



**Section of Taxation**

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August 26, 2008

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

Re: Comments on Proposed Regulations Under Section 6694 and 6695

Dear Commissioner Shulman:

Enclosed are comments on proposed regulations under section 6694 and 6695. 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,

A handwritten signature in black ink, appearing to read "Wm J Wilkins".

William J. Wilkins  
Chair-Elect, 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)  
Eric San Juan, Tax Legislative Counsel (Acting), Department of the Treasury  
Deborah Butler, Associate Chief Counsel, Internal Revenue Service

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**AMERICAN BAR ASSOCIATION  
SECTION OF TAXATION  
COMMENTS ON PROPOSED REGULATIONS  
UNDER SECTION 6694 AND 6695**

The following comments (“Comments”) are submitted on behalf of the American Bar Association Section on Taxation (the “Section”) and have not been approved by the House of Delegates or the 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 John Colvin. Substantive contributions were made by David Casten, Seth Cohen, Rochelle L. Hodes, Michael Lang, Alexandra Minkovich, David Moise, Fred Murray, Phillip Pillar, Ronald Wiener and Mark Wilensky. The 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 who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed in the Comments or may have advised clients in the application of such principles, and all could be affected to the extent 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 submission to the government, or otherwise to influence the outcome, with respect to the specific subject matter of these Comments.

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Date                    August 26, 2008

## EXECUTIVE SUMMARY

These Comments address proposed regulations (the “Proposed Regulations”) implementing amendments to the tax return preparer penalties under sections 6694 and 6695<sup>1</sup> – and related provisions under sections 6060, 6107, 6109, 6696 and 7701(a)(36) – made by the Small Business and Work Opportunity Tax Act of 2007. The Proposed Regulations were issued published in the Federal Register on June 17, 2008.<sup>2</sup>

We believe the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) have done an excellent job of reconciling the amendments to the tax return preparer penalties with the practical problems that arise in every-day practice. We generally support the approach in the Proposed Regulations and we make the following recommendations:

1. Definition of Return. The Proposed Regulations, when finalized, should more narrowly define the types of information returns or other documents that the Service may treat as a “substantial portion” of a taxpayer’s return, excluding certain information returns subject to penalties pursuant to sections 6721 *et seq.*, and certain other forms unrelated to the computation of tax liability.
2. Preparer’s Obligation to Sign a Return. The Service should clarify that a preparer who is responsible for the overall substantive accuracy of the preparation of a return or claim for refund is required to sign the return or claim.
3. Penalty Arising from Pass-Through Returns. The Proposed Regulations, when finalized, should limit the amount of penalty that may be collected against the preparer of a pass-through return to the greater of \$1,000 or one half of the fees collected for the return preparation services.
4. Person with Supervisory Responsibility. Application of the penalty against a person with “overall supervisory responsibility”<sup>3</sup> for a position within a firm should be limited to cases in which some degree of fault can be attributed to the person with overall supervisory responsibility.
5. Reliance on Taxpayers for Legal Conclusion. We suggest that the language in Proposed Regulation section 1.6694-1(e)(1) providing that, while a preparer can rely on factual information furnished by a taxpayer, a preparer “may not rely on information provided by a taxpayer with respect to legal conclusions on federal tax issues” be eliminated. The principle that preparers cannot rely on legal conclusions provided by taxpayers is clear from other portions of the

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<sup>1</sup> All references to “section” herein are to sections of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise expressly stated herein, and references to regulations are to the Treasury Regulations promulgated under the Code.

<sup>2</sup> 73 Fed. Reg. 34,560 (June 17, 2008).

<sup>3</sup> Prop. Reg. §§ 1.6694-1(b)(1) and (b)(3).

Proposed Regulations,<sup>4</sup> and its restatement in the portion of the Proposed Regulations dealing with the preparer’s ability to rely on information provided by taxpayers introduces ambiguity with respect to information provided by a taxpayer which may (unknown to the preparer) contain mixed questions of fact and law.

