New Standards For Advisors and Tax Returns Preparers Under IRC § 6694 and Circular 230 § 10.34

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I. IRC § 6694 and Circular 230 § 10.34 Prior to Recent Changes

A. IRC § 6694 Prior to Amendment by the Small Business and Work Opportunity Tax Act, H.R. 2206 ("H.R. 2206") [1]

1. In general. IRC § 6694 provides for a penalty to be imposed on a "tax return preparer" (defined below in III.A) if the amount of tax liability reflected on a tax return or claim for refund is understated.

2. Avoiding IRC § 6694 penalties prior to H.R. 2206. Prior to H.R. 2206, tax return preparers could avoid penalties under IRC § 6694 if one of the following conditions was satisfied:

a. The position resulting in the understatement had a realistic possibility of success on the merits (i.e., a one in three chance).[2]

b. The position resulting in the understatement was not frivolous (i.e., not patently improper)[3] and adequate disclosure was made.

i. In the case of a "signing preparer" (defined below at III.A.5.i), the adequate disclosure standard was satisfied if the position was disclosed on the taxpayer's tax return (e.g., on IRS Form 8275).[4]

[1] H.R. 2206 was signed into law on May 25, 2007, with an immediate effective date. However, as described below in IV.A, the IRS continued to apply pre-H.R. 2206 IRC §6694 to returns, amended returns and claims for refund due on or before December 31, 2007.

[2] Treas. Reg. § 1.6694-2(b) provides that "[a] position is consider to have a realistic possibility of being sustained on the merits if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits."

[3] See Treas. Reg. § 1.6694-2(c)(2).

[4] See Treas. Reg. § 1.6694-2(c)(3)(i).

ii. In the case of a "non-signing preparer" (defined below at III.A.5.ii), the adequate disclosure standard was satisfied if the preparer advised the taxpayer about potential accuracy-related penalties that could be imposed with respect to the position and how such penalties could be avoided through disclosure on the taxpayer's return.[5]

c. It could be shown that there was reasonable cause for the understatement and the return preparer acted in good faith.[6]

3. Income tax return preparers. Prior to H.R. 2206, only income tax return preparers were potentially subject to IRC § 6994 penalties.

4. $250 maximum penalty. Prior to H.R. 2206, the maximum penalty for a violation of IRC § 6694 was $250 per return or claim for refund.

B. Circular 230 §10.34 Prior to Amendments Proposed September 19, 2007 (the "Proposed Amendments")

1. Pre-amendment Circular 230 § 10.34 v. pre-amendment IRC § 6694. Prior to the Proposed Amendments, the rules of Circular 230 § 10.34 were similar to those of pre-amendment IRC § 6694. There were, however, several differences, including the following:

a. Prior to the Proposed Amendments, Circular 230 § 10.34 applied to "practitioners" (defined below at III.B) rather than to tax return preparers. (Circular 230 § 10.34 continues to apply to practitioners following the Proposed Amendments.)

b. Prior to the Proposed Amendments, Circular 230 § 10.34 applied to a position taken on any tax return, not just an income tax return. (Circular 230 § 10.34 continues to apply to any tax return following the Proposed Amendments.)

[5] Alternatively, in the case of a non-signing preparer, the adequate disclosure standard could also be satisfied by disclosure of the position on the taxpayer's return. See Treas. Reg. § 1.6694-2(c)(3)(ii).

[6] Treas. Reg. § 1.6694-2(d) describes factors to be considered in determining whether the reasonable cause and good faith standard was satisfied. The reasonable cause and good faith standard remains part of IRC § 6694 following the amendments of H.R. 2206 and is described below at V.G.

II. IRC § 6694 and Circular 230 § 10.34, Following Recent Changes

A. IRC § 6694, Following H.R. 2206

1. In general. As was the case prior to H.R. 2206, current IRC § 6694 provides for a penalty to be imposed on a tax return preparer if the amount of tax liability reflected on a tax return or claim for refund is understated.

