

**RETURN PREPARER PENALTIES:  
NEW STANDARDS, SEVERE FINES, CONFLICTING RULES**

Presented by:

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## ABOUT THE SPEAKER

**HALE E. SHEPPARD** (B.S., M.A., J.D., LL.M., LL.M.T.) is a shareholder with Chamberlain, Hrdlicka, White, Williams & Martin whose practice focuses on tax audits, administrative appeals, tax litigation, tax collection defense, and international tax.

Hale regularly handles tax disputes before the IRS and various state revenue agencies. If an issue cannot be resolved administratively, litigation often ensues. Hale has participated in various cases before the Tax Court, the Court of Federal Claims, and the U.S. District Court. He also deals with tax payment issues, such as collection due process hearings, installment agreements and offers-in-compromise.

Hale's recent reported cases and rulings include:

- *Topping v. Commissioner*, T.C. Memo 2007-92 (significant hobby loss case in which the Tax Court ruled in favor of the taxpayer on all major issues, including the equestrian and design aspects constituted one single activity, the activity was profit motivated, and the relevant expenses were ordinary, necessary and reasonable)
- *Vines v. Commissioner*, 126 T.C. 279 (multi-million dollar case of first impression involving the use of mark-to-market accounting by securities traders and the legal standards for granting extensions to file elections under Treas. Reg. § 301.9100-3)
- *IRS Private Letter Ruling 200751012* (administrative ruling granting taxpayer relief from potential back taxes, interest and penalties resulting from failure to properly report foreign retirement accounts).

Hale holds five degrees. At the University of Kansas, he earned a B.S., with distinction, M.A., with honors, and J.D. He later received an LL.M. degree in international law, with highest distinction, from the University of Chile. Finally, he obtained an LL.M. degree in taxation from the University of Florida, where he was a graduate tax scholar.

During his studies, Hale received several awards for academic excellence, including the Janice Dawson Quinn Tax Scholarship, Harry S. Truman Foundation Scholarship, Tinker Foundation Scholarship, National Security Education Program Fellowship, and Senator James B. Pearson International Fellowship. Hale also served as a graduate editor of the Florida Tax Review and as a member of the Kansas Journal of Law & Public Policy.

Currently, Hale is a columnist for the Journal of Taxation analyzing notable IRS rulings, an Advisory Board member of the Journal of Tax Practice & Procedure, a participant in the Atlanta Tax Forum, a representative in the IRS-Practitioner Liaison Committee, an adjunct professor of taxation at the John Marshall Law School, and an officer and Executive Committee member of the Georgia Bar Tax Section.

Along with advising clients on tax issues, Hale has written nearly 60 articles appearing in some of the nation's top law reviews and professional journals, including the Journal of International Taxation, The Practical Tax Lawyer, Journal of Tax Practice and Procedure, Taxes – The Tax Magazine, Journal of Pass-through Entities, Tax Management International Journal, Worldwide Tax Daily, Journal of Multi-State Taxation and Incentives, Tax Notes International, Practical Tax Strategies, The Monthly Digest of Tax Articles, Journal of Taxation, International Tax Journal, The Tax Adviser, University of Houston Business and Tax Law Journal, Vanderbilt Journal of Transnational Law, Northwestern Journal of International Law and Business, Texas International Law Journal, George Washington International Law Review, NYU Journal of Legislation and Public Policy, Minnesota Journal of Global Trade, North Carolina Journal of International Law and Commercial Regulation, Boston University International Law Journal, Tulane Journal of International and Comparative Law, American University International Law Review, Miami Inter-American Law Review, Florida State Journal of Transnational Law & Policy, UCLA Journal of International Law and Foreign Affairs, Indiana International and Comparative Law Review, Kansas Journal of Law & Public Policy, Oregon Journal of Environmental Law and Litigation, Brooklyn Journal of International Law, Texas Transnational Law Quarterly, Latin Insurance, Journal of Reinsurance, and the Inter-American Trade Report.

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**I. INTRODUCTION.**

Tax professionals have responsibilities, ethical rules, and legal duties established by:

- Internal Revenue Code
- Treasury regulations
- Circular 230
- ABA
- AICPA
- State Accountancy Boards
- State Code of Legal Ethics
- Not to mention state malpractice laws

Each regime carries the threat of sanctions for failing to adhere to a specified standard. These different thresholds provide a tax advisor with ample opportunity for confusion. In evaluating a tax position or return item, a tax advisor also must be aware that his or her standards of practice may affect the penalties imposed on the clients. Thus, a tax practitioner must decide which of the following standards must be met:

- Non-frivolous
- Reasonable basis
- Realistic possibility of success
- Substantial authority
- More likely than not a position will prevail
- Should
- Will

Not only do the different standards create confusion for the tax practitioner, they also create the possibility of sanctions under one regime for a practice or position that is quite acceptable under another. That increases the risk of a malpractice suit against a practitioner by a disappointed client!

## **II. PENALTIES ON TAXPAYERS/CLIENTS DRIVE THE PRACTICE STANDARDS AS MUCH AS THE PENALTIES ON PRACTITIONERS.**

### **A. Introduction.**

1. I.R.C. § 6662 provides for accuracy-related penalties for understatements of tax liability due to (i) a taxpayer's negligence or disregard of the rules or regulations, (ii) substantial understatements of income tax, (iii) substantial valuation misstatements, (iv) substantial overstatements of pension liabilities, and (v) substantial estate or gift tax valuation understatements. I.R.C. § 6662(b).
2. The amount of the penalty is generally 20% of the portion of the underpayment amount that is attributable to the prohibited conduct. I.R.C. § 6662(a).
3. However, the penalty may be doubled to 40% in cases of "gross" valuation misstatements. I.R.C. § 6662(h).
4. Accuracy-related penalties generally do not apply to any portion of a return to which a fraud penalty (under I.R.C. § 6663) or a reportable transaction penalty (under I.R.C. § 6662A) applies. I.R.C. § 6662(b)(flush language).
5. NOTE: This outline focuses on the standards of conduct for which taxpayers may be penalized, rather than other technical aspects of the penalty rules.

### **B. Negligence and Disregard of Rules and Regulations.**

#### **1. Negligence Defined.**

- a. A "negligent" taxpayer is one who fails to make a reasonable attempt to comply with the tax rules and regulations or who carelessly, recklessly, or intentionally disregards those rules. I.R.C. § 6662(c).
- b. The term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return. The term "negligence" also includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly. Treas. Reg. § 1.6662-3(b)(1).

- c. Under Treas. Reg. § 1.6662-3(b)(1), negligence is *strongly indicated* in the following situations:
- (1) A taxpayer fails to include on an *income* tax return an amount of income shown on an *information* return;
  - (2) A taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be "too good to be true" under the circumstances;
  - (3) A partner fails to comply with the requirements of I.R.C. § 6222, which requires that a partner treat partnership items on its return in a manner that is consistent with the treatment of such items on the partnership return (or notify the Secretary of the inconsistency); or
  - (4) A shareholder fails to comply with the requirements of I.R.C. § 6242, which requires that an S corporation shareholder treat subchapter S items on its return in a manner that is consistent with the treatment of such items on the corporation's return (or notify the Secretary of the inconsistency).

2. **Disregard of Rules or Regulations Defined.**

- a. Disregard. The term "disregard" includes any careless, reckless or intentional disregard of rules or regulations. Treas. Reg. § 1.6662-3(b)(2).
- b. Rules or regulations. The term "rules or regulations" includes the provisions of the Internal Revenue Code, temporary or final Treasury regulations, and revenue rulings or notices (other than notices of proposed rulemaking) issued by the IRS and published in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-3(b)(2).
- c. Careless. A disregard of rules or regulations is "careless" if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is contrary to the rule or regulation. Treas. Reg. § 1.6662-3(b)(2).
- d. Reckless. A disregard is "reckless" if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe. Treas. Reg. § 1.6662-3(b)(2).

- e. Intentional. A disregard is "intentional" if the taxpayer knows of the rule or regulation that is disregarded. Treas. Reg. § 1.6662-3(b)(2).

3. **Standards to Avoid Negligence and Disregard Penalties.**

a. **Reasonable Basis for a Position.**

- (1) The taxpayer *generally* will not be penalized if there is a reasonable basis for the position. Treas. Reg. § 1.6662-3(b)(3).
- (2) Reasonable basis is a relatively high standard of tax reporting that is significantly higher than not frivolous or not patently improper. Treas. Reg. § 1.6662-3(b)(3).
- (3) The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. Treas. Reg. § 1.6662-3(b)(3).
- (4) If a return position is reasonably based on one or more of the authorities set forth in Treas. Reg. § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), then the return position will *generally* satisfy the reasonable basis standard, even though it may not satisfy the substantial authority standard, as defined in Treas. Reg. § 1.6662-4(d)(2).

b. **Reasonable Cause and Good Faith.**

- (1) The reasonable cause and good faith exception in Treas. Reg. § 1.6664-4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard. Treas. Reg. § 1.6662-3(b)(3).
- (2) Generally, no penalty shall be imposed under I.R.C. § 6662 or § 6663 (civil fraud) with respect to any underpayment if it is shown that there was reasonable cause for such portion and that the taxpayer acted in good faith with respect to the portion. I.R.C. 6664(c)(1); Treas. Reg. § 1.6664-4(a).

c. **Realistic Possibility of Success on Contrary Position.**

- (1) A taxpayer who takes a position (other than with respect to a reportable transaction) that is contrary to a revenue ruling or notice has *not* disregarded the ruling or notice if the

contrary position has a realistic possibility of being sustained on its merits. Treas. Reg. § 1.6662-3(b)(2).

**d. Adequate Disclosure of Contrary Position + Reasonable Basis.**

- (1) No accuracy-related penalty may be imposed on any portion of an underpayment that is attributable to a position contrary to a rule or regulation if the position is adequately disclosed. Treas. Reg. § 1.6662-3(c)(1).
  - (a) Disclosure is generally adequate if made on Form 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement), as appropriate. Treas. Reg. § 1.6662-3(c)(2); Treas. Reg. § 1.6662-4(f).
- (2) If the position relates to a reportable transaction, the transaction must be disclosed in accordance with Treas. Reg. § 1.6011-4 or § 1.6011-4T, as applicable. Treas. Reg. § 1.6662-3(c)(1).
- (3) In the case of a position contrary *to a regulation*, the position must be adequately disclosed and must represent a good faith challenge to the validity of the regulation. Treas. Reg. § 1.6662-3(c)(1).
- (4) The adequate disclosure exception does not apply, however, in the case of a position that does not have a reasonable basis or where the taxpayer fails to keep adequate books and records or to substantiate items properly. Treas. Reg. § 1.6662-3(c)(1).

**C. Substantial Understatement of Income Tax.**

**1. Substantial Understatement Defined.**

- a. Generally, there is a substantial understatement of income tax for any taxable year if the amount of the understatement is greater than either 10% of the tax required to be shown on the return or \$5,000. I.R.C. § 6662(d)(1)(A); Treas. Reg. § 1.6662-4(b)(1).
  - (1) NOTE – This is distinct from the "substantial omission" standard under I.R.C. § 6501(e) in the context of the statute of limitations on assessment. There, in the case of income taxes, the assessment period is extended from three years to six years if the taxpayer omits from gross income more than 25% of the amount of gross income stated in the return.

- b. In the case of corporations (other than an S corps and personal holding companies), there is a substantial understatement of income tax if the understatement is greater than the lesser of 10% of the tax required to be shown on the return or \$10 million. I.R.C. § 6662(d)(1)(B); Treas. Reg. § 1.6662-4(b)(1).

2. **Standards to Avoid Substantial Understatement Penalties.**

a. **Substantial Authority for (Undisclosed) Positions.**

(1) **Generally.**

- (a) For undisclosed transactions (that are not tax shelters), the general rule is that if there is substantial authority for the tax treatment of an item, then the item is treated as if it were shown properly on the return. Thus, for purposes of I.R.C. § 6662(d), the tax attributable to the item is not included in the understatement for that year. I.R.C. § 6662(d)(2)(B)(i); Treas. Reg. § 1.6662-4(d)(1).
- (b) The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. Treas. Reg. § 1.6662-4(d)(2).
- (c) The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard. Treas. Reg. § 1.6662-4(d)(2).

(2) **Determining Whether Substantial Authority Exists.**

- (a) For substantial authority to exist, the weight of the authorities supporting the treatment must be substantial in relation to the weight of authorities supporting contrary treatment. Treas. Reg. § 1.6662-4(d)(3)(i).
- (b) There may be substantial authority for more than one position with respect to the same item. Treas. Reg. § 1.6662-4(d)(3)(i).
- (c) Because the substantial authority standard is an *objective* standard (as opposed to a subjective standard), the taxpayer's belief that there is

substantial authority for the tax treatment of an item is *not* relevant in determining whether there is substantial authority for that treatment. Treas. Reg. § 1.6662-4(d)(3)(i).

- (d) The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. Treas. Reg. § 1.6662-4(d)(3)(ii).
- (e) NOTE – Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are *not* authority. However, the authorities underlying such expressions of opinion where applicable to the facts of a particular case may give rise to substantial authority for the tax treatment of an item. Treas. Reg. § 1.6662-4(d)(3)(iii).

**b. Reasonable Basis for (Disclosed) Positions.**

**(1) Generally.**

- (a) For disclosed transactions (that are not tax shelters), the general rule is that the item in question is not included in the understatement amount if
  - (1) the relevant facts affecting the item's tax treatment are adequately disclosed either in the return or a statement attached to the return,
  - (2) there is a reasonable basis for the position, and
  - (3) the taxpayer maintained adequate books and records with respect to the position. I.R.C. § 6662(d)(2)(B)(ii); Treas. Reg. § 1.6662-4(e)(1).

**(2) Adequate Disclosure.**

- (a) Disclosure is generally adequate if made on a properly completed Form 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement) that is attached to the return or qualified amended return. Treas. Reg. § 1.6662-4(f)(1).

