Practitioner Penalties: Potential Pitfalls in the Tax Trenches

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There is little real-world practical guidance available for tax practitioners. It is often difficult to find the appropriate balance between the government's desire for transparency and the client's desire to stay off the government's radar screen. Tax practitioners are often engaged to appropriately minimize taxes for their clients. They are not sinister individuals but may be unduly sanctioned not withstanding their best efforts at complying with complex statutory and case authorities.

Is there a difference in section 6694 betwen a "return preparer" and a nonpreparer adviser? Although section 6694 is intended for the "bad actors," it can be applied to any preparer. Be a prepared preparer — exercise your best judgment, document your advice and recommend adequate disclosures when appropriate. Your client is not your friend — if you need a friend, get a dog!

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Tax is an admirable profession. Historically, tax practitioners have been seen as sophisticated specialists operating in a complex world of ever-changing statutory and case authorities monitored by a government that respected the dedication and professionalism of the practitioners.

Over the last few years, something changed. Return preparers and tax practitioners have become cannon fodder for well-choreographed attacks by politicians and others. At his nomination hearing before the Senate Finance Committee, former IRS Commissioner Mark W. Everson stated, "There are clear indications that professional standards have eroded in some corners of the practitioner community. Attorneys and accountants should be the pillars of our system of taxation, not the architects of its circumvention." While the emphasis in his statement should have been on "some corners," the emphasis in his administration was on "the practitioner community." Every community has a neighborhood that you are inclined to warn your children about. However, few of us would choose to voluntarily remain in a community filled with thugs and murderers.

I. The IRS Strategic Plan

The IRS routinely develops five-year strategic plans as long-range guidance for its operating divisions. The IRS administers the laws and regulations governing the practice of tax professionals. The 2005-2009 IRS Strategic Plan contains four separate enforcement objectives, including: "To assure that attorneys, accountants and other tax

practitioners adhere to professional standards and follow the law.'' Practitioners who choose not to comply with established standards of conduct are subject to a broad range of coordinated actions to effectively address their misconduct — for example, the assessment of preparer penalties, disciplinary sanctions imposed under the authority of Circular 230, suspension of electronic filing privileges, pursuit of injunctive action, and, when warranted, criminal prosecutions by the Justice Department.

To accomplish the foregoing enforcement objective under the 2005-2009 Strategic Plan, the IRS committed to the following:

- Strengthen partnerships with practitioners to achieve the highest level of professional integrity and improve tax compliance. Tax professionals and the organizations to which they belong serve as the conduits for communications from the IRS on a variety of issues frequently dealing with ethics and integrity in practice.
- Establish and communicate clear, robust, current, and meaningful standards of conduct for tax practitioners. The IRS investigates allegations of misconduct on the part of tax practitioners and enforces the standards of practice for those who represent taxpayers before the Service, as outlined in Circular 230. The IRS will consider the assessment and collection of preparer penalties, the withdrawal of electronic filing privileges, and disbarment from representing clients before the Service. To ensure awareness of the consequences of practitioner misconduct, the IRS will make those sanctions a matter of public record, to the extent permitted under law and regulation.
- Establish and maintain a vigorous, targeted, and effective system of practitioner oversight. The Office of Professional Responsibility (OPR) works closely with the leadership of the operating divisions to identify improper practitioner behaviors that have the greatest impact on tax administration. The IRS also attempts to reach out to field personnel through continuing professional education sessions, information on its Web site, case-specific communications, and publicity about the results of its oversight efforts. Those efforts are expected to rejuvenate referrals of practitioner misconduct from IRS field components, as well as from the practitioner community itself. Referral information is then used to develop Service-wide coordinated strategies to deter, detect, and address practitioner misconduct.
- Establish and administer a fair, diligent, and effective system of sanctions for practitioners who fail to observe standards of conduct. There are numerous tools available to influence practitioner behavior, including, when appropriate, monetary sanctions through imposition of return preparer penalties; suspension or disbarment of practitioners who are covered by Circular 230, depriving them of the privilege to represent taxpayers before the IRS; criminal prosecution; revocation of electronic filing privileges; and injunctions initiated by the Justice Department.

Many within the IRS have not had the privilege of struggling through a tax season facing strict filing deadlines and attempting to comply with many technical rules, computer glitches, and somewhat or totally nonresponsive clients. Hopefully, the IRS strategic plan for the five-year period beyond 2009 will encourage a close working relationship with the tax practitioner community. To the extent possible, practitioners should get involved in tax administration. Practitioners should submit comments on issues and matters of importance within their areas of expertise. The IRS has a history of listening and attempting to respond to comments to the extent that is inconsistent with its inherent duties of tax administration and tax enforcement.

II. Consideration of Preparer Penalties

The preparer represents the fine line between increasingly demanding government inquiries and client desires to stay off the government's radar screen. The government wants transparency — if the client/taxpayer and his representative believe in the positions set forth within the tax return, the government believes those positions should be fully disclosed to the light of day. Taxpayers believe that the whale gets harpooned only when it comes up for air. Preparers believe that whatever they do, neither the government nor the client will be fully satisfied.

A. Examination Letter

The IRS Small-Business/Self-Employed (SB/SE) Division Examination Program Letter for fiscal 2008 defined the operational goals of the SB/SE and stated:

> Return preparers are a critical component of Tax Administration and provide a unique opportunity to impact taxpayer behavior and compliance with the tax law. We will develop and implement a Service-wide return preparer strategy to actively identify and address egregious preparers. We will identify preparers that promote overly aggressive positions for appropriate action. We will fully develop and coordinate preparer penalty issues, consider initiation of projects, and refer practitioners to the Office of Professional Responsibility, when appropriate. . . .
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> Penalties should be considered during every examination. Examiners must properly develop and document actions taken to determine the appropriateness of all applicable penalties. The reasonable cause provisions will be considered on a case-by-case basis taking into account all the pertinent facts and circumstances. . . .
>
> Return Preparer penalties should also be considered. Coordination with Area Return Preparer Coordinators will take place to determine if the initiation of Program Action Case procedures is appropriate. . . .
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> In FY 2008, our audit coverage will include cases representing the most egregious forms of noncompliance. The identification and development of fraud should be considered in all examinations. . . .
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> Areas are encouraged to identify egregious activities through Compliance Initiative Program (CIP) and Return Preparer Program cases. Inclusion of those types of cases supports our strategy for

addressing egregious non-compliance and our efforts to provide balanced coverage. Increased emphasis will be placed on returns with Schedule C activity that directly correlates to the Tax Gap. This is in recognition that $109 billion of the overall Tax Gap is due to underreporting on the part of individual business taxpayers.

B. Large and Midsize Business Division Memo

The IRS Large and Midsize Business Division memorandum ''Procedures for Tax Return Preparer Penalty Cases'' (Apr. 2008), *Doc 2008-9607, 2008 TNT 85-8*, set forth the following comments and procedures for LMSB examiners:

1. Taxpayer audit. The purpose of asserting penalties on return preparers is to increase compliance. When examining a return prepared by a tax return preparer, it is an examiner's responsibility to ensure that the identification and conduct provisions of the code were followed. If the provisions were not followed, it is the examiner's responsibility to assert the penalties. During every field examination, examiners should determine if return preparer violations exist. This determination is made based on oral testimony and/or written evidence during the examination process.

2. 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 in the presence of the taxpayer.

3. The interview. Interviews of the taxpayer should serve a dual purpose: to further the tax examination and 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 that 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?

Disclosure or the lack of disclosure affects 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.

When interviewing the taxpayer or preparer, an examiner should ask if any other services are provided by the preparer's firm and how long the preparer has been preparing returns for the taxpayer. Those simple questions will give an examiner 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 several years knows more about that client than a firm that is preparing the client's return for the first time.

4. Documentation of the facts. The examiner should document the case file following the conversation with the taxpayer or person with power of attorney. While each examiner has his own interview style, examiners should be vigilant in documenting statements made during these interviews.

CAUTION: In the workpaper files, examiners should document only that the required inquiries on the return preparer issues were completed. The taxpayer's answers to those inquiries should not be included in any workpapers in the taxpayer's case file. All information on the return preparer's activities and the applicability of any penalties regarding the return preparer should be separated from the taxpayer's case file. This information is then included in the return preparer penalty case file.

C. IRS Memorandum

The IRS memorandum ''Interim Guidance for Preparer Penalty Procedures for Employment Tax'' (Feb. 2009), *Doc 2009-2371, 2009 TNT 22-19*, set forth the following comments and procedures for employment tax examiners:

- During all field and office examinations, a determination will be made as to whether the facts and circumstances of the examination give rise to the development of a penalty issue. This determination will be made based on oral testimony or written evidence obtained during the examination process. Examiners are required to comment on preparer penalties on all cases examined.
- Examiners will not propose or discuss preparer penalties in the presence of the taxpayer. All information regarding the return preparer's activities and the applicability of any penalties regarding the return preparer should be separated from the taxpayer's case file.
- When a section 6694(a), (b), or 6695(f) penalty is asserted against an attorney, certified public accountant, enrolled agent, or enrolled actuary and is closed agreed by the examiner or sustained in

Appeals, or closed unagreed without Appeal contact, a referral to the director of OPR is mandatory.

Mainstream preparers have a high degree of pride in their work and do not get up in the morning intending to do the wrong thing. Most spend significant amounts of otherwise personal time attending continuing professional education (CPE) conferences and seminars to enhance their professional knowledge and expertise. Many far exceed whatever CPE requirements exist to maintain their professional licenses. The vast majority of preparers spend long hours struggling with uncertain facts, complex statutes, and ever-changing case authorities trying to do the right thing. They are a critical component of tax administration and know that a tax return does not represent an offer to negotiate with the government.

Experienced government representatives recognize the difference between those attempting to work within the system and those attempting to circumvent the system. Unfortunately, through attrition, there are fewer and fewer experienced government representatives toiling away in the tax trenches. Practitioners do not see and experience the many problems the government faces on an almost daily basis. Preparer penalties and sanctions are important for those who generally ignore their responsibility to reasonably comply.

Effective tax administration needs strong penalties applied by a respected IRS agency that will exercise an appropriate degree of discretion if merited by the circumstances involved. That same discretion should recognize that foot-faults can sometimes occur in a high-pressure, complex arena.

III. Overview: Section 6694 and the Regulations

We should encourage young adults to enter the profession rather than discouraging experienced practitioners from remaining in it. Effective May 25, 2007, the Small Business and Work Opportunity Act of 2007 (SBWOA) amended section 6694 to:

- broaden the scope of the tax return preparer penalties to include preparers of returns other than income tax returns;
- revise the standards of conduct tax return preparers must satisfy regarding uncertain tax positions taken to avoid imposition of the section 6694 penalty; and
- change the computation for the applicable monetary penalties for:

  1. understatements due to unreasonable positions under section 6694(a) from $250 to the greater of $1,000 or 50 percent of the income derived or to be derived by the return preparer from the preparation of the return or claim, and

  2. understatements due to a willful attempt to understate the tax liability or a reckless disregard or intentional disregard of rules and regulations under section 6694(b) from $1,000 to the greater of $5,000 or 50 percent of the income derived or to be derived by the return preparer from the preparation of the return or claim.

Most practitioners are reasonably familiar with the standards that must be satisfied to avoid application of the section 6694 penalty. For undisclosed positions, the SBWOA amended section 6694(a) to replace the ''realistic possibility of success'' standard with a requirement that the preparer knew (or reasonably should have known) of the position and had a reasonable belief that the tax treatment of the position would more likely than not be sustained on the merits. For years, ''more likely than not'' has been the standard under various state regulations, including those of New York, California, Virginia, and Alabama (for income tax purposes only). For disclosed positions, the SBWOA amended section 6694(a) to replace the ''non-frivolous'' standard with the requirement that the preparer knew (or reasonably should have known) of the position and had a reasonable basis for the tax treatment of the position.

The SBWOA amendments to section 6694 did not modify the exception to the penalty when it is demonstrated that, considering all the facts and circumstances, the preparer acted in good faith and there was reasonable cause for the understatement on the return. The standards for imposing the penalty for willful or reckless conduct under section 6694(b) were not changed; the SBWOA changed only the amount of the section 6694(b) penalty.

The IRS is responsible for administering section 6694 as enacted. The IRS does not make law and there are indications that it was not consulted about the SBWOA amendments to section 6694 when they were being considered by Congress. The SBWOA amendments to section 6694 were scored by congressional staff as a revenue generator to raise approximately $3 million in 2008, $5 million in 2009, $6 million in 2010, $8 million in 2011, and $9 million in 2012, totaling $31 million from 2008 to 2012 and $80 million from 2008 to 2017. Somehow, someone believed that return preparers should incur monetary penalties under section 6694 aggregating $80 million over the next 10 years. Could the practitioner community ever appropriately prepare to respond to this $80 million challenge?

Treasury and the IRS released Notice 2008-13, 2008-3 IRB 282, *Doc 2007-28351, 2008 TNT 1-6*, on December 31, 2007, providing interim guidance and identifying returns and documents subject to the SBWOA amendments to section 6694. Additional guidance was provided in Notice 2008-12, 2008-3 IRB 280, *Doc 2007-28349, 2008 TNT 1-5*, also released on December 31, 2007, regarding the implementation of the preparer signature requirement of section 6695(b). Notice 2008-46, 2008-18 IRB 868, *Doc 2008-8520, 2008 TNT 75-11*, was released on April 16, 2008, and added certain returns and documents to exhibits 1, 2, and 3 of Notice 2008-13. On June 17, 2008, Treasury and the IRS published proposed regulations (REG-129243-07), *Doc 2008-13243, 2008 TNT 117-9*, 73 *Fed. Reg.* 34,560, that provided proposed amendments to the regulations reflecting the amendments made by the SBWOA.