6. Reliance on Advice from Other Preparers. The Proposed Regulations, when finalized, should permit preparers to rely on advice received from other preparers in determining whether the preparer had “a reasonable belief that the position would more likely than not be sustained on the merits.”<sup>5</sup>
7. Computation of the Penalty in Cases Involving Firm and Individual Liability. We suggest that the Proposed Regulations, when finalized, provide an example illustrating how the 50% of gross income standard will work in cases involving both firm and individual liability.
8. Standard Approach to Adequate Disclosure. We recommend that the Proposed Regulations, when finalized, clarify that a firm does not violate the prohibition against having a “boilerplate disclaimer”<sup>6</sup> simply because it has adopted a standard approach to disclosure issues.
9. Disclosure of Taxpayer Return Information. There should be a mechanism to allow disclosure of taxpayer return information to preparers in the course of preparer penalty audits.
10. Reasonable Cause and Good Faith – Due Diligence. We believe that the amount of factual and legal due diligence required of a preparer to qualify for the “reasonable cause and good faith” defense should not be disproportionate to the amount of potential tax liability at issue with respect to the position.
11. Reasonable Cause and Good Faith – Changes in the Law. The Proposed Regulations, when finalized, should clarify that a preparer who becomes aware (or should become aware) of developments in the tax law only has a duty to determine whether previous advice is no longer reliable in cases where there has been either a statutory change or a change in controlling precedent.
12. Reasonable Cause and Good Faith – Generally Accepted Administrative or Industry Practice. The Proposed Regulations, when finalized, should provide that “generally accepted industry practices” include practice guidelines adopted by industry, as well as positions accepted by the Service with respect to industry-wide issues.

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<sup>4</sup> E.g., Prop. Reg. § 1.6694-2(d)(5)

<sup>5</sup> 73 Fed. Reg. 34,560 (June 17, 2008).

<sup>6</sup> Prop. Reg. § 1.6694-3(c)(3)(iii)

13. Burden of Proof. We suggest that the rules regarding “burden of proof”<sup>7</sup> in preparer penalty litigation either be eliminated or be substantially revised to comport with section 7491.
14. No Single Position is MLTN. Where there are more than two potential tax treatments, none of which is “more likely than not,” the Proposed Regulations, when finalized, should not penalize the preparer if the preparer reasonably concludes that one of the alternatives is more likely than the other to be sustained by the courts.

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<sup>7</sup> Prop. Reg. §§ 1.6694-2(e) and 1.6694-3(g).

## DISCUSSION

### 1. Definition of Return – Potential Inclusion of Information Returns.

Proposed Regulation section 301.7701-15(b)(4) provides a very broad definition of return that includes “any information return or other document identified in published guidance in the Internal Revenue Bulletin, 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.”

This proposed definition of return potentially includes documents that would not be treated as a return of income tax under existing case law.<sup>8</sup> In addition, this definition could include Form W-2,<sup>9</sup> Form 1099, Forms 2210 and 2220 (computation of underpayment of estimated taxes), and Forms 1139 and 1045 (tentative refund applications),<sup>10</sup> all of which are currently excluded from the definition of income tax return under Regulation section 301.7701-15(b). We recognize that Treasury and the Service have not identified any of the forms identified in this comment as an information return which will be treated as a return if the information contained therein constitutes a substantial portion of a taxpayer’s return. However, we believe that the Proposed Regulations, when finalized, should adopt a principled approach with respect to what types of forms may be identified in the future.

Forms W-2 and 1099 are often prepared by persons working for employers or service recipients, who have no obligation to the workers and service providers who receive such forms, and may have contrary interests. Many preparers of these returns are payroll services. As a policy matter, because the preparer of a Form W-2 or 1099 has no obligation running to the recipient of such forms, it would be anomalous to treat them as being responsible for a “substantial portion of the taxpayer’s return.” If improper positions are taken by a preparer working for an employer, such positions may also be reflected on the employment tax returns or the income tax return of the employer/service recipient, and subject to penalty with respect to such other return.

