April 3, 2008

Hon. Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on the 2007 Amendment to Section 6694 Preparer Penalty

Dear Commissioner Shulman:

Enclosed are comments on the 2007 amendments to the section 6694 preparer penalty rules. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Stanley L. Blend
Chair, Section of Taxation

Enclosure

cc: Hon. Donald L. Korb, Chief Counsel, Internal Revenue Service
Hon. Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
Karen Gilbreath Sowell, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Michael J. Desmond, Tax Legislative Counsel, Department of the Treasury
Deborah Butler, Associate Chief Counsel, Internal Revenue Service
The following comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, the Comments should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Michael B. Lang. Substantive contributions were made by Mark Allison, David Berek, Victoria Chemerys, Tom Foster, Karen L. Hawkins, Rochelle Hodes, Donald P. Lan, Roberta Mann, Alexandra Minkovich, Fred Murray, Phillip Pillar, Lew Walton, Rich Walton, and Ronald M. Wiener. These Comments were reviewed by Bryan C. Skarlatos, Chair of the Section’s Committee on Civil and Criminal Penalties. These Comments were further reviewed by Gersham Goldstein of the Section’s Committee on Government Submissions and by Kathryn Keneally, the Council Director for the Section’s Committee on Civil and Criminal Penalties.

Although members of the Section of Taxation who participated in preparing these Comments have clients that could be affected by the principles addressed by these Comments or may have advised clients in the application of said principles, and all could be affected to the extent that they are treated as preparers, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make, or has a specific individual interest in making, a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: April 3, 2008
EXECUTIVE SUMMARY

These Comments address the need for new regulations implementing recent changes to the tax return preparer penalty and the definition of tax return preparer in sections 6694 and 7701(a)(36), which provisions were amended by section 8246 of the U.S. Troop Readiness, Veteran’s Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007 (the “Act”) in three ways. First, the Act expanded the type of returns covered by section 6694 to include all tax returns instead of only income tax returns. Second, the Act increased the amount of the potential penalty. Third, the Act changed the standards for imposition of the penalty.

The Act raised the standard to avoid a penalty under section 6694(a) for undisclosed positions from “realistic possibility of success” (“RPOS”) to require that a preparer must have a “reasonable belief” that the position “would more likely than not be sustained on its merits” (“MLTN”). The Act also raised the penalty standard for disclosed positions from “not frivolous” to “reasonable basis,” thereby aligning that standard with the accuracy-related penalty standard for taxpayers under section 6662. All of the changes made by the Act were effective for returns prepared after May 25, 2007.

On June 11, 2007, Internal Revenue Service (the “Service”) issued Notice 2007-54, which provided guidance and transitional relief for all returns and claims for refund due on or before December 31, 2007. On December 31, 2007, the Service issued three additional notices: (i) Notice 2008-11 clarified the effective date provisions in Notice 2007-54; (ii) Notice 2008-12 listed the types of tax returns that must be signed by return preparers pursuant to section 6695; and (iii) Notice 2008-13 provided interim guidance regarding application of section 6694 until revised Regulations are issued.

We appreciate the efforts of the Treasury Department and the Service to provide prompt guidance on the amendments made to section 6694 by the Act. In particular, we believe that the approach taken in Notice 2008-13 achieves an appropriate balance between taxpayer and preparer burden and the needs of effective tax administration. We offer the following recommendations for making Notice 2008-13 permanent and modifying the existing Regulations interpreting section 6694:

1. **Definition of Tax Return Preparer**: Section 6694 should not apply to a nonsigning preparer unless the preparer knows or has reason to know that the advice given, if incorrect, could result in a deficiency that is a significant portion of the tax liability reported on the return. We also recommend that certain types of advice be identified in public guidance as *per se* tax return preparation services subject to section 6694.

2. **Reasonable Belief/MLTN Standard**: Regulations should provide rules concerning when a preparer will be determined to have a “reasonable belief” that a position
satisfies the MLTN standard. A preparer should be able to establish such a reasonable belief based on a well reasoned analysis of the law or reliance on certain types of advice provided by other tax professionals. Further, there should be a rebuttable presumption that a preparer had a reasonable belief that a position satisfies the MLTN standard if the position is supported by substantial authority. In such cases, the burden would be on the IRS to establish that the preparer did not reasonably believe that the position satisfied the MLTN standard.

3. Adequate Disclosure: A position that does not satisfy the MLTN standard should be considered to be adequately disclosed if:

(a) the position is disclosed in accordance with Reg. §1.6662-4(f);

(b) in the case of a signing preparer, the preparer provides the taxpayer with a disclosure statement and explains to the taxpayer the reasons for the disclosure and the possible advantages and disadvantages to the taxpayer of filing the disclosure; or

(c) in the case of a nonsigning preparer, the preparer explains to the taxpayer (or to the signing preparer, as the case may be), the differences between the potential penalties applicable to the taxpayer and the preparer and the possible advantages and disadvantages to the taxpayer of filing the disclosure (or how the signing preparer may satisfy the adequate disclosure requirements in the case of a nonsigning preparer providing advice to the signing preparer). 2

4. Reasonable Cause/Good Faith: The list of factors to be considered in determining reasonable cause and good faith contained in the current Regulations should be maintained and expanded to include (a) the preparer’s background, experience, and knowledge; (b) reliance on tax preparation assistance products (such as software used by preparers or taxpayers); and (c) reliance on generally accepted administrative or industry practices or conventions. We also recommend that the Regulations provide a reasonable cause and good faith defense in situations when the law is so undeveloped or unclear that it is unreasonably difficult or impossible to reach a conclusion as to whether a position satisfies the MLTN standard. We also recommend that the Regulations provide a reasonable cause and good faith defense in situations where the preparer reasonably believes the cost of fully evaluating a position equals or exceeds the tax liability at stake or the return

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2 Some members of the working group that prepared these Comments would prefer bifurcating the proposed rule for nonsigning preparers, such that a nonsigning preparer would be required to provide the taxpayer with a disclosure statement if the position is not supported by substantial authority. Supporters of this approach argue that the purpose of the 2007 amendments to section 6694 was to impose heightened standards, and the “substantial authority” standard was intended to provide a reasonable means for distinguishing between highly aggressive positions and good faith efforts to self-assess. See H.R. Conf. Rep. 97-760, 97th Cong., 2d Sess. 575 (1982). Nonetheless, because nonsigning preparers often have no involvement with the physical preparation of returns and may not have any control over whether the disclosure is used or filed, and because this proposal would result in a more complicated set of rules for preparers and taxpayers to understand, these Comments encourage Treasury and the Service to retain the approach adopted in Notice 2008-13.
preparer’s fee for preparing the return calculated without regard to the fee for evaluating positions on the return.