Effective October 3, 2008, the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (TEAMTRA) modified the SBWOA amendments to section 6694(a) to the extent of the applicable standards of conduct subject to the penalty. The definition of a reasonable position

(that is, conduct not subject to the penalty) is now divided into three separate tiers, each with its own standard to determine whether the position set forth in the return is an unreasonable position.

1. Disclosed positions. For disclosed positions, the amended section 6694(a) penalty applies unless there is or was a reasonable basis for the position set forth in the return (this standard now applies to returns prepared after May 25, 2007; see Notice 2009-5, 2009-3 IRB 309, *Doc 2008-26376, 2008 TNT 242-13*).

2. Undisclosed positions. For undisclosed positions, the amended section 6694(a) penalty applies unless there is or was substantial authority for the position set forth in the return (this standard now applies to returns prepared after May 25, 2007; see Notice 2009-5). Solely for purposes of section 6694(a), the term ''substantial authority'' has the same meaning as in reg. section 1.6662-4(d)(2) (or any successor provision) of the accuracy-related penalty regulations. The analysis prescribed by reg. section 1.6662-4(d)(3)(i) through (ii) (or any successor provisions) applies for purposes of determining whether substantial authority is present. The authorities considered in determining whether there is substantial authority for a position are those authorities described in reg. section 1.6662-4(d)(3)(iii) (or any successor provision).

There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. Reg. section 1.6662-4(d)(2). The weight of authorities is determined in light of the pertinent facts and circumstances in the manner prescribed by reg. section 1.6662-4(d)(3)(iii). The authorities referenced in reg. section 1.6662-4(d)(3)(iii) are relevant under amended section 6694 since the reasonable basis standard for disclosed positions, as interpreted in the Treasury regulations, expressly allows for consideration of those authorities. See Notice 2009-5, and reg. section 1.6662-3(b)(3).

There is substantial authority for a position for purposes of section 6694 if the taxpayer is the subject of a written determination as provided in reg. section 1.6662-4(d)(3)(iv)(A). In the case of a preparer, however, a written determination with a misstatement or omission of material fact is substantial authority unless the preparer knew or should have known of the misstatement or omission of material fact when the return or claim for refund was filed. The applicability of court cases to the taxpayer's situation by reason of the taxpayer's residence in a particular jurisdiction is not taken into account in determining whether there is substantial authority for a position in accordance with reg. section 1.6662-4(d)(3)(iv)(B). Despite the preceding sentence, there is substantial authority for a position if the position is supported by controlling precedent of a U.S. court of appeals to which the taxpayer has a right of appeal regarding the position. Finally, there is substantial authority for a position only if there is substantial authority on the date the return or claim for refund is deemed prepared, as prescribed by reg. section 1.6694-1(a)(2), or if there was substantial authority on the last day of the tax year to which the return relates.

Conclusions reached in treatises, legal periodicals, legal opinions, or opinions rendered by tax professionals (including tax return preparers) are not authority. The authorities underlying such expressions of opinion, if applicable to the facts of a particular case, however, may give rise to substantial authority for the position. Solely for purposes of section 6694(a), a preparer nevertheless will be considered to have met the standard in section 6694(a)(2)(A) if the preparer relies in good faith and without verification on the advice of another adviser, another preparer, or other party. Factors used in evaluating a preparer's good-faith reliance on the advice of another are found in reg. section 1.6694-2(e)(5).

3. Tax Shelters. For tax shelters as defined in section 6662(d)(2)(C)(ii), as well as reportable transactions to which section 6662A applies (that is, generally listed and reportable transactions having a significant purpose of tax avoidance or tax evasion), the amended section 6694(a) penalty generally applies unless there is or was a reasonable belief that the position set forth in the return would more likely than not be sustained on the merits (this standard applies to returns prepared for tax years ending after October 3, 2008; see Notice 2009-5).

Under interim guidance provided by Notice 2009-5, solely for purposes of section 6694(a), a position for a tax shelter (as defined in section 6662(d)(2)(C)(ii)) will not be deemed an unreasonable position described in section 6694(a)(2)(A) through (C) if there is substantial authority for the position and the preparer advises the taxpayer of the penalty standards applicable to the taxpayer if the transaction is deemed to have a significant purpose of federal tax avoidance or evasion. This advice to the taxpayer must explain that, if the position has a significant purpose of tax avoidance or evasion, there needs to be at a minimum substantial authority for the position, that the taxpayer must possess a reasonable belief that the tax treatment was more likely than not the proper treatment in order to avoid a penalty under section 6662(d) as applicable, and that disclosure in accordance with reg. section 1.6662-4(f) will not protect the taxpayer from assessment of an accuracy-related penalty if section 6662(d)(2)(C) applies to the position. The preparer must contemporaneously document the advice in his files.

If a nonsigning preparer provides advice to another preparer regarding a position for a tax shelter (as defined in section 6662(d)(2)(C)(ii)), the position will not be deemed an unreasonable position described in section 6694(a)(2)(A) through (C) if there is substantial authority for the position and the nonsigning tax return preparer provides a statement to the other preparer about the penalty standards applicable to the preparer under section 6694. Contemporaneously prepared documentation in the nonsigning preparer's files is sufficient to establish that the statement was given to the other preparer. If a nonsigning preparer and other preparer are employed by the same firm, contemporaneous documentation of advice provided by any preparer in that firm to the taxpayer regarding applicable penalty standards, as described in the immediately preceding paragraph, is also sufficient to

establish that the statement was given by a nonsigning preparer to the other preparers within the firm.

The above interim penalty compliance rules do not apply to a position described in section 6662A (a reportable transaction with a significant purpose of federal tax avoidance or evasion, or a listed transaction). For positions other than tax shelters and reportable transaction positions, Notice 2009-5 is effective for all advice rendered, or returns, amended returns, and claims for refund prepared after May 25, 2007. The interim guidance in Notice 2009-5 for tax shelters (within the meaning of section 6662(d)(2)(C)(ii)) and reportable transactions to which section 6662A applies is effective for tax shelter and reportable transaction positions on tax returns for tax years ending after October 3, 2008. See Notice 2009-5.

Final regulations revising the regulatory scheme governing tax return preparer penalties in accordance with the SBWOA and TEAMTRA amendments to section 6694 and other related provisions of the code were released effective December 22, 2008 (T.D. 9436, *Doc 2008-26370, 2008 TNT 242-11*, 73 *Fed. Reg.* 78,430). These regulations represent an attempt to balance the interests of the government in curtailing the activities of noncompliant preparers against the burdens imposed on all preparers in complying with amended section 6694 and the regulations.

There is little real-world practical guidance available for practitioners. Some practitioners are going to be swept into the river despite their best efforts to comply with complex tax laws and possibly because of uncooperative clients. Under pre-SBWOA section 6694, a CPA represented a return preparation client in an IRS audit focusing on various claimed travel and entertainment expense deductions. The return claimed accelerated depreciation deductions for two automobiles that were not each acquired and placed in service in the same tax year. Initially, the IRS proposed an adjustment of about $20,000. After some discussion, the adjustments to the return were reduced to below $5,000 and there were no penalties asserted against the taxpayer.

Soon thereafter, the accountant, in practice over 40 years with no prior disciplinary action, was assessed a willfulness pre-SBWOA penalty under section 6694(b) as the preparer of the returns claiming accelerated depreciation. The accountant filed an appeal. Appeals offered to resolve the dispute for the lower section 6694(a) penalty. The accountant discussed it with his partner and decided to just pay the lower penalty ''to get the matter behind'' him. However, his problems were not over. What he didn't know was that: (1) he was required to notify his State Board of Accountancy of the penalty within 30 days of its assessment (and was subject to a separate sanction for the failure to notify the state board within 30 days), and (2) that the Internal Revenue Manual then provided for the referral of practitioners to the OPR of all section 6694 penalties when closed on an agreed basis by the examiner or sustained in Appeals, or closed unagreed without Appeals contact. IRM 7 20.1.6.2.1. (July 8, 1999).

The accountant faced disciplinary proceedings from both the State Board of Accountancy and the OPR for an oversight that occurred during return preparation by a tax manager in his office. Sanctions from the OPR often include a requirement that the practitioner notify his clients of the disciplinary proceedings and the result (which may include a private reprimand, public censure, suspension, disbarment, monetary sanctions, or a civil injunctive action). Although OPR made an initial investigative inquiry, it soon thereafter appropriately terminated its investigation of the accountant, without sanctions.

Personality conflicts should not result in preparer penalties. In another recent situation, a CPA was asked to prepare delinquent returns for a new client who was then under examination for a return filed for an earlier year. The client provided the accountant with the proposed adjustments to the earlier return and completed the return preparation checklist provided by the accountant. There were no unusual items that might require further inquiry. Returns were prepared with the recommendation to file the original returns with the appropriate IRS service center and to provide the examining agent with courtesy copy of the filed returns. Experienced practitioners routinely file delinquent original returns with the appropriate service center, not with an examining agent.

The agent — who had advised the taxpayer to file the delinquent original returns directly with the agent — became enraged that the original returns were filed with the service center. The accountant was summoned to appear before the agent, was put under oath, and asked about his practice and client list. Shortly after the meeting, the accountant received an assessment of the willfulness penalty under section 6694(b) — of $5,000 for each of the two tax returns that were filed with the service center for ''willfully'' violating the agent's instructions that the original returns be provided directly to the agent. A significant part of the process of implementing the changes brought about by amended section 6694 will be educating government agents about when such penalties should not be considered.

Practitioners should remain concerned about the costs to taxpayers associated with increased diligence, as well as the possibility of practitioners being unduly sanctioned despite their best efforts to comply with complex statutory and case authorities and sometimes having to interact with unreasonable agents. The intense pressure of tax season has not been lessened by TEAMTRA's amendments to section 6694, although the regulations are headed in the right direction.

Preparer penalties should not be used as a negotiation tool by examining government agents. Most within the government have not had the pleasure of being in private practice, working with sometimes uncooperative clients, and lacking information believed necessary to complete a return on the day it is due. Further, preparers also must educate and reeducate themselves on ever-changing statutory and case authorities, at no additional cost to their clients. Administration of section 6694 by the IRS and the retraining of IRS personnel in a recessionary economy will be at least as important as the rules and procedures contained within the regulations.

Discovery of inadvertent return errors by an examining agent can easily lead to a discussion of possible penalties for the taxpayer or the preparer. If the preparer is representing the taxpayer in the examination, has a conflict arisen that may be exploited by the agent? Can

the preparer realistically continue to represent the taxpayer in the examination? If penalized, will the taxpayer later assert that the preparer somehow committed malpractice? Will plaintiffs' counsel sharpen their swords on the enhanced regulatory scheme set forth in the regulations and Circular 230?

A. Return Preparers Subject to Section 6694

Return preparers — no longer limited to preparers of income tax returns following SBWOA and the TEAMTRA — include both signing preparers and nonsigning preparers — that is, those who provide substantial advice to the taxpayer, to the signing preparer, or another adviser to the taxpayer regarding a position set forth within the return. A preparer is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any return of tax or any claim for refund of tax under the code. Reg. section 301.7701-15(a). Return preparers subject to section 6694 include preparers of estate, gift, goods and service, employment, and excise tax returns, and returns of exempt organizations.

A person who furnishes to a taxpayer or other tax return preparer sufficient information and advice so that completion of the return or claim for refund is largely a mechanical or clerical matter is considered a preparer, even though that person does not actually place or review placement of information on the return or claim for refund. Reg. section 301.7701-15(c). A person may be a preparer without regard to educational qualifications and professional status requirements and whether or not they are located within the United States. Reg. section 301.7701-15(d) and (e).

A person who prepares a claim for credit or refund under section 6694 for another person is not, for that preparation, a preparer as defined in section 7701(a)(36) and reg. section 301.7701-15. Further, the term ''preparer'' does not include:

- an individual providing only typing, reproduction, or other mechanical assistance in the preparation of a return or claim for refund;
- an individual preparing a return or claim for refund of a taxpayer;
- or an officer, general partner, member, shareholder, or employee of a taxpayer by whom the individual is regularly and continuously employed or compensated or in which the individual is a general partner (the employee of a corporation owning more than 50 percent of the voting power of another corporation, or the employee of a corporation more than 50 percent of the voting power of which is owned by another corporation, is considered the employee of the other corporation as well);
- an individual preparing a return or claim for refund for a trust, estate, or other entity of which the individual either is a fiduciary or is an officer, general partner, or employee of the fiduciary;
- an individual preparing a claim for refund for a taxpayer in response to either a notice of deficiency issued to the taxpayer or a waiver of restriction on assessment after initiation of an audit of the taxpayer or another taxpayer if a determination in the audit of the other taxpayer affects, directly or indirectly, the liability of the taxpayer for tax under subtitle A;
- a person who prepares a return or claim for refund for a taxpayer with no explicit or implicit agreement for compensation, even if the person receives an insubstantial gift, return service, or favor; and
- others as identified in reg. section 301.7701-15(f).

A signing preparer is the preparer who has the primary responsibility for the overall substantive accuracy of the preparation of the return or claim for refund. Reg. section 301.7701-15(b)(1). 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 when the advice is rendered. Reg. section 301.7701-15(b)(2)(i).

In determining whether an individual is a nonsigning preparer, time spent on advice that is given after events have occurred that represents less than 5 percent of the aggregate time incurred by that individual regarding the positions causing the understatement shall not be taken into account. Despite the foregoing, time spent on advice before the events have occurred is taken into account if all facts and circumstances show that the positions giving rise to the understatement is primarily attributable to the advice, the advice was substantially given before events occurred primarily to avoid treating the person giving the advice as a tax return preparer, and the advice given before events occurred was confirmed after events had occurred for purposes of preparing a tax return. Reg. section 301.7701-15(b)(2)(i).