To prevent stacking of penalties, the current penalty structure that has been in place since 1989, treats preparer penalties and information return penalties (sections 6721-6725) as mutually exclusive categories.

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<sup>8</sup> See, *Beard v. Commissioner*, 82 T.C. 766, 777 (1984), *affd. per curiam* 793 F.2d 139 (6th Cir. 1986) (providing a four-part test including calculating a liability). Nothing in the amendments made by the Small Business and Work Opportunity Act of 2007 demonstrates a Congressional intent to change the long established definition of a return. Rather, the 2007 amendments merely extend the preparer penalties to all types of tax (estate and gift, excise, etc.).

<sup>9</sup> Form W-2 was excluded from the definition of an income tax return under PLR 8034159 (June 2, 1980); PLR 8035069 (June 6, 1980); and GCM 38648 (March 3, 1981).

<sup>10</sup> Forms 1139 and 1045 (tentative refund applications) were excluded from the definition of a return in PLR 7846077 (August 21, 1978) and GCM 38071 (August 29, 1979), relying on the flush language of section 6411(a).

Accordingly, we recommend that the definition of the term “return” for purposes of sections 6694 and 6695 exclude information returns that are subject to the information return penalties,<sup>11</sup> as well as forms that are unrelated the computation of a liability on a tax return.<sup>12</sup>

## **2. Preparer’s Obligation to Sign a Return.**

The Proposed Regulations under section 6695 would penalize a “signing tax return preparer”<sup>13</sup> for failing to satisfy a number of statutory duties imposed on signing preparers, including failing to sign the return. The Proposed Regulations define a “signing tax return preparer” as any preparer who signs the return or claim for refund as well as preparers required to sign pursuant to Proposed Regulation section 1.6695-1(b). Proposed Regulation section 1.6695-1(b)(3) provides a rule for determining who among multiple tax return preparers involved in preparing a return is to be considered the preparer required to sign the return. However, no rule is provided to indicate when either one preparer individually or several preparers together have been sufficiently involved in the preparation of the return that either the individual preparer or one among the group is actually required to sign the return.

We recommend that this issue be clarified by modifying Proposed Regulation section 1.6695-1(b)(1) to read as follows:

An individual who is a tax return preparer as described in § 301.7701-15 of this chapter with respect to a return of tax or claim for refund of tax under the Code and who is responsible for the overall substantive accuracy of the preparation of the return or claim for refund that is not signed electronically shall sign the return or claim....

A conforming change should be made to the regulations governing electronically signed returns.

## **3. Maximum Penalty Limit for Pass-Through Returns.**

Section 6694(a) provides for a penalty equal to the greater of \$1,000 or 50% of income derived by the preparer. A nonsigning preparer is any tax return preparer who is not a signing tax return preparer who prepares a “substantial portion” of a return or claim for refund, with respect to events that have occurred at the time that the advice is rendered. With respect to nonsigning preparers, if the schedule, entry or other portion of the return prepared by the nonsigning preparer involves amounts of gross income or deduction that do not exceed \$10,000 in income/deduction, then the schedule, entry or

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<sup>11</sup> *I.e.*, section 6721 *et seq.*

<sup>12</sup> *E.g.*, computations of underpayment of estimated taxes (*i.e.*, Forms 2210 and 2220) and tentative refund applications (*i.e.*, Forms 1139 and 1045).