(b) The IRS may by annual revenue procedure (or otherwise) prescribe the circumstances under which disclosure of information on a return or qualified amended return is adequate. If the revenue procedure does not include an item, then disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275-R, as appropriate, attached to the return for the year or to a qualified amended return. Treas. Reg. § 1.6662-4(f)(2).

(1) See Rev. Proc. 2008-14, below

(c) 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. Treas. Reg. § 1.6662-4(f)(3).

**(3) Recent Clarifications on Adequate Disclosure.**

(a) The IRS recently issued Rev. Proc. 2008-14 (Jan. 25, 2008), which identifies the circumstances under which the disclosure on a taxpayer's return will be considered adequate for purposes of (i) reducing the understatement of income tax under I.R.C. § 6662(d) and (ii) avoiding the return preparer penalty under the new I.R.C. § 6694(a).

(b) Limited application. Rev. Proc. 2008-14 does *not* apply with respect to other penalties, such as negligence and disregard of rules or regulations, which are subject to an exception for adequate disclosure.

(c) Effective date. Rev. Proc. 2008-14 applies to (i) any income tax return filed on a 2007 tax form for a taxable year beginning in 2007 and (ii) to any income tax return filed on a 2007 tax form in 2008 for a short taxable year beginning in 2008.

**c. Reasonable Cause and Good Faith.**

(1) Generally, no penalty shall be imposed under I.R.C. § 6662 or § 6663 (civil fraud) with respect to any underpayment if it is shown that there was reasonable cause for such portion and that the taxpayer acted in good faith with respect to the portion. I.R.C. 6664(c)(1); Treas. Reg. § 1.6664-4(a).

**D. Valuation Misstatements.**

**1. General Rule.**

- a.** A penalty of 20% of the understatement of tax due to a "substantial" valuation misstatement generally may be imposed if (i) the value or adjusted basis of any property claimed on a return is 150% or more of the correct value or adjusted basis, (ii) the price of any property or services claimed on a return in connection with an I.R.C. § 482 transaction is 200% or more (or 50% or less) of the correct price, or (iii) the net I.R.C. § 482 transfer price adjustment is greater than the lesser of \$5 million or 10% of the taxpayer's gross receipts. I.R.C. § 6662(e)(1); Treas. Reg. § 1.6662-5(a).
- b.** A penalty of 40% of the understatement of tax due to a "gross" valuation misstatement generally may be imposed if (i) the value or adjusted basis of any property claimed on a return is 200% or more of the correct value or adjusted basis, (ii) the price of any property or services claimed on a return in connection with an I.R.C. § 482 transaction is 400% or more (or 25% or less) of the correct price, or (iii) the net I.R.C. § 482 transfer price adjustment is greater than the lesser of \$20 million or 20% of the taxpayer's gross receipts. I.R.C. § 6662(h)(2); Treas. Reg. § 1.6662-5(a).

**2. Standards to Avoid Substantial or Gross Valuation Penalties.**

**a. Adequate Disclosure – Not Possible.**

- (1) There is no adequate disclosure exception to the valuation misstatement penalty. Treas. Reg. § 1.6662-5(a).

**b. Reasonable Cause and Good Faith.**

- (1) This penalty does not apply to the extent that the reasonable cause and good faith exception to this penalty set forth in Treas. Reg. § 1.6664-4 applies. Treas. Reg. § 1.6662-5(a).
- (2) Generally, no penalty shall be imposed under I.R.C. § 6662 or § 6663 (civil fraud) with respect to any underpayment if it is shown that there was reasonable cause for such portion and that the taxpayer acted in good faith with respect to the portion. I.R.C. 6664(c)(1); Treas. Reg. § 1.6664-4(a).

**c. Special Rules for Charitable Deduction Property.**

- (1) There may be reasonable cause and good faith with respect to a portion of an underpayment that is attributable to a substantial (or gross) valuation misstatement of charitable

deduction property only if (i) the claimed value of the property was based on a "qualified appraisal" by a "qualified appraiser" and (ii) in addition to obtaining a qualified appraisal, the taxpayer made a good faith investigation of the value of the contributed property. I.R.C. § 6662(c)(2); Treas. Reg. § 1.6664-4(h).

**d. Economic Limit.**

- (1) No valuation misstatement penalty may be imposed for a taxable year, unless the portion of the underpayment for that year that is attributable to substantial or gross valuation misstatements exceeds \$5,000 (\$10,000 in the case of a corporation other than an S corporation or a personal holding company. I.R.C. § 6662(e)(2); Treas. Reg. § 1.6662-5(b).

**E. Substantial Overstatement of Pension Liabilities.**

**1. Tax Provision.**

- a. There is a substantial overstatement of pension liabilities if the actuarial determination of the liabilities taken into account for purposes of computing the deduction under I.R.C. § 404(a)(1) or (2) is 200% or more of the amount determined to be the correct amount of such liabilities. I.R.C. § 6662(f)(1)

**2. Standards to Avoid Penalties.**

**a. Reasonable Cause and Good Faith.**

- (1) Generally, no penalty shall be imposed under I.R.C. § 6662 or § 6663 (civil fraud) with respect to any underpayment if it is shown that there was reasonable cause for such portion and that the taxpayer acted in good faith with respect to the portion. I.R.C. 6664(c)(1); Treas. Reg. § 1.6664-4(a).

**b. Economic Limit.**

- (1) No penalty shall be imposed unless the portion of the underpayment for the taxable year attributable to substantial overstatements of pension liabilities exceeds \$1,000. I.R.C. § 6662(f)(2).

**F. Substantial Estate or Gift Tax Valuation Understatement.**

**1. Tax Provision.**

- a.** There is a substantial estate or gift tax valuation understatement if the value of any property claimed on any return of tax imposed by subtitle B is 50% or less of the amount determined to be the correct amount of such valuation. I.R.C. § 6662(g)(1).

**2. Standards to Avoid Penalties.**

**a. Reasonable Cause and Good Faith.**

- b.** Generally, no penalty shall be imposed under I.R.C. § 6662 or § 6663 (civil fraud) with respect to any underpayment if it is shown that there was reasonable cause for such portion and that the taxpayer acted in good faith with respect to the portion. I.R.C. 6664(c)(1); Treas. Reg. § 1.6664-4(a).

**c. Economic Limit.**

- (1)** No penalty shall be imposed unless the portion of the underpayment attributable to substantial estate or gift tax valuation understatements for the taxable period exceeds \$5,000. I.R.C. § 6662(g)(2).

**G. Reasonable Cause.**

**1. Generally.**

- a.** Even if a tax advisor fails to evaluate and/or disclose a return position under the applicable standard, a taxpayer may still be able to avoid penalties under I.R.C. § 6664(c) if it is shown that there was a reasonable cause for the understatement and the taxpayer acted in good faith with respect to that portion of the understatement.

- b.** The wording of I.R.C. § 6664(c) is mandatory: "No penalty shall be imposed" under I.R.C. § 6662 or 6663 with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

**2. A Taxpayer's Effort to Do the Right Thing Is Paramount.**

- a.** The most important factor in the reasonable cause determination is the extent of the taxpayer's effort to assess his or her proper tax

liability in light of all the circumstances. Treas. Reg. § 1.6664-4(b)(1).

**3. Taxpayers Often Rely on Tax Advisors to Determine Tax Liability.**

**a. General Standards in Non-Tax-Shelter Situations.**

- (1) **Reliance of others.** Reliance on an information return, or on the advice of a professional tax advisor or an appraiser, does not necessarily demonstrate reasonable cause and good faith. Reliance on an information return, professional advice, or other facts constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. Treas. Reg. § 1.6664-4(b)(1).
- (2) All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under federal tax law. Treas. Reg. § 1.6664-4(c)(1).
- (3) Reliance may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of federal tax law. Treas. Reg. § 1.6664-4(c)(1).
- (4) The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. Treas. Reg. § 1.6664-4(c)(1)(ii).
- (5) **Invalid regulation arguments.** A taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith, unless the taxpayer adequately disclosed, in accordance with Treas. Reg. § 1.6662-3(c)(2), the position that the regulation in question is invalid. Treas. Reg. § 1.6664-4(c)(1)(iii).
  - (a) Form 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement)
- (6) **The quality of advice is important.** Reliance on the advice of a professional tax advisor does not necessarily

demonstrate reasonable cause and good faith. The validity of the reliance turns on "the quality and objectivity of the professional advice obtained." *Swayze v. Commissioner*, 785 F.2d 715, 719 (9th Cir. 1986); *Klamath*, 472 F. Supp. 2d at 904.

**b. What Exactly is "Advice" in this Context?**

- (1) "Advice" is any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the I.R.C. § 6662 penalty. Treas. Reg. § 1.6664-4(c)(2).
- (2) The "advice" does not have to be in any particular form. Treas. Reg. § 1.6664-4(c)(2).

**c. Ominous Cross-Reference.**

- (1) Treas. Reg. § 1.6664-4(c)(3) directs us to the following rules applicable to tax advisors:
  - (a) Treas. Reg. §§ 1.6694-1 through 1.6694-3 (regarding return preparer penalties), and
  - (b) Circular 230. 31 CFR 10.22 (regarding diligence as to accuracy), 31 CFR 10.33 (regarding tax shelter opinions), and 31 CFR 10.34 (regarding standards for advising with respect to tax return positions and for preparing or signing returns).

**4. De facto Higher Standard for Tax-Motivated Investments.**

- a. For transactions *before* the effective date of the American Jobs Creation Act of 2004 (*i.e.*, October 22, 2004), there was no basis in the Internal Revenue Code or regulations to treat investors in tax shelters that relied on tax advisors any differently than other taxpayers. However, some courts have been responsive to IRS arguments that a taxpayer should have known better than to rely on a tax advisor because the promised tax benefits were "too good to be true."
- b. *Long Term Capital Holdings v. United States*, 330 F.Supp. 2d 122 (D.C. Conn 2004), *aff'd in unpublished op.*, 150 Fed. Appx. 40 (2d Cir. 2005). The taxpayers relied on an opinion from a prominent law firm that concluded that the transactions in issue "should" produce the promised tax benefits. Nevertheless, after finding that

the "lease-stripping" transactions did not have economic substance, the Court imposed a 40% gross valuation misstatement penalty and, alternatively, a 20% substantial understatement penalty. The district court criticized the tax opinion on the following grounds: (i) There were no contemporaneous memoranda memorializing the anticipated profits versus costs to support the "profit motive" and business purpose; (ii) The relevant Second Circuit authorities were not cited in the opinion; (iii) The tax opinion was late. It was not provided to the company until nine months after the tax return had been filed, and there were no existing drafts showing that an opinion had been given to the company before the filing of the return, and (iv) none of the principals of the general partner or the in-house tax counsel read the tax opinions.

- (1) *Santa Monica Pictures, LLC v. Commissioner*, T.C. Memo 2005-104. Santa Monica relied on opinions and legal memoranda from several reputable law firms and accounting firms that had nothing to do with the structuring of the transaction. However, after finding the transactions in question lacked economic substance, the Court was in no mood to forgive the penalties and found flaws with each of the opinions and reasons the taxpayer should not have relied on them, stating: "Under the circumstances, we believe that a reasonable and prudent person would recognize that the losses were 'too good to be true.'"
- (2) *Neonatology Associates, P.A. v. Commissioner*, 115 T.C. 43 (2000). Physicians in the Neonatology Associates practice group purchased an insurance product, relying on their insurance agent for advice as to the tax attributes of the product. The Tax Court found that the advisor was not a tax professional and that any reliance was unwarranted given the education of the physicians and the finding that the tax benefits of the product "were simply too good to be true."
- (3) *Elliott v. Commissioner*, 90 T.C. 960 (1988). Occasionally, the Tax Court will sustain penalties for a pedestrian transaction on the grounds that the results were "too good to be true." In *Elliott*, the petitioners conducted an Amway distributorship in their spare time and claimed deductions for various business expenses. Finding that unsubstantiated expenses in the amount of \$3,627.00 should be disallowed, the Tax Court sustained a negligence penalty, noting that expenses equal to one-third of the gross income from the business "would have put an ordinarily prudent taxpayer on notice that perhaps the situation was too good to be true."

5. **Special Rules Apply to I.R.C. § 6662A.** A different set of rules govern the application of the reasonable cause exception to I.R.C. § 6662A relating to reportable transactions.
- a. **General Rule.** No penalty shall be imposed on a taxpayer with respect to a reportable transaction understatement if there was reasonable cause for such understatement and the taxpayer acted in good faith. I.R.C. § 6664(d)(1).
- b. **Additional Requirements.** In addition to having reasonable cause and good faith, the following three items must be met. I.R.C. § 6664(d)(2).
- (1) the transaction must be adequately disclosed in accordance with the regulations under I.R.C. § 6011, and
  - (2) there was substantial authority for the position, and
  - (3) the taxpayer reasonably believed (subjective standard) that the position was more likely than not the proper position.
- c. **Taxpayers may not rely on certain opinions.** Along with other changes made by the 2004 Jobs act, specific rules were directed at tax advisors who give opinions on reportable transactions.
- (1) **Tax advisor disqualified.** If the tax advisor is a "material advisor," is compensated directly or indirectly by a material advisor, has a fee arrangement with respect to the transaction which is contingent on the tax benefits being sustained, or has a disqualifying interest with respect to the transaction, then the taxpayer may not rely on the opinion for penalty abatement purposes. I.R.C. § 6664(d)(3)(B)(ii).
  - (2) **Opinion disqualified.** Likewise, the taxpayer may not rely on the opinion if (i) it is based on unreasonable factual or legal assumptions, including assumptions about future events, (ii) unreasonably relies on representations or findings of the taxpayer or any other person, (iii) does not identify and consider all relevant facts, or (iv) fails to meet any other requirements in the regulations. I.R.C. § 6664(d)(3)(B)(iii).
    - (a) The implication is that an advisor giving an opinion on a reportable transaction must personally confirm all the underlying facts.

## H. New Penalty for Claims for Refund or Credit Without Reasonable Basis.

### 1. Introduction.

- a. New I.R.C. § 6672 was enacted as part of the Small Business and Work Opportunity Tax Act of 2007.
- b. Effective date. It applies to any claim filed after May 25, 2007.
- c. This penalty is imposed on the taxpayer, not the return preparer.