2. Avoiding penalties under IRC § 6694, following H.R. 2206. Following H.R. 2206, IRC § 6694 penalties can be avoided only if one of the following conditions is satisfied:

a. The preparer has a "reasonable belief" that the position is more likely than not ("MLTN") correct (i.e., greater than 50% chance).[7]

b. The position has a "reasonable basis" and adequate disclosure is made.

i. In the case of a "signing preparer" (defined below in III.A.5.i), the existing Treasury Regulations under Code § 6694 indicate that the adequate disclosure standard is satisfied if the position is disclosed on the tax return (e.g., on IRS Form 8275 or pursuant to Rev. Proc. 2008-14 (described at IV.D, below)).[8]

ii. In the case of a "non-signing preparer" (defined below at III.A.5.ii), the existing Treasury Regulations under IRC § 6694 indicate that the adequate disclosure standard is satisfied if the preparer advises the taxpayer about potential accuracy-related penalties that could be imposed with respect to the position and how such penalties can be avoided through disclosure on the taxpayer's return.[9]

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[7] Interim guidance in Notice 2008-13 (discussed below at V.E) describes how a tax return prepare can satisfy the standard of having a reasonable belief that a position is MLTN correct. The New York State Bar Association has asked Treasury to clarify in its final IRC § 6694 guidance whether (i) the "reasonable belief" test is an objective test or a subjective test (based upon what the preparer really believes) and (ii) how a preparer may establish that the reasonable belief test is met. See New York State Bar Tax Section Report and Appendix on the Definition of "Tax Return Preparer" and Other Issues Under Code Sections 6694, 6695 and 7701(a)(36) (December 20, 2007).

[8] See Treas. Reg. § 1.6694-2(c)(3)(i).

[9] Alternatively, in the case of a non-signing preparer, the adequate disclosure standard can also be satisfied by disclosure of the position on the taxpayer's return. See Treas. Reg. § 1.6694-2(c)(3)(ii).

c. It can be shown that there was reasonable cause for the understatement and the return preparer acted in good faith.[10]

3. Preparers of all tax returns. All tax return preparers (not just income tax return preparers) are now potentially subject to IRC § 6994 penalties.[11]

4. Penalty of up to 50% of income. The penalty for a violation of § 6694 is increased from $250 to up to 50% of the income derived by the return preparer with respect to the return. (It is not clear how income derived by the return preparer with respect to the return is to be determined.)

B. Circular 230 § 10.34 Following the Proposed Amendments

1. Standard for practitioner who signs return. Following the Proposed Amendments to Circular 230 § 10.34, a practitioner (defined below in III.B) who signs a taxpayer's return can avoid potential Circular 230 penalties if one of the following conditions is satisfied:

a. The practitioner has a reasonable belief that the tax treatment of each position on the return will MLTN be sustained on its merits,[12] or

b. There is a reasonable basis for each position on the return, and each position is adequately disclosed to the IRS. [13]

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[10] Treas. Reg. § 1.6694-2(d) describes factors to be considered in determining whether the reasonable cause and good faith standard is satisfied. These factors are discussed below in V.G in connection with Notice 2008-13, which incorporates by reference Treas. Reg. § 1.6694-2(d) and the factors described therein.

[11] Notice 2008-13 provides that until further guidance is issued, certain enumerated forms (such as IRS Form 990) are not tax returns to which IRC § 6694 applies, unless prepared willfully in a manner to understate a tax liability or in reckless and intentional disregard of the rules and regulations. See section A and exhibit 3 of Notice 2008-13 (described below at V.B.4).