<sup>13</sup> Prop. Reg. § 301.7701-15(b)(1).

other portion of the return is not considered substantial.<sup>14</sup> The Proposed Regulations provide that the preparer of a partnership return (or S corporation return) is treated as the preparer of the partners' (or shareholders') returns, provided the flowthrough amounts constitute a "substantial portion" of the partners' or shareholders' individual returns.<sup>15</sup>

In the case of partnership or other flow through entity returns, the penalty computation rules do not provide any guidance in the case where a preparer of the entity return is not engaged to provide any services to the entity's interest holders, but is nonetheless treated as a nonsigning preparer with respect to the interest holders' returns. We believe these rules should be clarified so that the 50% fee limit applies to all fees the preparer receives with respect to the preparation of the entity returns. If the preparer also receives fees to provide advice with respect to a particular interest holder's return, those fees should be taken into account for purposes of determining the fee limit.

The following example illustrates this concept. A lawyer prepares a Form 1065 for a non-public real estate investment partnership having 100 individuals as equal partners and is paid \$5,000 for the preparation. The partnership engaged in a like-kind exchange and deferred \$5,000,000 of gain. The lawyer knows that the deferral is a substantial portion of each partner's return, but the lawyer is not a paid preparer with respect to any partner's individual returns. The Service challenges the like-kind exchange and asserts the section 6694(a) penalty against the lawyer. The potential penalty would be \$2,500 (50% of \$5,000). However, the preparer is also a nonsigning preparer of the Forms 1040 for each partner. It is unclear whether there will be an additional penalty with respect to the returns of each of the partners, or whether the single penalty at the partnership level will be the entire penalty. Further, if there is an additional penalty for each partner's understatement, it is not clear how that amount would be determined (*i.e.*, is it based on the fee paid by the partnership? Is the fee deemed to be \$0 so that the \$1,000 penalty amount applies?). If there is a penalty amount attributable to the partnership return and each partner's return, is there a cap with respect to such penalty amount?

To address these uncertainties, we suggest that Treasury and the Service clarify the Proposed Regulations, when finalized, to limit the amount of the penalty to the greater of \$1,000 or 50% of the fees earned by the preparer with respect to preparation of the pass-through return. Thus, in the example above, regardless of the number of partners, the entire penalty amount imposed on the preparer could be no more than 50% of the total fees or \$2,500.<sup>16</sup>

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<sup>14</sup> Prop. Reg. § 301.7701-15(b)(3)(ii)(A).

<sup>15</sup> Prop. Reg. § 301.7701-15(b)(3)(iii).

<sup>16</sup> A preparer who made the same mistake (for the same fees) regarding the replacement period with respect to a section 1031 exchange on an individual return would be subject to a \$2,500 penalty.

#### **4. Responsibility within Firm – Supervisory Responsibility.**

In situations involving both signing and nonsigning tax return preparers within the same firm, the individual within the firm with overall supervisory responsibility for the position of the section 6694 penalty is the preparer if the Service cannot conclude which individual (as between the signing tax return preparer and other persons within the firm) is responsible for the position. The preamble indicates that this rule is intended to address situations where there is uncertainty regarding the identification of the primarily responsible preparer within the firm prior to the expiration of the statute of limitations. This default rule may be interpreted as imposing liability on a person with some level of “supervisory responsibility” for the position, but who is unaware of the position. For example, in a law firm, the head of the tax department may have “overall supervisory responsibility” for all tax legal opinions issued by the firm, but may be unaware of a critical factual error in a subordinate’s analysis. Moreover, there may well be ambiguity within the firm about who has “overall supervisory responsibility” for the position.

We recommend that the Proposed Regulations, when finalized, provide that a person with “supervisory responsibility” for the position be limited to persons who either (1) had actual knowledge of the position, or (2) through willfulness, recklessness, or gross indifference, failed to exercise appropriate diligence in the review of the position for which the penalty is being imposed. This recommendation is based on the standard in Proposed Regulation section 1.6694-2(a)(2) for determining whether firm liability is appropriate, and would ensure that only culpable individuals are subject to punishment.

