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Devil Is in the Details

→ Section 6694 Proposed Regulations

IRS proposed regulations, NPRM REG-129243-07,¹ issued on June 17, 2008, implement amendments to the tax return preparer penalties under Sec. 6694 and 6695 of the Internal Revenue Code reflecting amendments to the Code made by the Small Business and Work Opportunity Tax Act of 2007. The proposed regulations affect return preparers and provide guidance regarding Sec. 6694, as amended by the Small Business Act. Thanks to the lobbying efforts of the ABA, AICPA, and NAEA, Sec. 6694(a) has been amended² to eliminate the more-likely-than-not standard of conduct for unreasonable and undisclosed positions. Under the new law, return preparers will not be assessed by the penalty if there is or was “substantial authority” for the position.

The penalty for unreasonable undisclosed positions remains the same in an amount equal to the greater of \$1,000 or fifty percent of the income derived by the tax return preparer in cases where the return preparer knew or reasonably should have known of the unreasonable position. The reasonable cause exception remains the same. However, the more likely than not standard is made applicable to a tax shelter³ or a reportable transaction.⁴

Although there has been a great deal of concern about the size of the penalty under Sec. 6694(a) and (b) and standards of conduct, the proposed regulations have created standards for technical accuracy at an extraordinarily high threshold for tax return preparation.

These high technical standards will have a substantial impact on the present tax preparation industry to an even larger extent than either the size of the penalty or the standards of conduct legislated in Sec. 6694 as amended.

The reference to unreasonable positions in Sec. 6694(a) is misleading because one might assume the penalty will not apply if the return preparer believes the position taken is reasonable. Quite the contrary, Sec. 1.6694-2(b)(1) references quantitative and qualitative technical standards that must be followed by return preparers to avoid the Sec. 6694(a) penalties.

Sec. 1.6694-2(b)(1) provides that a tax return preparer may avoid the penalty under Sec. 6694(a) if the tax return preparer analyzes the pertinent facts and authorities, and in reliance upon that analysis, reasonably concludes in good faith that the position is likely to be sustained on its merits. Reference is made to Sec. 1.6662-4(d)(3)(ii) for the meaning of the term “analysis.”⁵

The Analysis Requirement of Sec. 1.6662-4(d)(3)(ii)

The analysis standard takes into account all facts and circumstances (e.g., the tax return preparer’s diligence) and is supported by a well-reasoned construction of the applicable statutory provision. A tax return preparer may rely in good faith without verification upon information furnished by the taxpayer, advisor, other tax return preparer, or other party (including another advisor or tax return preparer at the tax return preparer’s firm).

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The nature of the analysis prescribed by Sec. 1.6662-4(d)(3)(ii) deals with the weight accorded an authority. The weight of authority depends on its relevance and persuasiveness and the type of document providing the authority. An authority which merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts.

Because the analysis prescribed by Sec. 1.6662-4(d)(3)(ii) to avoid the Sec. 6694 penalty is one that considers the relevance and persuasiveness of the technical authority, return preparers must be alert to the fact that complex factual or legal issues that might otherwise be subject to the Sec. 6662 negligence penalty are also those that would be vulnerable to the Sec. 6694 penalty. The analysis needed to negate the 6662 penalty is also the analysis needed to negate the Sec. 6694 penalty.

The Authority Requirement of Sec. 1.6662-4(d)(3)(iii)

Sec. 1.6694-2(b)(3) provides that the authorities considered in determining whether a position satisfies the more likely than not standard are those authorities provided in Sec. 1.6662-4(d)(3)(iii) (or any successor provision). The return preparers must also take into account the types of authorities cited in Sec. 1.6662-4(d)(3)(iii) which references the relevant authorities that return preparers are required to take into account: the Internal Revenue Code, tax regulations, legislative history, case law, and other similar authority. Conclusions reached in treatises, legal periodicals, legal opinions, or opinions rendered by tax professionals are not authority.

The Substantial Authority Standard

The “substantial authority” standard⁶ is the same standard used to determine whether a taxpayer/client is subject to the twenty percent negligence penalty and is defined under Sec. 1.6662-4(d)(2) of the regulations. For this reason, the proposed regulations that specify

the “analysis” and the “authorities” described under this section of the regulations, as described above, should not be expected to be changed in the final regulations when issued. For those of you who have been confronted with the task of getting the twenty percent negligence penalty abated based upon substantial authority, you know how difficult it is to meet that standard. As a practical matter the negligence penalty is usually abated under the reasonable cause exception to the negligence penalty due to the difficulty of providing substantial authority. Fortunately, there is also a reasonable cause exception⁷ for the Sec. 6694(a) penalty.

