NEW YORK STATE BAR ASSOCIATION TAX SECTION

APPENDIX TO

REPORT ON THE DEFINITION OF "TAX RETURN PREPARER" AND OTHER ISSUES UNDER CODE SECTIONS 6694, 6695 AND 7701(a)(36)

APPENDIX DESCRIBING RULES, THEIR HISTORY AND OTHER BACKGROUND

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I. SECTIONS 6694 AND 7701(A)(36) PRIOR TO MAY 2007 AMENDMENTS

Prior to their amendment in May 2007, Section 6694[1] applied to any person who was an "income tax return preparer" within the meaning of Section 7701(a)(36). Section 6694 had two separate rules: Section 6694(a) applied to an income tax return preparer who acted "knowingly"; and Section 6694(b) applied to an income tax return preparer who acted "willfully", "recklessly" or with intentional disregard of rules or regulations.

Specifically, Section 6694(a) provided that an income tax return preparer is liable for a $250 penalty if there is an "understatement" with respect to the return (taken as a whole) that is due to a position the preparer knew (or reasonably should have known) of, unless:

(i) the position had a realistic possibility of being sustained on the merits ("RPSM"), which is generally considered to mean a 1/3 chance of success,

(ii) the position was not "frivolous" (generally considered to mean a 5-10% chance of success) and was disclosed "as provided in section 6662(d)(2)(B)(ii)", or

(iii) there was "reasonable cause for the understatement and [the preparer] acted in good faith".

Disclosure "as provided in section 6662(d)(2)(B)(ii)" refers to the disclosure made by a taxpayer and means that an IRS Form 8275 (or Form 8275-R) disclosure statement describing the position was filed with the income tax return. (This is explained more fully below.)

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[1] All "Section" references are to sections of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise noted.

Section 6694(b) provided that an income tax return preparer as to a return is liable for a $1,000 penalty if any part of the "understatement" with respect to the return (taken as a whole) is due to:

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

(ii) any "reckless or intentional disregard of rule or regulations" by the preparer.

Section 7701(a)(36) provided the definition of "income tax return preparer":

> "The term 'income 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 subtitle A or any claim for refund of tax imposed by subtitle A. 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."[2]

II. DESCRIPTION OF MAY 2007 AMENDMENTS (H.R. 2206) TO SECTIONS 6694 AND 7701(a)(36) AND RELATED CODE PROVISIONS

A. Section 6694

H.R. 2206[3] made three changes to Section 6694:

First, "income tax return preparer" was changed to "tax return preparer", so that both Sections 6694(a) and (b) now apply to any "tax return preparer".

Second, the two exceptions from the Section 6694(a) penalty that are based upon the strength of the return position were amended to provide that a preparer could avoid the penalty if:

(i) "there was … a reasonable belief that the position would more likely than not be sustained on its merits" (we refer to this as "MLTN"), which means a more than 50% chance, or

(ii) there was "a reasonable basis for the position" (which is generally considered to mean a 20% chance of success) and it was "disclosed as provided in section 6662(d)(2)(B)(ii)".

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[2] Subtitle A consists of Sections 1 through 1563.

[3] These changes were contained in §8246 of the *U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007, Subtitle B Small Business and Work Opportunity Tax Act of 2007* (Pub. L. No. 110-28) ("H.R. 2206").

The third exception (reasonable cause and good faith) was retained.

Third, the monetary penalties in both Sections 6694(a) and (b) were increased. Under Section 6694(a), the penalty is now the greater of $1000 and "50% of the income derived (or to be derived) by the tax return preparer with respect to the return or claim"; and under Section 6694(b), the penalty is now the greater of $5000 and 50% of the income derived (or to be derived) by the preparer.

Amended Section 6694(a) reads as follows:

> "6694(a) Understatement Due To Unreasonable Positions.--
>
> 6694(a)(1) In General.--Any tax return preparer who prepares any return or claim for refund with respect to which any part of an understatement of liability is due to a position described in paragraph (2) shall pay a penalty with respect to each such return or claim in an amount equal to the greater of
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> 6694(a)(1)(A) $1,000, or
>
> 6694(a)(1)(B) 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.
>
> 6694(a)(2) Unreasonable Position.--A position is described in this paragraph if--
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> 6694(a)(2)(A) the tax return preparer knew (or reasonably should have known) of the position,
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> 6694(a)(2)(B) there was not a reasonable belief that the position would more likely than not be sustained on its merits, and
>
> 6694(a)(2)(C)
>
> 6694(a)(2)(C)(i) the position was not disclosed as provided in section 6662(d)(2)(B)(ii), or
>
> 6694(a)(2)(C)(ii) there was no reasonable basis for the position.
>
> 6694(a)(3) Reasonable Cause Exception.--No penalty shall be imposed under this subsection if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith."