#### **5. Signing Preparers – Reliance upon Taxpayers – Legal Conclusions.**

Proposed Regulation section 1.6694-1(e)(1) provides that a preparer “generally may rely in good faith without verification upon information furnished by the taxpayer.” However, the preparer “may not rely on information provided by a taxpayer with respect to legal conclusions on Federal tax issues.”<sup>17</sup> It is clear from the remainder of the Proposed Regulations that a preparer is only entitled to rely on another advisor (and not the taxpayer) for advice on federal tax law (*i.e.*, legal conclusions), and only then if the preparer believes such other advisor is competent to render such advice.<sup>18</sup>

Some information that is commonly considered factual in nature may, on closer inspection, turn out be a mixed question of fact and law. For example, suppose a taxpayer sold a piece of real property during the year. To determine gain or loss on the sale, the preparer needs to know the taxpayer’s adjusted tax basis. A taxpayer’s adjusted tax basis in real property sold during the year may depend only on the taxpayer’s original cost. However, it may also depend on any number of other things, *e.g.*, whether the property was acquired in a prior like-kind exchange, whether the real property was acquired from a decedent, or what the “allowable depreciation” was with respect to the property. If the preparer simply obtained the adjusted tax basis in the property from the taxpayer’s books and records or on basis information furnished directly by or on behalf of

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<sup>17</sup> Prop. Reg. § 1.6694-1(e)(1).

<sup>18</sup> Prop. Reg. § 1.6694-2(d)(5).

the taxpayer, the preparer would not know or have reason to know whether this information was significantly affected by a legal conclusion. We believe that this regulation could cause confusion in the case of mixed questions of fact and law, especially where the preparer does not actually know that the information may reflect legal conclusions.

While we agree that a preparer is not entitled to rely on legal conclusions provided by the taxpayer, we recommend that the Proposed Regulations, when finalized, eliminate the sentence stating that a preparer may not rely on information provided by a taxpayer with respect to legal conclusions on Federal tax issues. The restatement of this principle in the regulation providing that preparers generally can rely on taxpayers for factual information may engender confusion in the case where the factual information provided (unknown to the preparer) contains embedded legal conclusions. Alternatively, the Proposed Regulations, when finalized, should clarify that the bar against relying on taxpayers with respect to legal conclusions applies only to an express statement by a taxpayer as to a legal conclusion on a federal tax issue, *e.g.*, “Section xx of the Code justifies the position I would like to take on the return.”

## **6. Signing Preparers - Reliance upon Advice from Other Preparers.**

The Proposed Regulations appear to contain an oversight that may be construed to preclude reliance on advice provided by another tax advisor, except to establish “reasonable cause.” The preamble to the Proposed Regulations states that a tax return preparer may meet the “reasonable belief that a position would more likely than not be sustained on the merits standard” if, among other things, the tax return preparer “relies on information or advice furnished by a taxpayer, advisor, another return preparer, or another party (even when the advisor or tax return preparer is within the tax return preparer’s same firm), as provided in proposed § 1.6694-1(e).” However, the only place in the text of the Proposed Regulations where a tax return preparer is permitted to rely on the “advice” of anyone is in Proposed Regulation section 1.6694-2(d), which defines “reasonable cause.”

This language in the preamble suggests that any omission in the text of the Proposed Regulations regarding this issue was merely an oversight. We recommend correcting this omission by amending Proposed Regulation sections 1.6694-1(e), 1.6694-2(b), and 1.6694-2(c) to specifically permit reasonable reliance on the advice of other advisors for purposes of establishing the existence of “a reasonable belief that the position would more likely than not be sustained on the merits,” as well as to establish “reasonable cause.” Preparers should also be permitted to reasonably rely on advice received from other advisors in determining their obligations with respect to positions that do not meet the MLTN standard (*e.g.*, the reasonable basis standard).