[12] For purposes of Circular 230 § 10.34 following the Proposed Amendments, a practitioner will be considered to have a reasonable belief that the tax treatment of a position on the return will MLTN be sustained on the merits if the practitioner analyzes the pertinent facts and authorities, and based on that analysis, reasonably concludes, in good faith, that there is a greater than 50% likelihood that the tax treatment will be upheld if the IRS challenges it. The authorities described in Treas. Reg. § 1.6662-4(d)(3)(iii) of the substantial understatement penalty regulations may be taken into account for purposes of this analysis. See amended Circular 230 § 10.34(e)(1).

[13] For purposes of Circular 230 § 10.34, following the Proposed Amendments, a position is considered to have a reasonable basis if it is reasonable based on one or more of the authorities described in Treas. Reg. § 1.6662-4(d)(3)(iii), which are detailed below in footnote 27 . See amended Circular 230 § 10.34(e)(2).

2. Standard for practitioner who does not sign return. Following the Proposed Amendments to Circular 230 § 10.34, a practitioner who advises a client to take a position on a tax return, or who prepares a portion of a tax return on which a position is taken can avoid potential Circular 230 penalties if one of the following conditions is satisfied:

   a. The practitioner has a reasonable belief that the position satisfies will MLTN be sustained on the merits; or

   b. The position has a reasonable basis and is adequately disclosed to the IRS.[14]

3. Penalties, including fine of up to 100% of gross income. In general, possible penalties for a Circular 230 violation are disbarment from practice before the IRS, suspension from practice before the IRS, censure, monetary fine, or a combination of these. Monetary fines for a Circular 230 violation can be up to 100% of the gross income derived from the engagement.[15]

   a. If the monetary penalty for a violation of Circular 230 §10.34 stacks with the IRC § 6694 monetary penalty, the combined monetary penalties can equal up to 150% of the gross income derived from the engagement.

III. Which Advisors Are Subject to The New Elevated Standards?

A. IRC §6694 – "Tax Return Preparers"

1. Definition of "tax return preparer". For purposes of IRC §6694, a "tax return preparer" is defined in IRC §7701(a)(36) and Treas. Reg. §301.7701-15 as "[a]ny person who prepares for compensation, or who employs (or engages) one or more persons to *prepare* for compensation, other than for the person, all or a *substantial portion* of any return or claim for refund..." (emphasis added).

   a. Treas. Reg. §301.7701-15(b) provides that a person will be considered to have "*prepared*" an entry on a return if he or she renders advice which is directly relevant to the

[14] In contrast, under both the existing IRC § 6694 regulations and Notice 2008-13, the adequate disclosure requirement can be satisfied by a nonsigning preparer who makes disclosure to the taxpayer (or another tax return preparer) about potential penalties, even if no disclosure is made to the IRS.

[15] See Notice 2007-39, 2007-20 IRB 1243 (April 23, 2007) and American Jobs Creation Act, Section 822, PL 108-357 (Oct. 22, 2004).

determination of the existence, characterization, or amount of an entry on a return or claim for refund.

b. Treas. Reg. §301.7701-15(b) provides that whether a person is considered to have prepared a "*substantial portion*" of a return is determined by comparing the length and complexity of, and the tax liability or refund involved in, the return or claim for refund as a whole.[16] However, this provision has been modified by Notice 2008-13 (discussed at V.C, below).

2. "Pure advisors" as tax return preparers. There are circumstances under which a person who merely gives oral or written advice on a specific issue of law can be a tax return preparer for purposes of IRC §6694.[17] Such persons are referred to by the New York State Bar Association Tax Section as a "pure advisors."[18] Under Treas. Reg. §301.7701-15(a)(2), a "pure advisor" will be a tax return preparer if:

a. the advice is given with respect to events which have occurred at the time the advice is rendered; and

b. the advice is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund.