A nonsigning preparer is someone who provides advice (written or oral) to a taxpayer (or to another preparer) when that advice leads to a position or entry that constitutes a substantial portion of the return. Reg. section 301.7701-15(b)(2)(i). The regulations provide several examples of situations involving nonsigning preparers. In Example 1 of reg. section 301.7701-15(b)(2)(ii), Attorney A, an attorney in a law firm, provides legal advice to a large corporate taxpayer regarding a completed corporate transaction. The advice provided by A is directly relevant to the determination of an entry on the taxpayer's return, and this advice leads to a position or entry that constitutes a substantial portion of the return. A, however, does not prepare any other portion of the taxpayer's return and is not the signing preparer of this return. A is considered a nonsigning preparer. In Example 2 of reg. section 301.7701-15(b)(2)(ii), Attorney B, an attorney in a law firm, provides legal advice to a large corporate taxpayer regarding the tax consequences of a proposed corporate transaction. Based on this advice, the corporate taxpayer enters into the transaction. Once the transaction is completed, the corporate taxpayer does not receive any additional advice from B regarding the transaction. B did not provide advice regarding events that have occurred and is not considered a preparer.

A person who renders tax advice on a position that is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund is deemed to have prepared that entry. Reg. section 301.7701-15(b)(3)(i). Whether a schedule, entry, or other portion of a return or claim for refund is a substantial portion is determined based on whether the

person knows or reasonably should know that the tax attributable to that item is a substantial portion of the tax required to be shown on the return or claim for refund. Reg. section 301.7701-15(b)(3)(i).

A single tax entry may constitute a substantial portion of the tax required to be shown on a return. Factors to consider in determining whether a schedule, entry, or other portion of a return or claim for refund is a substantial portion include, but are not limited to, the size and complexity of the item relative to the taxpayer's gross income and the size of the understatement attributable to the item compared with the taxpayer's reported tax liability. Reg. section 301.7701-15(b)(3)(i).

Solely for nonsigning preparers, the schedule or other portion is not considered to be a substantial portion if it involves amounts of gross income, amounts of deductions, or amounts on the basis of which credits are determined that are less than $10,000, or less than $400,000 and also less than 20 percent of the gross income as shown on the return or claim for refund (or, for an individual, the individual's adjusted gross income). Reg. section 301.7701-15(b)(3)(ii)(A) and (iii). If more than one item is involved, all those items are to be aggregated in applying the foregoing de minimis rule to a nonsigning preparer. Reg. section 301.7701-15(b)(3)(ii)(B).

A preparer of a return is not considered to be a preparer of another return merely because an entry reported on the return may affect an entry reported on the other return, unless the entry reported on the prepared return is directly reflected on the other return (for example, K-1 items from passthrough entities) and constitutes a substantial portion of the other return. Reg. section 301.7701-15(b)(3)(i) and (iii). For example, the sole preparer of a partnership return or S corporation return is considered a preparer of a partner's or a shareholder's return if the entry on the partnership or S corporation return reportable on the partner's or shareholder's return constitutes a substantial portion of the partner's or shareholder's return. Reg. section 301.7701-15(b)(3)(iii). As such, if the entry on a related return constitutes a substantial portion of that return, a practitioner (whether a preparer signing a flow-through return or a nonsigning preparer providing advice) may be a return preparer subjected to substantial penalties under section 6694 even if they have never seen the related return giving rise to the penalty.

The regulations illustrate the foregoing through the following example: Accountant C prepares Form 8886, "Reportable Transaction Disclosure Statement," to disclose reportable transactions. C does not prepare the tax return or advise the taxpayer regarding the tax return reporting the position of the transaction to which the Form 8886 relates. The preparation of Form 8886 is not directly relevant to the determination of the existence, characterization, or amount of an entry on a tax return or claim for refund. Rather, the form is prepared by C to disclose a reportable transaction. C has not prepared a substantial portion of the tax return and is not considered a preparer under section 6694. See Example 1 of reg. section 301.7701-15(b)(3)(iv). The foregoing regulations defining the preparer apply to returns and claims for refund filed, and advice provided, after December 31, 2008. Reg. section 301.7701-15(g).

B. One Preparer Per Position Per Firm

The evolution of existing business practices and the increased complexity of federal tax law have increased practice specialization. The regulations modify the previous "one preparer per firm" rule whereby the signing preparer — and no other person within the same firm — would be treated as the preparer of the return for purposes of section 6694. For nonsigning preparers, the person with overall supervisory responsibility for the return within the firm would be the preparer. The regulations focus on the return positions giving rise to the understatement and the persons responsible for each position. As such, reg. section 1.6694-1(b)(1) replaces the one preparer per firm rule with the one preparer per position per firm rule whereby an individual having primary responsibility for the questionable return position is deemed to be the preparer.

Only one person within a single firm can be considered primarily responsible for each position set forth on the return. If different firms are involved in the return preparation, there may be multiple preparers from the different firms primarily responsible for a single return position. Reg. section 1.6694-1(b)(1). The signer of the return is generally the person responsible for all positions set forth on the return under reg. section 1.6694-1(b)(2). However, in the current environment, the person signing the return may not actually have detailed knowledge of a questionable return position and may have reasonably relied on others within the same firm having greater expertise on particular issues.

If there are no signing preparers within a firm or it is determined that the signing preparer within the firm is not primarily responsible for the questionable position, the nonsigning preparer within the firm having overall supervisory responsibility for the questionable positions would be the preparer. Reg. section 1.6694-1(b)(3). If the information presented would support a finding that, within a firm, either the signing preparer or a nonsigning preparer is primarily responsible for the positions giving rise to the understatement, the section 6694 penalty may be assessed against either one of the individuals, but not both, as the primarily responsible preparer. Reg. section 1.6694-1(b)(4). An individual and the firm employing the individual or in which the individual is a partner, shareholder, or equity member can each be subject to the penalty. Reg. section 1.6694-1(b)(5). In a sole proprietorship, if an individual (other than the sole proprietor) working for a sole proprietorship is subject to the penalty, the sole proprietorship can also be subject to the penalty. Reg. section 1.6694-1(b)(5).

A firm that employs a preparer subject to a penalty under section 6694(a) (or a firm of which the individual preparer is a partner, member, shareholder, or other equity holder) is also subject to the penalty if and only if: (1) one or more members of the principal management (or principal officers) of the firm or a branch office participated in or knew of the conduct proscribed by section 6694(a); (2) the corporation, partnership, or other firm entity failed to provide reasonable and appropriate procedures for review of the position for which the penalty is imposed; or (3) those review procedures were disregarded by the corporation, partnership, or other firm entity through willfulness, recklessness, or gross

indifference (including ignoring facts that would lead a person of reasonable prudence and competence to investigate or ascertain in the formulation of the advice, or the preparation of the return or claim for refund, that included the position for which the penalty is imposed). Reg. section 1.6694-2(a)(2). See reg. section 1.6694-3(a)(2) regarding potential firm liability for penalties under section 6694(b), ''Penalty for Understatement Due to Willful, Reckless, or Intentional Conduct.'' Examples of the foregoing provisions are set forth in reg. section 1.6694-1(b)(6).

C. Understatement

An understatement exists if there is a net amount of tax (not including additions to tax, that is, penalties) payable as a result of the adjustment attributable to the questionable position. The amount of any understatement is not to be reduced by any later carryback loss. Reg. section 1.6694-1(c). If the penalty is assessed under section 6694 and it is subsequently established that there was no understatement of liability relating to the position, the penalty shall be abated. Reg. section 1.6694-1(d).

D. Date Return Is Deemed Prepared

For purposes of the penalties under section 6694, a return or claim for refund is deemed prepared on the date it is signed by the preparer. If a signing preparer fails to sign the return, the return or claim for refund is deemed prepared on the date the return or claim is filed. Reg. section 1.6695-1. For a nonsigning preparer, the relevant date is, based on all the facts and circumstances, the date the nonsigning preparer provides the tax advice for the position giving rise to the understatement. Reg. section 1.6694-1(d).

E. Standards of Conduct

The taxpayer standard to avoid imposition of accuracy penalties under section 6662 for undisclosed positions was set at a lower threshold (the reasonable basis standard for negligence and the substantial authority threshold for an understatement) than that for which the preparer could be penalized under the SBWOA amendments to section 6694(a) (more likely than not), which created an obvious conflict between the taxpayer and the preparer. The TEAMTRA amendments to section 6694(a) eliminated this disparity between the standards applicable to taxpayers and return preparers for positions not involving tax shelters as defined in section 6662(d)(2)(C)(ii) and reportable transactions to which section 6662A applies (that is, generally listed and reportable transactions having a significant purpose of tax avoidance or tax evasion).

Return positions or the appropriate tax treatment of an item under section 6694 are initially measured based on the relative possibility of success on the merits if challenged (the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue may be settled is not relevant in determining the appropriate preparer standard). This analysis dictates an evaluation of the favorable and unfavorable authorities relevant to the tax treatment of an item, which are taken into account in determining whether the appropriate standard exists. Reg. section 1.6662-4(d)(3)(i). The weight of authorities is to be determined in light of all pertinent facts and circumstances. The preparer's personal — although misguided — belief is not significantly relevant in determining whether the appropriate standard has been satisfied because it is intended to be an objective standard. However, the preparer's belief is relevant for purposes of satisfying the good-faith exception to the section 6694 penalty.

The weight accorded an authority depends on its relevance, persuasiveness, and the type of document providing the authority. Reg. section 1.6662-4(d)(3)(ii). For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue. An authority that merely states a conclusion is ordinarily less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from which information has been deleted, such as a private letter ruling, is diminished to the extent that the deleted information may have affected the authority's conclusions.

The type of document being relied on also must be considered. For example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue. An older private letter ruling, technical advice memorandum, general counsel memorandum, or action on decision generally must be accorded less weight than a more recent one. Any such document that is more than 10 years old generally is accorded very little weight. However, the persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account along with the age of the document. Reg. section 1.6662-4(d)(3)(ii). There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a preparer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision. Reg. section 1.6662-4(d)(3)(ii).

The authorities considered in determining whether a position satisfies the appropriate standard are described in reg. section 1.6662-4(d)(3)(iii). Those authorities include the tax code and other statutory provisions; final, proposed, and temporary regulations construing those statutes; revenue rulings and revenue procedures; tax treaties and the regulations thereunder; and court cases and various forms of legislative history. Private letter rulings and technical advice memorandums issued after October 31, 1976, and actions on decision and general counsel memorandums issued after March 12, 1981, as well as other enumerated IRS pronouncements could be considered by the preparer. Conclusions reached in treaties, legal periodicals, legal opinions, or opinions rendered by tax professionals are not authority. Reg. section 1.6662-4(d)(3)(iii).

Various potentially applicable standards of conduct include:

1. Not frivolous — 5 percent to 10 percent. A not frivolous position is one that is not patently improper. The test for frivolity is an objective test that must be evaluated in terms of the position's legal underpinnings.

2. Reasonable basis — 20 percent to 25 percent. Reasonable basis is a relatively high standard of tax reporting — that is, significantly higher than not frivolous or not patently improper. Reg. sections 1.6662-3(b)(3) and 1.6694-2(d)(2). The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in reg. section 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in reg. section 1.6662-4(d)(2). The reasonable basis standard is generally the standard for the taxpayer's treatment of an item on the return to avoid the imposition of an accuracy-related penalty for a disclosed item resulting in an understatement of tax.

3. Realistic possibility of success — 33 percent. The realistic possibility standard requires a good-faith belief that a position has a realistic possibility of being sustained on its merits. A position is considered to satisfy the realistic possibility standard if a reasonable and well-informed analysis by a person knowledgeable in tax law would lead that person to conclude that the position has approximately a one-in-three, or greater, likelihood of being sustained on its merits.

4. Substantial authority — 40 percent to 45 percent. The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts, including an evaluation of the relevant authorities, nature of the analysis, and types of authority. There may be substantial authority for more than one position for the same item. Because the substantial authority standard is an objective standard, the preparer's belief that there is substantial authority for the tax treatment of an item is not likely relevant in determining whether there is substantial authority for that treatment.

Substantial authority is generally the standard for the taxpayer's treatment of an item on the return to avoid the imposition of an accuracy-related penalty for an undisclosed item resulting in a substantial understatement of tax. The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50 percent likelihood of the position being upheld), but more stringent than the reasonable basis standard as defined in reg. section 1.6662-3(b)(3).

5. More likely than not — more than 50 percent. A preparer 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 preparer analyzes the pertinent facts and authorities and, based on that analysis, reasonably concludes in good faith that there is a greater than 50 percent likelihood that the tax treatment will be upheld if the IRS challenges it. Reg. section 1.6694-2(b)(1). The authorities described in reg. section 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. Reg. section 1.6694-2(b)(3).

Whether a preparer satisfies the more likely than not standard will be determined based on all facts and circumstances, including the preparer's diligence. Reg. section 1.6694-2(b)(1). In determining the level of diligence in a particular situation, the preparer's experience with the area of federal tax law and familiarity with the taxpayer's affairs, as well as the complexity of the issues and facts, will be taken into account. A preparer may reasonably believe that a position would more likely than not be sustained on its merits despite the absence of other types of authority if the position is supported by a well-reasoned construction of the applicable statutory provision. Reg. section 1.6694-2(b)(1).

For purposes of determining whether the preparer has a reasonable belief that the position would more likely than not be sustained on the merits, a preparer may rely in good faith without verification on information furnished by the taxpayer, adviser, other tax return preparer, or other party (including another adviser or tax return preparer at the tax return preparer's firm). Reg. section 1.6694-1(e), -2(b)(1), and -2(e)(5).