## **7. Income Derived – Compensation – Individual and Firm Allocation.**

We believe that the Proposed Regulations, when finalized, should contain an example illustrating how the penalty will be computed in cases involving employees and partners who spend a portion of their time on a particular position subject to the section

6694 penalty, for which the firm earns a specific amount. We suggest the inclusion of the following example:

A works for Firm F. A is an employee of Firm F, with a salary of \$75,000/year. A performs tax preparation work for Client C. The Client C return contains a position that results in an understatement subject to the § 6694 penalty. A spent 100 hours on this position (out of a total of 2,000 billed during the year). The total fees earned by Firm F with respect to the position reflected on Client C's return are \$50,000.

If A is subject to the penalty, the penalty amount computed under the 50% of income standard is  $0.5 \times (100/2,000) \times \$75,000 = \$1,875$ .

If Firm F is subject to the penalty, the penalty amount computed under the 50% of income standard is  $0.5 \times \$50,000 = \$25,000$ , less any penalty amount imposed against A. If a penalty of \$1,875 were assessed against A, and Firm F were subject to the penalty, a penalty of \$23,125 would be the amount of penalty to be assessed against Firm F.

## **8. Adequate Disclosure – Communicating Options to Taxpayers.**

When a position does not satisfy the “reasonable belief that the position would more likely than not be sustained on the merits” standard, but does satisfy the “reasonable basis” standard, and if the position is not appropriately disclosed on the tax return, the preparer is required to provide certain advice to taxpayers, and to prepare contemporaneous documentation that such advice was provided.<sup>19</sup> The proposed regulation provides that “no form of a general boilerplate disclaimer is sufficient to satisfy these standards.”<sup>20</sup> This provision appears to be aimed at stopping preparers who might attempt to opt out of penalty exposure entirely by telling clients, “Some items on your return may not meet the ‘more likely than not’ (‘MLTN’) standard. If the items do not meet MLTN, and if there is not ‘substantial authority’ supporting your position, you should disclose or face penalty exposure.”

However, we expect that many responsible firms and their insurance carriers will want procedures in place for making sure that preparers point out to their clients any reservations with respect to any positions that do not meet the MLTN standard, as well as a script/template for advising clients of their options when a specific position does not reach MLTN, when the position has “substantial authority,” and when the position only has a “reasonable basis.” The options will be similar for situations in each different category.

Accordingly, we believe that the provision against having a “boilerplate disclaimer,” should be clarified to state that having general procedures to follow in a situation where the preparer is unable to reach the “reasonable belief that the position

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<sup>19</sup> Prop. Reg. § 1.6694-2(c)(3)(iii).

<sup>20</sup> *Id.*

would more likely than not be sustained on the merits” standard does not violate the provision providing that “no form of general boilerplate is sufficient,” so long as the preparer specifies to the client which specific position or positions on the return do not meet the “more likely than not” standard,” and provides specific advice regarding the standards applicable to preparers and/or taxpayers relative to those positions as set out in proposed regulation 1.6694-2(c).

## **9. Disclosure of Taxpayer Returns or Return Information in Preparer Penalty Audits.**

Under current law, it is not clear whether a tax return preparer is able to obtain disclosure of taxpayer returns or return information (as defined in section 6103(b)) to the extent relevant and material to the examination of the tax return preparer with respect to a penalty under sections 6694(a) or (b). Section 6103, and the regulations thereunder, provide for limited disclosure of taxpayer returns and return information, with unauthorized disclosure potentially resulting in civil and/or criminal penalties.<sup>21</sup> By enacting section 6103(l)(4)(A)(ii), Congress recognized the need for tax return preparers to have access to returns and return information in the context of disciplinary hearings before or proceedings instituted by the Director of the Office of Professional Responsibility.<sup>22</sup> It is unclear, however, whether the Secretary may disclose returns or return information under section 6103(l)(4)(A)(ii) to tax return preparers prior to the examiner’s filing of a report with the Director of the Office of Professional Responsibility.