Accordingly, based on Treas. Reg. §301.7701-15(a)(2), an advisor who provides only "pre-transaction" should not be subject to IRC §6694. If, however, the advisor answers a question about the tax treatment of the transaction following its consummation, the advisor may be a tax return preparer.[19]

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[16] Treas. Reg. 301.7701-15(b)(2) contains a de minimis exception to the general rule of what constitutes a substantial portion of a return or claim for refund. Specifically, if the schedule, entry, or other portion of the return or claim or refund involves amounts which are (1) less than $2,000 or (2) less than $100,000 and also less than 20% of the taxpayer's gross income, then the schedule or other portion is not considered to be a substantial portion.

[17] Such persons would be considered "non-signing preparers" for purposes of the Treasury Regulations under IRC §6694. See discussion at III.A.5, below.

[18] See New York State Bar Tax Section Report and Appendix on the Definition of "Tax Return Preparer" and Other Issues Under Code Sections 6694, 6695 and 7701(a)(36), Report 1139 (December 20, 2007).

[19] Circular 230 §10.34 does not appear to provide a similar exception for "pre-transaction" advice.

3. Fiduciaries. A fiduciary is not a tax return preparer of a return for a trust or an estate.[20]

4. Multiple preparers. A return can have multiple preparers, but only one individual at a firm can be considered a preparer with respect to a particular return.[21] Both the individual preparer and the firm with which he or she is associated can be subject to IRC §6694 penalties.[22]

5. "Signing preparers" and "nonsigning preparers". Treas. Reg. §1.6694-1(b)(2) divides preparers into two categories: "signing preparers" and "nonsigning preparers." (The distinction is significant for purposes of the existing Treasury Regulations under IRC § 6694 (discussed above at II.A.2) and the interim IRC § 6694 guidance of Rev. Proc. 2008-13 (discussed below at V)).

    i. A "signing preparer" is any preparer who signs a tax return or claim for refund as a preparer.

    ii. A "nonsigning preparer" is any preparer who is not signing preparer. Examples of nonsigning preparers provided in Treas. Reg. §1.6694-1(b)(2) are preparers who provide advice (written or oral) to a taxpayer or to a preparer who is not associated with the same firm as the preparer who provides the advice.

6. Five Types of Service Providers Identified as Preparers by NYSBA. The New York State Bar Association has identified five different types of services providers who may be considered tax return preparers under the rules described above. These types of service providers, described in detail in the New York State Bar Tax Section Report and Appendix on the Definition of "Tax Return Preparer" and Other Issues Under Code Sections 6694,

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[20] For this purpose, a guardianship, conservatorship, committee and any similar arrangement for a taxpayer under a legal disability (such as a minor, an incompetent, or an infirm individual) is considered a trust or estate. See Treas. Reg. §301.7701-15(d).

[21] Treas. Reg. §1.6694-1(b)(1) provides rules for determining which individual at a firm is to be considered a tax return preparer. If a signing preparer (defined below in III.A.4) is associated with a firm, that individual, and no other individual associated with the firm, is a preparer with respect to the return. If two or more individuals associated with a firm or income tax return preparers with respect to a return or claim for refund, and none of them is the signing preparer, only one of the individuals is a preparer (i.e., nonsigning preparer) with respect to the return. In such a case, ordinarily the individual with overall supervisory responsibility for the advice given by the firm with respect to the return will be considered the preparer.

[22] See Treas. Reg. §§1.6694-1(b)(1), 1.6694-2(a)(2) and 1.6694-3(a)(2).

6695 and 7701(a)(36), Report 1139 (December 20, 2007), are summarized below:

a. The "Classic Preparer" generally does not commence work until after the tax year is closed. The taxpayer gives the Classic Preparer numerical data and documentation, and the Classic Preparer determines what numbers go on each line of the return, which schedules are required and how they should be completed. The Classic Preparer fills out the return for the taxpayer and is generally the "signing preparer."

b. The "Shadow Preparer" generally does everything the Classic Preparer does, except fill in the return. The Shadow Preparer then tells someone else (e.g., the taxpayer) exactly how to complete the return.

