The Proposed Preparer Penalty Regulations: The Good, the Bad and the Ugly

By Kip Dellinger

Kip Dellinger examines the proposed preparer penalty regulations.

They're heerrre! The Treasury and the IRS finally issued the long-awaited proposed regulations[1] that address the new penalty regime of Code Sec. 6694, as amended by the Small Business and Work Opportunity Tax Act of 2007.[2]

The proposed regulations contain a lengthy preamble that provides a fairly comprehensive discussion of the history of the preparer penalty regime that came into existence in the Tax Reform Act of 1976[3] and was significantly amended in the Omnibus Budget Reconciliation Act of 1989.[4] The substantive proposals incorporate much of the predecessor concepts with regard to the definitions and operation of the preparer penalty provisions, modify some of the former rules and add certain concepts—both to address the new penalty amounts as well as a new, expanded concept of who is a signing preparer. Depending on a particular tax professional's (or group of tax professional's) perspective, the proposals contain some good aspects, some bad ones and others that might characterized by some as just plain ugly (*see* Exhibit A for the Table of Contents of the proposed preparer penalty regulations).[5]

Previously the penalty with respect to a "tax treatment of an item" violation was $250; under the new law, it is $1,000 or, if greater, 50 percent of the income derived by the preparer from the preparation of the return that is subject to the penalty.[6]

In addition, the penalty for reckless conduct, a willful attempt to understate a tax liability, or for intentional disregard of rules or regulations—the "second-tier" penalty of Code Sec. 6694—is increased to $5,000 from $1,000 (or 50 percent of the income derived by the preparer from the preparation of the return that is subject to the penalty).[7]

As will be discussed, one of the "good" aspects of the proposals is that the 50-percent calculation may be limited respect to the amount earned attributable to the tax position that gives rise to the penalty; this is dependent on the tax preparer (or firm) furnishing evidence in support of the amounts received attributable to the tax position.

OPR Referrals and Circular 230–Related Monetary Penalties

The Preamble to the proposed regulations contains two comments likely to be of great comfort to tax practitioners.

First, the IRS intends to modify its internal guidance to provide that a referral to the Office of Professional Responsibility by a revenue agent will not be automatic when a penalty is assessed against a tax return preparer for a violation of the tax return position standard set forth in Code Sec. 6694(a) with regard to a tax return preparer who is regulated under Circular 230.[8] Presumably the guidance will be contained in the penalty handbook portion of the Internal Revenue Manual.

Secondly, 31 USC §330 authorizes the Treasury to impose monetary penalties on Circular 230 practitioners for violations of the provisions of the Circular's rules and requirements. The Preamble states that the Treasury and the IRS anticipate that Circular 230 will be revised to state that the IRS "generally" will not stack the Code Sec. 6694 penalties and the monetary penalties.[9]

Kip Dellinger, CPA, is Senior Tax Partner at Kallman And Co. LLP in Los Angeles and current Chair of the AICPA Tax Division Tax Practice Responsibilities Committee. His opinions in this article are his own and do not represent those of the AICPA.

Comment. The preamble's use of the term "generally" appears to indicate that in some circumstances—likely flagrant or egregious violations of Code Sec. 6694—both levels of penalties will be imposed. The preamble, with respect to penalty stacking, refers to Code Sec. 6694 and does not limit the comment to the tax return position subsection; so stacking will also apparently not apply to the Code Sec. 6694(b) provision.[10]

In addition, it is to be noted that the proposed regulations provide that both an individual and the firm that the individual is associated with may be subject to the penalty with regard to a given tax position.[11]

Who Is a Preparer?

The tax return preparer regulations have long provided that the penalty for tax return positions that do not meet certain requirements may be imposed on tax practitioners that physically prepare and sign income tax returns. In addition, tax practitioners that "advise" on income tax return positions when the advice is given with regard to tax return positions that—based on facts and circumstances and with an exception for specific amount—may be subject to the penalty.

The proposed regulations change the approach with respect to who is a tax return preparer; it should also be noted that the Small Business and Work Opportunity Tax Act of 2007 expanded the Code Sec. 6694 penalty regime to include all federal returns rather than merely income tax returns.[12]

Instead of retaining a "one preparer per firm"[13] approach, the proposed regulations adopt a "one preparer per tax position" approach.[14]

Signing Preparers

Under this approach, the preparer that signs a return is generally considered the person subject to the penalty.[15] However, the signing preparer may provide information that another person within the signing preparer's firm was primarily responsible for the tax positions on the return or claim for refund that gives rise to an understatement that generates a preparer penalty.

Observation. The term "understatement" retains its current, broad definition: "If, viewing the return as a whole, there is an understatement of the net amount payable with respect to any imposed by the Internal Revenue Code, or an overstatement of the net amount creditable or refundable with respect to any tax imposed by the Code."[16] Generally, the penalty has not been imposed except where the understatement of tax was of a magnitude that gave rise to a taxpayer accuracy-related penalty for income tax under Code Sec. 6662. The IRS will likely continue this approach; however, the proposed regulations do not require this. For estate and gift tax issues, the preparer penalty will be considered in the event the taxpayer is assessed an accuracy-related penalty under Code Sec. 6662 for valuation misstatement.

At first blush, it appears that the proposals encourage "finger pointing" as to who within a firm was responsible for a tax position that gave rise to a penalty. But the proposals address the reality of today's tax practice where multiple "experts" within a given signing preparer's firm may advise on different aspects of a tax return within their areas of expertise and, in fact, many firms encourage or mandate consultation with experts within a firm.

Comment. This approach also encourages the use of expertise within a firm as opposed to seeking advice from an tax practitioner or another firm not affiliated with signing preparer (or signing preparer's firm) in order for the signing preparer to assert a penalty defense that she relied on an expert (*i.e.*, a nonsigning preparer as currently characterized in the regulations.

Nonsigning Preparers

Signing preparers often rely on tax professionals not associated with their firm for advice rendered with respect to tax positions to be taken on a return, for example, a CPA firm prepares a return which a partner of the firm signs, but the CPA firm partner relies on an opinion from tax legal counsel (*i.e.*, a "nonsigning preparer") with respect to the tax treatment of certain items within the return. Because the proposed regulations provide that members of signing member's firm may be nonsigning preparers, the rules for nonsigning preparers are made the same for all such preparers, whether or not the nonsigning preparer is associated with the signing preparer (including the signing preparer's firm).

Observation. Advice given to a taxpayer prior to completion of a transaction (*i.e.*, "planning advice") is generally not considered "preparation" for a nonsigning preparer unless the advice is again given or reconfirmed in connection with filing of a return.[17] There is an exception that permits up to five percent of the aggregate time spent on the matter to be incurred after the events giving rise to the tax position have occurred.[18] It is to be noted that if the five-percent test is not met, the signing preparer or taxpayer, or both, may rely upon the advice to argue against the penalty under the reasonable cause exception to the penalty that will be discussed below.

