction)
 - a. Determination requires contemporaneous documentation in file – practitioner has burden of proof as to having made determination.
 - b. If preparer has reasonable belief position is at MLTN or substantial authority level (as applicable), no speech or disclosure required.

or

2. Reasonable basis, plus one of following:
 - a. Actual disclosure¹² (Form 8275) by taxpayer;
 - b. Preparer prepares and provides taxpayer with disclosure¹³ (Form 8275), with no “winky wink” that taxpayer won’t file it;
 - c. If substantial authority, for income tax returns, advise taxpayer of §6662 standards.
 - d. If tax shelter or reportable transaction,
 - i. If preparer does not reasonably believe position is MLTN, there is currently no clear way to drive the preparer standard any lower.
 - ii. Disclosure does not help post-Bailout Bill;
 - iii. Unclear at this time whether “speeches” help.
 - iv. Possible availability of “reasonable cause” exception (see earlier in outline).
 - e. For returns subject to §6662 (accuracy related penalty) other than substantial understatements, advise taxpayer of §6662 standards.

B. **Nonsigning Preparers** – alternatives:

1. Substantial authority determination by preparer (if not a “tax shelter” or “reportable transaction”) or MLTN determination by preparer (if a tax shelter or reportable transaction)
 - a. Determination requires contemporaneous documentation in file – practitioner has burden of proof as to having made determination.
 - b. If preparer has reasonable belief position is at MLTN or substantial authority level (as applicable), no speech or disclosure required.

¹² Disclosure is no longer an “out” for tax shelters or reportable transactions, barring any post-Bailout Bill technical corrections.

¹³ Disclosure is no longer an “out” for tax shelters or reportable transactions, barring any post-Bailout Bill technical corrections.

or

2. Proper speech¹⁴

a. If advising taxpayer directly:

- i. Reasonable basis; and
- ii. §6662 speech (warn taxpayer about requirements for avoiding penalties; substantial authority).

b. If advising other preparer only:

- i. Reasonable basis; and
- ii. §6664 speech (preparer obligations; warn that §6694 disclosure might be required).

xiii. Examples from Notice 2008-13 [Note – The Prop. Regs. do not appear expressly to state whether these have any continuing relevance. However, as noted below, statements from IRS officials clearly indicate that Example #10 no longer enjoys IRS support. FURTHER NOTE – all of these predate the 2008 Bailout Bill. Accordingly, they should be read in light of the revised language in **Appendix B.**]

- A. Example #1. Preparer prepares Form 8886 (Reportable Transaction Disclosure Statement) but does not prepare the taxpayer's actual tax return and did not advise the client on the transaction. Result: no §6694 penalty.
- B. Example #2. Preparer prepares Form 1065 (partnership return) and Schedules K-1 (flowing losses to partners). Preparer knows that the losses are significant part of at least one partner's liability. Result: potential §6694 penalty, unless MLTN or adequate disclosure and reasonable basis.
- C. Example #3. Attorney advises corporation on tax structuring, and corporation enters into the transaction. No further advice from attorney or anyone in attorney's firm to taxpayer or preparer. Unrelated preparer prepares return. Result: attorney did not prepare a substantial portion of the

¹⁴ Post-Bailout Bill, it is unclear if "speeches" to taxpayers or advisors is any help in avoiding the preparer penalties, if the position relates to a "tax shelter" or reportable transaction.

return; not liable for §6694 penalty.