### 2. General Rules.

- a. **Penalty amount.** If a claim for refund or credit with respect to *income* tax (other than a claim for a refund or credit relating to the earned income credit) is made for an "excessive amount," then the person making such claim shall be liable for a penalty in an amount equal to 20% of the excessive amount, unless it is shown that the claim for such excessive amount has a "reasonable basis." I.R.C. § 6676(a).
- b. **What is the "excessive amount"?** For purposes of I.R.C. § 6676, the term "excessive amount" means the amount by which the amount of the claim for refund or credit for any taxable year exceeds the amount of such claim allowable under this title for such taxable year. I.R.C. § 6676(b).
- c. **Exclusions.** The penalty under I.R.C. § 6676 shall *not* apply to any portion of the excessive amount of a claim for refund or credit which is subject to accuracy-related penalties under I.R.C. § 6662, accuracy-related penalties in cases of reportable transactions under I.R.C. § 6662A, or civil fraud penalties under I.R.C. § 6663.

### 3. Standards to Avoid Penalties Under I.R.C. § 6676.

- a. The penalty applies unless the taxpayer shows that the claim for such excessive amount has a "reasonable basis." I.R.C. § 6676(a)
- b. Reasonable basis for a position.
  - (1) NOTE – This is one of the standards used to avoid penalties for negligence or disregard of rules or regulations under I.R.C. § 6662.
  - (2) Reasonable basis is a relatively high standard of tax reporting that is significantly higher than not frivolous or not patently improper. Treas. Reg. § 1.6662-3(b)(3).

- (3) The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. Treas. Reg. § 1.6662-3(b)(3).
- (4) If a return position is reasonably based on one or more of the authorities set forth in Treas. Reg. § 1.6662-4(d)(3)(iii) (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 Treas. Reg. § 1.6662-4(d)(2).

**4. Application of the New I.R.C. § 6676 by the IRS.**

- a. Chief Counsel Advice 200747020 (Oct. 3, 2007) addresses how to calculate the penalty.
- b. The CCA provides the following simple formula that can be used to understand the computation of the penalty:
  - (1) X = amount of claim for refund or credit requested  
Y = amount of claim for refund or credit allowed  
X-Y = excessive amount  
20% x (X-Y) = Amount of the I.R.C. § 6676 penalty
- c. The CCA provides the following example. On March 8, 2008, taxpayer mails Form 1040 along with a check for \$400 to cover the amount due to the applicable Service Center. On June 10, 2008, taxpayer files Form 1040X as a result of changes in the amount of itemized deductions. Taxpayer claims a refund (line 23 of Form 1040X) in the amount of \$2,000. On consideration of the claim, the IRS determined that the taxpayer was not entitled to a refund in the amount of \$2,000, rather the amount of the refund allowed is only \$1,000. The disparity is not due to any argument having a reasonable basis. The excessive amount is \$1,000 (*i.e.*, \$2,000-\$1,000). The taxpayer will be assessed a penalty in the amount of \$200 (20% (\$2000-\$1000)).
- d. It is also important to note that the penalty will not apply if the taxpayer is able to show reasonable basis for the claim for refund or credit, or if any portion of the excessive amount of the claim for refund or credit is subject to a penalty under I.R.C. § 6662, 6662A or 6663.

### III. THE INTERNAL REVENUE CODE THREATENS PENALTIES AGAINST TAX ADVISORS IN A NUMBER OF SITUATIONS.

#### A. Important Initial Issue – Who Is a Tax Return Preparer These Days?

##### 1. I.R.C. §7701(a)(36) (as amended in 2007).

a. **General Rule.** The term “tax return preparer” means any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by this title or any claim for refund of tax imposed by this title.

(1) For purposes of the preceding sentence, the preparation of a "substantial portion" of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund. I.R.C. § 7701(a)(36)(A).

b. **Exceptions.** A person shall *not* be a “tax return preparer” merely because such person does the following. I.R.C. § 7701(a)(36)(B).

(1) furnishes typing, reproducing, or other mechanical assistance,

(2) prepares a return or claim for refund of the employer (or of an officer or employee of the employer) by whom he is regularly and continuously employed,

(3) prepares as a fiduciary, or as an officer, general partner, or employee of a fiduciary, a return or claim for refund for any person, or

(4) prepares a claim for refund for a taxpayer in response to:

(a) any notice of deficiency issued to such taxpayer, or

(b) in response to any waiver of restriction after the commencement of an audit of such taxpayer or another taxpayer if a determination in such audit of such other taxpayer directly or indirectly affects the tax liability of such taxpayer.

##### 2. Treas. Reg. § 301.7701-15 (not amended in 2007).

a. **In general.**

(1) An income tax return preparer is any 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 of tax under subtitle A or of any claim for refund of tax under subtitle A. Treas. Reg. § 301.7701-15(a).

- (2) A person who furnishes to a taxpayer or other preparer sufficient information and advice so that completion of the return or claim for refund is largely a mechanical or clerical matter is considered an income tax return preparer, even though that person does not actually place or review placement of information on the return or claim for refund. Treas. Reg. §301.7701-15(a)(1).
- (3) A person who only gives advice on specific issues of law shall *not* be considered an income tax return preparer, unless:
  - (a) The advice is given with respect to events which have occurred at the time the advice is rendered and is not given with respect to the consequences of contemplated actions; 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. For example, if a lawyer gives an opinion on a transaction which a corporation has consummated, solely to satisfy an accountant (not at the time a preparer of the corporation's return) who is attempting to determine whether the reserve for taxes set forth in the corporation's financial statement is reasonable, the lawyer shall not be considered a tax return preparer solely by reason of rendering such opinion. Treas. Reg. §301.7701-15(a)(2).
- (4) A person may be an income tax return preparer without regard to educational qualifications and professional status requirements. Treas. Reg. §301.7701-15(a)(2).

**b. What Is a "Substantial Portion"?**

**(1) Generally.**

- (a) Only a person (or persons acting in concert) who prepares all or a substantial portion of a return or claim for refund shall be considered to be a preparer (or preparers) of the return or claim for refund. Treas. Reg. §301.7701-15(b)(1)

- (b) A person who renders advice which is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund, will be regarded as having prepared that entry. Treas. Reg. §301.7701-15(b)(1).
- (c) Whether a schedule, entry, or other portion of a return or claim for refund is a substantial portion is determined by comparing the length and complexity of, and the tax liability or refund involved in, that portion to the length and complexity of, and tax liability or refund involved in, the return or claim for refund as a whole. Treas. Reg. §301.7701-15(b)(1)

(2) **Economic Limitation.**

- (a) If the schedule, entry, or other portion of the return or claim for refund involves amounts of gross income, amounts of deductions, or amounts on the basis of which credits are determined which are (i) less than \$2,000 or (ii) less than \$100,000 and also less than 20% of the gross income (or adjusted gross income if the taxpayer is an individual) as shown on the return or claim for refund, then the schedule or other portion is *not* considered to be a substantial portion. If more than one schedule, entry or other portion is involved, they shall be aggregated. Treas. Reg. §301.7701-15(b)(2)
- (b) Example. If a person, for an individual taxpayer's return, prepares a schedule for dividend income which totals \$1,500 and gives advice making him a preparer of a schedule of medical expenses which results in a deduction for medical expenses of \$1,500, the person is not a preparer if the taxpayer's adjusted gross income shown on the return is more than \$15,000. This paragraph shall not apply to a person who prepares all of a return or claim for refund. Treas. Reg. §301.7701-15(b)(2)

(3) **Returns Affecting Other Returns.**

- (a) A preparer of a return is not considered to be a preparer of another return merely because an entry or entries reported on the return may affect an entry

reported on the other return, unless the entry or entries reported on the prepared return are directly reflected on the other return and constitute a substantial portion of the other return. Treas. Reg. §301.7701-15(b)(3)

- (b) Example. The sole preparer of a partnership return of income or a small business corporation income tax return is considered a preparer of a partner's or a shareholder's return if the entry or entries on the partnership or small business corporation return reportable on the partner's or shareholder's return constitute a substantial portion of the partner's or shareholder's return. Treas. Reg. §301.7701-15(b)(3)

**c. To Which Returns Do the Rules Apply?**

- (1) A return of tax under subtitle A includes an individual or corporation income tax return, a fiduciary income tax return (for a trust or estate), a regulated investment company undistributed capital gains tax return, a return of a charitable remainder trust, a return by a transferor of stock or securities to a foreign corporation, foreign trust, or foreign partnership, a partnership return of income, a small business corporation income tax return, and a DISC return. Treas. Reg. §301.7701-15(c)(i).
- (2) A claim for refund of tax under subtitle A includes a claim for credit against any tax under subtitle A. Treas. Reg. § 301.7701-15(c)(2).
- (3) A return of tax under subtitle A does *not* include an estate tax return, a gift tax return, any other return of excise taxes or income taxes collected at source on wages, an individual or corporation declaration of estimated tax, an application for an extension of time to file an individual or corporation income tax return, or an information statement on Form 990, any Form 1099, or similar form. Treas. Reg. §301.7701-15(c)(ii).

**3. I.R.C. § 6694 (Code was amended in 2007, regulations were not).**

**a. Cross-references under I.R.C. 6694(f).**

- (1) Old law. For definition of *income tax return preparer*, see I.R.C. § 7701(a)(36)

- (2) **New law.** For definition of *tax return preparer*, see I.R.C. § 7701(a)(36)

b. **Definition of "Income Tax Preparer". Treas. Reg. § 1.6694-1(b)(1).**

- (1) **General definition.** Solely for purposes of the regulations under I.R.C. § 6694, the term "income tax return preparer" ("preparer") means any person who is an income tax return preparer within the meaning of I.R.C. § 7701(a)(36) and Treas. Reg. § 301.7701-15, except that no more than one individual associated with a firm (for example, as a partner or employee) is treated as a preparer with respect to the same return or claim for refund.
- (2) **Firm.** If a *signing preparer* is associated with a firm, then that individual, and no other individual associated with the firm, is a preparer with respect to the return or claim for purposes of I.R.C. § 6694.
- (3) **Two Non-Signing Preparers.** If two or more individuals associated with a firm are income tax return preparers with respect to a return or claim for refund within the meaning of I.R.C. § 7701(a)(36) and Treas. Reg. § 301.7701-15, and none of them is the signing preparer, then only one of the individuals is a preparer (*i.e., nonsigning preparer*) with respect to that return or claim for purposes of I.R.C. § 6694.
- (a) In such a case, ordinarily, the individual who is a preparer for purposes of I.R.C. § 6694 is the individual with overall supervisory responsibility for the advice given by the firm with respect to the return or claim.

c. **Signing and Nonsigning Preparers. Treas. Reg. § 1.6694-1(b)(2).**

- (1) A "signing preparer" is any preparer who signs a return of tax or claim for refund as a preparer.
- (2) A "nonsigning preparer" is any preparer who is not a signing preparer.
- (a) Examples of nonsigning preparers 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.

**B. I.R.C. § 6695 – Penalties for Not Signing Returns or Claims for Refund.**

1. **General.** The Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28) broadened the scope of I.R.C. § 6695 by substituting "tax return preparer" for "income tax preparer" everywhere that it appears in the statute.
2. **Effective Date.** Applies to all returns prepared after May 25, 2007.
3. **Revised Statutory Language.** As amended, I.R.C. § 6695(b) states:
  - a. Any person who is a *tax return preparer* with respect to *any return or claim for refund*, who is required by regulations prescribed by the Secretary to sign such return or claim, and who fails to comply with such regulations with respect to such return or claim, shall pay a penalty of \$50 for such failure, *unless* it is shown that such failure is due to reasonable cause and not due to willful neglect.
  - b. The maximum penalty imposed on any person with respect to documents filed during any calendar year shall not exceed \$25,000.
4. **"Interim Guidance" from the IRS.**
  - a. This IRS issued Notice 2008-12 on December 31, 2007.
  - b. Effective date. Notice 2008-12 took effect January 1, 2008.
  - c. Future Actions by IRS. The IRS intends to issue regulations on or before December 31, 2008 requiring signatures under I.R.C. § 6695(b) for all forms that are filed after December 31, 2008.
  - d. Notice 2008-12 explains the following:
    - (1) an individual who is a tax return preparer with respect to certain specified tax returns or claims for refund must sign the return or claim for refund *after* it is completed and *before* it is presented to the taxpayer (or nontaxable entity) for signature.
    - (2) If the tax return preparer is unavailable for signature, then another tax return preparer must review the entire preparation of the return or claim for refund, and then sign the return or claim for refund.
    - (3) If more than one tax return preparer was involved in the preparation of the return or claim for refund, then the individual tax return preparer who had the primary

responsibility for the overall substantive accuracy of the preparation of such return or claim for refund shall be considered to be the tax return preparer for purposes of I.R.C. § 6695(b).

- e. Notice 2008-12 contains a non-exhaustive list of returns or claims for refund filed *after December 31, 2007*, that must be signed by the tax return preparer in order to avoid penalties under I.R.C. § 6695(b). THE LIST IS LOCATED AT THE END OF THIS OUTLINE.
- f. Notice 2008-12 goes on to state that, provided that there are no current regulations requiring the signature of the tax return preparer, the preparer will *not* be subjected to the penalty under I.R.C. § 6695(b) with respect to tax returns and claims that are filed after December 31, 2007 (*i.e.*, the effective date of Notice 2008-12) and before December 31, 2008 (*i.e.*, the date by which the IRS expects to issue regulations regarding I.R.C. § 6695(b)). THE LIST IS LOCATED AT THE END OF THIS OUTLINE.

C. **I.R.C. § 6694. Understatement of Taxpayer's Liability by Tax Return Preparer.**

1. **Old Law** (in effect until May 25, 2007).

a. **Lower Penalty for "Unrealistic Positions"**. I.R.C. § 6694(a).