B. Section 6696

H.R. 2206 also amended Section 6696(e), which defines the terms "return" and "claim for refund" for purposes of Sections 6694, 6695 and 6695A. The amendments replaced each reference to "subtitle A" with a reference to "this title", which means title 26 (*i.e.*, the entire

Code). Thus, the term "return" is now defined for Section 6694 purposes as "any return of any tax imposed by this title".[4]

C. Section 7701(a)(36)

H.R. 2206 also amended Section 7701(a)(36) so that all references to "income tax return preparer" now refer to "tax return preparer" and all references to "subtitle A" refer to "this title". The amended Section 7701(a)(36) reads:

> "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. 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."

D. Other Sections

Finally, H.R. 2206 also amended the following Code sections to change the term "income tax return preparer" to "tax return preparer": Sections 6060, 6103(k)(5), 6107, 6109(a)(4), 6503(k)(4), 6695, 7407 and 7427.

III. REGULATORY DEFINITION OF "INCOME TAX RETURN PREPARER" UNDER PRIOR LAW

As explained above, revised Section 7701(a)(36) now defines a "tax return preparer", but the definition is in all other respects identical to the prior definition of an "income tax return preparer". The Regulations issued under the prior version of Section 7701(a)(36) (and Section 6694) establish the following rules for determining who is an "income tax return preparer":

1. The person must be performing the "preparation" for compensation.[5]

2. A person who does not physically place the information on the return (or review the physical return) is an "income tax return preparer" if the person "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".[6]

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[4] We note that this has created an ambiguity as to whether information returns, such as partnership returns, S corporation returns, and Form W-2s and 1099s, are "returns" for purposes of Section 6694.

[5] Treas. Reg. §301.7701-15(a)(4).

[6] Treas. Reg. §301.7701-15(a)(1).

3. A person who only gives advice (which can be entirely oral[7]) on specific issues of law is a preparer of the entries to which the advice relates if:

   a. the advice is given with respect to events which have already occurred at the time the advice is rendered;[8] and

   b. the advice is "directly relevant to the determination of the existence, characterization, or amount of an entry" on the return.[9]

4. The person must have "prepared" all or a "substantial portion" of the return.[10]

   a. If the person has prepared less than all of a return, he is an "income tax return preparer" if the entries he prepared, in the aggregate, constitute a "substantial portion" of the return. Whether a schedule, entry, or other portion of a return 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 or, and tax liability or refund involved in, the return or claim for refund as a whole."[11]

   b. Under a *de minimis* exception, a portion of a return is not considered a "substantial portion" if it involves, in the aggregate, amounts (i) less than $2,000 or (ii) less than $100,000 and also less than 20% of gross income as shown on the return.[12]

5. A preparer of one return (*e.g.*, a partnership return or an S corporation return) is not considered a preparer of another return (*e.g.*, the income tax return of a partner or shareholder) unless the entries reported on the first return "are directly reflected on the other return and constitute a substantial portion of the other return".[13]

6. The employer of a preparer is itself also a preparer.[14]

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7 *See* Treas. Reg. §1.6694-1(b)(2).

8 Treas. Reg. §301.7701-15(a)(2)(i).

9 Treas. Reg. §301.7701-15(a)(2)(ii).

10 Treas. Reg. §§301.7701-15(a) and (b)(1).

11 Treas. Reg. §301.7701-15(b)(1).

12 Treas. Reg. §301.7701-15(b)(2).

13 Treas. Reg. §301.7701-15(b)(3).

14 Treas. Reg. §301.7701-15(a).

7. If two (or more) persons within the same firm (employee #1 and employee #2) would both be "preparers", only one of them (plus their employer) is a "preparer" (this is the "one-per-firm rule") for purposes of Section 6694 (which is only one of the many Codes sections applicable to preparers).[15] To determine which one of these persons is the preparer, you need to first determine whether anyone from that firm is a "signing preparer" (under the rules described in the following section). If none of them is the signing preparer, then the preparer is the one individual with overall supervisory responsibility for the advice given by the firm.[16] Note that all the individuals at this firm could have contributed significantly, but only one will be a preparer. Oddly enough, someone who is not employed by this firm but gave advice to the taxpayer or to this firm (or otherwise prepared a portion of the return) could be another nonsigning preparer even if this person did less with respect to the return than the employees of this firm who escape the preparer designation.

8. An employee is not a preparer of his employer's return (or of the return of any corporation linked by 50% voting power with his employer), or of the returns of officers or other employees of his employer. In the case of a partnership, a general partner is not a preparer of the partnership's return, or of the returns of other general partners of the partnership.[17]

9. Mechanical assistance in the preparation of a return does not make a person a preparer.[18]

10. There is no specified limit on the number of preparers of any single return or claim for refund.[19]

IV. SIGNING AND NONSIGNING PREPARERS

A. Difference Between "Signing Preparer" and "Nonsigning Preparer"

The Section 7701(a)(36) Regulations identify all the "income tax return preparers" of a return. The current Regulations under Section 6694 then separate those preparers into two types: "signing preparers" and "nonsigning preparers". Any preparer who is not the signing preparer is a nonsigning preparer.

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[15] Treas. Reg. §1.6694-1(b)(1).

[16] Treas. Reg. §1.6694-1(b)(1).

[17] Treas. Reg. §301.7701-15(d).