The Reasonable Basis Standard

This lower standard applies to disclosed unreasonable positions if disclosed as provided in Sec. 6662(d)(2)(C)(ii) as recently amended. Sec. 1.6694-2(c)(2) of the regulations defines “reasonable basis” as the standard for disclosed positions and provides: “For purposes of this section, ‘reasonable basis’ has the same meaning as in Sec. 1.6662-3(b)(3) or any successor provision of the accuracy-related penalty regulations. For purposes of determining whether the tax return preparer has a reasonable basis for a position, a tax return preparer may rely in good faith without verification upon information furnished by the taxpayer, advisor, other tax return preparer, or other party (including another advisor or tax return preparer at the tax return preparer’s firm), as provided in Sec. 1.6694-1(e).”

Sec. 1.6662-3(b)(3) of the regulations defines reasonable basis as:

Reasonable basis is a relatively high standard of tax reporting that is significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in Sec. 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness



For purposes of determining whether the tax return preparer has a reasonable basis for a position, a tax return preparer may rely in good faith without verification upon information furnished by the taxpayer, advisor, other tax return preparer, or other party.

of the authorities and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in Sec. 1.6662-4(d)(2). (See Sec. 1.6662-4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty.)

The Section 6694(b) Penalty Risk

Tax return preparers are also at risk for the Sec. 6694(b) penalty (minimum penalty of \$5,000) when using data that is based on complex tax regulations (e.g., travel and entertainment expenses, charitable deductions, home office expenses, etc.), legal issues, or complex facts because Sec. 6694(b) will apply for understatements when the conduct of the preparer is reckless. There is little doubt IRS examiners may find negligence (within the meaning of Sec. 6662) the same as reckless within the meaning of Sec. 6694(b). Sec. 6662(c)⁸ includes reckless conduct as negligence. Heretofore, IRS has not enforced the prior \$250 penalty against return preparers. Presently, the large size of the minimum \$1,000 and \$5,000 penalties virtually assures examinations of the conduct of return preparers even for disclosed positions.

The Proposed Regulations as a Seminal Change in the Tax Preparation Industry

The technical thresholds for return preparers (i.e., the requirement to support positions taken in tax returns with relevant

analysis of the applicable technical authority necessary to negate or abate the Sec. 6694 penalties) have the potential to substantially reduce the number of professional tax return preparers who neither have the resources to do the technical research of the relevant technical authorities nor the training or background to present the relevant authorities to support a position to the IRS either orally or in a written technical memorandum. A mere citation to a tax statute or tax regulation cannot be expected to be sufficient to prevent the application of the penalty under Sec. 6694(a).

The proposed regulations can be expected to transform the tax preparation industry because even when positions (misnamed “unreasonable positions”) are disclosed to the IRS to take advantage of the lower reasonable basis standard, the disclosed position must be supported with a competent analysis of the relevant technical authority. Most return preparers do not have the physical resources or tax library to do the tax research for the analysis of the relevant technical authority. If the technical research is available, one needs the technical skill to document the technical position taken for the client’s file if the position is not disclosed or communicated in writing if the position taken is disclosed to the IRS. Also, disclosure to the IRS should be expected to trigger a tax examination of the taxpayer as well as consideration of the Sec. 6694 penalty because the statutory premise for disclosure is that you are disclosing an “unreasonable position” even when the return preparer believes the position is reasonable and meets the reasonable basis standards.

The Reasonable Cause Solution Is a Problematical Solution

There is a solution for return preparers who do not want the responsibility or risk of the minimum \$1,000 and \$5,000 penalties for each problematic position that has the potential of an understatement⁹ of tax, no matter how small the understatement.¹⁰ There is a reasonable cause exception¹¹ for the Sec. 6694(a) penalty but not for the Sec. 6694(b) penalty.

Sec. 1.6694-2(d) of the proposed regulations provides the specific standards necessary to meet the reasonable cause exception to the Sec. 6694(a) penalty if, considering all the facts and circumstances, it is determined the understatement was due to reasonable cause and the tax return preparer acted in good faith.