The preparer may avoid the section 6694(a) penalty by taking the position that he reasonably believed that the taxpayer's position satisfies the more likely than not standard if the taxpayer is the subject of a written determination. A written determination includes a position supported by the conclusion of a ruling or a determination letter (as defined in reg. section 301.6110-2(d) and (e)) issued to the taxpayer, by the conclusion of a technical advice memorandum in which the taxpayer is named, or by an affirmative statement in a revenue agent's report for a prior tax year of the taxpayer. Reg. sections 1.6662-4(d)(3)(iv)(A) and 1.6694-2(b)(3). The requirement that a position satisfies the more likely than not standard must be satisfied on the date the return is deemed prepared. Reg. section 1.6694-2(b)(5).

F. Reasonable Basis and Reliance

The section 6694(a) penalty will not apply if the return position has a reasonable basis and is adequately disclosed. Reg. section 1.6694-2(d)(2). The regulations expanded the ability of preparers to rely on others because that reliance is necessary given the increased complexity of the tax law, which often requires signing and nonsigning preparers to rely on the advice of others in ensuring compliance.

A preparer is not required to verify or review items reported on tax returns, schedules, or other third-party documents to determine if the appropriate standard is satisfied. Reg. section 1.6694-1(e)(1) and -2(b) allows a preparer to generally rely in good faith without verification of information furnished by the taxpayer. Further, a preparer may rely in good faith and without verification on information furnished by another adviser, another preparer, or other party (including another adviser or preparer at the preparer's firm). Reg. section 1.6694-1(e)(1) and -2(b).

The preparer is not required to audit, examine, or review books and records, business operations, or documents or other evidence to independently verify information provided by the taxpayer, adviser, other preparer, or other party. Reg. section 1.6694-1(e)(1). However, the preparer may not ignore the implications of information

furnished to the preparer or actually known by the preparer. The preparer must make reasonable inquiries if the information as received appears to be incorrect or incomplete. Reg. section 1.6694-1(e)(1). A preparer may not be intentionally ignorant of relevant facts in attempting to defeat imposition of the section 6694 penalty.

Various provisions of the code or regulations require that specific facts and circumstances exist (for example, that the taxpayer maintains specific documents) before a deduction or credit may be claimed. The preparer must make appropriate inquiries to determine the existence of facts and circumstances required by the code or regulations as a condition of the claiming of a deduction or credit. Reg. section 1.6694-1(e)(1). For example, for an IRS adjustment relating to the reporting of noncash charitable contributions, to avoid a penalty under section 6694, the preparer must inquire about the existence of a qualified appraisal or receive a completed Form 8283, ''Noncash Charitable Contributions,'' in accordance with the reporting and substantiation requirements under section 170(f)(11). See Example 1 of reg. section 1.6694-1(e)(3).

A preparer may rely in good faith without verification on a tax return that has been previously prepared by a taxpayer or another preparer and filed with the IRS. Reg. section 1.6694-1(e)(2). As such, a preparer who prepares an amended return (including a claim for refund) need not verify the positions set forth on the originally filed return. The preparer, however, may not ignore the implications of information furnished to the preparer or actually known by the preparer. Accordingly, the preparer must make reasonable inquiries if the information received appears to be incorrect or incomplete, and must confirm that the position being relied on has not been adjusted by examination or otherwise. Reg. section 1.6694-1(e)(2).

G. Adequate Disclosure

The section 6694(a) penalty will not apply if the return position (other than a position regarding a tax shelter or a reportable transaction to which section 6662A applies) has a reasonable basis and is adequately disclosed as set forth in reg. section 1.6694-2(d)(3). Reg. section 1.6694-2(d)(1). The disclosure, which should include all relevant facts and authorities, must be sufficient to reasonably apprise the IRS of the reason for the disclosure. A poorly drafted disclosure could itself be cause for various sanctions.

A recommendation for a disclosure should be in writing because the preparer will have to overcome the burden of demonstrating that the disclosure occurred and that it was adequate. Disclosures attached to the return should generally be set forth on Form 8275, ''Disclosure Statement.'' Some disclosures may be adequate if set forth on an income tax return in accordance with the annual revenue procedure described in reg. section 1.6662-4(f)(2) (see, for example, Rev. Proc. 2008-14, 2008-7 IRB 435, *Doc 2008-1640, 2008 TNT 18-12*). However, under the annual revenue procedure, the disclosure within the return itself for a return other than an income tax return will not be adequate for a preparer penalty under section 6694(a). Disclosure requirements are different for signing, as opposed to nonsigning, preparers.

1. Signing preparers. Under reg. section 1.6694-2(d)(3)(i), a signing preparer is deemed to satisfy the disclosure requirements of section 6694 for a position (other than a position regarding a tax shelter or a reportable transaction to which section 6662A applies) for which there is a reasonable basis but for which there is not substantial authority, if the preparer satisfies any of the following.

a. Position is disclosed. The position is disclosed in accordance with reg. section 1.6662-4(f) which permits disclosure on a properly completed and filed Form 8275, Form 8275-R, ''Regulation Disclosure Statement,'' as appropriate, or within the return itself in accordance with the annual revenue procedure described in reg. section 1.6662-4(f)(2). See Rev. Proc. 2008-14, identifying circumstances under which the disclosure on a taxpayer's return of an item or a position is adequate for reducing the understatement of income tax under section 6662(d) (relating to the substantial understatement aspect of the accuracy-related penalty), and for avoiding the preparer penalty under section 6694(a) (relating to understatements due to unreasonable positions) with respect to income tax returns. Rev. Proc. 2008-14 does not apply for any other penalty provisions (including the disregard provisions of the section 6662 accuracy-related penalty, which are subject to an exception for adequate disclosure). Also, under Rev. Proc. 2008-14, disclosure within the return itself for a return other than an income tax return will not be adequate for a preparer penalty under section 6694(a). Reg. section 1.6694-2(d)(3)(i)(A).

b. Prepared return that includes the disclosure provided to the taxpayer. The preparer provides the taxpayer with the prepared tax return that includes an appropriate disclosure in accordance with reg. section 1.6662-4(f). Reg. section 1.6694-2(d)(3)(i)(B). Example 1 of reg. section 1.6694-2(d)(3)(v) illustrates the situation whereby a preparer provides a return to the taxpayer with a disclosure statement but the taxpayer removes the disclosure before filing the return. In Example 1 an individual taxpayer hires Accountant R to prepare its income tax return. A particular position taken on the tax return does not have substantial authority although there is a reasonable basis for the position. The position is not for a tax shelter or a reportable transaction to which section 6662A applies. R prepares and signs the tax return and provides the taxpayer with the prepared tax return that includes Form 8275, disclosing the position taken on the tax return. The individual taxpayer signs and files the tax return without disclosing the position. The IRS later challenges the position taken on the tax return, resulting in an understatement of liability. R is not subject to a penalty under section 6694.

c. Advice to taxpayer of penalty standards. For returns or claims for refund that are subject to penalties under section 6662 other than the accuracy-related penalty attributable to a substantial understatement of income tax under section 6662(b)(2) and (d), the preparer advises the taxpayer of the penalty standards applicable to the taxpayer under section 6662. The preparer must also contemporaneously document the advice in the tax return preparer's files. Reg. section 1.6694-2(d)(3)(i)(C).

2. Nonsigning preparers. Under reg. section 1.6694-2(d)(3)(ii), a nonsigning preparer is deemed to satisfy the

disclosure requirements of section 6694 regarding a position (other than a position with respect to a tax shelter or a reportable transaction to which section 6662A applies) for which there is a reasonable basis but for which there is not substantial authority, if the preparer satisfies any of the following.

a. Position is disclosed. The position is disclosed in accordance with reg. section 1.6662-4(f), which permits disclosure on a properly completed and filed Form 8275 or 8275-R, as appropriate, or within the return itself in accordance with the annual revenue procedure described in reg. section 1.6662-4(f)(2). Reg. section 1.6694-2(d)(3)(ii).

b. Advice to taxpayers. The preparer advises the 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. The preparer must also contemporaneously document the advice in the preparer's files. The contemporaneous documentation should reflect that the affected taxpayer has been advised by a preparer in the firm of the potential penalties and the opportunity to avoid penalty through disclosure. Reg. section 1.6694-2(d)(3)(ii)(A).

Example 2 of reg. section 1.6694-2(d)(3)(v) sets forth the situation involving advice by Attorney S to a large corporate taxpayer concerning the proper treatment of complex entries on the taxpayer's tax return. S has reason to know that the tax attributable to the entries is a substantial portion of the tax required to be shown on the tax return within the meaning of reg. section 301.7701-15(b)(3). When providing the advice, S concludes that one position does not have substantial authority, although the position meets the reasonable basis standard. The position is not regarding a tax shelter or a reportable transaction to which section 6662A applies. S advises the corporate taxpayer that the position lacks substantial authority and the taxpayer may be subject to an accuracy-related penalty under section 6662 unless the position is disclosed in a disclosure statement included in the return. S also documents that this advice was contemporaneously provided to the corporate taxpayer when the advice was provided. Neither S nor any other attorney within S's firm signs the corporate taxpayer's return as a tax return preparer, but the advice by S constitutes preparation of a substantial portion of the tax return, and S is the individual with overall supervisory responsibility for the position giving rise to the understatement. Thus, S is a tax return preparer for purposes of section 6694. S, however, will not be subject to a penalty under section 6694.

c. Advice to another preparer. The preparer advises the other tax return preparer that disclosure under section 6694(a) may be required. The preparer must also contemporaneously document the advice in the preparer's files. The contemporaneous documentation should reflect that the preparer outside the firm has been advised that disclosure under section 6694(a) may be required. If the advice is to another nonsigning preparer within the same firm, contemporaneous documentation is satisfied if there is a single instance of contemporaneous documentation within the firm. Reg. section 1.6694-2(d)(3)(ii)(B).

3. Requirements for advice. To satisfy the foregoing disclosure standards of reg. section 1.6694-2(d)(3)(i)(C) and (ii), each return position for which there is a reasonable basis but for which there is not substantial authority must be addressed by the preparer. The advice to the taxpayer for each position, therefore, must be particular to the taxpayer and tailored to the taxpayer's facts and circumstances. The preparer is required to contemporaneously document that the advice was provided.

There is no general pro forma language or special format required for a tax return preparer to comply with those rules. A general disclaimer will not satisfy the requirement that the preparer provide and contemporaneously document advice regarding the likelihood that a position will be sustained on the merits and the potential application of penalties as a result of that position. Preparers, however, may rely on established forms or templates in advising clients regarding the operation of the penalty provisions of the code. A preparer may choose to comply with the documentation standard in one document addressing each position, or in multiple documents addressing all of the positions. Reg. section 1.6694-2(d)(3)(iii).

4. Passthrough entities. Disclosure of items attributable to a passthrough entity is adequate if made at the entity level in accordance with the foregoing rules. Reg. section 1.6694-2(d)(3)(iv). Thus, disclosure of passthrough items must be made on a Form 8275 or 8275-R, as appropriate, attached to the entity return (or qualified amended return), or on the entity's return in accordance with the revenue procedure described in reg. section 1.6662-4(f)(2), if applicable. A taxpayer (that is, partner, shareholder, beneficiary, or holder of a residual interest in a real estate mortgage interest conduit) also may make adequate disclosure regarding a passthrough item; however, if the taxpayer files a properly completed Form 8275 or 8275-R, as appropriate, in duplicate, one copy attached to the taxpayer's return (or qualified amended return) and the other copy filed with the IRS center with which the return of the entity is required to be filed. Each Form 8275 or 8275-R filed by the taxpayer should relate to the passthrough items of only one entity. Reg. section 1.6662-4(f)(5).

Taxpayers may be reluctant to attach Form 8275 to a return. Return preparers may tend to insist on disclosures for substantially every significant position that may be subject to question by the government. When the preparer recommends disclosure of an uncertain return position, is it to avoid the accuracy-related penalty, the return preparer penalty, or both? Is the preparer recommending disclosure to protect the preparer at the expense of exposing a questionable position on the return to the possible detriment of the taxpayer-client? Should the preparer recommend that the taxpayer seek independent advice before following the preparer's disclosure recommendation?

The most successful examination is the one that never occurs. Taxpayers often believe that a disclosure is a red flag essentially requesting an examination and that it represents some type of concession on the underlying merits of the return position. Disclosure, however, is merely disclosure — it should not affect the viability of

return positions, although a few whales have been harpooned while merrily swimming along far below the surface.

H. Willfulness and Reckless Disregard

A preparer is not considered to have recklessly or intentionally disregarded a rule or regulation in violation of section 6694(b) if the position contrary to the rule or regulation has a reasonable basis as defined in reg. section 1.6694-2(d)(2) and is adequately disclosed in accordance with reg. section 1.6694-2(d)(3)(i)(A) or (C) or reg. section 1.6694-2(d)(3)(ii). Reg. section 1.6694-3(c)(2). For positions contrary to a regulation, the position must represent a good-faith challenge to the validity of the regulation and, when the position is properly disclosed, the preparer must identify the regulation being challenged. For purposes of reg. section 1.6694-3(c)(2) relating to the section 6694(b) penalty, disclosure within the return in accordance with an annual revenue procedure under reg. section 1.6662-4(f)(2) is not applicable.

For a position contrary to a revenue ruling or notice (other than a notice of proposed rulemaking) published by the IRS in the Internal Revenue Bulletin, a preparer is not considered to have recklessly or intentionally disregarded the ruling or notice if the preparer reasonably believes that the position meets the substantial authority standard described in reg. section 1.6662-4(d) and is not for a reportable transaction to which section 6662A applies. Reg. section 1.6694-3(c)(3).

The term ''rules or regulations'' includes the provisions of the code, temporary or final Treasury regulations issued under the code, and revenue rulings or notices (other than notices of proposed rulemaking) issued by the IRS and published in the IRB. Reg. section 1.6694-3(e). The amount of any penalty to which a preparer may be subject under section 6694(b) for a return or claim for refund is reduced by any amount assessed and collected against the preparer under section 6694(a) for the same return or claim for refund. Reg. section 1.6694-3(f).