5. **Multi-Year Issues and Transition Rules**: We propose rules and examples to implement the application of section 6694 to items that affect returns in several years as well as items on returns prepared prior to the effective date of the new rules.

These recommendations are based on the assumption that section 6694 will remain in its current form, and that proposals to modify the statute, such as the proposal embodied in H.R. 4318, are not enacted. That said, we believe that the standards imposed on preparers should not be higher than those imposed on taxpayers, and respectfully request that Treasury and the Service work with Congress to address these concerns expeditiously.³ In addition, we are continuing to consider the issues raised by the proposed amendment to section 10.34 of Circular 230,⁴ as well as the mechanics for how any penalty under section 6694 should be calculated and safeguards that may be necessary to ensure that penalties are not inappropriately “stacked.”⁵

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DISCUSSION

1. DEFINITION OF TAX RETURN PREPARER

a. In General

We recommend that the definition of “tax return preparer” be centralized, as much as possible, in one Regulation. The term is currently used in sections 6107, 6109, 6694, 6695, 7216, 7701 and the Regulations under several of these provisions define the term differently. For example, Reg. § 301.7701-15 provides a general definition while Reg. § 1.6694-1(b) distinguishes between signing and nonsigning preparers solely for purposes of section 6694. The regulations under section 7216 treat office staff members as preparers even though they would not be preparers under section 6694. We recommend that all of the definitional rules be included in Reg. §301.7701-15 with appropriate cross references to and from other relevant regulations. To the extent consistent with the governing statutory provisions, we also suggest that the regulations use terminology that clearly distinguishes the different categories of preparers.

In addition, because most of the definitions and explanations of terms used in the penalty standards and applicable defenses are contained in regulations promulgated under sections 6662, 6664 and 6694, those definitions and explanations should be consolidated in one place with cross-references where appropriate. For example, the terms “reasonable belief,” “reasonable basis” and “good faith” all appear more than once in the Code and Regulations. These terms should each be defined in one place, perhaps under section 6662, with any variations in the definition attributable to the appearance of the terms in different contexts elaborated on as part of that single definition.

b. Returns or Claims Covered

We agree with the manner in which Notice 2008-13 defines most of the returns to which section 6694 should and should not apply. We believe that the best way to define returns and claims subject to the section 6694 penalty would be to publish lists of the returns that are and are not subject to the penalty. Publishing such lists would eliminate confusion and provide much needed guidance in this area.

In the absence of a definitive list, the Service could periodically provide administrative pronouncements on the types of “returns” that could trigger a section 6694 penalty. This was the Service’s practice under the prior version of section 6694. We propose that income tax documents which would not have triggered application of section 6694 under

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6 We further recommend that, as provided in paragraphs 1 and 2 of Section B of Notice 2008-13, the Regulations under section 7701(a)(36), defining “income tax return preparer” be revised to reflect the fact that section 7701(a)(36) now defines “tax return preparer.” Specifically, Reg. § 301.7701-15(c)(1) should be amended to delete all references to Subtitle A, to include estate, gift and generation-skipping tax returns as well as excise tax returns in the list of returns of tax in Reg. § 301.7701-15-(c)(1)(i), to delete these returns from those not included as returns of tax under Reg. § 301.7701-15(c)(1)(ii), and to make conforming changes throughout the Regulations.
such guidance continue to be treated as not subjecting those who prepare such documents to section 6694. These documents include Forms W-2, 7 1139, 8 and 1045. 9

Similarly, we believe the criteria for determining whether a non-income tax document is a return generally should be consistent with the manner in which income tax documents were handled under prior law. Therefore, the appropriate inquiry would be (1) whether the document is filed with the Service, and (2) whether the document computes and reports a tax liability under the internal revenue laws. We therefore recommend that guidance be issued (and periodically updated as necessary) to expressly provide that Forms 2210, 2220, 4868, 7004, 8300 and TD F 90-22.1 not be treated as tax returns for purposes of section 6694. On the other hand, we believe that certain forms and documents attached to a return should be treated as part of the return and that this should be stated expressly in the Regulations, perhaps with examples. For example, Forms 5471 and 5472, although denominated as information returns, are required to be attached to the Form 1120 and therefore should be treated as part of the Form 1120 for purposes of section 6694.

Finally, we recommend that the Regulations clarify that no section 6694 penalty can apply as a result of the preparation of a tax return for a nontaxable entity, unless the entity has a tax liability (e.g., a tax-exempt organization with a tax liability under the unrelated business income rules or, an S corporation with a tax liability under the section 1374 built-in gains rules), or as a result of the preparation of an information return. Section 6694 can only by its terms result in imposition of a penalty when there is an understatement of liability with respect to any return or claim for refund. Accordingly, there should be no section 6694 penalty imposed on the preparer of a return for an entity, such as a partnership, that is not subject to tax. While we recognize that the preparer of a partnership return may be considered as a preparer of a partner’s return under Reg. § 301.7701-15(b), we recommend that the Regulations provide examples expressly illustrating that no penalty can be imposed under section 6694 as a result of the preparation of a tax return of a nontaxable entity or an information return unless the preparer is considered a preparer of the ultimate taxpayer’s income tax return.

c. Signing Preparers

We believe the definition of the term “signing preparer” should be enhanced and reside in Reg. § 301.7701-15. Currently, the only guidance with respect to who must sign a return provides that the return must be signed by the person “who has primary responsibility as and among preparers for the overall substantive accuracy of the preparation of such return or claim for refund.” 10 While this is sufficient in cases where the roles of the

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7 See PLR 8034159 (June 2, 1980); PLR 8035069 (June 6, 1980); and GCM 38648 (March 3, 1981). If Form W-2 is treated as a return covered by section 6694, then payroll processors are return preparers. We do not believe this is the correct result.