The penalty may be imposed on any nonsigning preparer with respect to a tax position for which the nonsigning preparer is responsible.[19] In the case of multiple nonsigning preparers, the person with the overall supervisory authority is the responsible person unless that person provides evidence to the contrary.

A nonsigning preparer is responsible with respect to advising on a tax position if it is attributable to a "substantial portion of a return," which may be a single entry on a return. That determination remains a facts and circumstances test based on the size and complexity of the item relative to the taxpayer's gross income.[20] There is a *de minimis* exception solely for nonsigning preparers: f the item giving to the understatement is (1) less than $10,000, or (2) less than $400,000 if the item is also less than 20 percent of the taxpayer's gross income or, in the case an individual, adjusted gross income.[21]

Preparers of Passthrough Entity Returns

The proposed regulations retain the concept—much to the dismay of many tax practitioners—that the preparer of a passthrough entity tax return may also be considered the preparer of the recipient's passthrough items from the entity (for list of returns for which this rule applies, *see* Exhibit B). Therefore, for example, the preparer of a passthrough entity may be the preparer of the returns of the principal owners in situations even when the preparer does not prepare the principal owners' returns.

Observation. A nonsigning preparer can easily become the preparer of the returns of owners of a passthrough entity with respect to a tax position on which the nonsigning preparer gives advice. For example, a nonsigning preparer (an attorney) gives advice to a partnership to the effect that a very significant real estate exchange qualifies for tax deferral under Code Sec. 1031. The signing preparer relies on such advice in preparing the passthrough entity's return and each partners' K-1. In this situation, the nonsigning preparer is likely the preparer of each partner's income tax return with regard to the Code Sec. 1031 treatment.

Liability of a Firm for the Preparer Penalty

A firm that employs a tax return preparer may also be subject to the preparer penalty when one or more members of the principal management of the firm or particular office participated in or knew of the conduct giving rise to a preparer penalty, the firm failed to provide reasonable and appropriate procedures for review of the tax position giving rise to the penalty or the procedures were knowingly disregarded by the firm through willfulness, recklessness or gross indifference.[22]

Observation. As constructed, the proposed regulations do not place the definition of a preparer in one place and the construct of who is a preparer can appear to be (if not factually the case) somewhat circular in application. Hopefully, the Treasury will consider this issue and attempt to clarify and centralize the definitions in constructing final regulations in this area.

Tax Position: Requirement of "Knowledge of" or "Reason to Know"

A tax preparer is only held responsible for tax positions of which the preparer has knowledge of or a reason to know. This is similar to the prior penalty provision and clearly permits a tax practitioner to rely on information submitted by, or representations of, the taxpayer. This provision is consistent as well with a similar long-standing provision under Circular 230. In addition, the rules have and continue to provide that a tax preparer—when relying on taxpayer information or representations—cannot ignore actual knowledge of inaccuracies or obvious implications that the information is inaccurate or incorrect.[23]

Observation. For example, in providing a tax preparer with information with respect to qualifying replacement property in a Code Sec. 1033 real estate involuntary conversion, the taxpayer lists property that does not meet the requirements for replacement property. The tax preparer cannot ignore the implications of the nonqualifying property. On the other hand, if the preparer explains to the taxpayer the record-keeping requirements of Code Sec. 274 with regard to travel and entertainment expenses and the taxpayer represents that she has complied with the requirement, the preparer can rely upon an amount furnished by the taxpayer, for example, for business meals.

In addition, for purposes of the preparer penalties under Code Sec. 6694, a preparer may rely in good faith without verification upon a tax return previously prepared and filed by a taxpayer or by another return preparer. This permits, for example, a preparer to rely on an original return prepared by a taxpayer or another preparer when filing an amended return or claim for refund. This provision is also subject to the provision that the preparer filing the claim or amended return may not ignore the implications of information furnished to the tax preparer or actually known by the tax preparer.[24]

The proposed regulations provide three examples of the "reliance" provision that are relatively straightforward. Example 3 permits the preparer to rely upon an actuary for determining the deduction for a contribution to a qualified retirement plan, but then points out that while the preparer is not subject to the penalty, the actuary may be subject to the preparer penalty if the advice given by the actuary constitutes a substantial portion of the return.[25]

Confidence Thresholds

The Small Business and Work Opportunity Tax Act of 2007 substantially revised the tax preparer penalties—raising the penalty amounts for reckless conduct and for recommending (or advising on) a position on a tax return that is not "disclosed" if it will not meet a "more likely than not" threshold if challenged by the government (replacing a long-standing threshold of "realistic possibility of success" for nondisclosed positions).[26]

Comment. The accuracy-related penalty standard[27] for the taxpayer continues to require only substantial authority for a nondisclosed tax position on a return, thus creating an environment that will, on occasion but likely not often,[28] place the preparer and the taxpayer in conflict with regard to disclosure. This will only occur in those situations where the preparer believes there is substantial authority for the taxpayer's treatment of an item but the preparer is unable to arrive at a reasonable belief that treatment will more likely than not prevail in an administrative or judicial proceeding. As will be discussed, because the taxpayer in order to obtain the preparer's services might have to disclose a "tax position" for which the taxpayer standard does not otherwise require disclosure, the preparer and taxpayer have the option of allowing the preparer to effectively make disclosure to the taxpayer rather than to the government in satisfaction of the disclosure requirement.

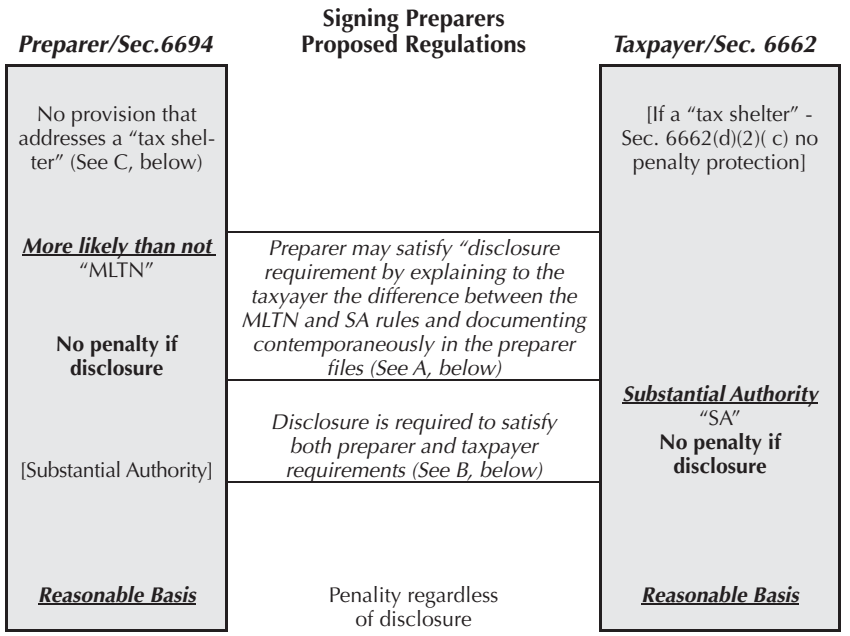
The preparer also now joins the taxpayer in the requirement that—to avoid potential penalties—there must be disclosure of the tax treatment of an item that does not meet the respective more likely than not or substantial authority thresholds and there must be a reasonable basis for the tax treatment of the item. Previously, for the preparer (or advice giver) there was only need that a disclosed position be "not frivolous." (*See* Chart 1, Preparer-Taxpayer Standards Disclosure.)[29]