The regulations provide examples intended to help clarify application of the foregoing provisions. In Example 1 of reg. section 1.6694-3(d), a taxpayer provided Preparer T with detailed check registers reflecting personal and business expenses. One of the expenses was for domestic help, and this expense was identified as personal on the check register. T knowingly deducted the expenses of the taxpayer's domestic help as wages paid in the taxpayer's business. T is subject to the penalty under section 6694(b). In Example 2 of reg. section 1.6694-3(d), a taxpayer provided Preparer U with detailed check registers to compute the taxpayer's expenses. U, however, knowingly overstated the expenses on the return. After adjustments by the examiner, the tax liability increased significantly. Because U disregarded information provided in the check registers, U is subject to the penalty under section 6694(b). In Example 3 of reg. section 1.6694-3(d), Preparer V prepares a taxpayer's return in 2009 and encounters certain expenses incurred in the purchase of a business. Final regulations provide that expenses incurred in the purchase of a business must be capitalized. One U.S. Tax Court case decided in 2006 has expressly invalidated that portion of the regulations. There are no courts that ruled favorably regarding the validity of that portion of the regulations, and there are no other authorities existing on the issue. Under those facts, V will have a reasonable basis for the position as defined in section 1.6694-2(d)(2) and will not be subject to the section 6694(b) penalty if the position is adequately disclosed in accordance with paragraph (c)(2) of this section, because the position represents a good-faith challenge to the validity of the regulations. Reg. section 1.6694-3(d).

I. Reasonable Cause and Good-Faith Exception

For the preparer, the most relevant penalty issue is the reasonableness of his belief in the reported position, not the likelihood that it will prevail. A preparer will be deemed to have acted in good faith when the preparer relied on the advice of a third party who the preparer had reason to believe was competent to render the advice. The penalty under section 6694(a) will not be imposed if, considering all the facts and circumstances, it is determined that the understatement was due to reasonable cause and that the preparer acted in good faith. Reg. section 1.6694-2(e). Factors to consider include the following.

1. Nature of the error causing the understatement. Whether the error resulted from a provision that was complex, uncommon, or highly technical, a competent preparer of tax returns or claims for refund of the type at issue reasonably could have made the error. The reasonable cause and good-faith exception, however, does not apply to an error that would have been apparent from a general review of the return or claim for refund by the preparer. Reg. section 1.6694-2(e)(1).

2. Frequency of errors. It is significant whether the understatement was the result of an isolated error (such as an inadvertent mathematical or clerical error) rather than a number of errors. Although the reasonable cause and good-faith exception generally applies to an isolated error, it does not apply if the isolated error is so obvious, flagrant, or material that it should have been discovered during a review of the return or claim for refund. Furthermore, the reasonable cause and good-faith exception does not apply if there is a pattern of errors on a return or claim for refund even though any one error, in isolation, would have qualified for the reasonable cause and good-faith exception. Reg. section 1.6694-2(e)(2).

3. Materiality of errors. It is significant whether the understatement was material in relation to the correct tax liability. The reasonable cause and good-faith exception generally applies if the understatement is of a relatively immaterial amount. Nevertheless, even an immaterial understatement may not qualify for the reasonable cause and good-faith exception if the error or errors creating the understatement are sufficiently obvious or numerous. Reg. section 1.6694-2(e)(3).

4. Preparer's normal office practice. It is important 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 occur rarely and the normal office practice was followed in preparing the return or claim for refund in question. Such a normal office practice must be a system for promoting accuracy and consistency in the preparation of returns or claims for

refund and generally would include, for a signing preparer, checklists, methods for obtaining necessary information from the taxpayer, a review of the prior year's return, and review procedures. Despite those rules, the reasonable cause and good-faith exception does not apply if there is a flagrant error on a return or claim for refund, a pattern of errors on a return or claim for refund, or a repetition of the same or similar errors on numerous returns or claims for refund. Reg. section 1.6694-2(e)(4).

5. Reliance on advice of others. It is important whether the preparer relied on the advice of, or schedules prepared by, another preparer. A preparer may rely without verification on advice and information furnished by the taxpayer and information and advice furnished by another adviser, another preparer, or other party, as provided in reg. section 1.6694-1(e). The preparer may rely in good faith on the advice of, or schedules or other documents prepared by, the taxpayer, another adviser, another tax return preparer, or other party (including another adviser or tax return preparer at the tax return preparer's firm) who the preparer had reason to believe was competent to render the advice or other information. The advice or information may be written or oral, but in either case, the burden of establishing that the advice or information was received is on the tax return preparer.

A preparer is not considered to have relied in good faith if: (a) the advice or information is unreasonable on its face; (b) the preparer knew or should have known that the other party providing the advice or information was not aware of all relevant facts; or (c) the preparer knew or should have known (given the nature of the preparer's practice) when 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. Reg. section 1.6694-2(e)(5).

6. Reliance on generally accepted administrative or industry practice. The preparer reasonably relied in good faith on generally accepted administrative or industry practice in taking the position that resulted in the understatement. A preparer is not considered to have relied in good faith if he knew or should have known (given the nature of the tax return preparer's practice) when the return or claim for refund was prepared that the administrative or industry practice was no longer reliable because of developments in the law or IRS administrative practice since the time the practice was developed. Reg. section 1.6694-2(e)(6). It remains somewhat unclear what may constitute ''administrative or industry practice.'' It will likely be determined to be well-accepted practices within the practitioner community that are not historically challenged by the IRS.

J. Section 6694 Returns and Claims for Refund

For purposes of section 6694, a tax return is a return (including an amended or adjusted return) filed by or on behalf of a taxpayer reporting liability for tax under the code, if the type of return is identified in published guidance in the IRB. A tax return also includes any information return or other document identified in published guidance in the IRB and that reports information that is or may be reported on another taxpayer's return under the code if the information reported on the information return or other document constitutes a substantial portion of the taxpayer's return within the meaning of reg. section 301.7701-15(b)(3). For purposes of section 6694, a claim for refund of tax includes a claim for credit against any tax that is included in published guidance in the IRB. A claim for refund also includes a claim for payment under sections 6420, 6421, or 6427. Reg. section 301.7701-15(b)(4).

Rev. Proc. 2009-11, 2009-3 IRB 313, *Doc 2008-26377*, *2008 TNT 242-14*, identifies the returns and claims for refund that are subject to the section 6694 penalties. Treasury and the IRS may add or remove documents from any of the categories in Rev. Proc. 2009-11 in future guidance as they implement the provisions of TEAMTRA and the regulations. Returns and other documents identified in Rev. Proc. 2009-11 include but are not limited to the following.

1. Tax returns reporting tax liability. Under Rev. Proc. 2009-11, ''tax returns reporting tax liability'' subject to section 6694 include, but are not limited to, the following:

- Income Tax Returns — Subtitle A (Form 990T, ''Exempt Organization Business Income Tax Return''; Form 1040 and 1040X, ''U.S. Individual Income Tax Return'' and ''Amended U.S. Individual Tax Return,'' respectively; Form 1041, ''U.S. Income Tax Return for Estates and Trusts''; Form 1120 and 1120X, ''U.S. Corporation Income Tax Return'' and ''Amended U.S. Corporation Income Tax Return,'' respectively; and Form 1120S, ''U.S. Income Tax Return for an S Corporation'');
- Estate and Gift Tax Returns — Subtitle B (Form 706, ''U.S. Estate Tax Return''; Form 709, ''United States Gift (and Generation-Skipping Transfer) Tax Return''; and Form 843, ''Claim for Refund and Request for Abatement'');
- Employment Tax Returns — Subtitle C (Form 843; Form 940, ''Employer's Annual Federal Unemployment (FUTA) Tax Return''; Form 941, ''Employer's Quarterly Federal Tax Return''; and Schedule H, Form 1040, ''Household Employment Tax''); and
- Miscellaneous Excise Tax Returns — Subtitle D (Form 990-PF, ''Return of Private Foundation'').

2. Information returns and other documents. Solely for purposes of section 6694, an information return listed in Rev. Proc. 2009-11 that includes information that is or may be reported on a taxpayer's tax return or claim for refund is a return to which section 6694 could apply if the information reported constitutes a substantial portion of that taxpayer's tax return or claim for refund. A person who for compensation prepares any of the informational forms listed in Rev. Proc. 2009-11, which do not report a tax liability but affect an entry or entries on a tax return and constitute a substantial portion of the tax return or claim for refund that does report a tax liability, is a preparer who is subject to section 6694. Under Rev. Proc. 2009-11, ''information returns and other documents'' subject to section 6694 include but are not limited to Form 706-GS (D-1), ''Notification of Distribution From a Generation Skipping Trust''; Form 926, ''Return by a U.S. Transferor of Property to a Foreign Corporation''; Form 1065, ''U.S. Return of Partnership Income''; Form 1120S, ''U.S. Income Tax Return for an S Corporation''; Form 3520, ''Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts''; Form

3520-A, ''Annual Information Return of Foreign Trust With a U.S. Owner (Under Section 6048(b))''; Form 5471, ''Information Return of U.S. Persons With Respect to Certain Foreign Corporations''; Form 5500, ''Annual Return/Report of Employee Benefit Plan''; Form 5500-EZ, ''Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan''; Form 8858, ''Information Return of U.S. Persons With Respect to Foreign Disregarded Entities''; and Form 8865, ''Return of U.S. Persons With Respect to Certain Foreign Partnerships.''

Rev. Proc. 2009-11 also provides that a document that includes information that is or may be reported on a taxpayer's tax return or claim for refund is treated as a return to which section 6694 could apply if the information reported constitutes a substantial portion of that taxpayer's tax return or claim for refund. For example, a person who prepares documents for compensation — such as depreciation schedules or cost, expense, and income allocation studies that do not report a tax liability but that will affect an entry or entries on a tax return that reports a tax liability, and constitute a substantial portion of such tax return — is a tax return preparer who is subject to section 6694.

3. Other documents not constituting a substantial portion of a taxpayer's tax return or claim for refund unless prepared willfully to understate tax or in reckless or intentional disregard of the rules or regulations. Solely for purposes of section 6694, some documents listed in Rev. Proc. 2009-11 that include information that is or may be reported on a taxpayer's tax return or claim for refund (and that constitutes a substantial portion of that tax return or claim for refund) will not subject the preparer to a penalty under section 6694(a). Those documents may, however, subject the preparer to a willful or reckless conduct penalty under section 6694(b) if the information reported on the document constitutes a substantial portion of the tax return or claim for refund and is prepared willfully in any manner to understate the liability of tax on a tax return or claim for refund, or in reckless or intentional disregard of rules or regulations. For example, preparation of a Form W-2, ''Wage and Tax Statement,'' reporting compensation may constitute preparation of a substantial portion of the Form 1040 return on which the compensation is reported if it is prepared willfully in a manner to understate the liability of tax.

A person who prepares all or a substantial portion of any of the following forms or other documents for compensation is not a preparer subject to section 6694(a) and (b) unless the form or document was prepared willfully in any manner to understate the liability of tax on a tax return or claim for refund or in reckless or intentional disregard of rules or regulations. Those documents include but are not limited to Form SS-8, ''Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding''; Form W-2 series of returns; Form 990, ''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 1099 series of returns; Form 5227, ''Split-Interest Trust Information Return''; Form 8027, ''Employer's Annual Information Return of Tip Income and Allocated Tips''; and Form 8288-B, ''Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests.''

K. Income Derived or to Be Derived

For purposes of computing the section 6694 penalties, income derived (or to be derived) means all compensation the preparer receives or expects to receive for the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) regarding the positions taken on the return or claim for refund that gave rise to the understatement. Reg. section 1.6694-1(f)(1). In the situation of a preparer who is not compensated directly by the taxpayer, but rather by a firm that employs the preparer or with whom the preparer is associated, income derived (or to be derived) means all compensation the preparer receives from the firm that can be reasonably allocated to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) regarding the positions taken on the return or claim for refund that gave rise to the understatement. Reg. section 1.6694-1(f)(1).

In the situation in which a firm that employs the individual preparer (or the firm of which the individual tax return preparer is a partner, member, shareholder, or other equity holder) is subject to a penalty under section 6694(a) or (b) under the provisions in reg. section 1.6694-2(a)(2) or -3(a)(2), income derived (or to be derived) means all compensation the firm receives or expects to receive for the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) regarding the positions taken on the return or claim for refund that gave rise to the understatement. Reg. section 1.6694-1(f)(1).

If the preparer or the preparer's firm has multiple engagements related to the same return or claim for refund, only those engagements relating to the positions taken on the return or claim for refund that gave rise to the understatement are considered for purposes of calculating the income derived (or to be derived) with respect to the return or claim for refund. Reg. section 1.6694-1(f)(2)(i). Only compensation for tax advice that is given for events that have occurred when the advice is rendered and that relates to the positions giving rise to the understatement will be taken into account for purposes of calculating the section 6694(a) or (b) penalties. If a lump sum fee is received that includes amounts not taken into account under the preceding sentence, the amount of income derived will be based on a reasonable allocation of the lump sum fee between the tax advice giving rise to the penalty and the advice that does not give rise to the penalty. Reg. section 1.6694-1(f)(2)(ii).

A refund to the taxpayer of all or part of the amount paid to the preparer or the preparer's firm will not reduce the amount of the section 6694 penalty assessed. In this context, a refund does not include a discounted fee or alternative billing arrangement for the services provided. Reg. section 1.6694-1(f)(2)(iii). It may be possible to demonstrate, based on information provided by the preparer or the preparer's firm, that an appropriate allocation of compensation attributable to the positions giving rise to the understatement on the return or claim

for refund is less than the total amount of compensation associated with the engagement. For example, the number of hours of the engagement spent on the positions giving rise to the understatement may be less than the total hours associated with the engagement. If so, the amount of the penalty is to be calculated based on the compensation attributable to the positions giving rise to the understatement. Otherwise, the total amount of compensation from the engagement will be the amount of income derived for purposes of calculating the penalty under section 6694. Reg. section 1.6694-1(f)(2)(iv).