[18] Treas. Reg. §301.7701-15(d)(1)

[19] The Regulations exclude certain other persons including: (i) a person who prepares a return as a fiduciary; and (ii) a person who prepares a refund claim after an audit of the taxpayer.

There is only one "signing preparer" (*i.e.*, person obligated by Section 6695 to sign the return as the preparer) of any single return. Technically, anyone who is as a preparer under the "substantial portion" rule is potentially the person obligated to sign as preparer. Generally, the person who has the primary responsibility for preparing the physical return (or had the overall responsibility for its preparation) is the person obligated to sign, and everyone else is a nonsigning preparer.

The technical rules for determining who is the "signing preparer" are as follows:

1. If a return has only one preparer, that preparer must sign the return.[20]

2. If there are two or more preparers, the return must be signed by "the individual preparer who has the primary responsibility as between or among the preparers for the overall substantive accuracy of the preparation of such return."[21] Performing merely the mathematical computations does not make a person the preparer with the primary responsibility.[22]

3. If the policies and practices of a firm require a partner to finally review the return, that partner must sign the document, even if the firm also gives a senior employee substantial supervisory responsibilities and even if the partner may not always fully exercise his review responsibilities.[23]

It is not always clear who the "signing preparer" is and even the IRS has found it difficult to apply its own rules to certain situations. For example, in PLR 7723032 (March 14, 1977), the IRS refused to rule on which one of the individuals involved was the signing preparer, but did rule that the organization (the individuals' employer) could not be the signing preparer and that whichever individual was determined to be the one obligated to sign was obligated to sign as an individual. The Preamble to the Section 6695 Regulations explains that the Regulations specifically require the signature of the individual preparer (instead of a signature in the name of the firm), so as to provide the IRS with a record of the individual who is actually responsible for the overall accuracy of the document.[24]

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[20] Treas. Reg. §1.6695-1(b)(1).

[21] Treas. Reg. §1.6695-1(b).

[22] Treas. Reg. §1.6695-1(b)(3), *Examples 1* and *2*.

[23] Treas. Reg. §1.6695-1(b)(3), *Example 2*. *See* also P.L.R. 7718019 (Feb. 4, 1977) (describing in detail the internal procedures at an accounting firm for return preparation and ruling on which of the various individuals involved was the one obligated to sign the return as the "signing preparer").

[24] T.D. 7519, 1978-1 C.B. 391.

If the preparer is unavailable for signature, another preparer must review the entire preparation of the return and then sign the return.[25] The only circumstance under which a person can sign her name to a return she did not prepare is if the signer reviews the entire preparation of the return and is satisfied that the return is prepared properly.[26] The Regulations do not permit the return preparer to delegate the signing of the return to another individual.[27]

B. Consequences of Being a Signing Preparer or Nonsigning Preparer

In addition to being subject to Section 6694, the other consequences under the Code of being a preparer are as follows.

> Section 6695: "A 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 willful neglect."[28] The Regulations provide that an individual who is an income tax return preparer with respect to a tax return shall sign the return after it is completed and before it is presented to the taxpayer for signature.[29]
>
> Section 6060: Any employer of a preparer (and any sole-proprietor preparer) must retain a record (name, TIN, and place of work of each return preparer) and make the record available to the IRS upon request.[30]
>
> Section 6107: A preparer must furnish a completed copy of the return to the taxpayer for the taxpayer's signature, and must retain a copy of the return or a list of the taxpayers for whom returns were prepared.
>
> Section 6107(c) authorizes regulations that provide that compliance by one preparer is deemed to be compliance by the others. There are no such regulations. Treas. Reg.

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25 Treas. Reg. §1.6695-1(b)(1)

26 *U.S. v. Bailey*, 789 F.Supp. 788, 815 (N.D. Tex. 1992).

27 Treas. Reg. §1.6695-1(b)(1)

28 Section 6695(b).

29 Treas. Reg. §1.6695-1(b)(1).

30 Treas. Reg. §1.6060-1. The Code authorizes the Secretary to require the record to be filed. The regulation requires simply that the record be available for inspection upon request.

§1.6107-1 states only that the employer of a preparer is the "preparer" for purposes of the §6107 requirements.[31]

Section 6109(a)(4): A return "prepared" by a preparer must show the preparer's TIN. Treas. Reg. §1.6109-2 limits this by providing that only the "signing" preparer's TIN is required on the return.

Section 6695: A "preparer" must sign the return.[32] (This is subject to the Treas. Reg. §1.6695-1(b)(2) tie-breaker rule for who must sign if there are two potential signers in the same firm.)

Section 6695 also sets out the monetary penalties for any failure to comply with Sections 6060, 6107, 6109(a)(4) or 6694. Each of these statutory provisions has a statutory "reasonable cause" exception.