More Likely Than Not for Nondisclosed Tax Positions Based on Reasonable Belief

For nondisclosed positions, the preparer must a have "reasonable belief" that the position will more likely than not be sustained if challenged. This standard is not entirely new as it has been the required standard for Circular 230 tax shelter–type written advice for the past three years; it has also been the required statutory standard for certain types of tax shelter transactions since at least 1997. It is also the state mandated standard for tax positions on California and New York income tax returns. As explained earlier, the tax preparer must have knowledge of, or a reason to know of, the tax position in the return.

The analysis required to arrive at a conclusion in good faith that a tax position satisfies the more likely than not (MLTN) confidence threshold is the familiar analysis required under the accuracy-

Chart 1. Preparer-Taxpayer Standards Disclosure Chart



Penalty Compliance Rules for Income Tax Returns

A. Proposed regs permits the tax preparer to satisfy the disclosure requirment by actual disclosure in the return on Form 8275, 8275-R, or in accordance with the annual revenue procedure that lists positions "considered disclosed" by virtue completing a tax return.

or

the tax preparer may satisfy the disclosure requirment by advising the taxpayer of the difference between the preparer (MLTN) and taxpayer (SA) disclosure requirements and the preparer contemporaneously documents in the preparer's files that the advice was provided *(in such situations, no disclosure is required)*.

B. Proposed regulations considers the disclosure requirement met if the preparer provides the taxpayer the prepared return containing the required disclosure statement.

C. In the case of a tax shelter, the preparer satisfies any disclosure requirements by advising the taxpayer of the standards applicable to the taxpayer (which is no penalty protection even if disclosed) and the preparer standard (disclosure and a reasonable basis). *No disclosure form is required.*

Non-signing Preparers

D. Advice to Taxpayer: any disclosure requirement is met by informing the taxpayer of the opportunity to avoid penalty by taxpayer disclosure where there is reasonable basis but not SA (non-signing preparer contemporaneous documentation required).

E. Advice to Signing Preparer: disclosure requirement for less than MTLN but where there is reasonable basis by informing the signing preparer of opportunity to avoid penalty by following A-C , above.

Penalty Compliance Rules for Other Tax Returns

For tax returns (or claims for refund) that are subject to Section 8682 penalties other than the substantial understatement penalty of Section 6662(b)(2) and (d), the preparer must advise the taxpayer of the penalty standards applicable to the taxpayer under Section 6662 (e.g. transfer pricing or estate and gift valuation penalties.

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related penalty regulations to insulate a taxpayer from that penalty under the substantial authority test[30] and the authorities the preparer may use to support any conclusion are those set forth in the accuracy-related penalty regulations.[31] Absent other types of authority, the preparer may conclude at MTLN if the position is supported by a well-reasoned interpretation of the applicable statute.[32]

The proposed regulations state that in determining the level of necessary due diligence in a specific situation, the preparer's experience with the area of federal tax involved, the preparer's familiarity with the taxpayer's affairs, and the complexity of the issues and facts will be taken into account in determining if the preparer has erred in analyzing whether the tax position meets the MLTN standard.

Observation. Clearly this due diligence evaluation on the part of IRS is a very subjective approach to assessing a penalty. However, the purpose and intent of the language appears intended to provide relief ("wiggle room") to the practitioner rather than a stick for the IRS to wield against preparers.

The proposed regulations contain four examples of the application of the MLTN standard, three of which are rather straightforward and consistent with the analysis and application of the taxpayer's substantial authority standard.[33]

Comment. Unfortunately, the fourth example, while clearly producing an expected result, fails to address an interesting aspect of the MLTN standard. It basically states that the preparer has reviewed the authorities and found five circuit courts of appeals decisions affecting the identified tax position. Three support the taxpayer's position and two would support a contrary position if taken by the government. In this obvious analysis, the example concludes that the tax preparer's reasonable belief that the more likely than not threshold is met. A far better

example would be to describe a situation where three circuit courts of appeal support the government position, while two support the taxpayer, noting however, that the two favorable opinions address the opposing opinions and that their conclusions are superior in legal analysis and would be confirmed if the case were before the Supreme Court. In such a circumstance, there is every reason to permit a tax professional to arrive at "reasonable belief that the MLTN confidence threshold is met."[34]

Reasonable Basis with Disclosure As the Minimum Confidence Threshold

If a tax position does not reach a MLTN confidence threshold but there is a reasonable basis for the tax treatment chosen by the preparer, then the preparer may take the position if it is disclosed.[35] This is the same standard that applies to taxpayers for the accuracy-related penalty when the taxpayer does not have substantial authority for the tax treatment of an item. Consequently, because Circular 230 and generally best practices requirements have long required the tax preparer to inform the taxpayer of the opportunity to avoid this penalty through disclosure, tax return preparers should be familiar with the reasonable basis standard.[36]

Observation. As mentioned, a conflict arises pertaining to disclosure when the taxpayer has substantial authority for the tax treatment of an item but the tax preparer does not have a reasonable belief that the tax position meets the MLTN standard. In that case, technically the preparer could not sign the return without disclosure and the taxpayer, in order to engage the preparer, would need disclose a position for which the taxpayer otherwise had no obligation to disclose. The proposed regulations retain the solution to this conflict in the same fashion as permitted in the temporary guidance of Notice 2008-13.[37] This is discussed in the next section.

Disclosure Methods

Signing Preparers

Similar to the temporary guidance set forth in Notice 2008-13, the proposed regulations provide that the tax return preparer may satisfy the disclosure requirements by complying with any one of the following options.[38]

For Income Tax Returns

- By disclosure of the position on a properly completed and filed Form 8275 (*Disclosure Statement*) or Form 8275-R (*Regulation Disclosure Statement*), as appropriate, or on the tax return in accordance with annual revenue procedure that provides a list of items considered as disclosed by their inclusion in the tax return[39]
- If the position does not meet the nondisclosed position standard of substantial authority for the taxpayer, the preparer includes in the return the appropriate disclosure statement or discloses pursuant to the annual revenue procedure.
- If the position is supported by substantial authority but the prepare cannot conclude at the more likely than not confidence level, the practitioner may advise the taxpayer of all the penalty standards applicable to the taxpayer under Code Sec. 6662 (accuracy-related penalty). The taxpayer must also contemporaneously document this advice in the tax return preparer's files.