- D. Example #4. Attorney advises corporation on tax structure and one line entry on corporation's tax return. However, the item is an insignificant portion. Result: attorney did not prepare a substantial portion of the return; not liable for §6694 penalty.
- E. Example #5. Attorney develops "tax avoidance" strategy, and advises 50 taxpayers who implement the strategy and significantly reduce their tax liability. Attorney does not sign or prepare returns. Result: attorney is a non-signing preparer; potentially liable for §6694 penalty.
- F. Example #6. Taxpayer gives preparer a schedule that appears on its face to be correct. Preparer prepares return based on schedule. It later turns out the schedule was wrong. Result: preparer is not required to audit information provided by taxpayer if it appears correct on its face. Preparer is not liable for the §6694 penalty.
- G. Example #7. Company has a defined benefit plan. Preparer relies on actuary's advice on the deduction limit under §404(a)(1)(A). Later, it turns out the actuary was wrong, and part of the contribution exceeded the deduction limit. Result: preparer is not liable for the §6694 penalty, provided preparer reasonably relied on the actuary.
1. Note: analogize this to a Family Limited Partnership valuation / discount appraisal
 2. Compare with an FLP case where the disallowance is due to §2036, rather than the amount of the discount.
- H. Example #8. Taxpayer tells preparer he made a charitable contribution of real estate worth \$50,000, but in fact did not. Preparer does not ask for a qualified appraisal, and does not complete the required Form 8283 (substantiation requirements). Result: preparer is potentially liable for the §6694 penalty.
- I. Example #9. Preparer handled taxpayer's prior years' tax returns, but later learns that taxpayer failed to provide a 1099 for a bank account. On learning of that omission, preparer asks for and obtains the 1099 for the current year,

and files accordingly. Result: preparer is not liable for the §6694 penalty for the prior years – he had no reason to know of the missing 1099.

- J. Example #10. [OBSOLETE BY ISSUANCE OF PROPOSED REGULATIONS – LEFT HERE FOR ILLUSTRATION]
1. Preparer spots issue on taxpayer’s expensing of various items. Preparer researches, and determines there is a reasonable basis, but cannot reach a MLTN standard because “*it was impossible to make a precise quantification regarding whether the position would be more likely than not on the merits.*” Preparer signs the return, and the position is not disclosed on the return. The IRS later disagrees with the position. Result: preparer is not liable for the §6694 penalty.
 2. IRS has announced in advance of release of pending Proposed Regulations that “*The much-loved example 10 in the Notice did not live; it died a very glorious death.*” Comments on May 9, 2008 of Deborah Butler, IRS Associate Chief Counsel for Procedure and Administration to Administrative Practice session of the American Bar Association Section of Taxation.
- K. Example #11. Preparer believes corporate taxpayer’s proposed return position is not MLTN, but believes it has substantial authority. Preparer advises corporation of the differing standards and disclosure opportunities. Corporation files the return without disclosing, based on substantial authority exception to accuracy-related penalty in §6662(d)(1)(B)(i). IRS later disagrees with the position. Result: preparer is not liable for the §6694 penalty.
- L. Example #12. Attorney advises large corporation in writing on proper treatment of complex and substantial entries on corporation’s tax return. Attorney concludes one position is not MLTN and also does not have substantial authority, but does have reasonable basis. Attorney contemporaneously advises corporation, in writing, that the position lacks substantial authority and that corporation will be subject to accuracy-related penalties unless a disclosure statement is included in the return. Corporation

decides not to disclose. Neither attorney nor her firm signs the return. Results: (a) attorney is a non-signing preparer, but (b) is not liable for the §6694 penalty.

II. Circular 230

A. Background.

1. Circular 230 is a set of regulations which govern practice before the IRS. Many tax shelter investors felt “burned” by tax opinions which are misleading as to the protection they offer and/or where the opinion writer does not disclose its financial stake in the transaction. See, e.g., Illes v. Commissioner, 982 F.2d 163 (6th Cir. 1992) and Neonatology Associates v. Commissioner, 299 F.3d 221 (3rd Cir. 2002), where taxpayers were not allowed to reasonably rely on professional advice from a tax advisor who had a financial stake in the transaction.
2. Circular 230 applies to lawyers, accountants, and any other tax professionals (e.g., return preparers, enrolled agents, etc.) who practice before the IRS.

B. 31 CFR (Circular 230) § 10.34 – Standards with respect to tax returns and documents, affidavits and other papers.

1. Current rules
 - a. Practitioner may not advise filing anything with IRS:
 - i. The purpose of which is to delay or impede the administration of the Federal tax laws;
 - ii. That is frivolous; or
 - iii. That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.
 - b. Practitioner must inform a client of any penalties that are reasonably likely to apply to the client with respect to a position taken on a tax return if—
 - i. The practitioner advised the client with respect to the position; or
 - ii. The practitioner prepared or signed the tax return.