(1) The old law provided that an income tax preparer shall pay a penalty of \$250 with respect to the return or claim if:

(a) any part of any understatement of liability with respect to any return or claim for refund is due to a position for which there was *not* a "realistic possibility of being sustained on its merits," and

(1) A position is considered to have a "realistic possibility of being sustained on its 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 (realistic possibility standard). Treas. Reg. §1.6694-2(b)(1).

(b) the income tax return preparer knew (or reasonably should have known) of such position, and

- (c) such position either was not adequately disclosed (as provided in I.R.C. § 6662(d)(2)(B)(ii)) or was frivolous,
- (d) unless it is shown that there is reasonable cause for the understatement and such person acted in good faith.

**b. Higher Penalties in Cases of Willfulness or Recklessness.**  
I.R.C. § 6694(b)

(1) The old law increased the penalty to \$1,000 if any part of the understatement of liability with respect to any return or claim for refund was due to:

(a) to a willful attempt in any manner to understate the liability for tax, or

(1) A preparer acted "willfully" if he or she disregards information furnished by the taxpayer or other persons in an attempt to wrongfully reduce the tax liability of the taxpayer. Treas. Reg. § 1.6694-3(b).

(b) to any reckless or intentional disregard of rules or regulations.

(1) A preparer acted "recklessly" if he or she takes a position on the return or claim that is contrary to a rule or regulation and the preparer knows, or is reckless in not knowing of, the rule or regulation in question. Treas. Reg. § 1.6694-3(c)(1)

(2) A preparer is reckless in not knowing of a rule or regulation if the preparer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable preparer would observe in the situation. Treas. Reg. § 1.6694-3(c)(1)

**2. New Law** (in effect after May 25, 2007).

**a. Lower Penalty for "Unreasonable Positions".** I.R.C. § 6694(a)(1).

- (1) The new law provides that any tax return preparer who prepares any return or claim for refund to which any part of an understatement of liability is due to an "unreasonable position" shall pay a penalty of the greater of \$1,000 or 50% of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

**b. Definition of "Unreasonable Position". I.R.C. § 6694(a)(2).**

- (1) The new law states that a position is an "unreasonable position" if:
  - (a) the tax return preparer knew (or reasonably should have known) of the position, and
  - (b) there was *not* a "reasonable belief" that the position would "more likely than not" be sustained on its merits, and
  - (c) the position was not adequately disclosed (as provided in I.R.C. § 6662(d)(2)(B)(ii)), or
  - (d) there was no "reasonable basis" for the position.

**c. Reasonable Cause Exception. I.R.C. §6694(a)(3).**

- (1) The new law provides that no penalty will be imposed if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith

**d. Higher (higher) Penalties for Willfulness or Recklessness. I.R.C. § 6694(b).**

- (1) The new law increases the penalty to the greater of \$5,000 or 50% of the income derived (or to be derived) by the tax return preparer if any part of the understatement of liability with respect to any return or claim for refund is due to:
  - (a) to a willful attempt in any manner to understate the liability for tax, or
  - (b) to any reckless or intentional disregard of rules or regulations.

**3. Comparing the Old Law and the New Law.**

- a. Scope increased: income tax return preparer v. tax return preparer.

- b. lower penalty standard increased.
- c. lower penalty amount increased.
- d. higher penalty amount increased (but not the standard).

4. **"Transitional Relief" Issued by the IRS: Notice 2007-54.**

- a. **Quick Action.** The changes to I.R.C. § 6694 introduced by the Small Business and Work Opportunity Tax Act of 2007 applied to documents prepared after May 25, 2007. However, the IRS quickly issued "transitional relief" in the form Notice 2007-54 (June 11, 2007).
- b. **Relief.** In order to provide sufficient time to address issues pertaining to the implementation of the Small Business and Work Opportunity Tax Act of 2007, the IRS provided the following transitional relief:
  - (1) For *income* tax returns, amended returns, and refund claims, the standards set forth under the *previous* law and *current* regulations under I.R.C. § 6694 will be applied in determining whether the IRS will impose a penalty.
  - (2) For *all other* returns, amended returns, and claims for refund, including estate, gift, and generation-skipping transfer tax returns, employment tax returns, and excise tax returns, the "reasonable basis" standard set forth in the regulations issued under I.R.C. § 6662, without regard to the disclosure requirements contained therein, will be applied in determining whether the IRS will impose a penalty.
- c. **Effective Date.** The transitional relief in Notice 2007-54 applies to:
  - (1) all returns, amended returns, and refund claims due on or before December 31, 2007 (determined with regard to any extension of time for filing);
  - (2) 2007 estimated tax returns due on or before January 15, 2008; and
  - (3) 2007 employment and excise tax returns due on or before January 31, 2008.

5. **Clarification of "Transitional Relief" – Notice 2008-11.**

- a. **Clarification.** Approximately six months later, the IRS issued Notice 2008-11 (Dec. 31, 2007) to clarify issues raised by tax practitioners about the "transitional relief" provided earlier in Notice 2007-54.
- b. **Amended Returns and Claims for Refund.** Questions have arisen regarding the extent to which amended returns or claims for refund qualify for transitional relief under Notice 2007-54. There is no set due date for such returns and claims other than prior to the expiration of the period proscribed by the applicable statute of limitations. The transitional relief described in Notice 2007-54 applies to timely amended returns or claims for refund (other than 2007 employment and excise tax returns) filed on or before December 31, 2007, and to timely amended employment and excise tax returns or claims for refund filed on or before January 31, 2008.
- c. **Original Tax Returns on Extension.** Questions have arisen regarding the extent to which original tax returns due on extension *after* December 31, 2007, but filed *on or before* December 31, 2007, qualify for transitional relief. The transitional relief described in Notice 2007-54 applies to original returns (other than 2007 employment and excise tax returns) filed on or before December 31, 2007, and to original employment and excise tax returns filed on or before January 31, 2008.
- d. **Advice By Non-signing Preparers.** Questions have also arisen regarding the extent to which advice rendered by non-signing preparers qualifies for transitional relief under Notice 2007-54. The transitional relief described in Notice 2007-54 applies to non-signing preparers for advice provided on or before December 31, 2007.
- e. **Future Guidance From the IRS.** In future guidance, the IRS intends to provide transitional rules to address amended returns filed *after* the expiration of the transitional relief period described in Notice 2007-54 that relate to original returns filed under previous law or during the transitional relief period.

6. **Interim Guidance Regarding I.R.C. § 6694: Notice 2008-13.**

- a. **Purpose.** The IRS issued Notice 2008-13 (Dec. 31, 2007) to provide more guidance on the implementation of the tax return preparer penalty provisions under I.R.C. § 6694 and the related

definitional provisions under I.R.C. § 7701(a)(36), as amended by the Small Business and Work Opportunity Tax Act of 2007.

- b. **Effective Date.** Notice 2008-13 is effective as of:
  - (1) January 1, 2008, for all tax returns, amended tax returns, and claims for refund (other than 2007 employment and excise tax returns) filed on or after that date, and with respect to advice provided on or after that date; and
  - (2) February 1, 2008, for all 2007 employment and excise tax returns filed on or after that date, and with respect to advice provided on or after that date.
- c. **Future Guidance.** In 2008, the IRS intends to revise the regulatory scheme governing tax return preparer penalties. Until then, Notice 2008-13 provides interim guidance on the application of preparer penalties.
- d. **IRS Recognizes Some Problems.** As part of the regulatory process, the IRS will determine the appropriate modifications to the existing regulatory framework, given the complexities and anomalies created by the inter-relationship of the amendments to I.R.C. § 6694 applicable to tax return preparers and the various accuracy-related penalty provisions applicable to taxpayers under I.R.C. § 6662, as well as the inter-relationship of the amendments to I.R.C. § 6694 and the regulations governing the practice before the IRS in Circular 230.
- e. **Ominous Warnings.** Notice 2008-13 states that "[i]t is important to note that the regulations expected to be finalized in 2008 may be substantially different from the rules described in this notice, and in some cases more stringent."
- f. **Default.** Except to the extent modified by the interim guidance in Notice 2008-13, and until further guidance is issued, *existing* regulations and guidance under I.R.C. §§ 6694 and 7701(a)(36) will remain in effect.
- g. **Returns and Claims for Refund Subject to the I.R.C. § 6694 Penalty.**
  - (1) **Tax Returns and Claims for Refund/Credit.**
    - (a) Solely for purposes of I.R.C. § 6694, a return or claim for refund includes the tax returns listed on Exhibit 1 (which is located at the end of this

outline) or a claim for refund with respect to any such return.

- (b) A claim for refund of tax includes a claim for credit against any tax.
- (c) A person who for compensation prepares all or a substantial portion of a tax return listed on Exhibit 1, or a claim for refund with respect to any such tax return, is a tax return preparer who is subject to I.R.C. § 6694.

(2) **Information Returns and Other Documents.**

(a) **Summary of Current Rules.**

- (1) Under current regulations, a person who for compensation prepares information returns or other documents that include information that is or may be reported on a taxpayer's tax return is subject to I.R.C. § 6694 if the information reported on the information return or other document constitutes a substantial portion of the taxpayer's tax return, notwithstanding the fact that the information return or other document may not be reporting the liability of the taxpayer.
- (2) The current regulatory definitions of substantial portion and substantial preparation require a facts and circumstances analysis of each document prepared and a comparison of the items included on that document with the tax return that actually reports a tax liability. Treas. Reg. 301.7701-15(b).
- (3) **Example.** Under current regulations, the preparer of a Form 1065 (U.S. Return of Partnership Income) may be deemed to be the preparer of any of the partners' individual income tax return (e.g., Form 1040, U.S. Individual Income Tax Return), if the items on the partnership return constitute a substantial portion of that partner's income tax return. Treas. Reg. § 301.7701-15(b)(3).

(b) Information Returns Constituting a Substantial Portion of a Taxpayer's Tax Return.

- (1) Solely for purposes of I.R.C. § 6694, an information return listed on Exhibit 2 (which is located at the end of this outline) that includes information that is or may be reported on a taxpayer's tax return or claim for refund is a return to which I.R.C. § 6694 could apply if the information reported constitutes a substantial portion of that taxpayer's tax return or claim for refund.
- (2) A person who for compensation prepares any of the forms listed on Exhibit 2, which form does not report a tax liability but does affect an entry or entries on a tax return and constitutes a substantial portion of the tax return or claim for refund that does report a tax liability, is a tax return preparer who is subject to I.R.C. § 6694.

(c) Other Documents Constituting a Substantial Portion of a Taxpayer's Tax Return.

- (1) Solely for purposes of I.R.C. § 6694, a document that includes information that is or may be reported on a taxpayer's tax return or claim for refund is treated as a return to which I.R.C. § 6694 could apply if the information reported constitutes a substantial portion of that taxpayer's tax return or claim for refund.
- (2) Example. A person who for compensation prepares documents, such as depreciation schedules or cost, expense or income allocation studies, that do not report a tax liability but which will affect an entry or entries on a tax return that does report a tax liability, and that constitute a substantial portion of such tax return, is a tax return preparer who is subject to I.R.C. § 6694.

(d) Other Documents Not Constituting a Substantial Portion of a Taxpayer's Tax Return Unless Prepared Willfully to Understate Tax or in Reckless or Intentional Disregard of the Rules or Regulations.

- (1) Solely for purposes of I.R.C. § 6694, a document listed on Exhibit 3 (which is located at the end of this outline) that includes information that is or may be reported on a taxpayer's tax return or claim for refund (and that constitutes a substantial portion of such tax return or claim for refund) will not subject the preparer to a penalty under I.R.C. § 6694(a).
- (2) However, a document listed on Exhibit 3 may subject the preparer to a willful or reckless conduct penalty under I.R.C. § 6694(b) if the information reported on the document constitutes a substantial portion of the tax return or claim for refund and is prepared willfully in any manner to understate the liability of tax on a tax return or claim for refund, or in reckless or intentional disregard of rules or regulations.
- (3) Example. Preparation of a Form W-2 (Wage and Tax Statement) reporting certain executive compensation may constitute preparation of a substantial portion of the Form 1040 return on which the compensation is reported if it is prepared willfully in a manner to understate the liability of tax.
- (4) A person who for compensation prepares all or a substantial portion of any of the forms or other documents listed on Exhibit 3 is *not* a tax return preparer subject to I.R.C. § 6694(a) *unless* the form or document was prepared willfully in any manner to understate the liability of tax on a tax return or claim for refund or in reckless or intentional disregard of rules or regulations.

**h. Who Is a Tax Return Preparer?**

- (1) Solely for purposes of I.R.C. § 6694, the term "tax return preparer" in I.R.C. § 7701(a)(36) is defined by using the definitions in Treas. Reg. § 1.6694-1, Treas. Reg. § 1.6694-3 and Treas. Reg. § 301.7701-15 (none of which has been updated to comport with legislative changes to § I.R.C. 6694 or § 7701(a)(36)), *with the following modifications*:
- (a) Eliminating the word "income" as a modifier to tax return preparer throughout Treas. Reg. §§ 1.6694-1, 1.6694-3, and 301.7701-15.
- (1) This modification conforms the current regulations to amendments made by the Small Business and Business Opportunity Work Act of 2007.
- (b) Expanding the definition of returns and claims for refund from returns of tax under subtitle A (i.e., *income* tax), claims for refund under subtitle A, or similar language, to include returns of tax and claims for refund under subtitles A through E of the Code throughout Treas. Reg. §§ 1.6694-1, 1.6694-3, and 301.7701-15.
- (1) This modification conforms the current regulations to amendments made by the Small Business and Business Opportunity Work Act of 2007.
- (c) Interpreting the term "substantial portion" 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 determination (or disallowance of a claim for refund) that the preparer knows or reasonably should know is a "significant portion" of the tax liability reported on the tax return (or, in the case of a claim for refund, a "significant portion" of the tax originally reported or previously adjusted).
- (1) 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 other portion.

- (2) What does "significant portion" mean? Why not use specific percentages or numbers?