Factors to consider include:

- Nature of the error causing the understatement
- Frequency of errors
- Materiality of errors
- Tax return preparer’s normal office practice
- Reliance on advice of others. A tax return preparer is not considered to have acted in good faith if:
 - (i) The advice or information is unreasonable on its surface;
 - (ii) The tax return preparer knew or should have known the other party providing the advice or information was not aware of all relevant facts; or
 - (iii) The tax return preparer knew or should have known (given the nature of the tax return preparer’s practice) at the time the return or claim for refund was prepared that the advice or information

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Most tax return preparations are based on routine data that is not problematical.

was no longer reliable due to developments in the law since the time the advice was given.

- Reliance on generally accepted administrative or industry practice.

Playing It Safe

Return preparers will not be subject to either the Sec. 6694(a) penalty or Sec. 6694(b) penalty if they participate in the preparation of the return but they are not the “return preparer” as defined in the proposed regulations.

Under the proposed regulations, there can be more than one return preparer for a single tax return based on whether there is another for any separate position taken within the same return. The IRS will focus each Sec. 6694(a) penalty on the position(s) giving rise to the understatement on the return or claim for refund and any responsible parties with respect to such position(s). Thus, the “one preparer per firm” rule is no longer applicable and the penalty will apply, if at all, to each preparer for each position taken within the same return within the same firm.

Under both the current and the proposed regulations, an individual is a tax return preparer subject to Sec. 6694 if the individual is primarily responsible for the position on the return or claim for refund giving rise to the understatement.

Under proposed Sec. 1.6694-1(b)(1), only one person within a firm will be considered primarily responsible for each position giving rise to an understatement and, accordingly, be subject to the penalty. In the course of identifying the individual who is primarily responsible for the position, the IRS may advise multiple individuals within the firm that it may be concluded they are the individual within the firm who is primarily responsible. In some circumstances, there may be more than one tax return preparer who is primarily responsible for the position(s)

giving rise to an understatement if multiple tax return preparers are employed by, or associated with, different firms.

Proposed Sec. 1.6694-1(b)(2) provides that the individual who signs the return or claim for refund as the tax return preparer will generally be considered the person who is primarily responsible for all the positions on the return or claim for refund giving rise to an understatement. The one-preparer-per-firm-rule, however, is revised by the proposed regulations if the IRS concludes that another person within the signing tax return preparer’s firm was primarily responsible for the position(s) giving rise to the understatement. The IRS will identify, as the return preparer, a person who may have overall responsibility in terms of signing the return, but who may lack detailed knowledge of, or responsibility for, a problematic return position, and who reasonably relied on another professional at the same firm with greater knowledge of, and responsibility for, the accuracy of a position giving rise to the understatement.

Proposed Sec. 1.6694-1(b)(3) establishes a similar rule for situations when there are one or more non-signing tax return preparers at the same firm. If there are one or more non-signing tax return preparers at the firm and no signing tax return preparer within the firm, the individual within the firm with overall supervisory responsibility for the position(s) giving rise to the understatement is the tax return preparer who is primarily responsible for the position for purposes of Sec. 6694. Additionally, if after the application of proposed Sec. 1.6694-1(b)(2) it is concluded that the signer is not primarily responsible for the position or the IRS cannot conclude which individual (as between the signing tax return preparer and other persons within the firm) is primarily responsible for the position, the individual non-signing tax return preparer within the firm with overall



supervisory responsibility for the position(s) is the tax return preparer who is primarily responsible for the position(s) giving rise to the understatement.

Proposed Sec. 1.6694-2 and 1.6694-3(a)(2) provide that a firm is also subject to the Sec. 6694 penalties under specified circumstances that include situations when the firm's review procedures are disregarded by the firm 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.

Accordingly, when the facts indicate the signing tax return preparer is the primarily responsible tax return preparer under proposed Sec. 1.6694-1(b)(1) and (b)(2), IRS may assess the Sec. 6694 penalty against that individual when appropriate under the statute and regulations. In situations when the facts indicate the non-signing tax return preparer with overall supervisory responsibility is the primarily responsible tax return preparer under proposed Sec. 1.6694-1(b)(1) and (b)(3), the IRS may assess the Sec. 6694 penalty against that individual when appropriate. In situations when it is unclear which individual, as between the signer and other non-signing tax return preparers at the firm, the IRS may assess the Sec. 6694 penalty against the non-signing tax return

preparer with overall supervisory responsibility with respect to the position giving rise to the understatement when appropriate. Consequently, return preparers who do not meet the definition of a return preparer in the proposed regulations are immune from all 6694 penalties.