- c. Practitioner also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.
- d. Practitioner generally may rely in good faith without verification upon information furnished by the client, but may not ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

2. **Proposed Circular 230 Regulations Issued September 26, 2007 (72 FR 54621) –**

- a. Revises requirements **before practitioner can sign a tax return or advise on a tax return position:**
- b. Practitioner must meet one of two tests:
 - i. Have **reasonable belief** that the tax treatment of each position on the return would **more likely than not**¹⁵ be sustained on its merits; **or**
 - ii. Both
 - A. Each position on return has a reasonable basis; and
 - B. Is in fact adequately disclosed to the IRS.
- c. Effective when Regs. are finalized, but no earlier than January 1, 2008.
- d. It appears a non-signing practitioner would qualify under the new rules only if:
 - i. The taxpayer actually discloses adequately (regardless of whether practitioner advises the disclosure);
 - ii. The advisor believes the position meets the more likely than not standard; or
 - iii. The advisor counsels against the taxpayer taking the position.

¹⁵ Presumably (hopefully?) this will be changed in light of changes made in the 2008 Bailout Bill – see **Appendix B**.

- e. Who Really Knows? How does a practitioner know whether something is more likely than not to prevail where the inquiry is primarily factual. Examples:
 - i. Whether property is held primarily for investment.
 - ii. Transfer pricing.

- f. The Rebellious Client – what happens if the return preparer advises a position and/or disclosure, sends the return to the taxpayer for filing, and the taxpayer revises it to be self-prepared and changes the position and/or fails to include the disclosure? Presumably, the return preparer would be protected if he/she can show a copy of the package sent to the taxpayer for filing.

- g. Circular 230 is broader than Code §6694 (Preparer Penalty):
 - i. Preparer penalty applies only where a preparer was involved in a “substantial portion” of the return; whereas

 - ii. Circular 230 applies where a preparer was involved in any portion of a return. See 5/22/08 comments of Thomas Kane, Special Counsel to IRS Chief Counsel, made at Federal Bar Association’s 20th Annual Insurance Tax Seminar – 2008 TNT 101-7.

3. Monetary (and Other) Penalties for Violations of Circular 230.

- a. Background. American Jobs Creation Act of 2004 (AJCA 2004) amended 31 USC §300 (the enabling legislation for Circular 230, allowing the regulation of practice before the IRS) to allow for monetary penalties to be imposed on a practitioner.

- b. Statutory causes for monetary penalties:
 - i. Is incompetent;
 - ii. Is disreputable;
 - iii. Violates Circular 230; or
 - iv. Willfully and knowingly misleads or threatens represented parties, or a prospective party with an intent to defraud.

- c. Incompetent or disreputable conduct – Circular 230, Section 10.51 and 10.52
 - i. Conviction of a tax offense;
 - ii. Conviction of an offense involving dishonesty or breach of trust;

- iii. Conviction of any felony under federal or state law that renders the practitioner unfit to practice before the IRS;
 - iv. Willfully failing to make federal tax returns;
 - v. Willfully evading, attempting to evade, or participating in any way in the evading or attempted evasion of any assessment or payment of any federal tax;
 - vi. Knowingly counseling or suggesting to a client an illegal plan to evade federal taxes or the payment thereof;
 - vii. Contemptuous conduct:
 - A. Use of abusive language;
 - B. Making false accusations;
 - C. Circulating or publishing malicious or libelous matter;
 - viii. Giving a false tax opinion, knowingly, recklessly or through gross incompetence;
 - ix. Knowingly aiding and abetting another person to practice before the IRS during a period of his or her suspension, disbarment or ineligibility;
 - x. Willfully failing to sign a return prepared by a practitioner when such a signature is required; and
 - xi. Willfully disclosing tax return information.
- d. Maximum amount of penalty:
- i. General rule – maximum penalty is the income the practitioner derived from the prohibited conduct. 31 USC §300.
 - ii. If the conduct is part of a larger engagement, the maximum penalty is the income the practitioner derived from the entire engagement. Notice 2007-39.
 - iii. Less than the maximum may be imposed based on:
 - A. The culpability of the violating practitioner or his/her employer or firm;
 - B. The extent of the duty owed to the client;
 - C. The actual harm done to the client; or
 - D. Other mitigating factors, including whether the practitioner, employer or firm:
 - 1. Took prompt action to correct the noncompliance;
 - 2. Promptly ceased to engage in the prohibited conduct;
 - 3. Attempted to rectify any harm done by the conduct; or