The state of the law regarding the Service’s ability to disclose taxpayer returns or return information to a preparers under section 6103(h)(4) is uncertain, insofar as the Circuit Courts of Appeals are divided as to whether that section permits disclosure only to Federal officials and employees or allows audit disclosures.<sup>23</sup> It is also unclear whether information regarding taxpayer returns becomes “taxpayer return information,” pursuant to section 6103(b), with respect to the preparer, when such information is used as a basis for computing a proposed preparer penalty liability.

We recommend that Treasury and the Service issue regulations providing that section 6103(l)(4)(A)(ii) permits the Secretary or its delegate to disclose taxpayer returns and return information to a tax return preparer at the tax return preparer’s request upon initiation of an examination of the tax return preparer for tax return preparer penalties, to the extent that the Secretary or its delegate determines that the returns and return information are relevant and material to the examination. We believe that such disclosure

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<sup>21</sup> See, e.g., sections 7213(a)(1) and 7431.

<sup>22</sup> See also, Circular 230, section 10.72(d)(3) - (4), providing for disclosure of returns or return information to any practitioner or appraiser “whose rights are or may be affected by an administrative proceeding under this subpart D.”

<sup>23</sup> See, e.g., *Chamberlain v. Kurtz*, 589 F.2d 827 (5th Cir. 1979); *First Western Government Securities, Inc. v. United States*, 796 F.2d 356 (10th Cir. 1986); *Mallas v. United States*, 993 F.2d 1111 (4th Cir. 1993).

is within the scope of section 6103(l)(4)(A)(ii) insofar as an examination of the tax return preparer may eventually result in an administrative action or proceeding under Circular 230.

#### **10. Exception for Reasonable Cause and Good Faith.**

Generally, we believe that the Proposed Regulations, when finalized, should specify that the amount of factual and legal due diligence required on the part of the preparer in order to qualify for the “reasonable cause and good faith” defense should not be disproportionate to the amount of the tax liability that would be affected by the position at issue.

#### **11. Reliance Upon the Advice of Others.**

Proposed Regulation section 1.6694-2(d)(5)(iii) provides that a preparer may not rely upon the advice of another advisor if,

[t]he tax return preparer knew or should have known (given the nature of the tax return preparer’s practice) at the time that the return or claim for refund was prepared, that the advice or information was no longer reliable due to developments in the law since the time the advice was given.

This provision could be construed to impose a duty on a preparer who received advice from another preparer prior to the preparation of the return and who later learns (or has reason to learn) of legal developments, to conduct due diligence in order to determine whether the advice or information provided is still reliable in light of the developments in the law.

We believe that the phrase “reliable due to developments in the law” is inherently ambiguous, and difficult to apply even to relatively simple tax advice. Certainly, signing tax return preparers who become aware of the enactment of a federal tax statute or a Supreme Court decision that directly altered the treatment of a significant item on a return could determine that prior inconsistent advice is no longer reliable. For example, in *Knight v. Commissioner*, 128 S.Ct. 782 (2008), the Supreme Court ruled that a trust’s investment advisory fees were subject to the two percent AGI floor of section 67. Preparers should be aware of this decision and be able to determine that prior inconsistent advice is no longer reliable.

However, other legal developments, although possibly important to the analysis of the issue, may not rise to the level that they make the prior analysis “unreliable.” Suppose, at the time that the advice was initially given, there was a Tax Court decision in favor of the position advocated by the advisor, and a Court of Federal Claims decision contrary to the position advocated by the advisor. The advisor relied on the Tax Court decision (arguing that it was better reasoned) to opine that the position was “more likely than not.” A post-advice decision by a federal district court agreeing with the Court of Federal Claims opinion outside the taxpayer’s jurisdiction may well be a “development in the law.” Depending on the analysis employed by the district court, the opinion may

render the position objectively no longer “more likely than not.” However, the existence of an additional court case contrary to the advisor’s position does not necessarily render the position “unreliable,” in the same way that a new statute or controlling precedent would. A preparer who is relying on another advisor should not be required to Shepardize cases and independently evaluate their impact.