**i. When Was the Return Prepared?**

- (1) Solely for purposes of I.R.C. § 6694, a return or claim for refund is deemed prepared on the date reflected by the tax return preparer's signature.
- (2) If a *signing preparer* fails to sign the tax return, then the tax return is deemed prepared on the date the tax return is filed.
- (3) In the case of a *non-signing preparer*, the relevant date is the date the person provides the advice, which date will be determined based on all the facts and circumstances.
- (4) For purposes of this interim guidance, the rules described in this section will apply instead of Treas. Reg. § 1.6694-2(b)(5).

**j. How Does a Preparer Meet the New Penalty Standard under I.R.C. § 6694(a) – Reasonable Belief That More Likely Than Not Sustainable?**

**(1) Meeting the New Standard.**

- (a) Solely for purposes of I.R.C. § 6694, a tax return preparer is considered to reasonably believe that the tax treatment of an item is more likely than not the proper tax treatment 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.
- (b) For purposes of interim guidance, the standard described in this section will apply instead of Treas. Reg. § 1.6694-2(b).

(2) **Reliance on Others.**

- (a) For purposes of determining whether the tax return preparer has a reasonable belief that the position would more likely than not be sustained on the merits, a tax return preparer *may rely* in good faith without verification upon information furnished by the taxpayer, as provided in Treas. Reg. § 1.6694-1(e).
- (b) In addition, a tax return preparer *may rely* in good faith and without verification upon information furnished by another advisor, tax return preparer or other third party.
- (c) 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 more likely than not be sustained on the merits.
- (d) However, the tax return preparer may not ignore the implications of information furnished to the tax return preparer or actually known to the tax return preparer.
- (e) The tax return preparer also must make reasonable inquiries if the information furnished by another tax return preparer or a third party appears to be incorrect or incomplete.

k. **How Does a Preparer Meet the New Penalty Standard under I.R.C. § 6694(a) – Reasonable Basis?**

(1) **Meeting the New Standard.**

- (a) Solely for purposes of I.R.C. § 6694, "reasonable basis" will be interpreted in accordance with Treas. Reg. § 1.6662-3(b)(3).
- (b) For purposes of this interim guidance, the standards described in this section will apply instead of Treas. Reg. § 1.6694-2(c).

(2) **Reliance on Others.**

- (a) These rules are identical to those in the preceding section of the outline.

1. **How Does a Preparer Meet the New Penalty Standard under I.R.C. § 6694(a) – Reasonable Cause?**

(1) **Meeting the New Standard.**

- (a) Solely for purposes of I.R.C. § 6694, the IRS generally will continue to consider the factors described in Treas. Reg. §§ 1.6694-2(d)(1) to -2(d)(4).

- (b) However, the factor regarding "reliance on advice of another preparer" found in Treas. Reg. § 1.6694-2(d)(5) is replaced by the rules described below.

- (1) For purposes of this interim guidance, a tax return preparer will be found to have acted in good faith when the tax return preparer relied on the advice of a third party who is not in the same firm as the tax return preparer and who the tax return preparer had reason to believe was competent to render the advice. The advice may be written or oral, but in either case the burden of establishing that the advice was received is on the tax return preparer.

- (2) A return preparer is not considered to have relied in good faith if

- i) The advice is unreasonable on its face,
- ii) The tax return preparer knew or should have known that the third party advisor was not aware of all relevant facts; or
- iii) The tax return preparer knew or should have known (given the nature of the tax return preparer's practice), at the time the tax return or claim for refund was prepared, that the advice was no longer reliable due to

developments in the law since the time the advice was given.

**m. Interim Penalty Compliance Rules.**

**(1) Signing Tax Return Preparers.**

(a) Solely for purposes of I.R.C. § 6694, a signing tax return preparer shall be deemed to meet the requirements of I.R.C. § 6694 with respect to a position for which there is a reasonable basis but for which the tax return preparer does not have a reasonable belief that the position would more likely than not be sustained on the merits, if the tax return preparer meets any of the following four requirements:

(1) One of four. The position is disclosed in accordance with Treas. Reg. § 1.6662-4(f) (which permits disclosure on a properly completed and filed Form 8275 or Form 8275-R, as appropriate, or on the tax return in accordance with the annual revenue procedure described in Treas. Reg. § 1.6662-4(f)(2)); or

i) *See* Rev. Proc. 2008-14 (Jan. 25, 2008)

(2) Two of four. If the position would not meet the standard for the taxpayer to avoid a penalty under I.R.C. § 6662(d)(2)(B) without disclosure, the tax return preparer provides the taxpayer with the prepared tax return that includes the disclosure in accordance with Treas. Reg. § 1.6662-4(f); or

i) NOTE – I.R.C. § 6662(d)(2)(B) provides that the amount of the understatement does not include (i) any item for which there is substantial authority for the tax treatment, or (ii) any item for which for which there is a reasonable basis for the tax treatment and the treatment is adequately disclosed.

- (3) Three of four. If the position would otherwise meet the requirement for nondisclosure under I.R.C. § 6662(d)(2)(B)(i), the tax return preparer advises the taxpayer of the difference between the penalty standards applicable to the taxpayer under I.R.C. § 6662 and the penalty standards applicable to the tax return preparer under I.R.C. § 6694, and contemporaneously documents in the tax return preparer's files that this advice was provided; or
- i) NOTE – I.R.C. § 6662(d)(2)(B) provides that the amount of the understatement does not include (i) any item for which there is substantial authority for the tax treatment, or (ii) any item for which there is a reasonable basis for the tax treatment and the treatment is adequately disclosed.
- (4) Four of four. If I.R.C. § 6662(d)(2)(B) does not apply because the position may be described in I.R.C. § 6662(d)(2)(C), the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer under I.R.C. § 6662(d)(2)(C) and the difference, if any, between these standards and the standards under I.R.C. § 6694, and contemporaneously documents in the tax return preparer's files that this advice was provided.
- i) NOTE – I.R.C. § 6662(d)(2)(C) provides that the amount of the understatement is not reduced by any item attributable to a tax shelter, i.e., an entity, plan or arrangement with a significant purpose of avoiding or evading federal income tax..
- (b) For purposes of this interim guidance, the rules applicable to signing tax return preparers described above will apply instead of Treas. Reg. § 1.6694-2(c)(3)(i).

(2) **Non-Signing Tax Return Preparer.**

- (a) **Dealing with Taxpayers.** Solely for purposes of I.R.C. § 6694, a non-signing tax return preparer shall be deemed to meet the requirements of I.R.C. § 6694 with respect to a position for which there is a reasonable basis but for which the non-signing tax return preparer does not have a reasonable belief that the position would more likely than not be sustained on the merits, if the advice to the taxpayer includes a statement *informing the taxpayer* of any opportunity to avoid penalties under I.R.C. § 6662 that could apply to the position as a result of disclosure, if relevant, and of the requirements for disclosure.
- (b) **Dealing with Another Preparer.** If a non-signing tax return preparer provides *advice to another tax return preparer*, a non-signing tax return preparer shall be deemed to meet the requirements of I.R.C. § 6694 with respect to a position for which there is a reasonable basis but for which the non-signing tax return preparer does not have a reasonable belief that the position would more likely than not be sustained on the merits, if the advice to the tax return preparer includes a statement that disclosure under I.R.C. § 6694(a) may be required.
- (c) **Written Advice.** If the advice with respect to a position is *in writing*, then the statement must be in writing.
- (d) **Oral Advice.** If the advice with respect to a position is *oral*, then the statement also may be oral.
- (e) For purposes of this interim guidance, the rules applicable to non-signing tax return preparers described in above will apply instead of Treas. Reg. § 1.6694-2(c)(3)(ii).

n. **Examples.**

- (1) **Example 1.** Accountant A prepares a Form 8886, Reportable Transaction Disclosure Statement, that is used to disclose reportable transactions. Accountant A does not prepare the tax return or advise the taxpayer regarding the tax return reporting position of the transaction to which the

Form 8886 relates. The preparation of the Form 8886 is not directly relevant to the determination of the existence, characterization, or the amount of an entry on a tax return or claim for refund. Rather, the Form 8886 is prepared by Accountant A to disclose a reportable transaction. Accountant A has not prepared a substantial portion of the tax return and is not considered a tax return preparer under I.R.C. § 6694.

- (2) Example 2. Accountant B prepares a partnership's Form 1065 (including Schedules K-1) allocating the partnership's losses among its partners in proportion to their original investment. Accountant B is not an employee of either the partnership or the general partner. Accountant B knows that the loss deduction calculated by Accountant B and claimed by one of the partners on that partner's tax return, if disallowed, is the most significant portion of the liability on that partner's tax return. Accountant B has prepared a substantial portion of that partner's tax return and is considered a tax return preparer under I.R.C. § 6694.
- (3) Example 3. Attorney C, an attorney in a law firm, advises a large corporate taxpayer on specific issues of law regarding the tax consequences of a proposed corporate transaction. Based upon this advice, the corporate taxpayer enters into the transaction. Once the transaction is completed, the corporate taxpayer does not receive any additional advice from Attorney C or anyone in Attorney C's firm with respect to the proposed corporate transaction. Six months later, the corporate taxpayer hires Preparer D, who is not associated with the same firm as Attorney C, to prepare its entire tax return. Attorney C has not prepared a substantial portion of the corporation's tax return and is not considered a tax return preparer under I.R.C. § 6694.
- (4) Example 4. Attorney D, an attorney in a law firm, advises a large corporate taxpayer concerning the proper treatment and amount of a single entry on the corporate taxpayer's tax return. The tax liability involved in this entry is an insignificant portion of the tax liability for the corporate tax return as a whole. Neither Attorney D nor any other attorney associated with Attorney D's firm signs the corporate taxpayer's tax return as a tax return preparer. Attorney D has not prepared a substantial portion of the corporation's tax return and is not considered a tax return preparer under I.R.C. § 6694.

- (5) Example 5. Attorney E specializes in tax planning at a law firm and develops Strategy Y, a plan with a significant purpose of tax avoidance. Attorney E provides advice with respect to Strategy Y to 50 taxpayers. The 50 taxpayers implement Strategy Y in a manner that significantly reduces the Federal tax liability that would otherwise be reported on their tax returns. After Strategy Y is entered into, Attorney E advises each of the 50 taxpayers on the reporting of specific amounts that Attorney E knows will be placed on the tax return of each of the 50 taxpayers. Attorney E knows that the tax liability involved in this entry, if disallowed, is a significant portion of the tax liability for each of the tax returns. Neither Attorney E nor any other person associated with Attorney E's firm signs the taxpayers' tax returns as a tax return preparer. The advice relating to Strategy Y constitutes preparation of a substantial portion of each of the 50 taxpayers' tax returns. Thus, Attorney E is a tax return preparer under I.R.C. § 6694.
- (6) Example 6. During an interview conducted by Preparer F, the taxpayer provided a schedule prepared by another advisor in Preparer F's firm for use in preparing the taxpayer's tax return. The schedule did not appear to be incorrect or incomplete. On the basis of this information, Preparer F completed the tax return. It is later determined that there is an understatement of liability for tax that resulted from incorrect information on the schedule. Preparer F is not required to audit, examine or review the schedule in order to verify independently that the information on the schedule met the standard requiring a reasonable belief that the position would more likely than not be sustained on the merits. Preparer F is not subject to a penalty under I.R.C. § 6694.
- (7) Example 7. In preparing a tax return, Accountant G relies on the advice of an actuary concerning the limit on deductibility under I.R.C. § 404(a)(1)(A) of a contribution by an employer to a qualified pension trust. The actuary providing the advice was not associated with Accountant G's firm. On the basis of this advice, Accountant G completed the tax return. It is later determined that there is an understatement of liability for tax that resulted from incorrect advice provided by the actuary. Accountant G had no reason to believe that the advice was incorrect or incomplete, and the advice appeared reasonable on its face. Accountant G was also not aware of any reason why the

actuary did not know all of the relevant facts or that the advice was no longer reliable due to developments in the law since the time the advice was given. Accountant G is not subject to a penalty under I.R.C. § 6694.

- (8) Example 8. During an interview conducted by Preparer H, a taxpayer stated that he had made a charitable contribution of real estate in the amount of \$50,000 during the tax year, when in fact he had not made this charitable contribution. Preparer H did not inquire about the existence of a qualified appraisal or complete a Form 8283 in accordance with the reporting and substantiation requirements under I.R.C. § 170(f)(11). Preparer H reported deductions on the tax return for the charitable contribution which resulted in an understatement of liability for tax. Preparer H is subject to a penalty under I.R.C. § 6694.
- (9) Example 9. Preparer I prepared the tax returns of a taxpayer for each of the past three years. While preparing this year's tax return, Preparer I realizes that the taxpayer did not provide a Form 1099 for a bank account that produced significant taxable income in each of the previous three years. When Preparer I asked the taxpayer about any other existing income and the lack of this Form 1099, the taxpayer furnishes the Form 1099 to Preparer I for use in preparation of the tax return. Preparer I did not know that the taxpayer owned an additional bank account this past year that generated taxable income and the taxpayer did not reveal this information to the tax return preparer. Preparer I is not subject to a penalty under I.R.C. § 6694.
- (10) Example 10. A corporate taxpayer hires Accountant J to prepare its tax return. Accountant J encounters an issue regarding various small asset expenditures. Accountant J researches the issue and concludes that there is a reasonable basis for a particular treatment of the issue. Accountant J cannot, however, reach a reasonable belief whether the position would more likely than not be sustained on the merits because it was impossible to make a precise quantification regarding whether the position would more likely than not be sustained on the merits. The position is not disclosed on the tax return. Accountant J signs the tax return as the tax return preparer. The IRS later disagrees with this position taken on the tax return. Accountant J is not subject to a penalty under I.R.C. § 6694.

(11) Example 11. A corporate taxpayer hires Accountant K to prepare its income tax return. Accountant K does not reasonably believe that a particular position taken on the tax return would more likely than not be sustained on its merits although there is substantial authority for the position. Accountant K prepares and signs the tax return without disclosing the position taken on the tax return, but advises the corporate taxpayer of the difference between the penalty standards applicable to the taxpayer under I.R.C. § 6662 and to the tax return preparer under I.R.C. § 6694, and contemporaneously documents in the tax return preparer's files that this advice was provided. The corporate taxpayer signs and files the tax return without disclosing the position because the position meets the requirements for nondisclosure under I.R.C. § 6662(d)(2)(B)(i). The IRS later disagrees with the position taken on the tax return, resulting in an understatement of liability reported on the tax return. Accountant K is not subject to a penalty under I.R.C. § 6694.