Observation. Presumably the advice to the taxpayer of all the penalty standards is intended to be limited by the term "applicable," so that the preparer does not need to discuss the transfer pricing provisions with an individual taxpayer not engaged in business or the estate and gift valuation misstatement provisions where there is no estate or no gift.

Comment. Essentially, the proposed regulations (consistent with the Temporary Guidance in Notice 2008-13) permit the preparer to effectively fulfill the statutory requirement of "disclosure" of positions that do reach a MTLN confidence threshold by making such disclosure to the taxpayer (and not making it in a filed tax return). This ameliorates the problem that would arise in requiring disclosure in a return to satisfy a tax preparer standard in a situation where the taxpayer would not be required to disclose.

It is also important to note that the proposed regulations (and IRS and Treasury personnel involved with the regulations drafting have made clear in published comments) require the tax preparer to inform the taxpayer with respect to each tax position subject to this method of disclosure and the advice must be particular to the taxpayer and tailored to the taxpayer's facts and circumstances.[40]

For tax return positions involving tax shelter transactions, or listed, or reportable transactions for which there is no specific statutory opportunity to avoid the accuracy-related penalty through disclosure, the tax return preparer may satisfy the disclosure requirement by advising the taxpayer that there must be at a minimum substantial authority for the position, that the taxpayer must have a reasonable belief that the treatment is more likely than not the proper treatment in order to avoid a penalty under the tax shelter, listed or reportable transactions provisions—and the preparer must advise the taxpayer that disclosure will not protect the taxpayer from assessment of an accuracy-related penalty if either the tax shelter, or listed and reportable transactions penalty provisions apply.

For Other Than Income Tax Returns

For returns and claims for refund that are subject to the accuracy-related penalty of Code Sec. 6662 other than the substantial understatement penalty (*e.g.*, estate and gift tax valuation or transfer pricing penalties under those provisions), the tax return preparer must advise the taxpayer of the penalty standards applicable to the taxpayer under the accuracy-related penalty provisions (*e.g.*, the penalties for estate and gift tax valuation misstatements or transfer pricing misstatements).

Nonsigning Preparers

The disclosure standard may be satisfied by disclosure of the position on a properly completed and filed Form 8275 (*Disclosure Statement*) or Form 8275-R (*Regulation Disclosure Statement*), as appropriate, or on the tax return in accordance with annual revenue procedure that provides a list of items considered as disclosed by their inclusion in the tax return.

Other Options

The nonsigning taxpayer has other options (far more likely to be the options selected) depending on whether the advice is given to the taxpayer or given to another tax return preparer (which will usually be the signing preparer.

Advice to Taxpayers[41]

If the nonsigning preparer does not have a reasonable belief in a MLTN confidence level for the tax position, the nonsigning preparer must advise the taxpayer of any opportunity to avoid the accuracy-related penalties, if relevant, that could apply to the position and of any opportunity to avoid those penalties by disclosure—also advising the taxpayer of the applicable standards for disclosure. The preparer must also contemporaneously document the advice in the preparer's files.

Observation. Basically, where substantial authority supports a tax position, the nonsigning preparer is not required to address the penalty issue when advising the taxpayer. Where substantial authority does not exist for the tax position but there is a reasonable basis for the chosen treatment, then the nonsigning preparer is required to inform the taxpayer.

Advice to Another Tax Preparer[42]

If the nonsigning preparer does not have a reasonable belief in a MLTN confidence level for the tax position, the nonsigning preparer must advise the other preparer that disclosure under the preparer penalty provisions of Code Sec. 6694(a) may be required.

Comment. This process effectively puts the other preparer (usually a signing preparer) on notice with regard to the penalties and that other preparer will follow the guidance with respect disclosure and communications with the client. This does not mean that the preparer that receives the advice cannot rely upon the advice to avoid the preparer penalty (reliance is discussed below under reasonable cause).

Passthrough Entities[43]

In the case of a passthrough entity, the disclosure requirement with regard to an item is satisfied if the disclosure requirements for signing or nonsigning preparers, discussed above, occur at the entity level to the appropriate representatives of the entity (*e.g.*, a partnership tax matters partner).

Reasonable Cause Exception to the Preparer Penalty[44]

The proposed regulations provide an exception to the preparer tax return position penalty based on reasonable cause for failure to meet the standards for penalty assessment and conditioned on the preparer having acted in good faith. In reading the proposals in this area, it is apparent that IRS examiners, supervisors and appeal officers will have enormous discretion in evaluating whether or not a penalty should be waived or abated for reasonable cause.

The following are discussed as factors to consider in evaluating reasonable cause the proposed regulations.

- **Nature of the error causing the understatement.** The exception doe not apply to an error that would be apparent from a general review of the return or claim for refund. However, consideration is given to an error resulting from a provision of law that is complex, uncommon or highly technical and a competent tax return preparer could have reasonably made the error with regard to the issue.
- **Frequency of errors.** Exceptions to imposition of the penalty will be considered when the error is isolated—provided it is not flagrant, or so obvious that it would be discovered during a review of the return. No exception will be made, though, where there is a pattern of errors, even where the error that gives rise to the penalty is for a tax position that is isolated with regard to that particular position.
- **Materiality of errors.** The exception generally applies if the understatement of tax is of a relatively immaterial amount.

Observation. Unlike the taxpayer's accuracy-related penalty based on substantial understatement, which effectively has a materiality threshold, there is no dollar threshold in the statute pertaining to the preparer penalty.

- **Tax return preparer's normal office practice.** An exception will be made if the preparer's normal office practices indicate that the error in question would rarely occur and the normal office practice was followed in preparing the return or claim for refund in question. The normal office systems in the case of a signing preparer include checklists, methods for obtaining taxpayer information and review procedures (including a review of the prior year's return).
- **Reliance on advice of others.** The reliance on advice of others is broad in scope. It permits the preparer to rely without verification upon advice and information furnished by the taxpayer or other party; this includes schedules or other documents prepared by the taxpayer, another advisor, another tax return preparer or other party (including another advisor or tax return preparer at signing preparer's firm). The relying preparer must have reason to believe that party on which reliance is placed is competent to render the advice or provide the information. In this regard, a preparer cannot assert good faith reliance on another party if:
  - the advice of information is unreasonable on its face;
  - the tax preparer knew or should have known that the other party was not aware of all the relevant facts; or
  - the preparer knew or should have known[45] at the time the return or claim for refund was prepared that the advice or information was no longer reliable because of developments in the law since the time the advice was given.

  The advice on which the preparer places reliance is not limited specifically to tax return advice for return preparation that effectively makes the advisor a nonsigning preparer. This provision appears to encompass reliance on pretransaction advice if such advice conforms to the above standards.
- **Reliance on generally accepted administrative or industry practice.** A reasonable cause exception is permitted where a preparer reasonably relied in good faith on a generally accepted administrative or industry practice in taking the position that resulted in an understatement of tax. The preparer is responsible for monitoring the status of administrative or industry practice.