If both an individual within a firm and a firm that employs the individual (or the firm of which the individual is a partner, member, shareholder, or other equity holder) are subject to a penalty under section 6694 under the provisions in reg. section 1.6694-2(a)(2) or -3(a)(2), the amount of penalties assessed against the individual and the firm shall not exceed 50 percent of the income derived (or to be derived) by the firm from the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) regarding the positions taken on the return or claim for refund that gave rise to the understatement. The portion of the total amount of the penalty assessed against the individual preparer shall not exceed 50 percent of the individual's compensation as determined under reg. section 1.6694-1(f)(1) and (2). Reg. section 1.6694-1(f)(3). Examples of the foregoing are set forth in reg. section 1.6694-1(f)(4).

L. Burden of Proof

In any proceeding regarding the penalty imposed by section 6694(a), the preparer will bear the burden of proof on whether: (1) the preparer knew or reasonably should have known that the questioned position was taken on the return; (2) there is reasonable cause and good faith regarding that position; and (3) the position was adequately disclosed in accordance with reg. section 1.6694-2(c).

In any proceeding regarding the penalty imposed by section 6694(b), the government bears the burden of proof on whether the preparer willfully attempted to understate the tax liability. Section 7427. The preparer bears the burden of proof on other issues such as whether: (1) the tax return preparer recklessly or intentionally disregarded a rule or regulation; (2) a position contrary to a regulation represents a good-faith challenge to the validity of the regulation; and (3) disclosure was adequately made in accordance with reg. section 1.6694-3(c)(2).

M. Third-Party Contacts

Section 7602 provides that during an examination, the IRS may not contact any person other than the taxpayer regarding the determination or collection of the tax liability of that taxpayer without providing reasonable advance notice that those third-party contacts may occur. The notice and record-keeping requirements come into effect whenever the examiner addresses the taxpayer as a third party, that is, whenever the examiner directly asks the taxpayer for information needed for making a determination on the preparer's liability for a penalty.

In the course of routine examinations, the preparer penalty issue is usually not subject to third-party notification and record-keeping requirements. Criteria for applying the section 6694 penalties are decided by the character of the adjusted positions to the taxpayer's return and the preparer's role in the noncompliance. Information on the applicability of preparer penalties is often a byproduct of a taxpayer examination and does not always require examiners to directly address the taxpayer as a third party for information on the preparer's conduct. The notice requirements of section 7602(c) are not immediately triggered by a taxpayer's response that provides a basis for conducting a preparer penalty investigation. For example, to account for an erroneous return position and determine if a section 6662 penalty applies against the taxpayer, the examiner may ask the taxpayer what information he gave the preparer and to what extent the preparer was informed of all relevant facts in order to determine if the taxpayer reasonably relied on the advice of the preparer. Reg. section 1.6664-4(c). The taxpayer's response may justify the preparer penalty.

N. Statute of Limitations

The penalty under section 6694(a) must be assessed within three years of the filing date of the return or claim for refund to which the penalty is being assessed. Section 6696(d)(1). The statute of limitations on a return preparer penalty case under section 6694(a) can be extended under section 6501(c)(4) using Form 872-D, ''Consent to Extend the Time on Assessment of Tax Return Preparer Penalty'' (see Rev. Rul. 78-245). The willful disregard penalty under section 6694(b) may be assessed at any time. Section 6696(d)(1).

If the statutory period for assessment of the section 6694(a) penalty is about to expire and the preparer will not agree to an extension, the IRS will likely assess the penalty. The preparer, on request, should be provided postassessment appeal rights in the same way preassessment appeal rights would have been provided. The IRS will not normally submit preparer penalty cases to Appeals if fewer than 180 days remain on the statute of limitations. Instead, it will usually first request an extension of the statutory period for assessment.

O. Administrative Appeal Rights

Section 6696(b) provides that the normal deficiency procedures do not apply to the assessment of section 6694 penalties. However, reg. section 1.6694-4(a)(1) and section 6696 allow a preassessment appeals procedure whereby the IRS is to generally provide a report of the preparer penalty examination to the preparer before assessment of a penalty under section 6694. Reg. section 1.6694-4(a)(2) provides that, before assessment, unless the period of limitations (if any) under section 6696(d) expires without adequate opportunity for assessment, the IRS shall send a 30-day letter to the preparer notifying him of the proposed penalty or penalties and offering an opportunity to the preparer to request further administrative consideration and a final administrative determination by the IRS concerning the assessment. If the preparer then makes a timely request, assessment may not be made until the IRS makes a final administrative determination adverse to the preparer. If the preparer requests preassessment Appeals consideration, the request should normally be granted.

IRS Examination Procedures (IRM 20.1.6.1.3 (July 8, 1999)) provide that an unagreed preparer penalty case under section 6694 will not be sent to Appeals for consideration before the related unagreed income tax case is submitted to Appeals. If the two cases are submitted separately, IRS will include in the preparer case file information on the current status and location of the unagreed taxpayer deficiency.

P. Other Administrative Procedures

For claims filed and advice provided after December 31, 2008:

1. Notice and demand. The IRS is required to issue a statement of notice and demand for payment for all penalties assessed against the preparer under section 6694 and reg. section 1.6694-1. Reg. section 1.6696-1(a).

2. Claim filed by tax return preparer. Section 6696(c) and reg. section 1.6696-1(b) authorize the filing of claims for credit or refund on any penalties paid under section 6694. To avoid enforced collection, within 30 days after the date of notice and demand for payment, the preparer must pay at least 15 percent of the penalty and timely file a claim for refund on Form 6118, ''Claim for Refund of Income Tax Return Preparer Penalties.'' Using the procedure described in section 6694(c)(1), collection of the remaining portion of the penalty will be suspended until the earlier of 30 days after the refund claim is denied, or 30 days from the period ending six months after the preparer files the claim. If the preparer later timely files a proceeding in a U.S. district court for the determination of the penalty during either of those 30-day periods, collection of the section 6694 penalty will continue to be suspended until the final resolution of the proceeding. Reg. section 1.6694-4 and -4(a)(5).

A claim for credit or refund of a penalty (or penalties) assessed against a preparer under section 6694 and reg. section 1.6694-1 may be filed under reg. section 1.6696-1 only by the preparer (or the preparer's estate) against whom the penalty (or penalties) is assessed and not by, for example, the preparer's employer. The foregoing is not intended to impose any restrictions on the preparation of the claim for credit or refund. The claim may be prepared by the preparer's employer or by other persons. In all cases, however, the claim for credit or refund shall contain the information specified in reg. section 1.6696-1(d) and shall be verified by a written declaration by the preparer that the information is provided under penalty of perjury. Reg. section 1.6696-1(b).

3. Separation and consolidation of claims. A preparer shall file a separate claim for each penalty assessed under section 6694 in each statement of notice and demand issued to the preparer. Reg. section 1.6696-1(c).

4. Content of claim. Each claim (Form 6118) for credit or refund for any penalty (or penalties) paid by a preparer under section 6694 and reg. section 1.6694-1 shall include the following information, verified by a written declaration by the preparer that the information is provided under penalty of perjury:

- The preparer's name.
- The preparer's identification number. If the preparer is: (1) an individual (not including the preparer's employer) who is a citizen or resident of the United States, the preparer's Social Security number (or such alternative number as may be prescribed by the IRS in forms, instructions, or other appropriate guidance) shall be provided; (2) an individual who is not a citizen or resident of the United States and also was not employed by another preparer to prepare the document (or documents) for which the penalty was assessed, the preparer's employer identification number shall be provided; or (3) a person (whether an individual, corporation, or partnership) that employed one or more persons to prepare the document for which the penalty was assessed, the preparer's employer identification number shall be provided.
- The preparer's address where the IRS mailed the statement (or statements) of notice and demand and, if different, the preparer's address shown on the document (or documents) for which the penalty was assessed.
- The address of the IRS campus or office that issued the statement of notice and demand for payment of the penalty (or penalties) and the date and identifying number of the statement of notice and demand.
- The identification, by amount, type, and document to which related, of each penalty included in the claim. Each document referred to in the preceding sentence shall be identified by the form title or number, by the taxpayer's (or nontaxable entity's) name and taxpayer identification number, and by the tax year to which the document relates; the date of payment of the amount of the penalty included in the claim; and the total amount claimed.
- A statement setting forth in detail: Each ground on which each penalty overpayment claim is based and facts sufficient to apprise the IRS of the exact basis of each such claim. Reg. section 1.6696-1(d).

5. Form for filing a claim. Form 6118 is the form prescribed for making a claim as provided in reg. section 1.6696-1. Reg. section 1.6696-1(e).

6. Place for filing a claim. A claim shall be filed with the IRS campus or office that issued to the preparer or appraiser the statement of notice and demand for payment of the penalty included in the claim. Reg. section 1.6696-1(f).

7. Time for filing a claim. Except as provided in section 6694(c)(1) and reg. section 1.6694-2(a)(3)(ii) and (4), and in section 6694(d) and reg. section 1.6694-1(c), a claim for a penalty paid by a preparer under section 6694 and reg. section 1.6694-1 shall be filed within three years from the date the payment was made. Payment is considered made on the date payment is received by the IRS or, if applicable, on the date an amount is credited in satisfaction of the penalty. For purposes of determining whether a claim is timely filed, the rules under sections 7502 and 7503 and the provisions of reg. sections 1.7502-1, -2, and 1.7503-1 apply. Reg. section 1.6696-1(g).

8. Application of refund to outstanding liability of preparer. The IRS may, within the applicable period of limitations, credit any amount of an overpayment by a preparer of a penalty paid under section 6694 and reg. section 1.6694-1 against any outstanding liability for any tax (or for any interest, additional amount, addition to the tax, or assessable penalty) owed by the preparer making the overpayment. If a portion of an overpayment

is so credited, only the balance will be refunded to the preparer. Reg. section 1.6696-1(h).

9. Interest. Section 6611 and reg. section 301.6611-1 apply to the payment by the IRS of interest on an overpayment by a preparer of a penalty (or penalties) paid under section 6694(d) and reg. section 1.6694-1. Section 6601 and reg. section 301.6601-1 apply to the payment of interest by a tax return preparer or appraiser to the IRS on any penalty (or penalties) assessed against the tax return preparer under section 6694 and reg. section 1.6694-1. Reg. section 1.6696-1(i).

10. Action for refund of penalty. A preparer may not file a complaint maintaining a civil action for the recovery of any penalty paid under section 6694(d) and reg. section 1.6694-1 unless the preparer has previously filed a claim for credit or refund of the penalty with the IRS as provided in reg. section 1.6694-1 (and the court has jurisdiction of the proceeding). Sections 6694(c) and 7422. Except as provided in section 6694(c)(2) and reg. section 1.6694-2(b), the periods of limitation contained in section 6532 and reg. section 301.6532-1 apply to a preparer's action for the recovery of any penalty paid under section 6694 and reg. section 1.6694-1. The rules under section 7503 and reg. section 301.7503-1 apply to the timely commencement by a preparer of an action for the recovery of any penalty paid under section 6694 and reg. section 1.6694-1. Reg. section 1.6696-1(j).

IV. Unlawful Disclosures — Section 7216

Section 7216 is a criminal provision enacted by Congress in 1971 that prohibits return preparers from knowingly or recklessly disclosing or using tax return information. Reg. section 301.7216 had been substantially unchanged for over 30 years and did not address the modern return preparation marketplace, particularly electronic filing and the cross-marketing of financial and commercial products and services during the return preparation experience. After a long process that included many public suggestions and comments, updated regulations were published on January 7 and July 2, 2008, and apply to uses and disclosures occurring on or after on January 1, 2009 (T.D. 9375, *Doc 2008-101, 2008 TNT 3-4*, 73 *Fed. Reg.* 1,058; T.D. 9437, *Doc 2008-26304, 2008 TNT 242-12*, 73 *Fed. Reg.* 76,216).

Return preparers who knowingly or recklessly make unauthorized disclosures of or use information furnished in connection with the preparation of an income tax return are subject to criminal sanctions (that is, imprisonment) under section 7216. A violation of section 7216 is a misdemeanor, with a maximum penalty of up to one year imprisonment or a fine of not more than $1,000, or both, together with the costs of prosecution. Section 7216(b) establishes exceptions to the general rule in section 7216(a) and also authorizes Treasury to promulgate regulations prescribing additional permitted disclosures and uses.

Section 6713(a) prescribes a related civil penalty for unauthorized disclosures or uses of information furnished in connection with the preparation of an income tax return. The penalty for violating section 6713 is $250 for each disclosure or use, not to exceed a total of $10,000 for a calendar year. Section 6713(b) provides that the exceptions in section 7216(b) also apply to section 6713. Reg. section 301.7216-3 provides that, unless section 7216 or reg. section 301.7216-2 specifically permits the disclosure or use of tax return information, a preparer may not disclose or use a taxpayer's tax return information before obtaining consent from the taxpayer. Reg. section 301.7216-3(a) provides that consent must be knowing and voluntary. Reg. section 301.7216-3(a)(3)(i) prescribes the form and content requirements that all consents to disclose or use must include.

For purposes of section 7216, ''tax return information'' includes all the information preparers obtain from taxpayers or other sources in any form or manner that is used to prepare tax returns or is obtained in connection with the preparation of returns. It also includes all computations, worksheets, and printouts preparers create; correspondence from IRS during the preparation, filing, and correction of returns; statistical compilations of tax return information; and tax return preparation software registration information. All tax return information is protected by section 7216 and the underlying regulations.