(12) Example 12. Attorney L advises a large corporate taxpayer in writing concerning the proper treatment of complex entries on the corporate taxpayer's tax return. Attorney L has reason to know that the tax liability involved in these entries, if disallowed, is a significant portion of the tax liability for the tax return. When providing the advice, Attorney L concludes that one position with respect to these entries does not meet the reasonable belief that the position would more likely than not be sustained on the merits standard and also does not have substantial authority, although the position meets the reasonable basis standard. Attorney L, in good faith, advises the corporate taxpayer in writing that the position lacks substantial authority and the taxpayer will be subject to an accuracy-related penalty under I.R.C. § 6662 unless the position is disclosed in a disclosure statement included in the return. Attorney L also documents the fact that this advice was contemporaneously provided to the corporate taxpayer in writing at the time the advice was provided. The corporate taxpayer decides not to include a disclosure statement in the return. Neither Attorney L nor any other attorney associated with Attorney L's firm signs the corporate taxpayer's return as a tax return preparer, but the advice by Attorney L constitutes preparation of a substantial portion of the tax return. Thus, Attorney L is a tax return preparer

for purposes of I.R.C. § 6694. Attorney L, however, will not be subject to a penalty under I.R.C. § 6694.

**7. Harmonizing Penalty Standards.**

**a. Tax Return Preparer Standards.** Penalties generally may be imposed on return preparers under the new I.R.C. § 6694 in cases of taxpayer understatements:

- (1) In cases of undisclosed positions, a return preparer must have a reasonable belief that the position would more likely than not be sustained on the merits.
- (2) In case of disclosed positions, a return preparer must have a reasonable basis for the position.

**b. Taxpayer Standards.** Taxpayers are subject to a variety of accuracy-related penalties for underpayments of tax under I.R.C. § 6662. In cases of undisclosed positions not involving tax shelters, penalties may be avoided if there was substantial authority for the position.

**c. Harmonizing standards.** The IRS realizes that these disparate standards could result in a conflict of interest between return preparers and their clients. Therefore, the IRS has proposed lower standards for preparers. U.S. Treasury Department. *General Explanations of the Administration's Fiscal Year 2009 Revenue Proposals* (Feb. 2008), pg. 93.

- (1) In case of disclosed positions, a return preparer must have a reasonable basis for the position.
- (2) In case of undisclosed positions, a return preparer must have substantial authority for the position.
- (3) In the case of reportable transactions, a return preparer must have a reasonable belief that the position would more likely than not be upheld on the merits.

**D. Penalties for Aiding and Abetting an Understatement – I.R.C. § 6701.**

**1. Penalty.** Under I.R.C. § 6701(a), a penalty shall be imposed on any person who

- a.** aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim or other document, and



submitted to IRS, if it "would result" in an understatement if actually filed. *Golletz v. United States*, 1991 WL 66371 (N.D. Ill. 1991).

**7. Burden of Proof.**

- a. The burden of proving liability is on the government by a preponderance of the evidence. I.R.C. § 6703(a); *Mattingly v. United States*, 924 F.2d 785 (8th Cir. 1991); *Barr v. United States*, 67 F.3d 469 (2d Cir. 1995).

**8. No Statute of Limitations on Assessment.**

- a. There is no statute of limitations on assessment of penalties under I.R.C. § 6701, and courts have refused to infer one. *See Mullikin v. United States*, 952 F.2d 920, 928 (6th Cir. 1991), *cert. denied*, 506 U.S. 827 (1992); *Lamb v. United States*, 977 F.2d 1296, 1297 (8th Cir. 1992).
- b. However, once assessed, the penalties must be collected within 10 years. I.R.C. § 6502.

**E. Criminal Penalties May Also Apply.**

1. **Tax Evasion.** A preparer (or any other person) who willfully attempts in any manner to evade or defeat payment of any tax is guilty of a felony and may be fined up to \$100,000 (\$500,000 for a corporation) or imprisoned for not more than five years or both. I.R.C. § 7201. *See United States v. Noske*, 117 F.3d 1053 (8th Cir. 1997).
2. **Criminal Failure to File.** Any person who willfully fails to file a return, keep records or supply information required by the Code is guilty of a misdemeanor. The penalty may be a fine up to \$25,000 (\$100,000 for a corporation), or imprisonment for not more than one year, or both. I.R.C. § 7203. A preparer who does file his own return may be convicted under this provision. *See Edwards v. United States*, 375 F.2d 862 (9th Cir. 1967); *United States v. McCaffrey*, 181 F.3d 854 (7th Cir. 1999).
3. **False Returns.** Any person who willfully aids, assists in or counsels the preparation or presentation of a return or claim that is fraudulent or false as to any material matter commits a felony. A person convicted of this offense may be fined up to \$100,000 (\$500,000 for a corporation) or imprisoned not more than three years or both. I.R.C. § 7206. *See, e.g., United States v. Conlin*, 551 F.2d 534 (2d Cir. 1977) (preparer who frequently filed returns with similar misstatements showed willfulness rather than mere negligence); *United States v. Clardy*, 612 F.2d 1139 (9th Cir. 1980) (assisted client in claiming sham interest deductions); *United*

*States v. Fletcher*, 322 F.3d 508 (8th Cir. 2003) (advised clients to take deductions for pet expenses and other personal expenses).

4. **Recent Indictments and Close Encounters.** Several recent indictments demonstrate how the government may attempt to criminalize behavior of tax professionals – Jenkins & Gilchrist, Sidley Austin Brown & Wood, KPMG, Ernst & Young.

#### IV. **CIRCULAR 230.**

A. **Generally.** Circular 230 regulates practice before the IRS, spelling out who may practice, the duties and restrictions relating to practice, sanctions for violations, and procedural rules applicable to disciplinary proceedings. This outline will focus on monetary penalties, as well as the new standards for advising with respect to tax positions and for preparing and signing returns.

#### B. **Introduction of Monetary Penalties in 2004.**

1. **Pre-2004.** Penalties for violations were limited to censure, suspension or disbarment.
  - a. Section 10.50(a) – Authority to censure, suspend, or disbar. The Secretary of the Treasury, or his or her delegate, after notice and an opportunity for a proceeding, may censure, suspend or disbar any practitioner from practice before the IRS if the practitioner is shown to be incompetent or disreputable, fails to comply with any regulation in this part, or with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client. Censure is a public reprimand.
2. **Post-2004.** The American Jobs Creation Act of 2004 expanded the penalties that the IRS could impose to include monetary penalties on conduct occurring after October 22, 2004.
  - a. "The Secretary may impose a monetary penalty on any representative [practicing before the IRS]."
  - b. "If the representative was acting on behalf of an employer or any firm or other entity in connection with the conduct giving rise to such penalty, the Secretary may impose a monetary penalty on such employer, firm, or entity if it knew, or reasonably should have known, of such conduct."
  - c. "Such penalty shall not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty, and may be in addition to, or in lieu of, any suspension, disbarment, or censure of the representative."

3. **Clarification of Monetary Penalty: Notice 2007-39.**
4. **Guidance Three Years Late.** Approximately two and one-half years after American Jobs Creation Act of 2004 introduced monetary penalties, the IRS issued Notice 2007-39 (April 23, 2007) to provide guidance regarding the penalties.
  - a. **Amount of the Monetary Penalty.**
    - (1) **Maximum penalty.** The aggregate amount of the monetary penalty (or penalties) imposed by the IRS for any prohibited conduct may not exceed the collective gross income derived by the practitioner and the employer, firm, or other entity in connection with such prohibited conduct.
    - (2) **Maximum penalty.** If a single act of prohibited conduct giving rise to a monetary penalty is an integral part of a larger engagement, the amount of the penalty will be limited by the “gross income derived (or to be derived)” from the larger engagement.
    - (3) **No Benefit from Getting Stuffed.** In determining the amount of the monetary penalty (or penalties), the IRS will consider amounts that the practitioner, employer, firm, or other entity could reasonably expect to realize, irrespective of whether the amounts have actually been received.
    - (4) **Discretionary Amount.** The IRS has discretion to impose a monetary penalty in an amount *less* than the amount allowed by statute.
    - (5) **Factors Considered.** In determining the amount of the penalty (or penalties), the IRS will consider the level of culpability of the practitioner, firm, or other entity; whether the practitioner, firm, or other entity violated a duty owed to a client or prospective client; the actual or potential injury caused by the prohibited conduct; and the existence of aggravating or mitigating factors.
    - (6) **Mitigating Factors.** Mitigating factors may include whether the practitioner, employer, firm, or other entity took prompt action to correct the noncompliance after the prohibited conduct was discovered; promptly ceased engaging in the prohibited conduct; attempted to rectify any harm caused by the prohibited conduct; or undertook measures to ensure that the prohibited conduct would not occur again in the future.

- (7) **Foot Faults.** In general, the IRS will not impose monetary penalties in cases of minor technical violations, when there is little or no injury to a client, the public, or tax administration, and there is little likelihood of repeated similar misconduct.

b. **Imposition of a *Separate* Penalty on Employer, Firm, or Other Entity.**

- (1) **Separate Penalty on Entity.** If a practitioner acted on behalf of an employer, firm, or other entity in connection with prohibited conduct, then the IRS may impose a *separate* monetary penalty on the employer, firm, or other entity if the employer, firm, or other entity knew, or reasonably should have known, of the prohibited conduct.

- (2) **Acting for Entity.** A practitioner is considered to have acted on behalf of an employer, firm, or other entity if:

- (a) An agency relationship existed between the practitioner and the employer, firm, or other entity;
- (b) The purpose of the agency relationship was to provide services in connection with practice before the IRS, and
- (c) The prohibited conduct giving rise to the penalty arose in connection with the agency relationship.

- (3) **Actual or Constructive Knowledge.** An employer, firm, or other entity knows or reasonably should know of the prohibited conduct if:

- (a) One or more members of the principal management (or officers) of the employer, firm, or other entity, or one or more members of the principal management (or officers) of a branch office knows, or has information from which a person with similar experience and background would reasonably know, of the prohibited conduct; or
- (b) The employer, firm, or other entity through willfulness, recklessness, or gross indifference (including ignoring facts that would lead a person of reasonable prudence and competence to investigate or ascertain) did not take reasonable steps to ensure compliance with Circular 230; and one or more individuals associated with the employer, firm, or

other entity, in connection with their agency relationship with the employer, firm, or other entity, engages in prohibited conduct within the meaning of section 10.52 of Circular 230 that harms a client, the public, or tax administration, or a pattern or practice of failing to comply with Circular 230.

(4) **Factors Considered.** When determining if a monetary penalty should be imposed on an employer, firm, or other entity, the IRS will consider factors in addition to whether the employer, firm, or other entity knew, or reasonably should have known, of the prohibited conduct (or whether the employer, firm or other entity did not use reasonable efforts to ensure compliance with Circular 230). For example, the IRS will consider the gravity of the misconduct, any history of noncompliance by the employer, firm, or other entity, preventative measures in effect prior to the misconduct, and any corrective measures taken by the employer, firm, or other entity after the prohibited conduct was discovered, including measures to ensure that future prohibited conduct does not occur.

c. **Example 1.** Attorney A specializes in tax planning and works out of a national accounting firm's headquarters. Attorney A is involved in the development of off-the-shelf tax planning strategies, including Strategy X. Attorney A has wide discretion over his day-to-day work product and rarely supervises other professionals at the firm. Attorney A rarely deals directly with clients as this work is handled by other firm partners or employees. Attorney A works directly with the firm's other attorneys, accountants and support staff across the country to market and fine-tune Strategy X. Clients of the firm are examined by the Service with respect to Strategy X, but Attorney A is not identified on any Form 2848 as a representative. Attorney A reports to the director of the firm's tax practice. The director of the firm's tax practice provides general oversight as to Attorney A. The director of the firm's tax practice was aware of the strategies that Attorney A developed, including Strategy X, although he was not necessarily familiar with the technical tax details of each strategy. The director of the firm's tax practice also knew that Strategy X generated measurable revenue for the firm. OPR determines that Attorney A engaged in prohibited conduct in violation of Circular 230 in the creation, promotion and marketing of Strategy X. Attorney A acted on behalf of the firm because an agency relationship existed between Attorney A and the firm, and the misconduct arose in connection with that agency relationship as Attorney A worked on behalf of the firm to promote Strategy X.

The firm knew or had reason to know of the prohibited conduct in this situation. The director of the firm's tax practice, who is a member of principal management of the firm, had general knowledge that Attorney A developed the tax-advantaged strategies. Alternatively, in the absence of general knowledge, the director of the firm's tax practice would need to inquire into Strategy X because it added measurably to the firm's revenue. Both Attorney A and the firm are subject to a monetary penalty.

- d. **Example 2.** Unenrolled Return Preparer B owns and operates her own firm that provides return preparation services to the public and also specializes in preparing Forms 656, *Offers In Compromise*. B's firm employs 10 attorneys, CPAs and enrolled agents (all practitioners) and 15 unenrolled return preparers. B supervises and directs all of her employees. B's firm is structured in such a manner so that the first and predominant contact for clients coming in from the public is with the unenrolled return preparers. The unenrolled return preparers assist clients with preparing Forms 656 that are later submitted directly to the Service. B does not review individual Forms 656 but has provided specific instructions to her staff regarding how to complete false and misleading Forms 656 in violation of Circular 230. In order to facilitate the submission to the Service of the false or misleading Forms 656, B's procedure is to authorize one of her 10 practitioners to submit a Form 2848 on behalf of a client much later in the process, well after submission of the Forms 656 in violation of Circular 230. Although B is not a practitioner, the practitioner's actions in submitting the Forms 2848 are done on behalf of the firm pursuant to an agency relationship and occur in connection with prohibited conduct. B's firm is considered to know or have reason to know of the prohibited conduct because B, a member of principal management, instructed her staff regarding completion of the forms in violation of Circular 230. The practitioner's actions subject B's firm to a monetary penalty.