8 PLR 7846077 (Aug. 21, 1978); GCM 38071 (Aug. 29, 1979).

9 Id.

10 Reg. § 1.6695-1(b)(2).
various preparers who may be involved in providing the taxpayer with assistance in preparing its return are clearly defined, it is not clear who must sign the return when more than one preparer is responsible for portions of the return, but no one preparer actually puts “pen to paper” and prepares the return. Accordingly, we propose that when no person is primarily responsible for the overall substantive accuracy of the preparation of the return or claim, the person who has primary responsibility for preparing the return showing the taxpayer’s overall tax liability be required to sign the return or claim.

It is also unclear whether an individual is required to sign the return if the taxpayer prepares his or her own return, but engages the individual to review the return. Even if the taxpayer has an in-house tax practitioner who prepares the return, the existing Regulations provide that the individual who reviews the return is not treated as a preparer under section 7701(a)(36). This is further complicated if the taxpayer engages the individual to review a particular schedule, entry, or transaction. This situation gives rise to two questions: (1) whether reviewing a return should be treated as preparation of that return, and (2) if so, whether an individual reviewing a return should ever be required to sign the return. We recommend that an individual who reviews all or part of a return or claim be treated as a preparer with respect to the portion of the return reviewed for purposes of determining whether the individual is a preparer for purposes of section 7701(a)(36). If the individual is determined to be a preparer under this standard the question of whether the individual is required to sign the return or claim would then be determined under the previously discussed provisions.

d. Nonsigning Preparers

Nonsigning preparers often are perceived and think of themselves as advisors rather than tax return preparers. Reg. § 1.6694-1(b)(2) defines a nonsigning preparer as “any preparer who is not a signing prepare,” and Reg. § 301.7701-15(a)(1) states that a person who only gives advice on specific issues of law is not an income tax return preparer, unless “the advice is given with respect to events which have occurred at the time the advice is given” and “the advice is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund” and the return or claim was prepared for compensation. Further, for such advice to cause the advisor to be considered a preparer, the advice must constitute a “substantial portion” of the return determined by comparing the “length and complexity” of the advice given to the length and complexity of the matter reported as a whole. Reg. § 301.7701-15(b)(2).

This is a complex definition that is full of ambiguities. As a result, it can be difficult or even impossible for advisors to determine whether they are “tax return preparers” subject to section 6694. Because of these problems, and because we are not convinced that it is appropriate to subject pure tax advice to penalties under section 6694, we considered recommending that the nonsigning preparer category be eliminated from section 6694. Ultimately, however, we chose not to make that recommendation.

See, e.g., Rev. Rul. 84-3, 1984-1 C.B. 264; PLR 7902033 (Oct. 11, 1978); PLR 8608018 (Nov. 21, 1985); and TAM 8731004 (April 14, 1987).
See Reg. § 301.7701-15(d)(2).
Nonetheless, it would be inequitable to impose a penalty under section 6694(a) upon a person who did not understand that their advice is being relied on by either a signing preparer or the taxpayer. We believe that it is important to define a nonsigning preparer for purposes of section 6694 in such a way that an individual treated as a nonsigning preparer either knows or should know that he or she is subject to the standards and potential penalties under section 6694. Based on these considerations, we make the following suggestions:

(i) We recommend that the following language be added to the other elements contained in the regulatory definition of a nonsigning preparer in Reg. § 1.6694-1(b)(2):

       An individual who provides written or oral advice or information prepared for and provided to a taxpayer or preparer for use by that taxpayer or preparer with respect to a return of tax or claim for refund will not be treated as a nonsigning preparer unless the individual knew, or had reason to know, that (i) with respect to a tax return, the advice or information given, if wrong, could result in a deficiency that is a significant portion of the tax liability reported on the return filed after the date on which the advice or information is provided or (ii) with respect to a claim for refund, the advice or information given relates to a significant portion of the amount of refund claimed on the claim filed after the date on which the advice or information is provided.

(ii) We recommend that the distinction between tax planning and tax return preparation be better defined. Although it is possible for someone to provide both tax planning and tax return preparation services, it is important that the advisor clearly understands this distinction so the advisor can know when he or she will be treated as a nonsigning preparer. Thus, the definition of nonsigning preparer should be carefully crafted to include services that directly relate to the reporting of an item on the return, without including services that are directed solely at tax planning or tax controversy activities.

(iii) We recommend that the current rule distinguishing between advice with respect to facts that have not yet occurred (planning) and advice with respect to facts that have occurred (return preparation) be retained and clarified by examples. We also suggest that the Regulations be amended to provide that a single preparer may be treated as providing both tax planning and tax return preparation advice, depending on the scope of services performed. Example 5 in Notice 2008-13 is a good illustration of an individual who provides both planning and return preparation advice. However, that example should be clarified to provide that advice provided before the taxpayer entered into the transaction is tax planning advice and that advice on the tax return reporting of the transaction after the transaction was entered into is the tax preparation advice. Further, to
permit the example to apply more universally, an additional example that does not involve a tax shelter transaction should be added on this point.

(iv) If an advisor who provides planning advice or other information (such as an asset allocation schedule) before a transaction occurs is asked to confirm that advice or information after the closing or implementation of the transaction, we recommend that the confirmation of prior advice be treated as new advice at the time of such confirmation. In such cases, the advisor would be treated as a preparer with respect to the confirmatory advice if the confirmatory advice or information otherwise meets the substantial portion standard. By making this recommendation, we do not mean to suggest that the original pre-transaction advice cannot be relied upon by the taxpayer if it is stated with the appropriate degree of certainty about the tax consequences of the transaction and the taxpayer has not deviated from the plan that formed the basis for the advice.