Disclosure of tax return information is the act of making tax return information known to any person in any manner whatsoever. Reg. section 301.7216-2 provides exceptions allowing preparers to disclose tax return information without a taxpayer's prior written consent under certain limited circumstances, such as disclosures to the IRS; other taxing jurisdictions or the courts; disclosures to other U.S.-based tax return preparers that assist in preparing the return; and disclosures for the purpose of obtaining legal advice. All other disclosures not specifically authorized require tax return preparers to secure from taxpayers advance signed consents.

Rev. Proc. 2008-35, 2008-29 IRB 132, *Doc 2008-14522, 2008 TNT 128-9*, supplements reg. section 301.7216-3, and provides specific form and content guidance to preparers for obtaining consents to disclose and consents to use taxpayer data in both paper and electronic environments. Generally, preparers must obtain the signed consent of the taxpayer on paper or electronically before they can disclose taxpayer return information to anyone or use it for any purpose other than in the context of preparing and filing the return. Separate consents are required for disclosures and use. Rev. Proc. 2008-35 further updates the rules regarding disclosures of tax return information by preparers to provide an exception that allows a U.S.-based preparer to obtain consent from a taxpayer to disclose a taxpayer's SSN to a non-U.S.-based preparer when the U.S. preparer makes the disclosure through the use of an ''adequate data protection safeguard,'' the non-U.S. preparer receives the SSN via an ''adequate data protection safeguard,'' and the U.S. preparer verifies the maintenance of the adequate data protection safeguards in the request for the taxpayer's consent.

Consent forms must include certain language and warnings as described in reg. section 301.7216-3(a)(3) and Rev. Proc. 2008-35. Tax return preparers must obtain consent to disclose tax return information before returns are provided to the taxpayer for signature and before tax return information is disclosed. A taxpayer's consent to each separate disclosure or use of tax return information must be contained on a separate written document, which can be furnished on paper or electronically. For

example, the separate written document may be provided as an attachment to an engagement letter furnished to the taxpayer. The regulations apply to paid preparers, software developers, electronic return originators, and other persons or entities engaged in tax return preparation services or services that are auxiliary to return preparation. They also apply to most volunteer tax preparers, for example, Volunteer Income Tax Assistance and Tax Counseling for the Elderly volunteers, and employees and contractors employed by tax return preparation companies in a support role.

V. Other Preparer Penalties

While most people who prepare tax returns and represent taxpayers before the IRS are professional and honest and provide excellent service to their clients, there are some who fall below the applicable legal and ethical standards. The preparer is not required to independently verify a taxpayer's information but must make reasonable inquiries if that information appears to be incorrect or incomplete. Copies of client-provided information supporting the return positions should be retained. A review of prior-year returns to determine the reasonableness of the client-provided information on the current return is a good practice.

Circular 230 specifies that a preparer gaining knowledge of a client's omission shall advise the client promptly in writing of that noncompliance, error, or omission. There is no duty to file an amended return, but practitioners should consider withdrawing to avoid being associated with the noncompliance. Penalties that can be imposed against return preparers in addition to sections 6694 and 7216 include but are not limited to:

- **Section 6695(a):** Failure by an income tax return preparer to furnish a copy of the tax return to the taxpayer, $50 for each failure, subject to a reasonable cause exception, not to exceed $25,000 in any calendar year.
- **Section 6695(b):** Failure by an income tax preparer to sign a required return, $50 for each failure, subject to a reasonable cause exception, not to exceed $25,000 in any calendar year.
- **Section 6695(c):** Failure by an income tax return preparer to furnish a required TIN, $50 for each failure, subject to a reasonable cause exception, not to exceed $25,000 in any calendar year.
- **Section 6695(d):** Failure by an income tax return preparer to retain a completed copy of the return or a record of the taxpayer's name, identification number, tax year, and type of return prepared, $50 for each failure, subject to a reasonable cause exception, not to exceed $25,000 in any calendar year.
- **Section 6695(g):** Failure by an income tax return preparer to comply with the due diligence requirements with respect to determining a taxpayer's eligibility for, or amount of, the earned income credit, $100 for each failure.
- **Section 6701:** Aiding and abetting the understatement of a tax liability, $1,000 for each failure ($10,000 for corporate returns). However, no penalty shall be assessed under section 6694 on any person for any document for which a penalty has been assessed under section 6701.
- **Section 6713(a):** Disclosing or using any tax return information other than to prepare or assist in preparing the taxpayer's return, $250 for each failure, not to exceed $10,000 in any calendar year. Section 7216 provides criminal sanctions for the unauthorized disclosure of such information. Disclosure under a court order is excluded, but a mere discovery request or subpoena duces tecum issued by an attorney is not a court order. Each separate use or disclosure must have an individual consent. If the client will not consent in writing to the disclosure, the practitioner should not provide such information without an appropriate court order. Other information not received in connection with tax return preparation (such as reporting documents) is not subject to this restriction and can be subpoenaed when relevant to issues raised in litigation. Section 7602 provides that the IRS may summon either the taxpayer or a third party and may require production of documents or records. Section 7609 requires notice to the taxpayer within three days of an IRS summons being served on third parties such as taxpayer's bank, accountant, or attorney. The taxpayer has 20 days to file a motion to quash. After 20 days, the IRS issues a certificate stating the period has expired and that the third party has no liability for compliance. If a practitioner receives an informal request for such information from the IRS, they should likely request that the IRS issue an appropriate certificate, unless the client consents in writing.
- **Criminal Sanctions:** For sufficiently egregious conduct, the IRS can also seek criminal sanctions — that is, incarceration of the practitioner in a federal prison. Those sanctions may include:
  - **Section 7206(1)** — making a false statement.
  - **Section 7206(2)** — aiding and abetting preparation or presentation of false returns or documents.
  - **Section 7207** — submitting false documents.
  - **18 U.S.C. section 371** — Conspiracy.
  - **Mail Fraud, Wire Fraud, and Money Laundering** are now more liberally used in shelter cases (Tax Division Directive 128).
- **Injunctions: Section 7407(a):** Even when bringing a criminal prosecution, the IRS may seek to enjoin an income tax return preparer engaging in specific abusive practices or from acting as an income tax return preparer. An injunction may be issued if a court determines that the preparer has: (1) engaged in conduct subject to a preparer penalty under section 6694 or section 6695, (2) engaged in conduct subject to a criminal penalty under the code, (3) misrepresented his eligibility to practice before the IRS, (4) misrepresented his experience or education as a preparer, (5) guaranteed the payment of any tax refund or the allowance of any tax credit, or (6) engaged in any other fraudulent or deceptive conduct that substantially interferes with the proper administration of the tax law; and that injunctive relief is appropriate to prevent the recurrence of that conduct.
- **Section 6695(a):** Appraisers can also be subject to penalties. Section 6695A imposes a penalty on a

person who prepares an appraisal that results in a section 6662 substantial or gross valuation misstatement if the person knew or reasonably should have known that the appraisal would be used in connection with a return or refund claim. This penalty can be as much as 125 percent of the fee received for the appraisal.

VI. Whistle-Blower Rewards

Authorities throughout the world pay informants for valuable information. Those tactics may not be pretty, but they are both legal and effective, allowing surgical strikes while preserving limited tax enforcement resources. Many civil and criminal investigations attributable to whistle-blowers have recently been commenced. In time, whistle-blower rewards should help unveil whatever then remains of bank secrecy around the world as even low-level clerks in foreign financial institutions realize there is a much easier road to retirement than long hours at a computer. They can make money the old-fashioned way — reporting the indiscretions of those hiding money in nominee accounts in foreign countries.

The IRS is authorized to pay whistle-blowers up to 30 percent of the recovered tax, interest, and penalties. Section 7623(a) authorizes the Treasury secretary to pay a reward in ''such sum as he deems necessary for (1) detecting underpayments of tax, or (2) detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws or conniving at the same.'' Section 7623(b) entitles an informant to receive as a reward at least 15 percent (but no more than 30 percent) of the collected proceeds, including penalties, interest, additions to tax, and additional amounts, resulting from any administrative or judicial action or from any settlement thereof for specific information that caused the investigation and resulted in the recovery. Notice 2008-4, 2008-2 IRB 253, *Doc 2007-27740, 2007 TNT 245-13*, provides guidance on how to file whistle-blower claims submitted on Form 3949-A, ''Information Referral,'' under section 7623.

If the taxes, penalties, interest and other amounts in dispute exceed $2 million and a few other qualifications set forth in section 7623(b) are satisfied, the IRS will pay 15 percent to 30 percent of the amount collected. If the taxpayer is an individual, his annual gross income must be more than $200,000. If the whistle-blower disagrees with the outcome of the claim, he can appeal to the Tax Court.

There is an award program under section 7623(a) for other whistle-blowers — generally those who do not meet the dollar thresholds of $2 million in dispute or cases involving individual taxpayers with gross income of more than $200,000. The awards through this program are less, with a maximum award of 15 percent up to $10 million. In addition, the awards are discretionary and the informant cannot dispute the outcome of the claim in Tax Court. Submissions that do not qualify under section 7623(b) will generally be processed under section 7623(a).

The statutory threshold for individual taxpayers reflects a balance reached by Congress intended to help the IRS avoid spending limited resources on an avalanche of informant claims that have little revenue potential. The IRS is looking for solid information, not an educated guess or unsupported speculation. The IRS is looking for a significant federal tax issue — this is not a program for resolving personal problems or disputes about a business relationship. Whistle-blowers are looking for a quick payday at the expense of taxpayers who should have anticipated that money talks.

VII. OPR Referrals of Assessed Preparer Penalties

Regulations governing practice before the IRS, are set out in Title 31, Code of Federal Regulations, Part 10, and are published in pamphlet form as Treasury Department Circular 230. The regulations prescribe the duties and restrictions relating to that practice and the disciplinary sanctions for violating the regulations.

OPR, formerly known as the Director of Practice, enforces those regulations governing the practice of attorneys, CPAs, enrolled agents, enrolled actuaries, and appraisers before the IRS as set forth in Circular 230. (A copy of Circular 230 is available at http://www.irs.gov.) OPR also reviews applications from individuals who wish to become an enrolled agent or enrolled actuary. OPR has the authority to impose suspension, disbarment, or significant monetary fines on federally authorized tax practitioners, firms, and other entities. In addition, as part of any OPR investigation, it may and likely will contact current and former clients.

Currently, the IRM requires a referral to OPR in all cases in which a return preparer penalty is assessed. IRM 20.1.6.2.1 (Feb. 8, 2008). One may assume that examiners have a better sense of situations that should be referred to OPR and those that should not. Often, during the audit, examiners have spent considerable time with the preparer and get a sense for those who exercised their best efforts as compared with those who should be referred to OPR. Rather than mandatory referrals, we should trust the judgment of the field examiners and their managers in making the decision to refer a practitioner to OPR. If we trust them to examine the taxpayer, we should trust them to make the preliminary determination on referring a practitioner to OPR.

A. Disciplinary Sanctions

The sanctions to be imposed for violation of Circular 230 include:

1. Disbarment from practice before the IRS. An individual who is disbarred is not eligible to represent taxpayers before the IRS.

2. Suspension from practice before the IRS. An individual who is suspended is not eligible to represent taxpayers before the IRS during the term of the suspension.

3. Censure in practice before the IRS. Censure is a public reprimand. Unlike disbarment or suspension, censure does not affect an individual's eligibility to represent taxpayers before the IRS, but OPR may subject the individual's future representations to conditions designed to promote high standards of conduct.

4. Monetary penalty. A monetary penalty may be imposed on an individual who engages in conduct subject to sanction or on an employer, firm, or entity if the individual was acting on its behalf and if it knew, or reasonably should have known, of the individual's conduct.

5. Disqualification of appraiser. An appraiser who is disqualified is barred from presenting evidence or testimony in any administrative proceeding before Treasury or the IRS.

Under Circular 230, attorneys, CPAs, enrolled agents, enrolled actuaries, and enrolled retirement plan agents may not assist, or accept assistance from, individuals who are suspended or disbarred for matters constituting practice (that is, representation) before the IRS, and they may not aid or abet suspended or disbarred individuals to practice before the IRS. Public announcements of disciplinary sanctions appear in the IRB at the earliest practicable date.

B. Describing Disciplinary Sanctions

Disciplinary sanctions are described as:

1. Disbarment by decision after hearing, suspension by decision after hearing, censure by decision after hearing, monetary penalty imposed after hearing, and disqualified after hearing. An administrative law judge conducts an evidentiary hearing upon OPR's complaint alleging violation of the regulations and issues a decision imposing sanctions. After 30 days from the issuance of the decision, in the absence of an appeal, the ALJ's decision becomes the final agency decision.

2. Disbarment by default decision, suspension by default decision, censure by default decision, monetary penalty imposed by default decision, and disqualified by default decision. An ALJ, after finding that no answer to OPR's complaint had been filed, grants OPR's motion for a default judgment and issues a decision imposing sanctions.

3. Disbarment by decision on appeal, suspension by decision on appeal, censure by decision on appeal, monetary penalty imposed by decision on appeal, and disqualified by decision on appeal. The decision of the ALJ is appealed to the agency appeal authority, acting as the delegate of the Treasury secretary, and the appeal authority issues a decision imposing sanctions.

4. Disbarment by consent, suspension by consent, censure by consent, monetary penalty imposed by consent, and disqualified by consent. In lieu of a disciplinary proceeding being instituted or continued, an individual accepts OPR's offer to a consent to one of these sanctions. Typically, an offer of consent will provide for: suspension for an indefinite term; conditions that the individual must observe during the suspension; and the individual's opportunity, after a stated number of months, to file with OPR a petition for reinstatement affirming compliance with the terms of the consent and affirming current eligibility to practice (that is, an active professional license or active enrollment status). An enrolled agent or an enrolled retirement plan agent may also offer to resign in order to avoid a disciplinary proceeding.