## 5. **Stacking of Penalties?**

- a. The Internal Revenue Manual currently requires a referral to OPR in all cases in which a penalty under I.R.C. § 6694 is assessed. I.R.M. § 20.1.6.2.1 (07-08-1999).
- b. Could this cause a "stacking" of penalties, *i.e.*, 50% of the income derived (or to be derived) by the tax return preparer under I.R.C. § 6694(a) and up to 100% of the gross income derived (or to be derived) under Circular 230?

C. **Standards for Advising With Respect to Tax Return Positions and for Preparing or Signing Returns – Section 10.34.**

1. **Old Standard. Realistic Possibility.**

- a. **Section 10.34(a) – Signing Returns.** A practitioner may not *sign a tax return* as a preparer if the practitioner determines that the tax return contains a position that does not have a realistic possibility of being sustained on its merits (the realistic possibility standard), unless the position is not frivolous and is adequately disclosed to the Internal Revenue Service.
- b. **Section 10.34(a) – Advising or Preparing Returns.** A practitioner may not *advise* a client to take a position on a tax return, *or prepare* the portion of a tax return on which a position is taken, unless the practitioner determines that the position satisfies the realistic possibility standard or the position is not frivolous and the practitioner advises the client of any opportunity to avoid the accuracy-related penalty in I.R.C. § 6662 by adequately disclosing the position and of the requirements for adequate disclosure.
- c. **Section 10.34(d)(1) – Definition of "realistic possibility".** A position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well informed analysis of the law and the facts 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.
- d. **Section 10.34(d)(2) – Definition of "frivolous".** A position is frivolous if it is patently improper.

2. **Issuance of Separate Proposed and Final Regulations.** On September 25, 2007, the IRS issued separate proposed and final regulations to update Circular 230 to, among other things, conform to the changes to I.R.C. § 6694 by the Small Business and Work Opportunity Tax Act of 2007.

3. **Proposed Regulations (REG-138637).**

- a. **Scope.** The proposed regulations only address Circular 230 § 10.34(a) and (e)
- b. **Effective Date.** The proposed regulations are applicable to returns filed or advice provided on or after the date that final regulations are published, but no earlier than January 1, 2008.

- c. **Section 10.34(a). Signing Returns.** A practitioner may not sign a tax return as a preparer, unless
- (1) the practitioner either has a reasonable belief that the tax treatment of each position on the return would more likely than not be sustained on its merits (the more likely than not standard), or
  - (2) there is a reasonable basis for each position and each position is adequately disclosed to the IRS.
- d. **Section 10.34(a). Advising or Preparing Returns.** A practitioner may not advise a client to take a position on a tax return, or prepare the portion of a tax return on which a position is taken, unless
- (1) The practitioner has a reasonable belief that the position satisfies the more likely than not standard; or
  - (2) The position has a reasonable basis and is adequately disclosed to the IRS.
- e. **Section 10.34(e)(1) – Definition of "more likely than not".** A practitioner is considered to have a reasonable belief that the tax treatment of a position is more likely than not the proper tax treatment if the 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), or any successor provision, of the substantial understatement penalty regulations may be taken into account for purposes of this analysis.
- f. **Section 10.34(e)(2) – Definition of "reasonable basis".** A position is considered to have a reasonable basis if it is reasonably based on one or more of the authorities described in Treas. Reg. § 1.6662-4(d)(3)(iii), or any successor provision, of the substantial understatement penalty regulations. 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.
- g. **Section 10.34(e)(3) – Definition of "frivolous".** A position is frivolous if it is patently improper.

4. **Final Regulations (T.D. 9359).**

- a. **Scope.** The final regulations change many sections of Circular 230.
- b. **Effective Date.** Generally, September 26, 2007.
- c. **Changes.** The final regulations contain many interesting changes, including the following:

d. **Section 10.2 – Definitions.**

(1) **Section 10.2(a)(4).** The term "practice before the IRS" comprehends all matters connected with a presentation to the IRS or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the IRS. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the IRS, rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion, and representing a client at conferences, hearings and meetings.

(2) **Section 10.2(a)(6).** A "tax return" includes an amended tax return and a claim for refund.

e. **Section 10.34 – Standards with Respect to Tax Returns and Documents, Affidavits, and Other Papers.**

(1) **Section 10.34(a)** – Found in the *proposed* regulations. It deals with "tax returns."

(2) **Section 10.34(b)** – Documents, Affidavits and Other Papers (other than tax returns).

(a) Section 10.34(b)(1). A practitioner may not advise a client to take a position on a document, affidavit or other paper submitted to the IRS unless the position is not frivolous.

(b) Section 10.34(b)(2). A practitioner may not advise a client to submit a document, affidavit or other paper to the IRS:

- (1) the purpose of which is to delay or impede the administration of the federal tax laws;

- (2) that is frivolous; or
- (3) that contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation, unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.

(3) **Section 10.34(c)**. Advising clients on potential penalties–

- (a) Section 10.34(c)(1). A practitioner must inform a client of any penalties that are reasonably likely to apply to the client with respect to:
  - (1) A position taken on a tax return if the practitioner advised the client with respect to the position, or the practitioner prepared or signed the tax return; and
  - (2) Any document, affidavit or other paper submitted to the IRS.
- (b) Section 10.34(c)(2). The practitioner also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.
- (c) Section 10.34(c)(3). This paragraph (c) applies *even if* the practitioner is not subject to a penalty under the Internal Revenue Code with respect to the position or with respect to the document, affidavit or other paper submitted.

(4) **Section 10.34(d)** – Relying on information from clients.

- (a) A practitioner advising a client to take a position on a tax return, document, affidavit or other paper submitted to the IRS, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client.
- (b) The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an

important fact or another factual assumption, or incomplete.

(5) **Section 10.34(e)**. Found in the *proposed* regulations.

(6) **Section 10.34(f)**. Effective/applicability date.

(a) § 10.34 is applicable to tax returns, documents, affidavits and other papers filed on or after September 26, 2007.

f. **Section 10.50 – Sanctions.**

(1) **Section 1050(a)** – Authority to censure, suspend, or disbar.

(a) The Secretary of the Treasury, or delegate, after notice and an opportunity for a proceeding, may censure [*i.e.*, publicly reprimand], suspend, or disbar any practitioner from practice before the IRS if the practitioner

(1) is shown to be incompetent or disreputable (within the meaning of § 10.51),

(2) fails to comply with any regulation in this part (under the prohibited conduct standards of § 10.52), or

(3) with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client.

(2) **Section 10.50(c)** – Authority to impose monetary penalty–

(a) Section 10.50(c)(1). In general.

(1) The Secretary of the Treasury, or delegate, after notice and an opportunity for a proceeding, may impose a monetary penalty on any practitioner who engages in conduct subject to sanction.

(2) If the practitioner was acting on behalf of an employer or any firm or other entity in connection with the conduct giving rise to the penalty, then the Secretary of the Treasury, or delegate, may impose a monetary penalty on the employer, firm, or

entity if it knew, or reasonably should have known, of such conduct.

(b) Section 10.50(c)(2) – Amount of penalty.

(1) The amount of the penalty shall not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty.

(3) **Section 10.50(e)** – Effective/applicability date.

(a) This section is applicable to conduct occurring on or after September 26, 2007, *except* §10.50(c), which applies to prohibited conduct that occurs after October 22, 2004.

**g. Section 10.51 – Incompetence and Disreputable Conduct**

(1) Incompetence and disreputable conduct for which a practitioner may be sanctioned under § 10.50 includes, but is not limited to, the following:

(a) Conviction of any criminal offense under the federal tax laws.

(b) Conviction of any criminal offense involving dishonesty or breach of trust.

(c) Conviction of any felony under federal or state law for which the conduct involved renders the practitioner unfit to practice before the IRS.

(d) Giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of the Treasury or any officer or employee thereof, or to any tribunal authorized to pass upon Federal tax matters, in connection with any matter pending or likely to be pending before them, knowing the information to be false or misleading.

(1) Facts or other matters contained in testimony, Federal tax returns, financial statements, applications for enrollment, affidavits, declarations, and any other document or statement, written or oral, are included in the term "information."

- (e) Solicitation of employment as prohibited under § 10.30, the use of false or misleading representations with intent to deceive a client or prospective client in order to procure employment, or intimating that the practitioner is able improperly to obtain special consideration or action from the IRS or any officer or employee thereof.
- (f) Willfully failing to make a federal tax return in violation of the federal tax laws, or willfully evading, attempting to evade, or participating in any way in evading or attempting to evade any assessment or payment of any federal tax.
- (g) Willfully assisting, counseling, encouraging a client or prospective client in violating, or suggesting to a client or prospective client to violate, any federal tax law, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade federal taxes or payment thereof.
- (h) Misappropriation of, or failure properly or promptly to remit, funds received from a client for the purpose of payment of taxes or other obligations due the United States.
- (i) Directly or indirectly attempting to influence, or offering or agreeing to attempt to influence, the official action of any officer or employee of the IRS by the use of threats, false accusations, duress or coercion, by the offer of any special inducement or promise of an advantage, or by the bestowing of any gift, favor or thing of value.
- (j) Disbarment or suspension from practice as an attorney, CPA, public accountant or actuary by any duly constituted authority of any state, territory, or possession of the United States, including a Commonwealth, or the District of Columbia, any federal court of record or any Federal agency, body or board.
- (k) Knowingly aiding and abetting another person to practice before the IRS during a period of suspension, disbarment or ineligibility of such other person.

- (l) Contemptuous conduct in connection with practice before the IRS, including the use of abusive language, making false accusations or statements, knowing them to be false or circulating or publishing malicious or libelous matter.
- (m) Giving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or engaging in a pattern of providing incompetent opinions on questions arising under the Federal tax laws.
- (n) Willfully failing to sign a tax return prepared by the practitioner when the practitioner's signature is required by the federal tax laws, unless the failure is due to reasonable cause and not due to willful neglect.
- (o) Willfully disclosing or otherwise using a tax return or tax return information in a manner not authorized by the Internal Revenue Code, contrary to the order of a court of competent jurisdiction, or contrary to the order of an administrative law judge.

**h. Section 10.52 – Violations subject to Sanctions**

- (1) A practitioner may be sanctioned under Section 10.50 if the practitioner willfully violates any of the regulations contained in Circular 230, or recklessly or through gross incompetence violates Section 10.34, Section 10.35 (requirements for covered tax opinions), Section 10.36 (procedures to ensure compliance) or Section 10.37 (requirements for other written tax advice)

**V. AICPA AND STATE ACCOUNTANCY BOARDS.**

**A. AICPA Code of Professional Conduct.** The Code of Professional Conduct ("AICPA Code") adopted by the American Institute of Certified Public Accountants ("AICPA") applies to a member certified public accountant ("CPA"), regardless of his or her respective field (public practice, industry, government, or education).

- 1. Written Directives of AICPA.** The AICPA Code operates in conjunction with two types of written directives, *Interpretations of Rules of Conduct* and *Ethics Rulings*.

- a. Interpretations of Rules of Conduct. *Interpretations* are adopted by the professional ethics division's executive committee after exposure to state societies, state boards, practice units and other interested parties. The *Interpretations* are intended to provide guidelines as to the scope and application of the Code. Any CPA who departs from such guidelines must justify that action in a disciplinary hearing.
  - b. Ethics Rulings apply to individual CPAs. *Ethics Rulings* are formal rulings made by the professional ethics division's executive committee after exposure to state societies, state boards, practice units and other interested parties. The *Rulings* summarize the application of the Code to a particular set of circumstances. Any CPA who disregards a *Ruling* in similar circumstances to which it applies must justify that action before a disciplinary hearing.
- B. CPAs Should Consult State Rules. In addition to the AICPA Code, a CPA should consult the ethical guidelines of state societies, the state board of accountancy, the Securities and Exchange Commission, and any governmental agency which may regulate the particular business or transaction. Many states have rules that require all CPAs to comply with the AICPA Code.
- C. CPAs Must "Honor the Public Trust." The AICPA Code conveys upon every member CPA the general duty to "honor the public trust" and "provide quality services, enter into fee arrangements, and offer a range of services." AICPA Code, § 53, Article II.
- D. CPAs Must Avoid CONFLICTS of Interest. CPAs have a duty to act with integrity, free of conflicts of interest in discharging professional responsibilities, and to demonstrate due care in practice. AICPA Code, § 54-56.
- E. Duty of Confidentiality. A CPA, pursuant to the AICPA, owes a client the duty of confidentiality. AICPA Code § 301.01. The duty, however, cannot cause the CPA to do any of the following:
  - 1. Violate Compliance Standards. Violate the duty to maintain compliance standards under Section 202.01 (AICPA Code § 301.01);
  - 2. Comply With Subpoena or Summons. Avoid complying with a validly issued and enforceable subpoena or summons *Id.*;
  - 3. Prohibit Review of Practice. Prohibit the review of the CPA's professional practice under AICPA authorization *Id.*; or
  - 4. Preclude Initiation of Complaint. Preclude a member CPA from initiating a complaint with, or responding to any inquiry made by, the professional ethics division, the trial board of the AICPA, or another duly

constituted investigative or disciplinary body of a state CPA society or Board of Accountancy *Id.*

F. **With Regard to Tax Advice by CPAs, the AICPA Uses the "Realistic Possibility of Success" Standard.** The AICPA did not use a numerical threshold to describe this "realistic possibility of success" standard. Rather, by interpretive statement, CPAs are provided guidance through a series of 15 illustrations.