(v) We recommend that certain services be identified in published guidance (which can be updated as needed) as per se tax return preparation services so that individuals will know that providing such services will subject them to possible section 6694 penalties no matter when the advice or information is provided. These tax return preparation services should include activities such as research and experimentation studies, cost segregation studies, fixed asset studies, inventory studies, transaction cost studies, section 199 studies, travel and entertainment studies, section 381 and 382 studies, earnings and profits studies and basis studies.

2. THE REASONABLE BELIEF/MLTN STANDARD

The definition of “reasonable belief” that the position would satisfy the MLTN standard under section 6694, as amended by the Act, consists of two parts: (a) “reasonable belief” and (b) “more likely than not [to] be sustained on its merits.” This construction appears to be modeled on Reg. § 1.6662-4(g)(4), the standard for avoiding the section 6662 penalty in the case of non-corporate tax shelter items and Reg. § 1.6664-4(f)(2)(i)(B), the standard for the reasonable cause defense for corporate tax shelter items.

Under the existing section 6664 Regulations, the MLTN standard is defined either in terms of the taxpayer’s own belief, or in terms of the taxpayer’s belief based on the opinion of a qualified advisor, as follows:

- The taxpayer analyzes the pertinent facts and authorities in the manner described in Reg. §1.6662-4(d)(3)(ii) and the taxpayer reasonably concludes that the position has more than a 50 percent chance of prevailing if challenged by the Service; or

- The taxpayer reasonably relies on the opinion of an advisor and the advisor analyzes the pertinent facts and authorities in the manner described in Reg. § 1.6662-4(d)(3)(ii), and the advisor’s opinion
unambiguously states that the position has a greater than 50 percent likelihood of prevailing if challenged by the Service.

While it would be tempting to define the MLTN standard for tax return preparers by referring to the standard in the section 6664 Regulations without modification, in our view it would not be appropriate to do so. The section 6664 Regulations were intended to address transactions with “the principal purpose” (i.e., a purpose that exceeds all other purposes) of avoiding or evading tax. By contrast, the section 6694 standard applies to all tax positions on a return for all types of taxpayers, even those who do not engage in “principal purpose” type tax planning. In addition, the preparer, unlike the taxpayer, has no control over whether the taxpayer does or does not engage in principal purpose transactions and, therefore, should not be held to the same standard as the taxpayer in this regard.

We agree with the approach adopted in Notice 2008-13 which requires a tax return preparer to analyze the pertinent facts and authorities in a manner described in Reg. § 1.6664-4(d)(3)(ii) and reasonably conclude in good faith that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged on the merits. However, we do not believe that a preparer should be limited to considering only those authorities listed in Reg. § 1.6662-4(d)(3)(iii). For example, in the absence of meaningful guidance that directly controls the resolution of a particular issue, the preparer should be able to satisfy the section 6694 standard by analyzing authorities governing analogous situations and forming a reasonable belief that the position reported on the tax return satisfies the MLTN standard.

Moreover, in determining whether there is a reasonable belief that a position meets the MLTN standard, a return preparer should be expressly permitted to rely on advice and information provided by third parties, subject to certain caveats. In the case of advice provided by another person, a preparer should be permitted to rely in good faith on such advice if the advice appears to satisfy the requirements of Reg. § 1.6664-4(f)(2)(i)(B)(2) or (i) is not unreasonable on its face, (ii) the advisor claimed to have knowledge of all the relevant facts, and (iii) the preparer did not know or have reason to know of any changes in facts or law after the advice was given that would materially affect the advice.

In the case of a transaction planner who would not be treated as a nonsigning preparer, the Regulations should provide that a preparer may rely in good faith on the transaction planner’s advice in certain circumstances. If the advice does not specify an accuracy standard, the preparer must determine whether there is a reasonable belief that the position is MLTN. However, in cases where the transaction planner’s advice specifies an accuracy standard of at least MLTN, the preparer may rely in good faith on the advice even though the preparer has not confirmed that the position satisfies the MLTN standard as long as the advice either satisfies the requirements of Reg. § 1.6664-4(f)(2)(i)(B)(2), or (i) is not unreasonable on its face, (ii) the transaction planner claimed to have knowledge of all the relevant facts, and (iii) the preparer did not know or have reason to know of any changes in facts or law after the advice was given that would materially affect the advice.
We further recommend that, even if the preparer is not relying on the advice of another advisor, the preparer should be presumed to satisfy the MLTN standard if the preparer determines in good faith that the position has substantial authority as that term is defined in the regulations under Reg. § 1.6662-4(d)(3). In determining whether a position is supported by substantial authority, the preparer should be permitted to rely on authorities listed in the Regulations under section 6662, including guidance issued by the Service, and other authorities, such as treatises, that are customarily relied upon by tax practitioners of like experience and education. We believe the Regulations should expressly provide that the preparer’s experience and expertise should be taken into account in determining whether the preparer’s reliance on particular authorities is reasonable.

If the preparer has determined in good faith that a position is supported by substantial authority, we believe the burden should shift to require the Service to show that the position did not satisfy the MLTN standard. This recommendation, when coupled with those above, would create an appropriate balance between the statutory requirement and the reality that in some cases it can be impossible or impractical for even the most sophisticated preparer to conclude that a position is MLTN to prevail, let alone the generalist who is often in the position of preparing returns.