5. Suspension by decision in expedited proceeding, suspension by default decision in expedited proceeding, suspension by consent in expedited proceeding. OPR institutes an expedited proceeding for suspension (based on certain limited grounds, including loss of a professional license and criminal convictions).

C. Disclosing Disciplinary Sanctions

OPR has the authority to disclose the grounds for disciplinary sanctions if:

- an ALJ or the Treasury secretary's delegate on appeal has issued a decision on or after September 26, 2007, which was the effective date of amendments to Circular 230 that permit making such decisions publicly available;
- the individual has settled a disciplinary case by signing OPR's "consent to sanction" form, which requires consenting individuals to admit to one or more violations of the regulations and to consent to the disclosure of the individual's own return information related to the admitted violations (for example, failure to file federal income tax returns); or
- OPR has issued a decision in an expedited proceeding for suspension.

The IRS has many tools in its arsenal to monitor and sanction return preparers. Penalties under section 6694 are likely to be assessed in appropriate cases. However, in trying to balance its enforcement efforts, IRS has stated an intention to modify the IRM such that referrals by agents to OPR will not be per se mandatory when a penalty is assessed under section 6694(a). Instead, in matters involving nonwillful conduct, the IRS will generally look for a pattern of failing to satisfy the appropriate penalty standards before making the referral to OPR, although egregious conduct subjecting the preparer to the section 6694(a) penalty may also form a basis for the OPR referral.

A visible OPR serves as a gentle reminder of professional responsibilities and is good for the practitioner community. Most practitioners practice within a more conservative arena where the line may be the mere appearance of some impropriety. Others pursue some technical reading of the limits of their professional responsibilities and frequently put their toes on the line. Some, typically less visible to mainstream practitioners and their clients, proceed at full throttle with a hope and desire they won't appear on the IRS or OPR radar screen.

Practitioners and OPR should exercise their best efforts to identify practitioners who choose to ignore their professional responsibilities. The integrity of our tax system depends on a visible enforcement mechanism for problem practitioners. OPR must punish those who deserve it and appropriately exercise discretion for practitioners who have done their best to comply with a complex, sometimes confusing code.

VIII. Notification of State Licensing Authorities

Many states have statutes and regulations requiring the notification of the state licensing authority in the event a practitioner receives notification of a practitioner penalty or an inquiry investigation from an agency such as the OPR. A failure to timely notify the licensing authority within the required time period (typically 30 days from receipt of knowledge of the notification or inquiry) could result in a separate, additional violation.

An example of a state statute requiring notification of the state licensing authority is the requirement in California Business and Professions Code Section 5063 for California CPAs to notify the State Board of Accountancy of a practitioner penalty. In part, California Business and Professions Code Section 5063 provides:

(a) A licensee shall report to the board in writing of the occurrence of any of the following events occurring on or after January 1, 1997, within 30 days of the date the licensee has knowledge of these events: . . . (3) The cancellation, revocation, or suspension of the right to practice as a CPA or a public accountant before any governmental body or agency.

(b) A licensee shall report to the board in writing, within 30 days of the entry of the judgment, any judgment entered on or after January 1, 2003, against the licensee in any civil action alleging any of the following: . . . (5) Any actionable conduct by the licensee in the practice of public accountancy, the performance of bookkeeping operations, or other professional practice.

(c) The report required by subdivisions (a), (b), and (c) shall be signed by the licensee and set forth the facts which constitute the reportable event. If the reportable event involves the action of an administrative agency or court, then the report shall set forth the title of the matter, court or agency name, docket number, and dates of occurrence of the reportable event.

IX. Summary and Recommendations

- **Your client is not your friend.** If you need a friend, get a dog!
- **Think 'substantial authority.'** Section 6694 requires a ''substantial authority'' standard, or reasonable basis plus disclosure.
- **Think disclosure.** Section 6694 and reg. section 1.6694-1, et seq. contain a disclosure defense for the preparer. All recommendations for disclosure should be in writing and clearly indicate the reason for the disclosure. And in most situations, the disclosure itself should be on a Form 8275 attached to the return. An appropriate disclosure may be sufficient to explain the potentially questionable position such that the IRS determines an examination is not required. A misleading disclosure may support disciplinary sanctions.
- **Tax advice is sufficient for section 6694 to apply.** It is not necessary to see the return to be the preparer. A person who renders advice that is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund, will be regarded as having prepared that entry. 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 with the length and complexity of, and tax liability or refund involved in, the return or claim for refund as a whole. There can be more than one preparer potentially subject to section 6694.
- **OPR referrals.** IRS employees will generally consider a referral to OPR if a preparer penalty is sustained. They are required to make those referrals if there is a pattern of conduct and a preparer penalty is sustained. Even if those referrals are discretionary, some within the IRS may feel compelled to make the referral for even a single violation. Accordingly, anticipate an increase in the incidences of referrals to OPR.
- **Limit the nature and scope of services to be provided in the engagement letter.** Have separate written engagement letters for separate engagements. Do not exceed the scope of an engagement letter without another engagement.
- **Requirements to notify state licensing authorities.** Many states have requirements for a licensee to notify the state licensing authority in the event of a preparer penalty. Failure to provide timely notification could be a separate violation. If the section 6694 penalty is assessed, notify your licensing authority. It may be awkward, but it is appropriate.
- **Establish a system of checklists for preparation and advice — and follow the system.** Best practices in the office must provide a system for promoting accuracy and consistency in the preparation of returns or claims and generally should include, in the case of a signing preparer, checklists, methods for obtaining necessary information from the taxpayer, a review of the prior year's return, and review procedures.
- **E-mails have a life of their own.** ''Delete'' merely takes the e-mail off your screen. Experienced investigators will locate deleted e-mails. Only render such advice that you reasonably believe is accurate and appropriately supported by relevant authorities.
- **There are no hypothetical questions.** Do not respond unless you are confident you have received all relevant facts. Responses should be in writing, limited to the facts presented, and recite the facts and authorities being relied on in rendering the advice.
- **Fight, fight, fight . . . if facing a section 6694 penalty.** Although the economic penalty under section 6694(a) may be $1,000 (or 50 percent of the income derived from the specific engagement), the related investigations by OPR and the state licensing authorities may destroy the preparer's practice (and reputation). Anticipate that potential malpractice claims will routinely include allegations of a failure to comply with an appropriate federal tax standard of care and Circular 230. Anticipate that the government will contact the preparer's current and former clients and that they may require the preparer to also disclose the violations to their clients with a full explanation.
- **Maintain the appearance of cooperation and reasonableness when representing clients in a tax dispute.** The examining agent may make a referral for penalties under section 6694 and an OPR investigation based on information developed during the examination. The normal administrative process is designed to resolve factual or legal disputes. Be professional, courteous, and do not engage in a urological distance contest with the examining agent.
- **New clients.** Set practical guidelines regarding the acceptance of new clients. Consider speaking with

the clients' prior representatives to ascertain potential issues. The prospective client who talks poorly of the last representative(s) may be including you in the list for next year. Sometimes it's not the horse but the jockey who loses the race.

- **Supporting data.** Although the preparer does not have to examine or verify supporting information, he should ask whether such data have been satisfactorily maintained. He should encourage the client to maintain proper information supporting the information reflected on the return. ''Best practices'' likely require documentation of any tax-related research (including authorities both for and against the tax position), the reasoning behind the conclusion, and relevant authorities supporting the conclusion.
- **Preparer judgment — a tax return is not intended to represent an offer to negotiate with the government.** The judgment of the preparer and other tax advisers, not the client, should be the determining factor regarding positions set forth on the return. If the client refuses to comply with your recommendations, the significance of each recommendation in relation to the return may be the deciding factor regarding whether to withdraw from representation.
- **Document your advice to clients and others in writing.** Enough said — protect yourself and your firm. Timely confirming letters are better than your historical recollection that may differ from that of your client who is attempting to ''rely'' on your prior advice to avoid the imposition of a penalty.
- **No good deed goes unpunished.** Off-the-cuff advice and quick e-mail responses may, in some circumstances, be sufficient for section 6694 or Circular 230 to apply. Tax positions should be appropriately analyzed and discussed with the client. During that discussion, preparers should:
  - review and document all relevant facts;
  - explain that the position is an opinion based on the limited information presented;
  - include a discussion regarding any possible penalties that may be assessed; and
  - avoid technical terms that may be easily misunderstood by the client.
- **Anticipate increased assertions of preparer penalties.** The amendments to section 6694(a) may result in an increase in assertion of the section 6694 penalty. Many of these referrals could be based on confusion about the appropriate standard, inadvertent oversight, or relatively minor infractions. Be careful.
- **Target issues.** Issues warranting additional consideration include claimed valuations and discounts, foreign transactions, charitable contributions, mortgage interest limitations, reasonable compensation, worker classification status (independent contractor/employee status), section 1031 exchanges, auto expense substantiation, business gifts, and capitalized purchases.
- **Disclose, disclose, disclose.** Your client should not make the determination as to whether a disclosure is required. The section 6694 penalty and possible Circular 230 violations apply to you, not your client. When appropriate (or in doubt), disclose, disclose, disclose.

X. Looking to the Future

For the preparer, the most relevant penalty issue is the reasonableness of his belief in the reported position, not the likelihood it will prevail. Treasury and the IRS recognize that the majority of tax return preparers serve the interests of their clients and the tax system by preparing complete and accurate returns. IRS Commissioner Douglas Shulman has been well received by those within and without the government. He seems to be peddling as fast as he can to keep the IRS trains running efficiently and effectively. Also, he seems inclined to want to work with the practitioner community toward improving tax administration. Recently, at an American Bar Association Section of Taxation meeting, Shulman stated in part:

> Philosophically, I think of the legal community as an integral part of tax administration — not separate and apart from it. I am committed to working with the tax community — including the tax bar — in the spirit of partnership. The more we can work with you to help you and your clients get it right, the less time we need to spend dealing with problems after the fact. I look forward to engaging in focused and ongoing dialog with this group on areas where we can work together to reach our mutual objectives.
>
> One thing I want to make clear is that during my tenure at the IRS, I will continue to support a strong enforcement program.
>
> Now, let me share with you two philosophical inclinations that I bring with me to this job. First, I believe that in order for us to be effective, the IRS must understand the economic realities of the environment in which taxpayers operate. We will be much better at our work if we do not operate in a vacuum. We should not fear having a robust dialog with the taxpayer community. That doesn't mean we will always agree, but constant communication is important.
>
> The second philosophical point I want to highlight is my belief that we need to do everything we can to provide clear guidance to taxpayers. We should not be contributing to potential noncompliance by failing to issue guidance or issuing guidance that is subject to multiple and varied interpretations. Clarity is important to improving the level of compliance, and I will work toward a high level of clarity in the guidance that we issue. Achieving a high degree of clarity is incredibly difficult, and we'll never get it exactly right, but we should always strive to do better.
>
> Stated another way, IRS should do everything possible to make it as seamless and easy as possible for those taxpayers who are trying to pay the right amount of taxes to navigate our organization, get their questions answered, pay their taxes and get on their way.

''Seamless'' for taxpayers will significantly improve the world for tax practitioners. Clear, easily understood procedural rules and regulations will avoid many of the present uncertainties in the tax practitioner community. Tax planners are engaged for the purpose of appropriately minimizing taxes for their clients. They are not sinister individuals. All tax planning is not to be condemned. ''It is no surprise that a knowledgeable tax attorney would use numerous legal entities to accomplish different objectives. This does not make them illegitimate. Unfortunately such 'maneuvering' is apparently encouraged by our present tax laws and codes.'' *Ballard v. Commissioner*, 522 F.3d 1229 (11th Cir. 2008), *Doc 2007-2685*, *2007 TNT 23-15*.

The attention being drawn to amended section 6694 represents a significant opportunity for preparers to review their own procedures for gathering and documenting the information they receive. Preparers should be documenting, or know how they have arrived at, reporting positions for transactions that do not meet the appropriate standard. Issues warranting additional consideration include foreign transactions, charitable contributions, mortgage interest limitations, reasonable compensation, independent contractor status, claimed valuations and discounts, section 1031 exchanges, auto expense substantiation, business gifts, and capitalized purchases. If the preparer or his firm have review procedures (which they should), those procedures must be followed.

Preparer penalty issues will most often arise during or at the conclusion of an IRS examination of the taxpayer's return when some or all of an undisclosed or improperly disclosed position has been disallowed. Is it reasonable to believe that an agent, having disallowed a questionable position, will be convinced there was a more likely than not basis for the reported position? Also, most positions comprise several subpositions. If each subposition has a 40 percent chance of success on the merits, the primary position will not likely also have a 40 percent chance of success on the merits (40 percent of 40 percent of 40 percent is not 40 percent overall).

Although the section 6694 penalty structure is intended for the ''bad actors,'' it can be applied to any preparer. The combination of an inattentive preparer and an aggressive government agent could result in preparer penalties being assessed in many otherwise unintentional situations. One solution is to minimize the number of inattentive preparers through a strong educational and awareness process. Be prepared, exercise your best judgment, document your recommendations, and know that 98 percent of the problems in practice emanate from 2 percent of the clients. Clients who refuse to comply with a preparer's valued recommendations should be encouraged to seek other representation.

While a preparer may deem it economically beneficial to concede a penalty that has historically been $250 but is now $1,000/$5,000 (or 50 percent of the income derived from the specific engagement), he should consider fighting every assertion of a preparer penalty. The preparer's practice and reputation may depend on demonstrating that the penalty simply doesn't apply. The primary issue will remain the reasonableness of the preparer's belief and good faith in the reported position.

Do the right thing, don't be cute in any disclosures, and remember that, when in doubt, your friends and colleagues are there to help get you through the complexities of the code and relevant case authorities. You are not alone . . . it only feels that way.