4. Undertook measures to ensure the conduct would not be repeated.
- iv. The IRS is not to impose a penalty where the violation is a minor technical violation with little or no injury to a client or tax administration, the public or tax administration, and with little likelihood of repeated misconduct.
- e. Penalties on firm or employer
 - i. Under AJCA 2004, the IRS can impose penalties on the practitioner's employer or firm when:
 - A. The violating practitioner acts on behalf of the employer or firm; and
 - B. The employer or firm knew, or should have known, of the prohibited conduct.
 - ii. Practitioner is considered to have acted on behalf of an employer or firm if:
 - A. An agency relationship existed between the practitioner and the employer or firm;
 - B. The purpose of the relationship was to provide services in connection with practice before the IRS; and
 - C. The prohibited conduct arose in connection with the agency relationship.
 - iii. Firm or employer is considered to know or have reason to know of the practitioner's conduct if:
 - A. One or more of the principal management or principal officers of the employer or firm or a branch office of the employer or firm knew or had information that would lead a person of similar experience and background to reasonably have known of the prohibited conduct; or
 - B. The employer or firm willfully, recklessly, or with gross indifference did not take reasonable steps to ensure compliance with Circular 230 and a violation

occurred harming a client, the public, or tax administration.

C. Additional factors IRS will consider in whether to penalize firm or employer:

1. Gravity of the misconduct;
2. Any history of noncompliance;
3. The presence of measures meant to prevent noncompliance;
4. Corrective measures taken after discovery of noncompliance.

e. Is it a “hammer”?

- i. In the May 2005 ABA meetings, Cono Namorato, then-director of the IRS’ Office of Professional Responsibility, was confronted by practitioners’ concerns that IRS agents may threaten Circular 230 referrals as leverage in dealings with practitioners (i.e., “settle this case our way, or I’ll see to it your IRS license gets pulled”). He assured practitioners that such threats “would not be tolerated.”
- ii. Note for the complacent – Cono Namorato is no longer with OPR.

III. Recommended reading

- A. Muller, “Determining the Disciplinary Sanction: What Factors the Office of Professional Responsibility Considers in Ethics Enforcement”, *Journal of Tax Prac. & Proc.* p.13 (CCH Dec.2006-Jan.2007)
- B. Coustan, “Circular 230 Monetary Penalties – Notice 2007-39”, *Journal of Tax Prac. & Proc.* p.7 (CCH June-July 2007)
- C. Dellinger and Lassar, “The New Tax Preparer (and Advisor) Penalty Standards Under Code Sec. 6694: A More (or Less) Likely Than Not World”, *Journal of Tax Prac. & Proc.* p.29 (CCH Aug.-Sept. 2007).
- D. For a good, plain English article on the impact of Circular 230 on estate planners (though written prior to the Prop. Regs.), see Choate, “How I Will Comply with Circular 230,” page 22 of the July 2005 issue of *Trusts & Estates* magazine.
- E. Milton, *Paradise Lost* (1795). Read it for free -- see http://books.google.com/books?id=MKkDAAAQAAJ&dq=milton+%22paradise+lost%22&pg=PP1&ots=nHfXy4bBY9&sig=BxSfx65aot_nxvJSXTgiLRuwQ

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Appendix A

Code §6694 (Preparer Penalty) §7701(a)(36) (Definition of Preparer) [PRIOR TO BAILOUT BILL AMENDMENT]

§ 6694 Understatement of taxpayer's liability by tax return preparer.

(a) Understatement due to unreasonable positions.

[*** SEE Appendix B for 2008 amendment and effective date ***]

(1) In general.

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

(A) 1,000, or

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

(2) Unreasonable position.