As to factual issues, we recommend that the Regulations continue to include the principle in Reg. § 1.6694-1(e) that a preparer may rely in good faith without verification on information provided by the taxpayer, provided that the preparer does not know or have reason to know that the information is incorrect. Such a rule recognizes the real world contours and limitations of the relationship between taxpayers and preparers. We believe, however, that the Regulations should expressly provide that in determining the degree to which a preparer may rely on information provided by the client the preparer should take the preparer’s relationship with the client into account. For example, a preparer may not be able to rely on information provided by a new client to the same extent as information provided by a longstanding client who has a record of providing accurate information to the preparer. Further, in cases involving a longstanding relationship between the preparer and the client, we believe that the preparer should not be required to examine each deduction or credit anew each year, provided that the deduction or credit is consistent with claims made and believed to have been proper in previous years. However, if the preparer has actual knowledge that a deduction or credit taken in a previous year did not satisfy the MLTN standard, then the preparer is not entitled to rely on the treatment of the item on a prior return; the preparer must then make an independent determination whether the MLTN standard can be satisfied in the current year. Finally, we do not believe that reliance on information provided by the taxpayer regarding an issue of law is justifiable when a determination of whether the position satisfies the MLTN standard depends solely on evaluating that issue of law as to which all relevant facts are undisputed and we recommend that the Regulations expressly state this point.

3. ADEQUATE DISCLOSURE

a. Reasonable Basis
A preparer can avoid imposition of an understatement penalty under section 6694 with respect to a position for which there is a reasonable basis if the position is adequately disclosed as provided in section 6662(d)(2)(B)(ii). This standard is stated in the same language as the taxpayer accuracy standard under section 6662 for disclosed positions. We have considered whether the standard should be defined differently for preparers and have concluded that it should not. Nor do we believe that the standard should to any extent depend on the experience, training or knowledge of the preparer. We recommend that the first sentence of Reg. § 1.6694-2(c)(1) be amended to reflect the change in the statute. The phrase “reasonable basis” is defined in Reg. § 1.6662-3(b)(3), part of which is reflected in the Instructions to Form 8275 (Rev. Aug. 2007). We recommend that this definition be incorporated by reference into the Regulations under section 6694 in lieu of the current language in Reg. § 1.6694-2(c)(2) and that examples be included to illustrate its application.

b.  Deemed Disclosure

The existing Regulations and Notice 2008-13 provide different disclosure rules for signing preparers and nonsigning preparers.\(^{13}\) Under section 6694(a), as amended by the Act, there are a number of circumstances in which a disclosure required to avoid subjecting a tax return preparer to a penalty under section 6694(a) would not help the taxpayer in avoiding accuracy-related penalties. In recognition of this situation and the practical conflicts between the interests of the preparer and taxpayer that would arise in such situations,\(^{14}\) Notice 2008-13, Section G, provides interim procedures that both

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\(^{13}\) A nonsigning preparer would also be protected by disclosure in accordance with the rules that apply to signing preparers. The difficulty is that the nonsigning preparer has no control over whether the taxpayer actually discloses, so this protection may be of no benefit to the nonsigning preparer. The current regulatory structure therefore provides an alternative, discussed below, that is counterintuitive in treating a position as disclosed in the case of a nonsigning preparer merely because the nonsigning preparer tells the taxpayer that the taxpayer could avoid a possible penalty by disclosing.

\(^{14}\) The literal language of section 6694(a)(2)(C)(i) seems to require a signing tax return preparer to prepare the taxpayer’s return in a manner that would satisfy the disclosure requirements of section 6662(d)(2)(B)(ii) on a return filed by the taxpayer. Reg. § 1.6695(b)(1) requires a signing preparer to sign the return or claim for refund after it is completed and before it is presented to the taxpayer for signature. If the tax return preparer is a “practitioner” subject to the requirements of Circular 230, current section 10.34(c) of Circular 230 requires the practitioner-preparer to inform the client of penalties reasonably likely to apply to the taxpayer with respect to a position taken on the return and to inform the taxpayer of any opportunity to avoid such penalties by disclosure. Under section 10.29(a)(2) of Circular 230, a practitioner-preparer is not permitted to represent a client before the Service if there is a significant risk that the representation of the taxpayer would be materially limited by a personal interest of the practitioner. Under circumstances where the practitioner-preparer is required by section 6694(a)(2) to prepare the taxpayer’s return with a disclosure satisfying the section 6662(d) criteria but the inclusion of the disclosure on the return would not provide the taxpayer with an opportunity to avoid penalties, attaching the disclosure may be detrimental to the taxpayer. The disclosure may increase the likelihood that the Service would examine the taxpayer’s return, thereby causing the taxpayer to incur, at a minimum, additional time and expense in responding to the examination and potentially additional tax liability if the Service should attempt to disallow the position so disclosed (or any other position reflected on the return). In such a case, therefore, the personal interest of the practitioner-preparer in having disclosure attached to the return might be in conflict with the interests of the taxpayer-client if the client decided not to include the disclosure with the return.
signing and nonsigning preparers can use to satisfy the disclosure requirements of section 6694(a)(2)(C)(i) even if the return on which the position is reflected as filed by the taxpayer does not contain a disclosure that complies with section 6662(d)(2)(B)(ii)(I). In general, we support the approach adopted in Notice 2008-13 and recommend that it be incorporated into the Regulations such that a position that does not meet the MLTN standard would be considered to be adequately disclosed in any of the following circumstances:

(a) the position is disclosed in accordance with Reg. §1.6662-4(f);

(b) in the case of a signing preparer, the preparer provides the taxpayer with a disclosure statement and explains to the taxpayer the reasons for the disclosure and the possible advantages and disadvantages to the taxpayer of filing the disclosure; or

(c) in the case of a nonsigning preparer, the preparer explains to the taxpayer (or to the signing preparer, as the case may be), the differences between the potential penalties applicable to the taxpayer and the preparer and the possible advantages and disadvantages to the taxpayer of filing the disclosure (or how the signing preparer may satisfy the adequate disclosure requirements in the case of a nonsigning preparer providing advice to the signing preparer).