c. The "Pure Advisor" is a tax lawyer or accountant who gives legal advice without ever discussing or seeing the return. A Pure Advisor may be a tax return preparer for purposes of IRC §6694 based on Treas. Reg. §301.770-15(b), described above at III.A.2.

d. The "Schedule Preparer" is a tax lawyer or accountant who is usually a Pure Advisor, but who has been asked to assist in the preparation of a schedule to the return that relates to the advice being given. A Schedule Preparer will be a tax return preparer for purposes of IRC §6694 if the schedule or other attachment he or she prepares constitutes a "substantial portion" of the return.

e. The "Indirect Preparer" provides information returns (K-1's, 1099's, W-2's) that get sent to taxpayers who use the information to complete their income tax returns. An Indirect Preparer may be a tax return preparer for purposes of IRC §6694 if the information return affects a "substantial portion" of a taxpayer's income tax return.

B. Circular 230 §10.34 - "Practitioners"

1. Definition of "practitioner". For purposes of Circular 230, "practitioners" include attorneys, CPAs, enrolled agents, enrolled actuaries who are not currently suspended or disbarred from practice before the IRS.[23]

[23] See Circular 230 §§10.2, 10.3.

2. Practitioners to whom § 10.34 applies. Circular 230 §10.34 applies to (a) practitioners who sign returns, (b) practitioners who prepare a portion of a tax return and (c) practitioners who provide advice to a client with respect to a position taken on a tax return.

IV. IRS Guidance Regarding IRC §6694 Following H.R. 2206.

A. Notice 2007-54 (June 11, 2007). Notice 2007-54 provided transitional relief for returns, amended returns and refund claims due on or before December 21, 2007. Notice 2007-54 provided that the IRS would continue to apply the rules of IRC §6694 prior to amendment by H.R. 2206 to these returns, in spite of the immediate (May 25, 2007) effective date of the H.R. 2206 amendments to IRC §6694.

B. Notice 2008-11 (January 2, 2008). Notice 2008-11 clarified certain aspects of Notice 2007-54, including that advice provided by nonsigning preparers on or before December 31, 2007 (even if ultimately reflected on a return filed after December 31, 2007) would be subject to the standards of IRC §6694 prior to amendment by H.R. 2206.

C. Notice 2008-13 (December 31, 2007). See part V, below.

D. Rev. Proc. 2008-14 (January 25, 2008). Rev. Proc. 2008-14 provided an updated to Rev. Proc. 2006-48, and identifies circumstances under which disclosure on a return in accordance with applicable forms and instructions is adequate for purposes of reducing the IRC §6662(d) substantial understatement penalty and avoiding the IRC §6694 preparer penalty (assuming there is a reasonable basis for the position).[24]

V. Notice 2008-13.

A. In General. Notice 2008-13 (the "Notice") provides interim guidance regarding the implementation of the tax return preparer penalties under IRC §6694 and IRC §7701(a)(36) as amended by H.R. 2206. The rules in the Notice will apply until Treasury and the IRS issue further guidance, anticipated at the end of 2008.[25] The exiting regulations under IRC §6694 and §7701 remain effective, except to the extent modified by the Notice. The Notice contains eight sections (A-H), each of which is discussed below.

[24] Specified items include (1) IRS Form 1040 itemized deductions, including medial and dental expenses, interest expenses and taxes, (2) certain trade or business expenses, including legal expenses and casualty and theft losses, and (3) certain foreign tax items, including treaty-based return positions under IRC §7701(b).

[25] Treasury cautions in the Notice that regulations expected to be finalized in 2008 "may be substantially different from the rules described in the notice, and in some cases more stringent."

B. Section A – Returns and Claims for Refund Subject to IRC §6694. Section A of the Notice describes categories of returns to which IRC §6694 could apply. These are as follows:

1. Tax returns reporting tax liability. A return or claim for refund includes the returns listed on Exhibit 1 of the Notice. Most common returns are included, such as IRS Forms 1040, 1041, 706, 709, 706-GS(D), 706-GS(T), 990-PF.