To resolve the fact that each of the foregoing obligations can be performed by only one person per return, and practically cannot be performed by the nonsigning preparer,[33] each section of the Regulations indicates (somewhat ambiguously) that the reasonable cause exception applies to every failure by the nonsigning preparer to perform these obligations. The Regulations do this by first referring to the existence of the reasonable cause exception and then stating the following conclusion:

> "Thus, no penalty may be imposed . . . upon a person who is an income tax return preparer solely by reason of—
>
> (i) section 301.7701-15(a)(2) and (b) on account of having given advice on specific issues of law; or
>
> (ii) section 301.7701-15(b)(3) on account of having prepared the return solely because of having prepared another return which affects amounts reported on the return."[34]

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[31] Treas. Reg. §1.6107-2 says: "The Commissioner may prescribe the form and manner of satisfying the requirements imposed by section 6107(a) and (b) and §1.6107-1(a) and (b) in forms, instructions, or other appropriate guidance (see §601.601(d)(2) of this chapter)." This regulation was adopted in 2004 to facilitate electronic filing of returns. T.D. 9119.

[32] Section 6695 also includes a diligence requirement for preparers preparing returns claiming the earned income credit and a prohibition on a preparer negotiating an IRS check issued to a taxpayer.

[33] It is interesting that the obligation under Section 6060 to maintain records of the names, TINs and place of work of all preparers is something that the employer of nonsigning preparers could practically do, but that obligation, like all the others, is made essentially inapplicable to nonsigning preparers. Thus, these Regulations appear to acknowledge that none of these rules (other than Section 6694) should apply to nonsigning preparers.

[34] Treas. Reg. §§1.6695-1(a)(1), (b)(4), (c)(1), and (d)(1).

Note that this is the only way in which a nonsigning preparer is safeguarded from facing a penalty for not complying with the obligations to (i) present the return to the taxpayer for signature (Section 6107); (ii) show the preparer's TIN on the return (Section 6109); (iii) sign the return (Section 6695); and (iv) maintain a record of each return preparer employed (Section 6060). Technically, the nonsigning preparer is still obligated to do these things, he is just told by these Regulations that if faced with the imposition of a penalty for not having done so, he can claim the "reasonable cause" defense.

> Section 6103(k)(5): If a penalty was imposed on a tax return preparer, this fact may be disclosed to state agencies that regulate return preparers.
>
> Section 7407: The IRS may seek an injunction prohibiting a preparer from engaging in certain practices.

V. REFERRAL OF SECTION 6694 VIOLATIONS TO OFFICE OF PROFESSIONAL RESPONSIBILITY

The Internal Revenue Manual currently provides that if a practitioner is found to have violated Section 6694(a) or (b), there must be an automatic referral of the practitioner to the Office of Professional Responsibility.[35]

This is contrary to the 1989 legislative history to Section 6694(a) which included the following under its discussion of the new Section 6694(a):

> "The committee intends that imposition of this penalty not lead to an automatic referral to the Internal Revenue Service Director of Practice. The committee believes that the IRS should exercise discretion in referring the specific cases to the Director of Practice. The committee also intends that, in exercising this discretion in response to this provision, the IRS not generally expand its investigations of preparer penalty cases."[36]

Both the 1989 House Report and the Conference Committee Report also contained a list of Administrative Recommendations to the IRS, which included the following:

> "(1) Disciplinary sanctions by the Director of Practice should not be viewed as an adjunct to the civil tax penalty system as it applies to tax return preparers. In matters involving non-willful conduct, the IRS should only refer cases to the Director of Practice

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[35] *See* Section 4.11.55.4.2.2.1 of the Internal Revenue Manual: "Situations Requiring a Mandatory Referral: ... A. Understatements due to unrealistic positions (IRC §6694(a)) - when closed agreed, sustained in Appeals, or closed unagreed without Appeals contact.

B. Willful or reckless conduct (IRC §6694(b)) - when closed agreed, sustained in Appeals, or closed unagreed without Appeals contact."

[36] House Rep. 101-247, at 1396.

in instances where the IRS can establish a pattern of failing to meet the required standards. An isolated instance in which a penalty may apply should not, in and of itself, require a referral unless willful conduct is involved.

....

(3) The IRS should instruct its employees that they cannot threaten the use of preparer penalties during an examination, Appeals conference, or other proceedings involving a tax advisor."[37]

VI. LEGISLATIVE HISTORY OF H.R. 2206 AND PRIOR PROPOSALS

A. Legislative History of H.R. 2206

H.R. 2006 was considered and passed by the House of Representatives and the Senate on May 24, 2007. The only descriptive legislative history is a Technical Explanation prepared by the Joint Committee on Taxation and released on May 24, 2007, in connection with the House's consideration of the Bill.[38]

This Joint Committee Explanation explained the existing law definition of an income tax return preparer as: "any person who prepares for compensation, or who employs other people to prepare for compensation, all or a substantial portion of an income tax return or claim for refund." There is no discussion whatsoever of the concept of "signing" and "nonsigning" preparers, or the fact that pursuant to the Regulations advice-givers may be "preparers".

In addition, the statutory text of the May 2007 amendment's effective date provisions and the Joint Committee's explanation of that provision suggest that Congress was not aware that the giving of advice itself could make someone a "preparer". The effective date provision (and the Joint Committee' explanation of it) both are as follows: "The provision is effective for tax returns prepared after the date of enactment." This statement reflects a concept of return preparation being a physical act that involves the preparer physically completing the tax return. This statement seems difficult to apply to advice-giving that is considered "return preparation".