Summary

The overall thrust of the proposed regulations is to turn the return preparation industry on its head by requiring substantive accuracy for all positions taken based upon the analysis and authoritative guidance of the Sec. 6662 statute and its underlying regulations. The problem with these technical standards is that many return preparers do not have the technical resources or the technical skill to meet them. The reasonable cause provision provides little comfort because it depends on multiple abstract standards that are each subject to the discretion of the IRS. The good news is that only one person in the firm for each position will be subject to the penalty. If there is a penalty issue, then the "firm" is likewise subject to the penalty. Given the large size of the penalties, it may be anticipated that the IRS will look to enforce the penalties notwithstanding the prior record of the IRS in not focusing on the \$250 penalty under prior law. Tax return preparers will be well advised to disclose the factually and legally complex position in order to reduce their technical responsibilities, but at the same time, disclosed positions (which unfortunately are designated as

"unreasonable positions" in the statute) are likely to trigger IRS examinations of the taxpayer which could in turn trigger taxpayer penalties.

Return preparation firms will need to spend much more time on tax return preparation resulting in much larger costs for tax return preparation. Clients will need to be educated about the advantages of disclosing return positions to the IRS. The cost of tax preparation will increase substantially in those cases involving complex factual and legal tax issues. For undisclosed positions, it would be wise to prepare a memorandum on any complex factual or legal issue in the client's file with an analysis of the applicable authorities that support the position taken along with a record of those in the firm that reviewed the position taken. Technical support should also be attached to the tax return for all positions disclosed to the IRS.

Outside tax experts may be needed in some cases to provide technical opinions to justify the positions taken. An expert memorandum on the issues, if correct, will protect the return preparers, the firm, and the taxpayer, and will reduce the need for the IRS to examine the return for the disclosed position.

The strategy for all return preparers should be to make a proper disclosure to the IRS so that only the reasonable basis standard is applicable because of the significantly lesser standard of conduct. The reduced standard should protect all preparers involved with the tax return in circumstances where the disclosed position is accompanied by a competent legal memorandum on the factual and legal issues from an outside tax expert. The reasonable basis standard should be a low threshold for a competent tax professional. There is obviously no penalty when the reasonable basis standard is met. The legal memorandum by an outside tax professional will also substantially reduce the possibility that the disclosed position will be selected for examination when compared with other disclosed positions from other tax return preparers who do not provide a memorandum on the facts and the law from a tax expert. **EA**

¹ The proposed regulations can be downloaded at www.Sec.6694penalty.com.

² Sec. 506 of the Emergency Economic Stabilization Act of 2008, signed by the President October 3, 2008 and made retroactive to the date of the Small Business Act on May 25, 2007.

³ Defined in Sec. 6662(d)(2)(C)(ii)

⁴ Defined in Sec. 6662A

⁵ This section of the proposed regulations applies the more-likely-than-not standard of conduct which contemplates that the penalty will not be applied if the return preparer is more than fifty percent accurate under the applicable law. Under the new and lower substantial authority standard, much less accuracy will be required. However, the lower standard does not change the important reference to Sec. 1.6662-4(d)(3)(ii) for the meaning of the term "analysis." The technical analysis requirement will be applied to the substantial authority standard of conduct.

⁶ Sec. 6694(a)(2)(A) as amended October 3, 2008

⁷ Sec. 6694(a)(3) as amended October 3, 2008

⁸ Sec. 6662(c) states the term negligence includes: any failure to make a reasonable attempt to comply with the provisions of the title and the term "disregard" includes any careless, reckless, or intentional disregard.

⁹ The proposed regulations do not have a safe harbor for small underpayments of tax.

¹⁰ Sec. 6694(e) states the term "understatement of liability" means any understatement of the net amount payable with respect to any tax imposed by Title 26 or any overstatement of the net amount creditable or refundable with respect to any such tax.

¹¹ Sec. 6694(a) provides as follows: No penalty shall be imposed under this subsection if it is shown there is reasonable cause for the understatement and the tax return preparer acted in good faith.