2. Information returns. Information returns listed on Exhibit 2 of the Notice may subject a preparer to IRC §6694 penalties if the information reported on the return constitutes a substantial portion of the taxpayer's tax return or claim for refund. Among the information returns included in Exhibit 2 are Forms 1065 (U.S. Return of Partnership Income, including Schedules K-1) and Form 1120S (U.S. Income Tax Return of an S Corporation (including Schedules K-1).

3. Other documents. The Notice provides that other documents prepared for compensation that do not report a tax liability but that affect an entry or entries that constitute a substantial portion of a return are considered to be returns for purposes of IRC §6694. Accordingly, for purposes of IRC §6694, it seems that appraisals constitute returns and appraisers may be considered tax return preparers.

4. Documents subject to §6694 only in the presence of willful or reckless conduct. Exhibit 3 of the Notice lists documents that will not be subject their preparers to §6694 penalties, unless prepared willfully in any manner to understate a tax liability or in reckless and intentional disregard of the rules and regulations. Documents listed on exhibit 3 include IRS Forms 1099, W-2, 990.

C. Section B – Definition of Tax Return Preparer. The Notice retains the definitions of tax return preparer contained in IRC §7701(a)(36) and Reg. §§1.6694-1, 1.6694-3 and 301.7701-15 (described above in III.A). However, the Notice modifies the definition of "substantial portion" contained in Treas. Reg. §301.7701-15(b)(1) to mean a schedule, entry or other portion of a tax return or claim for refund that, if adjusted or disallowed, could result in a deficiency that the preparer knows or reasonably should know is a significant portion of the tax liability reported on the tax return. This clarifies that any determination as to whether a person has prepared a substantial portion of a tax return and thus is considered a tax return preparer will depend on the relative size of the *deficiency* attributable to the schedule, entry or portion (rather than the relative size of what was actually entered on schedule, return or portion).

Examples 4 and 5 of section H of the Notice relate to the definition of "substantial portion."

D. Section C – Date Return is Prepared. For a signing preparer, a return is deemed prepared on the date reflected by the return preparer's signature. If the signing preparer fails to sign the return, the return is deemed prepared on the date it is filed. In the case of a nonsigning preparer, the relevant date is the date the person provides the advice, which date will be determined based on all facts and circumstances. The date a return is prepared is relevant to the standards and defenses applicable to the tax return preparer.

E. Part D – Reasonable Belief That the Tax Treatment of a Position Will MLTN be Sustained on the Merits. Part D of the Notice describes how a tax return preparer can satisfy the standard of having a reasonable belief that the tax treatment of a position would MLTN be sustained on the merits. The Notice provides that tax return preparer is considered reasonably to believe that the tax treatment of an item is MLTN the proper tax treatment (without taking into account the possibility that the tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled) if the tax return preparer analyzes the pertinent facts and authorities in the manner described in Treas. Reg. §1.6662-4(d)(3)(ii) and, in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50% likelihood that the tax treatment of the item will be upheld if challenged by the IRS. [26]

1. Reliance on information provided by others. The Notice provides that for purposes of determining whether a return preparer has a reasonable belief that a position would MLTN be sustained on the merits, the return preparer is entitled to rely in good faith without verification upon information furnished by the *taxpayer*, as provided in Treas. Reg. §1.6694-1(e). In addition, a tax return

[26] Treas. Reg. §1.6662-4(d)(3)(ii) provides that "the weight accorded to an authority depends on its relevance and persuasiveness, and the type of document providing the authority. For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from which information has been deleted, such as a private letter ruling, is diminished to the extent that the deleted information may have affected the authority's conclusions. The type of document also must be considered. For example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue. An older private letter ruling, technical advice memorandum, general counsel memorandum or action on decision generally must be accorded less weight than a more recent one. Any document described in the preceding sentence that is more than 10 years old generally is accorded very little weight. However, the persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account along with the age of the document. There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision."