As will be seen in the next section, none of the events leading up to the enactment of H.R. 2206 suggest that Congress intended or expected the revisions to Section 6694 to apply to advisors (or even persons who review or prepare small portions of tax returns).

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[37] House Rep. 101-247, at 1406; House Conf. Rep. 101-386, at 662-663.

[38] Joint Committee on Taxation, *Technical Explanation of the "Small Business and Work Opportunity Tax Act of 2007" And Pension Related Provisions Contained in H.R. 2206 as Considered by the House of Representatives on May 24, 2007* (JCX-29-07), May 24, 2007.

B. Prior Legislative Proposals to Change the Return Preparer Rules

1. November 5, 1999: Joint Committee on Taxation, Study Entitled, "Comparison of Recommendations of the Joint Committee on Taxation Staff and the Treasury Relating to Interest and Penalties"

In 1999, the Joint Committee on Taxation and the Treasury Department each released studies on the penalty and interest provisions of the Code, in response to mandates that they do so contained in The Internal Revenue Service Restructuring and Reform Act of 1999. That law directed each of them to make recommendations they deemed appropriate to simplify the administration of penalties and reduce taxpayer burdens. Both studies suggested changes to Sections 6694 and 6662. These two studies[39] were summarized in a side-by-side table format in the Joint Committee on Taxation's *Comparison of Recommendations of the Joint Committee on Taxation Staff and the Treasury Relating to Interest and Penalties*.[40]

For Section 6694, the studies recommended that the "RPSM" standard for undisclosed positions be increased to (i) MLTN (Joint Committee study) and (ii) substantial authority (Treasury Department study); and that the "not frivolous" standard for disclosed positions be increased to (i) substantial authority (Joint Committee study) and (ii) RPSM (Treasury Department study).[41]

The studies also recommended an increase in the monetary penalties under Section 6694: the Joint Committee recommended (i) for Section 6694(a), the greater of $250 and 50% of the preparer's fee and (ii) for Section 6694(b), the greater of $1,000 of 100% of the preparer's fee; the Treasury recommendations were similar but without a specific percentage being identified.

2. March 2006: President's Fiscal Year 2007 Budget Proposal

The President's Fiscal Year 2007 Budget Proposal proposed revising the return preparer rules by extending the return preparer penalties to preparers of all types of returns and related documents; no other changes to these rules were proposed. The Joint Committee estimated that these revisions would raise $3 million per year (through 2016).[42]

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[39] Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions As Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS-3-9), July 22, 1999; and Department of the Treasury, *Report to Congress on Penalty and Interest Provisions of the Internal Revenue Code*, October 1999.

[40] Joint Committee on Taxation, *Comparison of Recommendations of the Joint Committee on Taxation Staff and the Treasury Relating to Interest and Penalties* (JCX-79-99), November 5, 1999.

[41] The May 2007 amendments were (i) MLTN for undisclosed positions (i.e.., the same as the Joint Committee's recommendation) and (ii) reasonable basis for disclosed positions (which is a lower standard than both studies recommended for disclosed positions).

[42] Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2007 Budget Proposal* (JCS-1-06), March 2006, p. 248

The Joint Committee on Taxation explanation of the Budget Proposal included the following statement:[43]

> "Penalties for the failure to comply with tax laws are a necessary component of any tax system if broad compliance is to be expected. The present-law penalties that apply to income tax return preparers serve to establish and validate the standards of behavior set forth by the tax laws themselves, as well as to prevent specific departures from and enforce such laws. The proposal to expand present-law penalties for income tax return preparers to paid preparers of all types of tax returns and documents may enhance compliance by imposing on non-income tax return preparers the same or similar requirements that apply to income tax return preparers. In addition, the proposal may achieve a measure of uniformity and promote fairness in the tax system by treating similarly situated individuals in the same manner. However, the extent to which the proposal improves the overall functioning of the tax system depends on details which have not been specified, such as the definition of a "non-income tax return preparer" and whether such preparers will be subject to the same standards as income tax return preparers for purposes of imposing penalties for submitting false, incomplete, misleading, or frivolous returns."

3. June and September 2006: S. 1321, "Telephone Excise Tax Repeal and Taxpayer Protection And Assistance Act of 2006"

On June 20, 2006, the Senate Finance Committee approved the "Senate Finance Committee Chairman's Modifications To S. 1321, The 'Telephone Excise Tax Repeal Act Of 2005'". This marked-up bill included the return preparer changes that were eventually enacted in H.R. 2206.[44]

At that time, this was scored as having a negative revenue impact for the first 8 years and then raising $2 million over the final 2 years.[45] Interestingly, sometime between this scoring in June of 2006 and May of 2007 these same provisions were re-scored as raising $82 million over 10 years.