Accordingly, we believe that the Proposed Regulations, when finalized, should state that, in determining whether advice given prior to the preparation of a return is “reliable,” a preparer who relies upon another advisor need only determine that the position advocated by the advisor has not been overruled by subsequent legislation or adverse controlling precedent.

## **12. Reliance on Generally Accepted Administrative or Industry Practice.**

We believe that guidance should be provided to explain how a practitioner should determine whether a practice is “generally accepted.” For example, preparers should be able to rely on ethical and other practice guidelines published by the American Bar Association, the AICPA, or similar organizations in determining what “generally accepted” practices are. In addition, if the Service has permitted a specific technical position for an industry in the past, then such practice should be treated as “generally accepted” for purposes of qualifying for the exception, unless the Service has announced in published guidance that the practice is no longer accepted.

We believe that, in appropriate cases “industry practice” should be taken into account in determining both “reasonable belief that a position is MLTN,” as well as whether the position has a “reasonable basis.”

## **13. Burden of Proof in Preparer Penalty Litigation.**

The Proposed Regulations have retained, substantially unchanged, the rules in the current regulations regarding the burden of proof in any proceeding with respect to the penalty imposed by sections 6694(a) and (b), respectively.<sup>24</sup> The burden of proof rules may be relevant, for instance, in a refund suit filed by the tax return preparer pursuant to sections 6694(c) and 6696(c) - (d). The current regulations addressing the burden of proof were issued prior to the 1998 enactment of section 7491.

Under section 7491(a), the burden of proof in a court proceeding involving a tax liability (including a refund suit) is shifted to the government if the taxpayer introduces credible evidence with respect to a factual issue relevant to ascertaining the taxpayer’s liability for any tax and if certain other requirements are met. Moreover, under section 7491(c), the Secretary has the burden of production in a court proceeding with respect to an individual’s liability for any penalty, which would also appear to include a tax return preparer penalty.<sup>25</sup> Under section 7491(c), for instance, we believe that the Service

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<sup>24</sup> See Prop. Reg. §§ 1.6694-2(e) and 1.6694-3(g).

<sup>25</sup> See, section 6671(a) and Revenue Ruling 78-245, 1978-1 C.B. 435, treating tax return preparer penalties as a “tax.”

would have the burden of production for its case in chief, including demonstrating that the tax return preparer “knew or reasonably should have known that the questioned position was taken on the return” and that “the position was not adequately disclosed.”<sup>26</sup> Insofar as “reasonable cause and good faith” are an affirmative defense to penalty liability, the taxpayer should have the burden of production regarding those issues.<sup>27</sup> Accordingly, we recommend that the provisions regarding burden of proof be removed or revised to comport with section 7491.

#### **14. Preparer’s Alternatives When There Is No Position That is “More Likely Than Not.”**

Given the complexity of the Internal Revenue Code, and the different potential tax treatment available for certain items, there may be situations in which no single position is “more likely than not.” For example, the sole shareholder of a corporation takes funds from his or her corporation during the year, but dies before the end of the year. Do the funds constitute compensation, a dividend distribution, or the repayment of a loan? The facts about the intended characterization may be ambiguous. When the facts are uncertain, the three different positions (which have radically different tax consequences) may be equally plausible. Thus, there is no one position that is “more likely than not.”

We recommend that the Proposed Regulations, when finalized, provide that when there is no single position that is “more likely than not” to be the correct position, the preparer will not be penalized if he or she reasonably concludes that one of the alternative positions is the most likely to be sustained by a court (*vis-à-vis* the other positions) and takes that position on the return.

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<sup>26</sup> Prop. Reg. §§ 1.6694-2(e)(1) and (3).

<sup>27</sup> Prop. Reg. § 1.6694-2(e)(2).