preparer may rely in good faith and without verification upon information furnished by *another advisor, tax return preparer or third party*. Thus, a tax return preparer is not required to independently verify or review the items reported on tax returns, schedules or other third party documents to determine if the items meet the standard requiring a reasonable belief that the position would MLTN be sustained on the merits. However, a tax return preparer may not ignore the implications of information furnished to the tax return preparer or actually known to the tax return preparer. The tax return preparer must also make reasonable inquiries if the information furnished by another tax return preparer or third party appears to be incomplete or incorrect.

F. Part E – Reasonable Basis. The Notice describes what is meant by "reasonable basis" for purposes of IRC §6694. According to Teas. Reg. §1.6662-3(b)(3), reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in §1.6662-4(d)(3)(iii)[27] (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in § 1.6662- 4(d)(2).

1. Reliance on information provided by others. For purposes of determining whether a tax return preparer has a reasonable basis for a position, a tax return preparer can rely on information provided by others to the same extent as for purposes of determining whether the return preparer has a reasonable belief that a position would MLTN be sustained on the merits (described above at V.E.1).

[27] The authorities set forth in Treas. Reg. §1.6662-4(d)(3)(iii) are as follows: applicable provisions of the Internal Revenue Code and other statutory provisions; proposed, temporary and final regulations construing such statutes; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers; General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book); private letter rulings and technical advice memoranda issued after October 31, 1976; actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin); Internal Revenue Service information or press releases; and notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin

G. Part F – Reasonable Cause and Good Faith. In determining whether the reasonable cause and good faith standard is satisfied, the Notice provides that the IRS will continue to consider the factors described in Treas. Reg. §§1.6694-2(d)(1) to -2(d)(4). These include the nature, frequency and materiality of the error causing the understatement and the practitioner's normal office practices.[28]

1. Reliance on information provided by others. The Notice provides that a tax return preparer will be found to have acted in good faith if he or she relied on the advice of a third party who he or she had reason to believe was competent to render the advice. A tax return preparer is not considered to have relied in good faith on another if (a) the advice is unreasonable on its face, (b) the tax return preparer knew or should have known that the third party advisor was not aware of all relevant facts or (c) the tax return preparer knew or should have known, at the time the tax return was prepared, that the advice was no longer reliable due to developments in the law since the time the advice was given.

H. Part G - Interim Penalty Compliance Rules. Part G of the Notice provides IRC §6694 compliance rules with respect to return positions for which the tax return preparer does not have a reasonable belief that the position would MLTN be sustained on the merits. The compliance rules are different for signing preparers (defined above at III.A.5.i) and non-signing preparers (defined above at III.A.5.ii):

1. Signing preparers. Signing preparers can avoid penalties under IRC §6694 if any of the following alternatives are satisfied:

a. Alternative 1. The position has a ***reasonable basis*** and is ***actually disclosed*** (on IRS Form 8275 or on the tax return in accordance with Rev. Proc. 2008-14, described above in section IV.D).

b. Alternative 2. The position has a ***reasonable basis***, and the tax return preparer ***prepares disclosure*** (e.g., a completed IRS Form 8275) and gives it to the taxpayer. (There is no requirement that the taxpayer actually file the Form 8275.)