S. Rep. 109-336, to accompany S. 1321, was reported out by the Senate Finance Committee on September 15, 2006. This report contained the following discussion of the proposed changes to the return preparer rules:

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[43] *Id.*

[44] See Joint Committee on Taxation, *Description Of The Chairman's Modification To The Provisions Of S. 1321, The 'Telephone Excise Tax Repeal Act Of 2005' And S. 832, The 'Taxpayer Protection And Assistance Act Of 2005'* (JCS-28-06), June 28, 2006.

[45] Joint Committee on Taxation, *Estimated Revenue Effects of The Chairman's Modification to The Provisions Contained In S. 1321, The 'Telephone Excise Tax Repeal Act of 2005,' And S. 832, The 'Taxpayer Protection and Assistance Act of 2005,' Scheduled For Markup by The Committee on Finance on June 28, 2006* (JCX-29-06), June 26, 2006

"Reasons for Change

Penalties for the failure to comply with tax laws are a necessary component of any tax system if broad compliance is to be expected. Existing preparer penalties do not adequately deter and prevent noncompliance with tax laws. They should be broadened to include returns other than income tax returns. The thresholds of behavior to establish preparer noncompliance should be raised so that scams and schemes and other abusive transactions are discouraged. Penalty amounts have remained constant for years and are considered by some preparers to be a cost of business instead of an economic deterrent. The amounts should be increased to restore their deterrent impact. Preparer penalties also should be broadened to apply to refund claims with no reasonable basis to discourage unnecessary use of IRS resources and delays.

Explanation of Provision

The provision broadens the scope of the present-law preparer penalties to include preparers of estate and gift tax, employment tax, and excise tax returns, and returns of exempt organizations.

The provision alters the standards of conduct that must be met to avoid imposition of the penalties for preparing a return with respect to which there is an understatement of tax. First, the provision replaces the realistic possibility standard for undisclosed positions with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. The provision replaces the not-frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position."[46]

4. February and March 2007: President's Fiscal Year 2008 Revenue Proposals

The President's Fiscal Year 2008 Revenue Proposals proposed making two changes to the return preparer rules:

(1) extending the return preparer penalties to preparers of all types of returns and related documents (as indicated above this was also in the President's Fiscal Year 2007 Revenue Proposals);

(2) increasing the monetary penalties (essentially the same increases that were eventually enacted in H.R. 2206)

This was estimated as raising $80 million over 10 years.[47]

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[46] S. Rep. 109-336, at 51-52.

[47] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals* (Feb. 2007), available at http:/www.treas.gov/offices/tax-policy/library/bluebk07.pdf.

The Treasury's General Explanation described the "Reasons for Change" as follows:

> "Unscrupulous preparers facilitate the reporting of unreasonable and unrealistic positions on various types of returns in addition to income tax returns. Expanding the penalty to other types of returns and increasing the amount of applicable penalties will help to ensure the accountability of preparers."

The Joint Committee on Taxation described the President's proposals as follows:

"Expand preparer penalties

> Penalties for the failure to comply with tax laws are a necessary component of any tax system if broad compliance is to be expected. The present-law penalties that apply to income tax return preparers serve to establish and validate the standards of behavior set forth by the tax laws themselves, as well as to punish specific departures from such laws. Expanding present-law penalties for income tax return preparers to paid preparers of additional types of tax returns and documents may improve tax compliance by imposing on non- income tax return preparers the same or similar requirements that apply to income tax return preparers. In addition, the proposal may achieve a measure of uniformity and promote fairness in the tax system by treating similarly situated individuals in the same manner. However, the extent to which the proposal improves the overall functioning of the tax system depends on details which have not been specified, such as whether preparers of non-income tax returns will be subject to the same standards as income tax return preparers for purposes of imposing penalties for submitting false, incomplete, misleading, or frivolous returns.

Increase preparer penalties

> Proponents argue that the present-law preparer penalty amounts are inappropriately low and, therefore, an inadequate deterrent to noncompliance when substantial dollar amounts of tax are involved. Increasing the dollar amount of preparer penalties increases the expected costs of noncompliant behavior and, thus, could be expected to improve compliance. Proponents also argue that it is appropriate to assess the amount of the penalty by reference to the amount of the preparer's fee, which represents the best measure of the preparer's stake in the taxpayer's return. On the other hand, opponents argue that the imposition of a penalty on the greater of the a flat dollar amount, as increased by the proposal, or 50 percent of the preparer's fee will lead to anomalous results in situations in which the amount of the penalty exceeds the amount of tax in question.