A position is described in [this paragraph](#) if—

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

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

(C)

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

(ii) there was no reasonable basis for the position.

(3) Reasonable cause exception.

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

(b) Understatement due to willful or reckless conduct.

(1) In general.

Any tax return preparer who prepares any return or claim for refund with respect

to which any part of an understatement of liability is due to a conduct described in [paragraph \(2\)](#) shall pay a penalty with respect to each such return or claim in an amount equal to the greater of—

(A) \$5,000, or

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

(2) Willful or reckless conduct.

Conduct described in this paragraph is conduct by the tax return preparer which is—

(A) a willful attempt in any manner to understate the liability for tax on the return or claim, or

(B) a reckless or intentional disregard of rules or regulations.

(3) Reduction in penalty.

The amount of any penalty payable by any person by reason of [this subsection](#) for any return or claim for refund shall be reduced by the amount of the penalty paid by such person by reason of [subsection \(a\)](#).

(c) Extension of period of collection where preparer pays 15 percent of penalty.

(1) In general.

If, within 30 days after the day on which notice and demand of any penalty under [subsection \(a\)](#) or [\(b\)](#) is made against any person who is a tax return preparer, such person pays an amount which is not less than 15 percent of the amount of such penalty and files a claim for refund of the amount so paid, no levy or proceeding in court for the collection of the remainder of such penalty shall be made, begun, or prosecuted until the final resolution of a proceeding begun as provided in [paragraph \(2\)](#). Notwithstanding the provisions of [section 7421\(a\)](#), the beginning of such proceeding or levy during the time such prohibition is in force may be enjoined by a proceeding in the proper court. Nothing in this paragraph shall be construed to prohibit any counterclaim for the remainder of such penalty in a proceeding begun as provided in [paragraph \(2\)](#).

(2) Preparer must bring suit in district court to determine his liability for penalty.

If, within 30 days after the day on which his claim for refund of any partial payment of any penalty under [subsection \(a\)](#) or [\(b\)](#) is denied (or, if earlier, within 30 days after the expiration of 6 months after the day on which he filed the claim for refund), the tax return preparer fails to begin a proceeding in the appropriate United States district court for the determination of his liability for such penalty, [paragraph \(1\)](#) shall cease to apply with respect to such penalty, effective on the day following the close of the applicable 30-day period referred to in [this paragraph](#).

(3) Suspension of running of period of limitations on collection.

The running of the period of limitations provided in [section 6502](#) on the collection by levy or by a proceeding in court in respect of any penalty described in

[paragraph \(1\)](#) shall be suspended for the period during which the Secretary is prohibited from collecting by levy or a proceeding in court.

(d) Abatement of penalty where taxpayer's liability not understated.

If at any time there is a final administrative determination or a final judicial decision that there was no understatement of liability in the case of any return or claim for refund with respect to which a penalty under [subsection \(a\)](#) or [\(b\)](#) has been assessed, such assessment shall be abated, and if any portion of such penalty has been paid the amount so paid shall be refunded to the person who made such payment as an overpayment of tax without regard to any period of limitations which, but for this subsection, would apply to the making of such refund.

(e) Understatement of liability defined.

For purposes of [this section](#), the term "understatement of liability" means any understatement of the net amount payable with respect to any tax imposed by this title or any overstatement of the net amount creditable or refundable with respect to any such tax. Except as otherwise provided in [subsection \(d\)](#), the determination of whether or not there is an understatement of liability shall be made without regard to any administrative or judicial action involving the taxpayer.

(f) Cross reference.

For definition of tax return preparer, see [section 7701\(a\)\(36\)](#).

§ 7701 Definitions.

* * *

(36) Tax return preparer.

(A) In general. The term " tax return preparer" means any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by this title or any claim for refund of tax imposed by this title. For purposes of the preceding sentence, the preparation of a substantial portion of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund.

(B) Exceptions. A person shall not be an " tax return preparer" merely because such person—

(i) furnishes typing, reproducing, or other mechanical assistance,

(ii) prepares a return or claim for refund of the employer (or of an officer or employee of the employer) by whom he is regularly and continuously employed,

(iii) prepares as a fiduciary a return or claim for refund for any person, or

(iv) prepares a claim for refund for a taxpayer in response to any notice of deficiency issued to such taxpayer or in response to any waiver of restriction after the commencement of an audit of such taxpayer or another taxpayer if a determination in such audit of such other taxpayer directly or indirectly affects the tax liability of such taxpayer.