Some members of the working group that prepared these Comments would prefer modifying the approach set forth in Notice 2008-13 with a bifurcated rule for nonsigning preparers under which a nonsigning preparer would be required to provide the taxpayer with a disclosure statement if the position is not supported by substantial authority. Supporters of this approach argue that the purpose of the 2007 amendments to section 6694 was to impose heightened standards, and the “substantial authority” standard was intended to provide a reasonable means for distinguishing between highly aggressive positions and good faith efforts to self-assess. See H.R. Conf. Rep. 97-760, 97th Cong., 2d Sess. 575 (1982). Nonetheless, because nonsigning preparers often have no involvement with the physical preparation of returns and may not have any control over whether the disclosure is used or filed, and because this proposal would result in a more complicated set of rules for preparers and taxpayers to understand, these Comments encourage Treasury and the Service to retain the approach adopted in Notice 2008-13.

Finally, consistent with the approach taken in the existing Regulations and Notice 2008-13, we agree that a nonsigning preparer should be permitted to satisfy the deemed disclosure obligation with a statement that is written or oral, depending on the form of the underlying written advice. In addition, we agree that the required explanation to the taxpayer must be meaningful.

c. Specific Disclosure Alternatives

In the case of a signing preparer, disclosure of a position that does not satisfy the RB/MLTN standard is adequate only if provided on a properly completed and filed Form
8275 or 8275-R, or on the return in accordance with a revenue procedure.\textsuperscript{15} See Reg. § 1.6694-2(c)(3)(i), referring to Reg. § 1.6662-4(f). As recognized by Notice 2008-13, there is currently no disclosure process or form for returns other than income tax returns. At a minimum, we recommend that Forms 8275 and 8275-R be revised to cover all tax returns that may subject preparers to penalties under section 6694. We also recommend that the regulations expressly state that disclosures made on Form 8886 satisfy the disclosure requirements under both sections 6662 and 6694, as the Form 8886 already requires inclusion of sufficient detail for the Service to be able to understand the tax structure of the transaction being disclosed and the identity of all parties thereto. This approach would eliminate unnecessary duplicative disclosures while continuing to ensure that the Service receives appropriate disclosure and simplifying the requirements imposed on taxpayers and preparers.

We recommend that the Service continue the current practice of issuing periodic revenue procedures providing guidance about when positions reported on returns are already adequately disclosed without the need for additional disclosure or forms.\textsuperscript{16} We suggest that claims for refund that are clearly designated as “protective claims for refund” be included on the list of return positions for which additional disclosure is not required.

We also recommend that the disclosure rules in Reg. § 301.6501(c)(1)(f)(2) be adopted for purposes of defining adequate disclosure under section 6694 for estate and gift tax returns. Under sections 2504(c) and 2001(f), in the case of gifts made after August 5, 1997, if the transferred property is adequately disclosed on the gift tax return, once the statute of limitations for the year of the transfer has run for gift tax purposes, the value of the gift may not be adjusted for purposes of computing the donor’s gift tax liability for a subsequent year or the estate tax liability of the donor’s estate. Reg. § 301.6501(c)-1(f)(2) defines adequate disclosure in this context. While this disclosure standard was originally promulgated to buttress the gift tax statute of limitations, it is well thought out and should be used for section 6694 purposes.

Although we recommend the adoption of the adequate disclosure regulations under Reg. § 301.6501(c)(1)(f)(2) and (3) for section 6694 purposes, we recognize that this will not be sufficient to deal with many transfer tax concerns arising under expanded section 6694. The determination of gift or estate tax liability for transfers occurring after new section 6694’s effective date will often depend on the amounts of taxable gifts reported in earlier years which did not satisfy the MLTN standard when reported and for which there was no disclosure. We do not believe that retroactive application of new section 6694 to such gifts is appropriate when they enter into the calculation of gift or estate tax liability for post-new section 6694 returns, particularly in light of Notice 2007-54, applying a reasonable basis standard for transfer tax returns due before December 31, 2008. Accordingly, we recommend that, for the purpose of applying new section 6694 in such contexts, the Regulations provide that preparers may rely on any reported gift tax return

\textsuperscript{15} The latter alternative (disclosure in accordance with a revenue procedure) is not available to avoid the section 6694(b) penalty for intentional disregard of a rule or regulations. See Reg. § 1.6694-3(e)(1).

inclusions and valuations as well as exclusions for pre-2008 gift tax returns for which there is a reasonable basis, unless the preparer has actual knowledge that the prior returns are incorrect. We recommend that analogous rules be promulgated in the generation-skipping transfer tax context.

In addition, we recommend that Treasury adopt the appraisal alternative under Reg. § 301.6501(c)-1(f)(3), as modified to reflect the specific contexts involved, as an adequate disclosure alternative to filing Forms 8275 or 8275-R for appropriate return positions, including any positions involving valuation of property included on a transfer tax return, positions involving deductions for charitable contributions and reasonable compensation, and positions involving the inclusion in gross income of property that is not readily tradable in an established market. In the reasonable compensation context, we recommend that the regulations spell out the factors that should be addressed in the appraisal. Should Treasury adopt this recommendation, we would welcome the opportunity to provide further input on such regulations.

4. THE REASONABLE CAUSE/GOOD FAITH EXCEPTION

Section 6694(a) provides an exception to the tax return preparer penalty if “there is reasonable cause for the understatement” and the preparer “acted in good faith.” Presently, Reg. § 1.6694-2(d) provides a facts and circumstances test for determining whether the understatement was due to reasonable cause and whether the preparer acted in good faith. The Regulation describes five factors to be considered, none of which is determinative.

We recommend that this facts and circumstances test be retained in expanded form by adding three additional factors to the five factors currently listed: (1) the preparer’s background, experience, and knowledge; (2) reliance on preparer-assistance products (such as software, tax return preparation guides and other commonly used materials which are used in good faith by reputable preparers or by taxpayers to furnish information to their preparers); and (3) reliance on generally accepted administrative or industry practices or conventions. Reliance on tax protestor arguments identified in published guidance by the Service is per se unreasonable.