Comment. There are no examples provided with regard to the application of an accepted administrative or industry practice; seemingly, the burden will be on the preparer to establish the administrative or industry practice with some form of evidence. Also, the question arises as to the "level" of an administrative or industry practice, *i.e.*, must either of these practices (or both) be established "nationally," or may reliance be based on known practices within the general community of the taxpayer?

The Penalty for Understatement Due to Willful or Reckless Conduct

The Code Sec. 6694(b) penalty of $5,000 (or, if greater, 50 percent of the fees earned from preparation of the return or rendering of advice) applies to a willful attempt by the tax return preparer in any matter to understate the liability for tax shown on the return and any reckless or intentional disregard of rules or regulations by the preparer.[46]

Firm Liability

The penalty may be imposed on the firm that employs a preparer, but only in at least one of the following cases:

- One or more members of the principal management of the firm or branch office either participated in or knew of the proscribed conduct.
- The firm failed to provide appropriate procedures for review of the position subject to the penalty.
- Appropriate review procedures exist but were disregarded by the firm in formulating the advice.[47]

Exception to Reckless or Intentional Disregard of Regulations or Rules[48]

A tax return preparer will not be penalized under this provision if the preparer has a reasonable basis for the treatment and the position is adequately disclosed on a Form 8275-R. The regulation challenged must be identified and there is no confidence threshold that would permit nondisclosure.

For a position contrary to a ruling or notice published in the Internal Revenue Bulletin, a preparer will not be penalized if the preparer believes that the position will more likely than not be sustained on its merits in an administrative or judicial proceeding.

Observation. Under the existing preparer regulations, the preparer is not subject to this penalty if the preparer believes there is a realistic possibility of success in taking a position contrary to a rule or notice. This is a significant increase in the reporting standard; moreover, the taxpayer's standard for nondisclosure is the realistic possibility of success standard.[49] Consequently, the same preparer-taxpayer conflict exists in this situation that exists with regard to the "tax position" penalty where the preparer has a MLTN confidence level requirement and the taxpayer's standard is the lower one of substantial authority. The proposals do not contain a "disclosure to the taxpayer and contemporaneous documentation" substitute for disclosure in the return that applies to tax positions under the general tax position penalty provision of Code Sec. 6694(a). Hopefully, the final regulations will return the preparer standard to the realistic possibility of success level applicable to the taxpayer; if not, then the final regulations should provide for the discussion with the taxpayer and contemporaneous documenting in the preparer's file that applies under the Code Sec. 6694(a) disclosure regime.

Calculation of the Penalty Amount[50]

The minimum penalty for each improper or nondisclosed (when required) tax position is $1,000 and is $5,000 for each act of willful or reckless conduct, including disregard of the rules and regulations. If greater, the penalty is 50 percent of the income derived or expected to be received by the tax preparer with respect to the return, claim for refund.

Observation. The statute seemingly provides that the penalty is based on the total income received or to be received by the tax preparer in connection with the engagement. But, as discussed below, the proposed regulations provide that the penalty calculation is based on income derived or to be derived with respect to the positions taken on the return that give rise to the understatement.[51] If there are good, bad and ugly aspects of the proposed regulations, this provision in the regulations is surely in the good column. This treatment is a fair trade-off with respect to those commentators that have suggested the "income derived or expected to be received" by a preparer (either a firm or employee) should be determined on a "net income" rather than "gross income" approach. The net income approach would seemingly lead to endless argument and be effectively an unworkable, administrative nightmare for both preparers and the government. Nonetheless, when a penalty is assessed with regard to complex positions involving substantial returns, this approach will present its own problems for both the government and the preparer (and the firm in some cases).

The proposals permit reasonable allocation of fees received by sole preparer, or compensation earned by a employee-preparer, in determining that portion of the fee that is considered attributable to the tax return position that gives rise to imposition of the penalty.[52] In this regard, the income derived or that a partner or employee tax return preparer expects to derive will be based on that preparer's income attributable to the return or advice engagement and an allocation made to determine that portion of the income attributable to the tax position that gives rise to the penalty.

In addition, the combined penalty as between a firm and a preparer shall not exceed 50 percent of the income derived or to be derived by the firm, and the total amount assessed against an individual may

not exceed 50 percent of the individual's compensation. Income derived in each case is considered that portion of the engagement income attributable to the tax position that gives rise to the penalty.

In a nod to large firms and particularly nonsigning preparer providing tax advice on various issues at various points in time, in the case of multiple engagements only those relating to the position(s) taken on the return that that give rise to the understatement are considered for purposes of calculating the income derived (or to be derived) with respect to the return or claim.[53]

What About the Covered Opinion Requirements of Circular 230?[54]

Depending on one's view of the scope of the covered opinion requirements of Circular 230 for written tax advice, it is possible that when advice is given in writing with regard to tax return positions, it might run head long into the Circular 230 rules. For example, if a nonsigning preparer furnishes written advice concerning a tax position to a taxpayer, despite the disclosure standard that only requires the discussion of the applicable taxpayer penalties, it is possible that negative advice might be required under Circular 230 to comply with the covered opinion standards.

The tax terrain has changed considerably in the three short years since the covered opinion regulations were promulgated, and many commentators have argued persuasively that the detailed regime in §10.35 should be repealed (with perhaps some expanded rules based guidance added to §10.37, which currently addresses "other written advice").

The process of finalizing the proposed preparer regulations appears to be welcome opportunity for the Treasury to revisit the covered opinion rules. If not to repeal, then to make clear that the covered opinion rules apply strictly to prospective, pre-transaction advice to taxpayers and that the proposed preparer regulations apply to post-transaction, "return filing advice."

Concluding Thoughts

The Treasury is to be commended in many respects for the promptness of issuing guidance addressing the May 2007 preparer penalty statutory change that included a deferral in June of 2007 of some of the provisions in the statute, workable temporary guidance in the form of Notice 2008-13 in January of 2008. And now these proposed regulations show every indication that the Treasury and the IRS desire to take a balanced approach to implementation of the preparer statute and recognition of the inherent conflict between the taxpayer and the return preparer-advisor in their differing disclosure requirements under the statute. While the proposals are certain to engender a significant number of comment letters with regard to the proposals, and the regulations will need some work, they represent a workable framework to move to the final regulations.

Endnotes

1 REG-129243-07 issued June 17, 2008.

2 For previous coverage of the Act and temporary rules, *see* Kip Dellinger and Sharon S. Lassar, *The New Tax Preparer (and Advisor) Penalty Standards Under Code Sec. 6694: A More (or Less) Likely Than Not World*, J. Tax Practice & Procedure, Aug.–Sept. 2007, at 29–36; and Kip Dellinger, *IRS Guidance on the Tax Preparer Penalty Statutory Revisions*, J. Tax Practice & Procedure, Feb.–Mar. 2008, at 29–35. Small Business and Work Opportunity Act of 2007 (P.L. 110-28).