Appendix B
October 2008 Amendment
to
Code §6694 (Preparer Penalty)
§7701(a)(36) (Definition of Preparer)

[BAILOUT BILL AMENDMENT]

H.R. 1424

Resolved, That the bill from the House of Representatives (H.R. 1424) entitled ` An Act to amend section 712 of the Employee Retirement Income Security Act of 1974, section 2705 of... (Engrossed Amendment as Agreed to by Senate)

SEC. 506. MODIFICATION OF PENALTY ON UNDERSTATEMENT OF TAXPAYER'S LIABILITY BY TAX RETURN PREPARER.

(a) In General- Subsection (a) of section 6694 is amended to read as follows:

`(a) Understatement Due to Unreasonable Positions-

`(1) IN GENERAL- If a tax return preparer--

`(A) prepares any return or claim of refund with respect to which any part of an understatement of liability is due to a position described in paragraph (2), and

`(B) knew (or reasonably should have known) of the position,

such tax return preparer shall pay a penalty with respect to each such return or claim in an amount equal to the greater of \$1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

`(2) UNREASONABLE POSITION-

`(A) IN GENERAL- Except as otherwise provided in this paragraph, a position is described in this paragraph unless there is or was substantial authority for the position.

`(B) DISCLOSED POSITIONS- If the position was disclosed as provided in section 6662(d)(2)(B)(ii)(I) and is not a position to which subparagraph (C) applies, the position is described in this paragraph unless there is a reasonable basis for the position.

`(C) TAX SHELTERS AND REPORTABLE TRANSACTIONS- If the position is with respect to a tax shelter (as defined in section 6662(d)(2)(C)(ii)) or a reportable transaction to which section 6662A applies, the position is described in this paragraph unless it is reasonable to believe that the position would more likely than not be sustained on its merits.

`(3) REASONABLE CAUSE EXCEPTION- No penalty shall be imposed under this subsection if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith.'

- (b) Effective Date- The amendment made by this section shall apply--
- (1) in the case of a position other than a position described in subparagraph (C) of section 6694(a)(2) of the Internal Revenue Code of 1986 (as amended by this section), to returns prepared after May 25, 2007, and
 - (2) in the case of a position described in such subparagraph (C), to returns prepared for taxable years ending after the date of the enactment of this Act.

Appendix C

Excerpts from LMSB Memorandum **For Field Examiners** **On Preparer Penalty Audits**

[For full text (13pp) see 2008 TNT 85-8]

C. Gather Pertinent Information from Audit

Each income tax examination is separate and distinct from the return preparer violation case relating to the income tax examination. Therefore, examiners will not propose or discuss conduct penalties per se in the presence of the taxpayer.

The Interview

Interviews of the taxpayer should serve a dual purpose: 1) to further the tax examination and 2) to identify violations by a tax return preparer. During the initial interview and throughout the examination process, the examiner should ask questions regarding the return preparation as appropriate to the case and issues being developed.

Whether through the interview process or other documentation, the examiner will need to determine whether tax violations may have been committed by a person who for compensation prepared all or a substantial portion of a return.

Questions should be tailored to the individual taxpayer and situation. Examples of questions which may be appropriate to a given situation include:

Did you meet with the preparer?

What documentation was provided to the preparer?

Did you receive a copy of the return or claim?

How was the preparer compensated?

Are you aware of any errors, omissions or mistakes on the return under examination?

Did you disclose this transaction on your tax return? Why? Why not?

Were there any concerns about how the transaction was reported? What sort of process is used to address those concerns and on what basis are decisions made?

Was there any discussion regarding potential penalties?

Was there any discussion regarding whether the transaction is subject to disclosure under [Revenue Procedure 94-69](#)?