These additional factors would help ensure that an appropriate balance is drawn between the need for tax return preparers to use good faith efforts to avoid preparing tax returns and giving advice in a manner that would result in tax returns being filed with “unreasonable positions” as defined in section 6694(a) and providing taxpayers with cost effective service. In its discussion of section 6694 and forthcoming guidance, the Service has noted the need for rules that apply to a broad spectrum of preparers, from those whose experience is limited to preparing tax returns and whose knowledge is based on Service publications and instructions to those who are experts in their fields and routinely provide sophisticated advice to taxpayers and whose knowledge is based on such authorities as the Code, Regulations, Service guidance such as Revenue Rulings, and case law. In all cases section 6694(a) should be applied so as not to penalize tax return preparers who are following sound practices and are making a good faith attempt to
comply with the applicable standards. Consider the following examples; the substance of which we believe should be incorporated into the regulations:

**Example 1:** Tax return preparer relied on forms and publications issued by the Service and on reputable legal treatises to determine whether a taxpayer can claim a deduction for certain business expenses. The position on the tax return does not meet the accuracy standard of section 6694. Unknown to the preparer, the Service recently released a CCA that takes a position contrary to the position taken by the preparer relying on the Service guidance and treatise. The preparer is not an attorney, CPA, or enrolled agent. The preparer’s experience consists solely of preparing tax returns for individual taxpayers. Because the preparer relied on Service guidance and his experience is limited, the preparer has reasonable cause for the understatement and acted in good faith. The preparer should not be subject to penalty under section 6694.

**Example 2:** Tax return preparer relied on commercially-available tax return preparation software and commonly used commercial tax return preparation guidebooks to assist her in preparing tax returns for individual taxpayers. The software is designed to make certain legal assumptions about the information provided to it, and these assumptions are ultimately determined to be incorrect on audit. Since the invalidity of the assumptions was not apparent to the tax return preparer as she was entering the information on the taxpayer’s return or from a review of the return, there is reasonable cause for the understatement and the preparer acted in good faith. The preparer should not be subject to a penalty under section 6694.

In addition, we suggest that the Regulations provide a reasonable cause and good faith defense in situations when the law is so undeveloped or unclear that it would be unreasonably difficult to reach a conclusion as to whether a position is MLTN correct. This was, we believe, the subject of example 10 in Notice 2008-13. We agree with the rule illustrated by that example and suggest that it be incorporated into the Regulations. However, we believe that a preparer should be eligible for a reasonable cause and good faith defense in situations where the state of the law makes it unreasonably difficult to form a MLTN conclusion only if the preparer contemporaneously documents the authorities the preparer reviewed in attempting to reach a conclusion and why the preparer could not reach a conclusion.

Situations will arise in which the cost of evaluating a position will be unreasonably high in comparison with both the amount of tax liability at issue and the overall cost of preparing the return. While we recognize that the new tax return preparer rules inevitably will increase the cost of tax return preparation in many cases, we believe that there should be some limit on the amount that a taxpayer should have to pay in order to insure compliance with these new rules. Accordingly we recommend that the regulations provide that, in determining whether the preparer acted in good faith, the preparer’s efforts to assure that the
positions taken on the tax return in question were not “unreasonable positions” as defined in section 6694(a)(2), a factor to be taken into account is the relationship between the cost of fully evaluating the positions in question and the tax liability at stake and the preparer’s fee for preparing the return calculated without regard to the fee for evaluating positions on the return. The following example illustrates this concept:

**Example 3.** A preparer prepares a tax return for an individual taxpayer who has a side “business” of growing vegetables, which involves a variety of modest costs, some of which are arguably capital expenditures, and similarly modest amounts of income. The taxpayer enjoys growing vegetables, personally consumes about 15 percent of the crops and showed a net loss for the past two years. The preparer cannot determine whether this activity is more likely than not to be treated as a trade or business as opposed to an activity not entered into for profit without considerable analysis of the facts, as well as a review of the proper treatment of certain specific expenditures, a process that would be unreasonably expensive in comparison with the fee that the preparer would charge to prepare the tax return and the tax liability at stake with respect to the position without conducting the evaluation. The preparer makes a good faith attempt to determine the proper position to take on the return, but it is later determined that the position is incorrect. In determining whether the preparer may use the reasonable cause and good faith exception to avoid the imposition of a penalty this factor will be taken into account and in the absence of other facts and circumstances indicating that the preparer did not act in good faith, the reasonable cause and good faith defense should apply to prevent the imposition of the section 6694(a) penalty.

The burden of proving the cost of evaluating a position should be on the preparer and should be determined by multiplying the amount of time required to perform the evaluation by either the preparer’s standard hourly rate charged to other clients during the period at issue or, if the preparer does not have a standard hourly rate, a deemed hourly rate based on the average rates charged by other tax return preparers for tax return preparation services in the same geographical area during the same period in time. A preparer shall be deemed to have carried the burden of proving the cost of evaluating a position if the preparer can show that the preparer made a good faith effort to determine the cost. A preparer shall not be required to do a detailed analysis or seek bids to determine the cost of evaluating a position.

Finally, we recommend that the penalty should not apply if the amount of the understatement does not exceed the lesser of $5,000 or 10 percent of the amount of tax liability because we believe that it is inappropriate to apply the penalty to low-value items on a taxpayer’s return. The same de minimis rule should be applied to claims as well as original tax returns. We recognize that it may be appropriate for individual and corporate taxpayers to be subject to different standards for low-value items and would welcome the opportunity to address this issue further.
5. MULTI-YEAR ISSUES AND TRANSITIONAL RULES

Questions have arisen concerning the applicability of the new standards to items on returns prepared in periods prior to the effective date of the new standards. These issues arise in the context of net operating loss and credit carryforwards, installment sales, basis items, a discovery of an improper accounting method for an item on a return, and amended returns. These issues also arise in the transfer tax area where earlier gift tax returns directly affect the computation of gift and estate tax liability on later filed returns. Our recommendations on these transfer tax issues are addressed above in the discussion of disclosure of positions for which there is reasonable basis. The more general problem of multi-year issues, particularly in light of the change in section 6694, is addressed below.