Prior Action

> A similar proposal was included in the President's fiscal year 2007 budget proposal. A similar provision was included in S. 1321, the "Telephone Excise Tax Repeal and

Taxpayer Protection and Assistance Act of 2006," as reported by the Senate Finance Committee."[48]

5. March 2007: Senate Amendments to House Spending Authorization Bill

On March 28, 2007, the Senate (Senators Grassley and Baucus) added amendments to the House's Spending Authorization Bill (subtitled as a bill making emergency supplemental appropriations for the fiscal year ending September 30, 2007).[49] The Senate's amendment added a new Section 550 that was the same as the provisions enacted in H.R. 2206. The Senate Finance Committee issues a release explaining this amendment as adding to the bill one of the President's Fiscal Year 2008 Budget Proposal's tax gap measures, but the amendment differed from the President's 2008 budget proposal in that the amendment included the change in the Section 6694 standards (from RPSM to MLTN and from not frivolous plus disclosure to reasonable basis plus disclosure).[50]

The amended bill was passed by the Senate on March 29, 2007. The Joint Committee on Taxation scored the provision as raising $82 million over 10 years.[51]

6. April, 2007: H.R. 1591,"Small Business and Work Opportunity Tax Act of 2007"

Section 7546 of H.R. 1591, as reported by the House Conference Committee, was the same as the return preparer provisions enacted in H.R. 2206.[52] At this time, the provisions were scored by the Joint Committee as raising $82 million over 10 years.[53]

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[48] Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2008 Budget Proposal* (JCS-2-07), March 26, 2007.

[49] Tax Analysts Doc 2007-7809. The Senate amendment identified these as amendments to H.R. 1591, but the press coverage identified the House bill as H.R. 976.

[50] Summary of Grassley 2nd Degree Amendment #798 to Kennedy #680, H.R. 1591, the Emergency Supplemental (Mar. 28, 2007), Tax Analysts Doc 2007-7903.

[51] Joint Committee on Taxation, *Estimated Revenue Effects Of The Tax Provisions Contained In H.R. 1591, As Passed By The Senate On March 29, 2007* (JCX-22-07), April 4, 2007; *see* Tax Notes Mar. 30, 2007.

[52] *See* H. Rep. 110-107, Tax Analysts Doc 2007-10328; described in detail in Joint Committee on Taxation, *"Technical Explanation of the 'Small Business and Work Opportunity Tax Act of 2007' Contained in H.R. 1591 as Reported by the Conference Committee"* (JCX-24-07), April 24, 2007, Tax Analysts 2007-10308; see also Conf. Rep. Highlights, April 25, 2007, Tax Analysts Doc 2007-10448.

[53] Joint Committee on Taxation, *Estimated Revenue Effects of Revenue Provisions Contained in the Conference Agreement For H.R. 1591* (JCX-25-07), April 24, 2007, Tax Analysts Doc 2007-10307.

7. April 16, 2007: S. 1111 Was Introduced by Senator Wyden[54]

Section 311 of S. 1111 was the same as the provisions enacted in H.R. 2206.

8. May 8, 2007: H.R. 2206 Was Introduced by Representative Obey[55]

Section 7246 of this bill was the same as the Section 8246 of H.R. 2206 that was enacted in May 2007.

C. Congressional Hearings and Other Events

1. Nov. 15, 2006: Internal Revenue Service Advisory Council General Report (11/15/06)[56]

This report explains that the IRSAC is composed of a diverse array of private sector tax professionals with significant experience; each year, the IRS requests the IRSAC's views on important tax administration issues and the IRSAC researches the issues and reports back to the IRS.

This report addressed improving the performance of tax preparers. The IRSAC made the following points: preparers play a "vital" role in our tax system; if they are honest and competent "efficient tax administration is enhanced"; while there are no pre-requisites to being a tax return preparer, there are IRC sections that "describe proper conduct" and specify penalties for violations; while the precise number of person who prepare returns for others is not known, the number is estimated to exceed 1 million; over one half of all individual returns are prepared by paid preparers and the numbers for partnership and corporate returns are even higher.

The IRSAC recommended that the IRS to continue to focus on education and enforcement; and went on the explain that "IRS enforcement efforts with regard to tax preparers have focused on the most egregious instances of preparer fraud and abuse. While this is an appropriate emphasis, the number of cases pursued remains small, and penalties levied are not collected. To be effective, there must be more 'touches' and more effective follow-through."

With respect to the proposals for requiring tax preparers to register with the IRS, the IRSAC's 2006 study repeated the conclusions it had reached in 2001, namely that licensing may not reduce abusive behavior, may increase costs and/or reduce supply thereby hurting the

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[54] Headed as a bill to "make the Federal income tax system simpler, fairer, and more fiscally responsible, and for other purposes." The tax return preparer rule revisions were one of many provisions under the heading "Improvements in Tax Compliance". *See* Tax Analysts Doc 2007-11775.

[55] The Bill heading stated that it was a bill to make "emergency appropriations for the fiscal year ending September 20, 2007, and for other purposes." The return preparer amendments were one of the provisions under the heading "Fair Minimum Wage and Tax Relief". *See* Tax Analysts Doc 2007-11394.

[56] http://www.irs.gov/pub/irs-utl/2006_irpac_public_meeting.pdf.

taxpaying public and that the IRS lacks resources to effectively administer and enforce a registration program.

2. March 20, 2007: House Ways and Means Committee, Subcommittee on Oversight, Hearing Entitled "IRS Operations, 2007 Filing Season, and Tax Gap"

On March 20, 2007, the House Ways and Means Committee held a hearing. As part of these hearings, the AICPA submitted a written statement addressing S. 1321, Section 407 (which would have made the same changes to the preparer rules as H.R. 2206 eventually did make).[57] The AICPA statement explained in detail the AICPA's concerns about the proposed change in the standards in Section 6694.