[28] More specifically, Treas. Reg. § 1.6694-2(d)(1) – 2(d)(4) provides that the following factors should be considered in determining whether the reasonable cause and good faith standard is satisfied: whether the error resulted from a provision that was so complex, uncommon or highly technical that a competent preparer of returns or claims of the type at issue reasonable could have made the error, whether the understatement was the result of an isolated error rather than a number of errors, the materiality of errors, whether the preparer's normal office practice, when considered together with other facts and circumstances such as the knowledge of the preparer, indicates that the error in question would rarely occur and the normal office practice was followed in preparing the return or claim in question.

c. Alternative 3. The position has ***substantial authority*** (a standard that is more stringent than reasonable basis but less stringent than MLTN)[29] and the tax return preparer ***advises the taxpayer*** of the differences between the penalty standards applicable to taxpayer under IRC § 6662 and the penalty standards applicable to the tax return preparer under IRC §6694 and ***contemporaneously documents that this advice was provided***. Option 3 cannot be utilized if the position relates to a "tax shelter" as defined in IRC § 6662(d)(2)(C)(ii) or a listed transaction.

i. If Alternative 3 is utilized, it seems that the tax return preparer would need to advise the taxpayer that disclosure to the IRS is not necessary for the taxpayer avoid substantial understatement penalties under IRC § 6662(d) but that disclosure is necessary for the tax return preparer to avoid penalties under IRC § 6694.

d. Alternative 4. If the position relates to a ***"tax shelter"*** as defined in IRC § 6662(d)(2)(C)(ii), the position has a ***reasonable basis*** and the tax return preparer ***advises the taxpayer*** of the differences between the penalty standards applicable to taxpayer under IRC 6662 and the penalty standards applicable to the tax return preparer under IRC §6694 and ***contemporaneously documents that this advice was provided***.

i. If Alternative 4 is utilized, it seems that the tax return preparer would have to advise the taxpayer that the preparer can avoid penalties under IRC § 6694 if the position is disclosed to the IRS, but that such disclosure will not help the taxpayer avoid substantial understatement penalties under IRC § 6662(d).

2. Non-signing preparers. Nonsigning preparers can avoid penalties under IRC §6694 if either of the following alternatives is satisfied:

a. Alternative 1. If a nonsigning preparer is advising a taxpayer directly (rather than advising another tax return preparer), the position has a ***reasonable basis*** and the tax

[29] Treas. Reg. § 1.6662-4(d) provides that "[t]he substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the more likely than not standard…., but more stringent than the reasonable basis standard…. The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied."

return preparer ***advises the taxpayer*** of any opportunity to avoid penalties under IRC § 6662 through disclosure to the IRS and, if relevant, describes the requirements for disclosure, and contemporaneously documents that this advice was provided.

i. If the advice with respect to a position is oral, the advice regarding penalties may be oral. If the advice with respect to the position is written, the advice regarding penalties must be in writing.

b. Alternative 2. If a nonsigning preparer is ***advising another tax return preparer***, the position has a ***reasonable basis*** and the nonsigning preparer ***advises the other preparer*** that disclosure under IRC § 6694(a) may be required.

i. If the advice with respect to a position is oral, the advice concerning disclosure under IRC § 6694(a) may be oral. If the advice with respect to the position is written, the advice concerning disclosure under IRC § 6694(a).

I. Part H – Examples. Part H of the Notice provides examples that illustrate the provisions of the Notice and the existing rules under the § § 6694 and 7701(a)(36) regulations.

1. Example 10. Example 10 of the Notice, which relates to the reasonable cause and good faith defense to IRC § 6694 penalties, has generated particular discussion. This example seems to permit a signing preparer to avoid IRC § 6694 penalties without disclosure despite lacking a reasonable belief that a position would MLTN be sustained on the merits. The issue in the example relates to various small asset expenditures of the taxpayer. The preparer researches the issue but is unable to determine whether the position would MLTN be sustained on the merits. Treasury and IRS officials have cautioned against trying to plan based on this example and "overdiagnosing" the examples generally.[30]

[30] Comments of Anita Soucy (attorney-adviser in Treasury Office of Tax Policy) and Deborah Butler, IRS associate chief counsel. New York State Bar Association Tax Section Annual Meeting, January 29, 2008. See also Lee A. Sheppard, NYSBA Takes on Preparer Penalty: Example 10 Explained, Tax Notes Today, 2008 TNT 20-4 (Jan. 30, 2008).