3 Tax Reform Act of 1976 (P.L. 94-455).

4 Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239).

5 The burden of proof with regard to the imposition of the tax return position penalty is placed on the tax return preparer that is assessed a penalty. Proposed Reg. §1.6694-2(e) and §1.6694-3(g)

6 Code Sec. 6694(a)(1) as amended by Act Sec. 8264(b) of P.L. 110-28. In the case of a "nonsigning" preparer (*see* note 7, *infra*), the preparer's "income" will likely be the fee charged for providing the advice.

7 It is to be noted that with respect to attorneys, CPAs and enrolled agents (Federally Authorized Practitioners or "FAPs" subject to Circular 230 governing their duties in representing taxpayers before the IRS), monetary fines may be imposed for violations of the provisions of Circular 230 of up to 100 percent of their fees derived from the act that gives rise to the violation. The author believes that in evaluating Circular 230 penalty assessments, the IRS will take into consideration any Code Sec. 6694 penalty imposed on these practitioners to avoid so called "piling on" of penalties for tax professionals subject to both types penalties. The apparent piling on issue stems from the fact that the majority of tax preparers are not subject to Circular 230; the only possible manner for Congress to impose what it believes will be a deterrent to misbehavior by these practitioners is the Code Sec. 6694 penalty regime; FAPs become enmeshed in this web of enforcement.

8 "Explanation of Provision" in the Preamble to REG-129243-071. Circular 230 governs the right to "represent" taxpayers before the IRS and that right is granted to attorneys, certified public accountants, enrolled agents and enrolled actuaries; representation generally comprehends representing clients in all examination, appeals and collection proceedings before the IRS. All other tax practitioners have only limited privileges under Circular 230—generally one may represent a taxpayer in an examination proceeding with respect to a return prepared by the non–Circular 230 practitioner; he or she

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Exhibit A. Proposed Code Sec. 6694 Regulations Table of Contents*

Reg. §1.6694-1 Code Sec. 6694 penalties applicable to tax return preparers.

(a) Overview.
- (1) In general.
- (2) Date return is deemed prepared.

(b) Tax return preparer.
- (1) In general.
- (2) Responsibility of signing tax return preparer.
- (3) Responsibility of nonsigning tax return preparer.
- (4) Tax return preparer and firm responsibility.
- (5) Examples.

(c) Understatement of liability.

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

(e) Verification of information furnished by taxpayer or other third party.
- (1) In general.
- (2) Verification of information on previously filed returns.
- (3) Examples.

(f) Income derived (or to be derived) with respect to the return or claim for refund.
- (1) In general.
- (2) Compensation.
  - (i) Multiple engagements.
  - (ii) Reasonable allocation.
  - (iii) Fee refunds.
  - (iv) Reduction of compensation.
- (3) Individual and firm allocation.
- (4) Examples.

(g) Effective/applicability date.

Reg. §1.6694-2 Penalty for understatement due to an unreasonable position.

(a) In general.
- (1) Proscribed conduct.
- (2) Special rule for corporations, partnerships, and other firms.

(b) Reasonable belief that the position would more likely than not be sustained on its merits.
- (1) In general.
- (2) No unreasonable assumptions.
- (3) Authorities.
- (4) Examples.
- (5) Written determinations.
- (6) When more likely than not standard must be satisfied.

(c) Exception for adequate disclosure of positions with a reasonable basis.
- (1) In general.
- (2) Reasonable basis.
- (3) Adequate disclosure.
  - (i) Signing tax return preparers.
  - (ii) Nonsigning tax return preparers.
    - (A) Advice to taxpayers.
    - (B) Advice to another tax return preparer.

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(iii) Requirements for advice.
(iv) Pass-through entities.
(v) Examples.
(d) Exception for reasonable cause and good faith.
(1) Nature of the error causing the understatement.
(2) Frequency of errors.
(3) Materiality of errors.
(4) Tax return preparer's normal office practice.
(5) Reliance on advice of others.
(6) Reliance on generally accepted administrative or industry practice.
(e) Burden of proof.
(f) Effective/applicability date.

Reg. §1.6694-3 Penalty for understatement due to willful, reckless, or intentional conduct.

(a) In general.
(1) Proscribed conduct.
(2) Special rule for corporations, partnerships, and other firms.
(b) Willful attempt to understate liability.
(c) Reckless or intentional disregard.
(d) Examples.
(e) Rules or regulations.
(f) Code Sec. 6694(b) penalty reduced by Code Sec. 6694(a) penalty.
(g) Burden of proof.
(h) Effective/applicability date.

Reg. §1.6694-4 Extension of period of collection when tax return preparer pays 15 percent of a penalty for understatement of taxpayer's liability and certain other procedural matters.

(a) In general.
(b) Tax return preparer must bring suit in district court to determine liability for penalty.
(c) Suspension of running of period of limitations on collection.
(d) Effective/applicability date.

Endnotes

* This section lists the captions that appear in Regs. §§ 1.6694-1 through 1.6694-4.

Exhibit B. Tax Returns Reporting Tax Liability

Income Tax Returns–Subtitle A

- Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*
- Form 990T, *Exempt Organization Business Income Tax Return*
- Form 1040, *U.S. Individual Income Tax Return*
- Form 1040A, *U.S. Individual Income Tax Return*
- Form 1040-EZ, *Income Tax Return for Single Filers and Joint Filers With No Dependents*
- Form 1040-EZT, *Claim for Refund of Federal Telephone Excise Tax*
- Form 1040X, *Amended U.S. Individual Income Tax Return*
- Form 1040-PR (Anexo H-PR), *Contribuciones sobre el Empleo de Empleados Domesticos*
- Form 1041, *U.S. Income Tax Return for Estates and Trusts*
- Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*
- Form 1066, *U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return*
- Form 1120, *U.S. Corporation Income Tax Return*
- Form 1120-C, *U.S. Income Tax Return for Cooperative Associations*
- Form 1120-IC DISC, *Interest Charge Domestic International Sales—Corporation Return*
- Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*
- Form 1120S, *U.S. Income Tax Return for an S Corporation*
- Form 1120X, *Amended U.S. Corporation Income Tax Return*
- Form 8831, *Excise Taxes on Excess Inclusions of REMIC Residual Interests (Code Sec. 860E)*
- Form 8924, *Excise Tax on Certain Transfers of Qualifying Geothermal or Mineral Interests* (New Form, *Exclusion from Capital Gains*)
- Form 1040-C, *U.S. Departing Alien Income Tax Return*
- Form 1040NR, *U.S. Nonresident Alien Income Tax Return*
- Form 1040NR-EZ, *U.S. Income Tax Return for Certain Nonresident Aliens With No Dependents*
- Form 1041-N, *U.S. Income Tax Return for Electing Alaska Native Settlement Trusts*
- Form 1041-QFT, *U.S. Income Tax Return for Qualified Funeral Trusts*
- Form 1120-FSC, *U.S. Income Tax Return of a Foreign Sales Corporation*
- Form 1120-H, *U.S. Income Tax Return for Homeowners Associations*
- Form 1120-L, *U.S. Life Insurance Company Income Tax Return*
- Form 1120-ND, *Return for Nuclear Decommissioning Funds and Certain Related Persons*
- Form 1120-PC, *U.S. Property and Casualty Insurance Company Income Tax*
- Form 1120-POL, *U.S. Income Tax Return for Certain Political Organizations*
- Form 1120-REIT, *U.S. Income Tax Return for Real Estate Investment Trusts*
- Form 1120-RIC, *U.S. Income Tax Return for Regulated Investment Companies*
- Form 1120-SF, *U.S. Income Tax Return for Settlement Funds (Under Section 468B)*
- Form 1040-SS, *U.S. Self-Employment Tax Return*
- Form 2438, *Undistributed Capital Gains Tax Return*
- Form 8288, *U.S. Withholding Tax Return for Disposition by Foreign Persons of U.S. Real Property Interests*
- Form 8752, *Required Payment or Refund under Section 7519*
- Form 8804, *Annual Return for Partnership Withholding Tax (Section 1446)*