Disclosure or the lack of disclosure under [Revenue Procedure 94-69](#) impacts the consideration of preparer penalties. If a dubious transaction is disclosed on the tax return, the transaction will have to be more egregious to warrant the imposition of preparer penalties. However, disclosure of the transaction does not in itself prohibit imposition of preparer penalties. There must still be a reasonable basis for the position (effective 5-25-2007). Under prior law (effective to 5-24-2007), the position could not be frivolous.

When interviewing the taxpayer or preparer ask if any other services are provided by the preparer's firm and how long the preparer has been preparing returns for the taxpayer? These simple questions will give you an idea of the extent of the preparer's knowledge regarding the taxpayer's financial situation/status and alert you as to the applicability of penalties. A tax return preparer who has been preparing a client's return for a number of years is more knowledgeable than a firm that is preparing a client's return for the first time.

Appendix D

Proposed Regulations – Circular 230

*72 FR 54621, **

FEDERAL REGISTER

Vol. 72, No. 186

Proposed Rules

DEPARTMENT OF THE TREASURY

Office of the Secretary of the Treasury

31 CFR Part 10

[REG-138637-07]

RIN 1545-BH01

Regulations Governing Practice Before the Internal Revenue Service

72 FR 54621

DATE: Wednesday, September 26, 2007

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed modifications of the regulations governing practice before the IRS (Circular 230). These proposed regulations affect individuals who practice before the IRS. The proposed amendments modify § 10.34 of Circular 230 relating to standards with respect to tax returns.

DATES: Written or electronic comments and requests for a public hearing must be received by October 26, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-138637-07), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-138637-07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically via the Federal eRulemaking Portal at <http://www.regulations.gov> (IRS REG-138637-07).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Matthew S. Cooper at (202) 622-4940; concerning submissions of comments and request for a public hearing, Kelly Banks of the Publications and Regulation Branch at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

This document contains proposed amendments to § 10.34 of Circular 230. [Section 330 of title 31 of the United States Code](#) authorizes the Secretary of the Treasury to regulate the practice of representatives before the Treasury Department. Pursuant to section 330 of title 31, the Secretary has published the regulations in Circular 230 (31 CFR part 10).

On May 25, 2007, the President signed into law the Small Business and Work Opportunity Tax Act of 2007, [Public Law 110-28 \(121 Stat. 190\)](#), which amended several provisions of the Internal Revenue Code to extend the application of the income tax return preparer penalties to all tax return preparers, alter the standards of conduct that must be met to avoid imposition of the penalties for preparing a return that reflects an understatement of liability, and increase applicable penalties. On June 11, 2007, the IRS released [Notice 2007-54, 2007-27 IRB 1](#) (see § 601.601(d)(2)(ii)(b)), providing guidance and transitional relief for the return preparer provisions under [section 6694 of the Internal Revenue Code](#), as recently amended.

Final regulations are, simultaneously to these proposed regulations, being promulgated on September 26, 2007 modifying the general standards of practice before the IRS under Circular 230. Those final regulations finalize the standards with respect to documents, affidavits and other papers as proposed, with modifications. Those final regulations, however, do not finalize the standards with respect to tax returns under § 10.34(a) and the definitions under § 10.34(e) because of the amendments made by the Small Business and Work Opportunity Tax Act of 2007. Rather, the Treasury Department and the IRS are reserving § 10.34(a) and (e) in those final regulations and are simultaneously issuing this notice of proposed rulemaking proposing to amend this part to reflect these recent amendments to the Code.

The Treasury Department and the IRS have determined that the professional standards under § 10.34 of Circular 230 should conform with the civil penalty standards for return preparers. Previously, for example, on June 20, 1994 ([59 FR 31523](#)), the regulations were modified to reflect more closely the rules under section 6694 and professional guidelines. The standards with respect to tax returns in § 10.34(a) of these proposed regulations have been amended to reflect changes to [section 6694\(a\) of the Internal Revenue Code](#) made by the Small Business and Work Opportunity Tax Act of 2007.