1. **The Realistic Possibility Standard.** The AICPA describes the realistic possibility standard as less stringent than the substantial authority standard and the more likely than not standard that apply under the Internal Revenue Code
2. **Due Diligence Required for Evaluating Position.** In determining whether a realistic possibility exists, the AICPA recommends that an accountant do all of the following: establish relevant background facts; distill the appropriate questions from those facts; search for authoritative answers to those questions; resolve the questions by weighing the authorities uncovered by that search; and arrive at a conclusion supported by the authorities.
  - a. **The realistic possibility standard may be met despite the absence of certain types of authority.** For example, an accountant may conclude that the realistic possibility standard has been met when the position is supported only by a well-reasoned construction of the applicable statutory provision.
  - b. **Professional Judgment Required.** In determining whether the realistic possibility standard has been met, the AICPA leaves it to the professional judgment of the accountant to determine the extent of research required with respect to all the facts and circumstances known to the member.
  - c. **Evaluation Must Be Made On Each Position.** The AICPA permits an accountant to conclude that more than one position meets the realistic possibility standard. Therefore, an accountant may advocate two opposing standards if the accountant believes both are acceptable.

## **Notice 2008-12: Items Included**

- Form 990-T, Exempt Organization Business Income Tax Return
- Form 990-PF, Return of Private Foundation or I.R.C. § 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation
- Form 1040, U.S. Individual Income Tax Return
- Form 1040A, U.S. Individual Income Tax Return
- Form 1040-C, U.S. Departing Alien Income Tax Return
- Form 1040EZ, Income Tax Return for Single and Joint Filers With No Dependents
- Form 1040NR, U.S. Nonresident Alien Income Tax Return
- Form 1040NR-EZ, U.S. Income Tax Return for Certain Nonresident Aliens With No Dependents
- Form 1040-PR, Planilla para la Declaración de la Contribución Federal sobre el Trabajo por Cuenta Propia (Incluyendo el Crédito Tributario Adicional por Hijos para Residentes Bona fide de Puerto Rico)
- Form 1040-SS, U.S. Self-Employment Tax Return (Including the Additional Child Tax Credit for Bona Fide Residents of Puerto Rico)
- Form 1040X, Amended U.S. Individual Income Tax Return
- Form 1041, U.S. Income Tax Return for Estates and Trusts
- Form 1041-N, U.S. Income Tax Return for Electing Alaska Native Settlement Trusts
- Form 1041-QFT, U.S. Income Tax Return for Qualified Funeral Trusts
- Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
- Form 1065, U.S. Return of Partnership Income
- Form 1065-B, U.S. Return of Income for Electing Large Partnerships
- Form 1066, U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return
- Form 1120, U.S. Corporation Income Tax Return
- Form 1120-C, U.S. Income Tax Return for Cooperative Associations
- Form 1120-F, U.S. Income Tax Return of a Foreign Corporation
- Form 1120-FSC, U.S. Income Tax Return of a Foreign Sales Corporation
- Form 1120-H, U.S. Income Tax Return for Homeowners Associations
- Form 1120IC-DISC, Interest Charge Domestic International Sales Corporation Return
- Form 1120-L, U.S. Life Insurance Company Income Tax Return
- Form 1120-ND, Return for Nuclear Decommissioning Funds and Certain Related Persons
- Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return
- Form 1120-POL, U.S. Income Tax Return for Certain Political Organizations
- Form 1120-REIT, U.S. Income Tax Return for Real Estate Investment Trusts
- Form 1120-RIC, U.S. Income Tax Return for Regulated Investment Companies
- Form 1120S, U.S. Income Tax Return for an S Corporation
- Form 1120-SF, U.S. Income Tax Return for Settlement Funds (Under I.R.C. § 468B)
- Form 1120X, Amended U.S. Corporation Income Tax Return
- Form 2438, Undistributed Capital Gains Tax Return

### **Notice 2008-12: Items Excluded**

- Form CT-1, Employer's Annual Railroad Retirement Tax Return
- Form CT-2, Employee Representative's Quarterly Railroad Tax Return
- Form 11-C, Occupational Tax and Registration Return for Wagering
- Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return
- Form 706-A, United States Additional Estate Tax Return
- Form 706-D, United States Additional Estate Tax Return Under Code I.R.C. § 2057
- Form 706-GS(D), Generation-Skipping Transfer Tax Return For Distributions
- Form 706-GS(T), Generation-Skipping Transfer Tax Return For Terminations
- Form 706-NA, United States Estate (and Generation-Skipping Transfer) Tax Return -- Estate of nonresident not a citizen of the United States
- Form 706-QDT, United States Estate Tax Return for Qualified Domestic Trusts
- Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return
- Form 720, Quarterly Federal Excise Tax Return
- Form 720X, Amended Quarterly Federal Excise Tax Return
- Form 730, Monthly Tax Return for Wagers
- Form 843, Claim for Refund and Request for Abatement
- Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return
- Form 940-PR, Planilla para la Declaración Federal ANUAL del Patrono de la Contribución Federal para el Desempleo (FUTA)
- Form 941, Employer's QUARTERLY Federal Tax Return
- Form 941-PR, Planilla para la Declaración Federal TRIMESTRAL del Patrono
- Form 941-SS, Employer's QUARTERLY Federal Tax Return
- Form 941-M, Employer's MONTHLY Federal Tax Return
- Form 943, Employer's Annual Federal Tax Return for Agricultural Employees
- Form 943(PR), Planilla Para la Declaración ANUAL De La Contribución Del Patrono De Empleados Agrícolas
- Form 944, Employer's ANNUAL Federal Tax Return
- Form 944-PR, Planilla para la Declaración ANUAL de la Contribución Federal del Patrono 944(SP), Declaración Federal ANUAL de Impuestos del Patrono o Empleador
- Form 944-SS, Employer's ANNUAL Federal Tax Return
- Form 945, Annual Return of Withheld Federal Income Tax
- Form 1040 (Schedule H), Household Employment Taxes
- Form 1040-PR (Anexo H-PR), Contribuciones sobre el Empleo de Empleados Domesticos
- Form 2290, Heavy Highway Vehicle Use Tax Return
- Form 2290(FR), Declaration d'Impot sur L'utilisation des Vehicules Lourds sur les Routes
- Form 2290(SP), Declaración del Impuesto sobre el Uso de Vehículos Pesados en las Carreteras
- Form 4720, Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code
- Form 5330, Return of Excise Taxes Related to Employee Benefit Plans
- Form 8612, Return of Excise Tax on Undistributed Income of Real Estate Investment Trusts
- Form 8613, Return of Excise Tax on Undistributed Income of Regulated Investment Companies

- Form 8725, Excise Tax on Greenmail
- Form 8831, Excise Taxes on Excess Inclusions of REMIC Residual Interests
- Form 8849, Claim for Refund of Excise Taxes
- Form 8876, Excise Tax on Structured Settlement Factoring Transactions
- Form 8924, Excise Tax on Certain Transfers of Qualifying Geothermal or Mineral Interests

**Notice 2008-13: Exhibit 1**

**Tax Returns Reporting Tax Liability**

**Income Tax Returns -- Subtitle A**

Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation;  
Form 990-T, Exempt Organization Business Income Tax Return;  
Form 1040, U.S. Individual Income Tax Return;  
Form 1040A, U.S. Individual Income Tax Return;  
Form 1040EZ, Income Tax Return for Single and Joint Filers With No Dependents;  
Form 1040EZ-T, Request for Refund of Federal Telephone Excise Tax;  
Form 1040X, Amended U.S. Individual Income Tax Return;  
Form 1040-PR (Anexo H-PR), Contribuciones sobre el Empleo de Empleados Domesticos;  
Form 1041, U.S. Income Tax Return for Estates and Trusts;  
Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons;  
Form 1066, U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return;  
Form 1120, U.S. Corporation Income Tax Return;  
Form 1120-C, U.S. Income Tax Return for Cooperative Associations;  
Form 1120-IC DISC, Interest Charge Domestic International Sales Corporation Return;  
Form 1120-F, U.S. Income Tax Return of a Foreign Corporation;  
Form 1120S, U.S. Income Tax Return for an S Corporation;  
Form 1120X, Amended U.S. Corporation Income Tax Return;  
Form 8831, Excise Taxes on Excess Inclusions of REMIC Residual Interests; and  
Form 8924, Excise Tax on Certain Transfers of Qualifying Geothermal or Mineral Interests (New Form, Exclusion from Capital Gains).

**Estate and Gift Tax Returns -- Subtitle B**

Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return;  
Form 706-A, United States Additional Estate Tax Return;  
Form 706-D, United States Additional Estate Tax Return Under Code Section 2057;  
Form 706-GS(D) Generation-Skipping Transfer Tax Return for Distributions;  
Form 706-GS(T) Generation-Skipping Transfer Tax Return for Terminations;  
Form 706-NA, United States Estate (and Generation-Skipping Transfer) Tax Return -- Estate of nonresident not a citizen of the United States;  
Form 706-QDT, United States Estate Tax Return for Qualified Domestic Trusts;  
Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return; and  
Form 843, Claim For Refund and Request for Abatement (also used to claim refunds for employment and certain excise tax returns).

### Employment Tax Returns -- Subtitle C

Form CT-1, Employer's Annual Railroad Retirement Tax Return;  
Form CT-2, Employee Representative's Quarterly Railroad Tax Return;  
Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return;  
Form 940-PR, Planilla para la Declaración Federal ANUAL del Patrono de la Contribución Federal para el Desempleo (FUTA);  
Form 941, Employer's QUARTERLY Federal Tax Return;  
Form 941-PR, Planilla para la Declaración Federal TRIMESTRAL del Patrono;  
Form 941-SS, Employer's QUARTERLY Federal Tax Return;  
Form 941-M, Employer's MONTHLY Federal Tax Return;  
Form 943, Employer's Annual Federal Tax Return for Agricultural Employees;  
Form 943-PR, Planilla para la Declaración ANUAL de la Contribución Federal del Patrono de Empleados Agrícolas;  
Form 944, Employer's ANNUAL Federal Tax Return;  
Form 944-PR, Planilla para la Declaración ANUAL del Patrono;  
Form 944(SP), Declaración Federal ANUAL de Impuestos del Patrono o Empleador;  
Form 944-SS, Employer's ANNUAL Federal Tax Return;  
Form 945, Annual Return of Withheld Federal Income Tax;  
Form 1040-SS, U.S. Self-Employment Tax Return (Including the Additional Child Tax Credit for Bona Fide Residents of Puerto Rico).

### Miscellaneous Excise Tax Returns -- Subtitle D

Form 11-C, Occupational Tax and Registration Return for Wagering;  
Form 720, Quarterly Federal Excise Tax Return;  
Form 720X, Amended Quarterly Federal Excise Tax Return;  
Form 730, Monthly Tax Return for Wagers;  
Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation (with respect to the excise tax based on investment income);  
Form 2290, Heavy Highway Vehicle Use Tax Return;  
Form 2290(FR), Declaration d'Impot sur L'utilisation des Vehicules Lourds sur les Routes;  
Form 2290(SP), Declaración del Impuesto sobre el Uso de Vehículos Pesados en las Carreteras;  
Form 4720, Return of Certain Excise Taxes Under Chapters 41 and 42 of the Code;  
Form 5330, Return of Excise Taxes Related to Employee Benefit Plans;  
Form 8612, Return of Excise Tax on Undistributed Income of Real Estate Investment Trusts;  
Form 8613, Return of Excise Tax on Undistributed Income of Regulated Investment Companies; and  
Form 8849, Claim for Refund of Excise Taxes.

### Alcohol, Tobacco, and Certain Other Excise Taxes -- Subtitle E

Form 8725, Excise Tax on Greenmail; and  
Form 8876, Excise Tax on Structured Settlement Factoring Transactions.

**Notice 2008-13: Exhibit 2**

**Information Returns That Report Information That is or May be Reported on Another Tax Return That May Subject a Tax Return Preparer to the I.R.C. § 6694(a) Penalty if the Information Reported Constitutes a Substantial Portion of the Other Tax Return**

Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding;  
Form 1065, U.S. Return of Partnership Income (including Schedules K-1);  
Form 1120S, U.S. Income Tax Return for an S Corporation (including Schedules K-1);  
Form 5500, Annual Return/Report of Employee Benefit Plan;  
Form 8038, Information Return for Tax-Exempt Private Activity Bond Issues;  
Form 8038-G, Information Return for Tax-Exempt Governmental Obligations; and  
Form 8038-GC, Information Return for Small Tax-Exempt Governmental Bond Issues,  
Leases, and Installment Sales.

**Notice 2008-13: Exhibit 3**

**Forms That Would Not Subject a Tax Return Preparer to the I.R.C § 6694(a) Penalty Unless Prepared Willfully in any Manner to Understate the Liability of Tax on a Return or Claim for Refund or in Reckless or Intentional Disregard of Rules or Regulations**

Form 1099 series of returns;  
Form W-2 series of returns;  
Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding;  
Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.  
Form 990, Return of Organization Exempt from Income Tax;  
Form 990-EZ, Short Form Return of Organization Exempt From Income Tax;  
Form 990-N, Electronic Notice (e-Postcard) for Tax-Exempt Organizations not Required To File Form 990 or 990-EZ;  
Form 1040-ES, Estimated Tax for Individuals;  
Form 1120-W, Estimated Tax for Corporations;  
Form 2350, Application for Extension of Time to File U.S. Income Tax Return;  
Form 2350 (SP), Solicitud de Prorroga para Presentar la Declaracion Del Impuesto Sobre el Ingreso Personal de los Estados Unidos.  
Form 4137, Social Security and Medicare Tax on Unreported Tip Income;  
Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes;  
Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return;  
Form 4868 (SP), Solicited de Prorroga Automatic para Presentar la Declaracion del Impuesto Sobre el Ingreso Personal de los Estados Unidas.  
Form 5558, Application for Extension of Time to File Certain Employee Plan Returns;  
Form 7004, Application for Automatic 6-Month Extension of Time To File Certain Business Income Tax, Information, and Other Returns;  
Form 8109, Federal Tax Deposit Coupon;  
Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips;  
Form 8809, Application for Extension of Time to File Information Returns;  
Form 8868, Application for Extension of Time To File an Exempt Organization Return;  
Form 8892, Application for Automatic Extension of Time to File Form 709 and/or Payment of Gift/Generation-Skipping Transfer Tax; and  
Form 8919, Uncollected Social Security and Medicare Tax on Wages.