Estate and Gift Tax Returns–Subtitle B

- Form 706, *U.S. Estate Tax Return*
- Form 706-A, *United States Additional Estate Tax Return*
- Form 706-D, *United States Additional Estate Tax Return Under Code Section 2057*
- Form 706-GS(D), *Generation-Skipping Transfer Tax Return for Distributions*

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- Form 706-GS(T), *Generation-Skipping Transfer Tax Return for Terminations*
- Form 706-NA, *United States Estate (and Generation-Skipping Transfer) Tax Return—Estate of non-resident not a citizen of the United States*
- Form 706-QDT, *United States Estate Tax Return for Qualified Domestic Trusts*
- Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*
- Form 843, *Claim For Refund and Request for Abatement (also used to claim refunds for employment and certain excise tax returns)*

Employment Tax Returns–Subtitle C

- Form CT-1, *Employer's Annual Railroad Retirement Tax Return*
- Form CT-2, *Employee Representative's Quarterly Railroad Tax Return*
- Form 940, *Employer's Annual Federal Unemployment Tax Return*
- Form 940-PR, *Planilla para la Declaración Federal ANUAL del Patrono de la Contribución Federal para el Desempleo (FUTA)*
- Form 941, *Employer's QUARTERLY Federal Tax Return*
- Form 941-PR, *Planilla para la Declaración Federal TRIMESTRAL del Patrono*
- Form 941-SS, *Employer's QUARTERLY Federal Tax Return*
- Form 941-M, *Employer's MONTHLY Federal Tax Return*
- Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*
- Form 943-PR, *Planilla Para la Declaración ANUAL de la Contribución Federal del Patrono De Empleados Agrícolas*
- Form 944, *Employer's ANNUAL Federal Tax Return*
- Form 944-PR, *Planilla para la Declaración ANUAL de la Contribución Federal del Patrono*
- Form 944(SP), *Declaración Federal ANUAL de Impuestos del Patrono o Empleador*
- Form 944-SS, *Employer's ANNUAL Federal Tax Return*
- Form 945, *Annual Return of Withheld Federal Income Tax*
- Form 1040-SS, *U.S. Self-Employment Tax Return*

Miscellaneous Excise Tax Returns–Subtitle D

- Form 11-C, *Occupational Tax and Registration Return for Wagering*
- Form 720, *Quarterly Federal Excise Tax Return*
- Form 720X, *Amended Quarterly Federal Excise Tax Return*
- Form 730, *Monthly Tax Return for Wagers*
- Form 990-PF, *Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation* (with respect to the excise tax based on investment income)
- Form 2290, *Heavy Highway Vehicle Use Tax Return*
- Form 2290(FR), *Declaration d'Impot sur L'utilisation des Vehicules Lourds sur les Routes*
- Form 2290(SP), *Declaración del Impuesto sobre el Uso de Vehículos Pesados en las Carreteras*
- Form 4720, *Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code*
- Form 5330, *Return of Excise Taxes Related to Employee Benefit Plans*
- Form 8612, *Return of Excise Tax on Undistributed Income of Real Estate Investment Trusts*
- Form 8613, *Return of Excise Tax on Undistributed Income of Regulated Investment Companies*
- Form 8849, *Claim for Refund of Excise Taxes*

Alcohol, Tobacco, and Certain Other Excise Taxes–Subtitle E

- Form 8725, *Excise Tax on Greenmail*
- Form 8876, *Excise Tax on Structured Settlement Factoring Transactions*

Information Returns That Report Information That Is or May be Reported on Another Tax Return That May Subject a Tax Return Preparer to the Code Sec. 6694(a) Penalty if the Information Reported Constitutes a Substantial Portion of the Other Tax Return

- Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*
- Form 1065, *U.S. Return of Partnership Income (including Schedules K-1)*
- Form 1120S, *U.S. Income Tax Return for an S Corporation (including Schedules K-1)*
- Form 5500, *Annual Return/Report of Employee Benefit Plan*
- Form 8038, *Information Return for Tax-Exempt Private Activity Bond Issues*
- Form 8038-G, *Information Return for Government Purpose Tax-Exempt Bond Issues*
- Form 8038-GC, *Consolidated Information Return for Small Tax-Exempt Government Bond Issue*

Forms That Would Not Subject a Tax Return Preparer to the Code Sec. 6694(a) Penalty Unless Prepared Willfully in Any Manner to Understate the Liability of Tax on a Return or Claim for Refund or in Reckless or Intentional Disregard of Rules or Regulations

- Form 1099 series of returns
- Form W-2 series of returns
- Form W-8BEN, *Beneficial Owner's Certificate of Foreign Status for U.S. Tax Withholding*
- Form SS-8, *Determination of Worker Status*
- Form 990, *Return of Organization Exempt from Income Tax*
- Form 990-EZ, *Short Form Return of Organization Exempt From Income Tax Form 990-N, Electronic Notice (e-Postcard) for Tax-Exempt Organizations not Required To File Form 990 or 990-EZ*
- Form 1040-ES, *Estimated Tax for Individuals*
- Form 1120-W, *Estimated Tax for Corporations*
- Form 2350, *Application for Extension of Time to File U.S. Income Tax Return*
- Form 2350 (SP), *Application for Extension of Time to File U.S. Income Tax Return (Spanish Version)*
- Form 4137, *Social Security and Medicare Tax on Unreported Tip Income*
- Form 4768, *Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes*
- Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*
- Form 4868 (SP), *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return (Spanish Version)*
- Form 5558, *Application for Extension of Time to File Certain Employee Plan Returns*
- Form 7004, *Application for Automatic 6-Month Extension of Time To File Certain Business Income Tax, Information, and Other Returns*
- Form 8109, *Federal Tax Deposit Coupon*
- Form 8027, *Employer's Annual Information Return of Tip Income and Allocated Tips*
- Form 8809, *Application for Extension of Time to File Information Returns*
- Form 8868, *Application for Extension of Time To File an Exempt Organization Return*
- Form 8892, *Application for Automatic Extension of Time to File Form 709 and/or Payment of Gift/Generation-Skipping Transfer Tax*
- Form 8919, *Uncollected Social Security and Medicare Tax on Wages*

ENDNOTES

may only appear in an appeals or collection proceeding to provide information in behalf of the taxpayer (but may not "represent" the taxpayer).