Presently, Reg. § 1.6694-1(e) provides that a tax return preparer generally may rely in good faith without verification upon information furnished by the taxpayer, and therefore need not audit, examine or review books and records, business operations, or documents to verify the taxpayer’s information. However, the return preparer may not ignore the implications of information furnished to the preparer or actually known by the preparer. Similarly, under Reg. § 1.6694-2(d)(5) a preparer may rely in good faith on the advice of or schedules prepared by another preparer who the preparer had reason to believe was competent to render the advice, except where the advice is unreasonable on its face, the preparer knew or should have known that the other preparer was not aware of all relevant facts, or, the preparer knew or should have known that the advice was no longer reliable due to developments in the law since the time the advice was given. This approach was followed in the provisions of Notice 2008-13.

Following these principles, we believe that, in cases where advice was given or a position was taken on a return filed before the effective date of current Section 6694 and that advice or position affects multiple years, the regulations should provide that, if the advice or position satisfied the standard for avoiding a penalty at the time the advice was given or the return on which the position was taken was filed, then a preparer may continue to rely on that advice or position in preparing future returns as long as the preparer does not know and should not have known about any changes in facts or law that would materially affect propriety of the advice or position. In addition, a preparer should be treated as having reasonable cause for reliance on another preparer’s advice issued prior to the effective date of current section 6694, whether reflected in a filed return or not, where that advice affects post effective date tax periods, unless the preparer is aware of any changes in facts or law that would make the prior advice fail to satisfy the section 6694 standards.

Furthermore, it would be unduly burdensome to require preparers to reexamine all multiyear issues solely because the standard for avoiding a penalty has changed. For example, preparers should not be required to examine undisclosed positions that met the standards in previous years, or review the computations of carryforwards or other items that are carried to the present year; nor should further disclosures be required for items included in the current year’s return that were disclosed in a prior year return. Moreover, we believe the preparer of an amended return should be able to rely on the information in
an original return prepared by another preparer, again provided the reliance is reasonable and in good faith. Similar principles should apply to permit reliance on prior year returns or original returns prepared by the taxpayer. These principles are reflected to some extent in existing regulations, but should be described more specifically because of the change to section 6694.\footnote{Reg. § 1.6662-4(f)(4) provides that the disclosure required under section 6662 is adequate with respect to an item that is included in any loss, deduction or credit that is carried to another year if it is made in connection with the return (or qualified amended return) for the taxable year in which the carryback or carryover arises (the loss or credit year). Disclosure is not required in connection with the return for the taxable year in which the carryback or carryover is taken into account. Conversely, Reg. § 1.6662-4(f)(3) provides that disclosure with respect to a recurring item, such as the basis of recovery property, must be made for each taxable year in which the item is taken into account.}

In cases where the advice was given after the effective date of current section 6694 and the advice affects multiple years, we believe that regulations should provide that the preparer is treated as the return preparer only of the return with respect to which the advice was given, unless the preparer would otherwise be treated as a preparer for subsequent years. We recommend that a preparer be permitted to rely on advice issued by another preparer after the effective date of current section 6694 unless the preparer knows or has reason to know of changes in the law or the facts that would materially affect the advice.

These principles are illustrated by the following examples:

**Example 4:** Taxpayer acquired an intangible asset in 2004 and began amortizing its costs under section 197 in that year. In 2009, Taxpayer engaged a preparer, P, to prepare its 2008 tax return. Information on the prior return indicated to P that Taxpayer did not have substantial authority to amortize the costs of the intangible asset under section 197, but that there was a reasonable basis for such treatment. The position is not contrary to a rule or regulation. P is required to prepare the Form 8275 and provide it to Taxpayer with the completed 2008 tax return. P is also required to advise Taxpayer about penalty exposure under section 6662 and the opportunity to avoid the penalty through disclosure. P is not required to ensure that Taxpayer files the return with the disclosure. If P had not known or had reason to know from the information on the return

\footnote{The discovery of an improper accounting method presents additional issues because of the requirement that the Commissioner approve changes. Disclosure on a Form 8275 or 8275-R cannot help a tax return preparer where the tax position does not have reasonable basis support. In instances where the preparer knows or should have known that the taxpayer was employing an incorrect method of accounting and consent by the IRS is needed to change to a proper method, the preparer should prepare a Form 3115 and file it with the Service at the time the preparer signs the return and disclose that fact in the return either by attaching a copy of the Form 3115 to the return or through a statement of explanation. If the Form 3115, for some reason cannot be completed at the time the preparer signs the return, then the preparer should attach a statement to the tax return that the taxpayer is in the process of preparing a Form 3115 and intends to file it with the Service to change to a proper method.}
that Taxpayer did not have substantial authority to amortize the cost involved, P could have prepared the 2008 return without a form 8275 in reliance on the earlier filings.

**Example 5:** Taxpayer’s 2005 calendar year income tax return which was timely filed on September 15, 2006, included Tax Position X that was not supported by substantial authority, but for which there was a reasonable basis. No disclosures were made with this original filing. On March 31, 2009, P was engaged to amend the 2005 return for an item completely unrelated to and with no effect on Tax Position X. P was aware that Tax Position X did not have substantial authority. P has a reasonable belief that the amended position is more likely than not to prevail. No disclosure is required for P to avoid the section 6694 penalty with respect to the amended return.

**Example 6:** Assume the same facts as Example 5 except the 2009 amendment does affect Tax Position X. P is required to prepare the Form 8275 to disclose Tax Position X and provide it to Taxpayer with the completed amended 2005 return. P is also required to advise Taxpayer about potential penalty exposure under section 6662 and the opportunity to avoid the penalty through disclosure. P is not required to ensure that Taxpayer files the return with the disclosure.

**Example 7:** Taxpayer has an NOL carryforward from 2006 that can be used to reduce Taxpayer’s taxable income on its 2008 calendar year income tax return. The preparer of the 2008 tax return does not need to determine whether there were any tax return positions taken in the 2006 tax year that did not meet the MLTN standard. In addition, adequate disclosure of the position giving rise to the NOL on the 2008 return does not cure any lack of disclosure with respect to 2006.