Under § 10.34(a) of these proposed regulations, a practitioner may not sign a tax return as a preparer unless the practitioner has a reasonable belief that the tax treatment of each position on the return would more likely than not be sustained on its merits, or there is a reasonable basis for each position and each position is adequately disclosed to the Internal Revenue Service. A practitioner may not advise a client to take a position on a tax return, or prepare the portion of a tax return on which a position is taken, unless: (1) The practitioner has a reasonable belief that the position satisfies the more likely than not standard; or (2) the position has a reasonable basis and is adequately disclosed to the Internal Revenue Service. The definitions of "more likely than not" and "reasonable basis" under § 10.34(e) also are proposed to be amended to reflect these changes in accordance with the well-established definitions of these terms under the section 6662 penalty regulations.

On June 11, 2007, the IRS released [Notice 2007-54, 2007-27 IRB 1](#) (see § 601.601(d)(2)(ii)(b)), providing guidance and transitional relief for the return preparer provisions under section 6694 of the Code, as recently amended. In order to apply § 10.34 of these regulations consistently with the transitional relief under [Notice 2007-54](#), § 10.34(a) and (e) are proposed to apply to returns filed or advice provided on or after the

date that final regulations are published in the **Federal Register**, but no earlier than January 1, 2008.

Proposed Effective Date

These regulations are proposed to apply to returns filed or advice provided on or after the date that final regulations are published in the **Federal Register**, but no earlier than January 1, 2008.

* * *

Drafting Information

The principal author of these regulations is Matthew S. Cooper of the Office of the Associate Chief Counsel (Procedure and Administration).

List of Subjects in 31 CFR Part 10

Accountants, Administrative practice and procedure, Lawyers, Reporting and recordkeeping requirements, Taxes.

Proposed Amendments to the Regulations

Accordingly, 31 CFR part 10 is proposed to be amended to read as follows:

PART 10--PRACTICE BEFORE THE INTERNAL REVENUE SERVICE

Paragraph 1. The authority citation for 31 CFR part 10 continues to read as follows:

Authority: Sec. 3, [23 Stat. 258](#), secs. 2-12, [60 Stat. 237](#) et seq.; [5 U.S.C. 301](#), [500](#), [551-559](#); [31 U.S.C. 321](#); [31 U.S.C. 330](#); Reorg. Plan No. 26 of 1950, [15 FR 4935](#), [64 Stat. 1280](#), 3 CFR, 1949-1953 Comp., p. 1017.

Paragraph 2. Section 10.34(a) and (e), and paragraph (f) is revised to read as follows:

§ 10.34 Standards with respect to tax returns and documents, affidavits and other papers.

(a) *Tax returns.* A practitioner may not sign a tax return as a preparer unless the practitioner has a reasonable belief that the tax treatment of each position on the return would more likely than not be sustained on its merits (the more likely than not standard), or there is a reasonable basis for each position and each position is adequately disclosed to the Internal Revenue Service. A practitioner may not advise a client to take a position on a tax return, or prepare the portion of a tax return on which a position is taken, unless--

(1) The practitioner has a reasonable belief that the position satisfies the more likely than not standard; or

(2) The position has a reasonable basis and is adequately disclosed to the Internal Revenue Service.

* * * * *

(e) *Definitions.* For purposes of this section--

(1) *More likely than not.* A practitioner is considered to have a reasonable belief that the tax treatment of a position is more likely than not the proper tax treatment if the practitioner analyzes the pertinent facts and authorities, and based on that analysis reasonably concludes, in good faith, that there is a greater than fifty-percent likelihood that the tax treatment will be upheld if the IRS challenges it. The authorities described in [26 CFR 1.6662-4\(d\)\(3\)\(iii\)](#), or any successor provision, of the substantial understatement penalty regulations may be taken into account for purposes of this analysis.

(2) *Reasonable basis.* A position is considered to have a reasonable basis if it is reasonably based on one or more of the authorities described in [26 CFR 1.6662-4\(d\)\(3\)\(iii\)](#), or any successor provision, of the substantial understatement penalty regulations. Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. The possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account.

(3) *Frivolous.* A position is frivolous if it is patently improper.

(f) *Effective/applicability date.* Section 10.34(a) and (e) is applicable for returns filed or advice provided on or after the date that final regulations are published in the **Federal Register**, but no earlier than January 1, 2008.