[9] "Income Derived Determination in Computing Penalty Amount" in the Preamble to REG-129243-071

[10] Code Sec. 6694(b) imposes a penalty of $5,000 or, if greater, 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

[11] Proposed Reg. §1.6694-2(a)(2).

[12] Tax returns for this purpose include amended returns and claims for refund.

[13] The present regulations provide that only one individual can be a preparer subject to penalty from a "signing firm." No other preparer is responsible for the preparer penalty from a signing firm even if that individual provided significant advice with regard to a tax position in the return. The responsible preparer for a signing firm may, however, rely on advice from an advisor (or firm) independent of the signing preparer's firm. The advisor (or firm) is considered a "nonsigning" preparer and is generally responsible for the tax position advice and subject to the preparer penalty (in place of the signing preparer). It is obvious that this structure came to discourage the use of experts within a signing firm and encouraged the use of a "nonsigning" advisor or firm.

[14] Proposed Reg. §1.6694-1(b)(1) and (2).

[15] The proposed regulations provide that the date a return is deemed prepared is the date it is signed by a signing preparer, or on the date that advice is provided by a nonsigning preparer with respect to a position giving rise to an understatement.

[16] *See* Proposed Reg. §1.6694-1(c).

[17] Proposed Reg. §301.7701-15(b)(3).

[18] Proposed Reg. §301.7701-15(b)(1) and (b)(2).

[19] Proposed Reg. §1.6694-1(b)(3).

[20] Proposed Reg. §301.7701-15(b)(3).

[21] Proposed Reg. §301.7701-15(b)(1).

[22] Proposed Reg. §1.6694-2(a)(2).

[23] Proposed Reg. §1.6694-1(e)(1).

[24] Proposed Reg. §1.6694-1(e)(2).

[25] Proposed Reg. §1.6694-1(e)(3).

[26] Code Sec. 6694(a)(2), revised by P.L. 110-28.

[27] Code Sec. 6662. Although the author addresses the topic by referring to "items" or "tax positions" on a return, these definitions include "items" or "tax positions" not actually placed on a return because either the taxpayer or the preparer made a determination that the "item" or "tax position" was not required to be placed on the return. The actual statute merely refer to the "tax treatment of any item" and an understatement due to a "tax position."

[28] It is noted that where the taxpayer and the government each have substantial authority but do clearly reach a more likely than not confidence level, the preparer will conclude that, based on the taxpayer's facts, that there is a reasonable belief that taxpayer will prevail.

[29] Code Sec. 6694(a)(2), revised by P.L. 110-28.

[30] Proposed Reg. §1.6694-2(b), citing Reg. §1.6662-4(d)(3)(ii).

[31] Proposed Reg. §1.6694-2(b)(3).

[32] Proposed Reg. §1.6694-2(b)(1).

[33] Proposed Reg. §1.6694-2(b)(4).

[34] This is also entirely consistent with Financial Accounting Standards Board statement FIN 48: *Accounting for Uncertain Tax Positions, an Interpretation of FAS 109: Accounting for Income Taxes* that address the recognition of tax benefits in financial statements. FIN 48 predicates the MTLN evaluation on how the entity reasonably believes the court of last resort in a given tax jurisdiction would conclude.

[35] Code Sec. 6694(a)(2)

[36] Proposed Reg. §1.6694-2(c)(2); Proposed Reg. § 1.6662-3(b)(3). The prior threshold for disclosed positions for a preparer was merely that the position could not be frivolous. This did create a potential conflict with a taxpayer because the preparer's not frivolous argument provided the preparer penalty protection when the taxpayer did not have a reasonable basis for the position and thus was subject to the penalty—thus, the taxpayer often opposed disclosure and the preparer was unable to sign the return. Some commentators have "quantified" reasonable basis in a range of a 15- to 25-percent chance of being sustained on the merits if challenged. The regulations essentially state that reasonable basis is supported by a significantly stronger argument than not frivolous but does not rise to a realistic possibility of being sustained on the merits ("RPOS"). RPOS is described in the regulations as a one in three or and Circular 230 (prior to the changes of the Small Busines and Work Opportunity Tax Act of 2007) greater chance of being sustained on the merits. The author believes that reasonable basis may be supported by a forcible argument that based on the taxpayer's factual situation, the appropriate application of the law should support the taxpayer's treatment of the item.

[37] Kip Dellinger, *IRS Guidance on the Tax Preparer Penalty Statutory Revisions*, J. TAX PRACTICE & PROCEDURE, Feb.–Mar. 2008, at 29–35.

[38] Proposed Reg. §1.6694-2(c)(3).

[39] The annual procedure is described in Proposed Reg. §1.6662-(4)(f)(2); the most recent annual procedure is Rev. Proc. 2008-14, IRB 2008-7, 435.

[40] Proposed Reg. §1.6694-2(c)(3)(iii).

[41] Proposed Reg. §1.6694-2(c)(3)(E)(i).

[42] Proposed Reg. §1.6694-2(c)(3)(E)(ii).

[43] Proposed Reg. §1.6694-2(c)(3)(E)(iii).

[44] Proposed Reg. §1.6694-2(d).

[45] The proposed regulations qualify this "knowledge" provision in the respect that it should be evaluated based on the nature of the preparer's practice. This permits great latitude in smaller, less sophisticated practitioners ability to rely on competent third parties that provide advice and information.

[46] Proposed Reg. §1.6694-3(a)(1).

[47] Proposed Reg. §1.6694-3(a)(2).

[48] Proposed Reg.§1.6694-3(c)(2). Reliance on the annual revenue procedure for disclosed positions within a return does not apply to this exception.

[49] Reg. §1.6662-3(b)(2).

[50] Proposed Reg. §1.6694-1(f).

[51] Proposed Reg. §1.6694-1(f)(1).

[52] Proposed Reg. §1.6694-1(f)(2)(ii); *see also* Proposed Reg. §1.6694-1(f)(2)(iv).

[53] Proposed Reg. §1.6694-1(f)(2)(i); *see also* Proposed Reg. §1.6694-1(f)(2)(iv).

[54] Circular 230, §10.35.