The AICPA stated that it supported the expansion of Sections 6694 and 6695 to all tax returns, but regarded the change in substantive standards as "unwise" for the following reasons:

> "The AICPA is concerned that elevating the reporting standard for tax return preparers on all return items to the very highest standard that now is imposed only on tax shelter items -- the "more likely than not" standard -- would ultimately become an unworkable burden for the entire tax system. This elevation would not necessarily create the desired result of weeding out abuses in the system but would create the unintended consequence of encouraging tax return preparers to recommend that taxpayers consider filing disclosures on virtually any return item on which there is the slightest question of uncertainty in the ultimate tax result. Clearly, this is not a desired outcome, nor is it likely to focus attention on potentially abusive tax avoidance transactions. The IRS would be swamped with paper; e-filing would be undermined; important disclosures would be overlooked; and a large percent of these voluminous disclosures would be meaningless."

The AICPA went on to explain that due to the complexity of our tax laws and the many issues awaiting administrative guidance, taxpayers and preparers have "wisely" been given the flexibility to make a reasonable interpretation without facing penalties simply because the IRS interprets the rule differently in an audit. Further, the AICPA explained that it is appropriate for the taxpayer to bear the ultimate burden for the contents of the return:

> "The Federal tax law is always changing and as a result, there is often limited or no authority or guidance for a particular return position at the time the return is filed. Even if there is some authority, it may be extremely difficult for taxpayers and preparers to know the probable correctness of many return positions given the exceedingly complex and dynamic nature of the tax law.
>
> It is not only unrealistic, but in many cases impossible, to ensure the high degree of accuracy required should Congress pass legislation imposing a "more likely than not

[57] AICPA Statement Submitted to House Ways and Means Subcommittee on Oversight, Public Hearing: IRS Operations, 2007 Filing Season, and Tax Gap, Tax Analysts Doc 2007-8517.

standard" on preparers in the case of undisclosed positions or even a "realistic possibility of success" standard for disclosed positions. We believe that the unfortunate result will be that taxpayers will be forced to avoid otherwise meritorious positions on their returns or make voluminous boilerplate disclosures that will not improve the overall compliance process.

...

Historically, the preparer standard has been below that of the taxpayer in order to provide an environment where taxpayers have access to the full range of competent, professional advice necessary to navigate through a very complicated tax system. Elevating the preparer standard above the taxpayer standard, particularly for routine transactions, is quite troubling in that the preparer could not sign a tax return reflecting a position that would be proper if the taxpayer prepared the tax return without professional assistance.

...

Rather we support retaining the two-tier, flat dollar penalty under current law. We believe that deterrence for preparers results, not from a dollar penalty, but from the possible adverse impact on the ability to practice and on their reputation for integrity and ethical behavior."

3. April 12, 2007: Senate Finance Committee, Hearing Entitled "Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure"

On April 12, 2007, the Senate Finance Committee held a hearing. The AICPA issued a Statement;[58] the portion of this statement addressing S.1321, Section 407, was the same as statement submitted to House Ways & Means Committee in March 2007 (which is discussed and quoted from above).

Senator Baucus, Chairman of the Senate Finance Committee issued a Hearing Statement[59] that included the following:

"Today's hearing will demonstrate that up-front measures are necessary to prevent inaccurate or false tax returns from being filed. The quality of tax return preparation has a direct effect on tax compliance and the size of the tax gap.

...

[In 2006] the accuracy of eighty million tax returns depended on the education, skill and integrity of tax professionals.

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[58] Tax Analyst Doc 2007-11234.

[59] Available at http://finance.senate.gov.

> Given their enormous effect on tax compliance and the tax gap, it is reasonable to expect that tax preparers will meet high standards of competency and trustworthiness.
>
> ...
>
> I believe that the vast majority of tax professionals are honest, and make every effort to stay up-to-date on the tax laws so the returns they prepare are accurate
>
> Unfortunately, that is not always the case. Anyone can hang out a shingle and charge fees to prepare a tax return without passing a single test or establishing that he or she can be trusted with a social security number or personal financial information.
>
> ...
>
> Today's witnesses will ... demonstrate that our nation's tax system is only as good as the quality and ethics of our nation's tax preparers ... [and] that paid preparers substantially affect the level of tax compliance and that filing season processes are vulnerable to abuse. Their testimony will lay the foundation for legislation I will introduce to strengthen the regulation of paid preparers... ."

Senator Chuck Grassley, the Ranking Member, issued an Opening Statement that included the following:[60]

> "I would have called [the hearing], "Sharks in the Water – Let the Taxpayer Beware," because there seems to be an increasing amount of danger in receiving an inaccurate or even fraudulently prepared tax return.
>
> In 2006, over 62 percent of all individual taxpayers used a paid preparer to complete their tax return. As a result, these preparers have a direct and substantial impact on tax compliance. And while I believe most tax return preparers are honest, knowledgeable individuals who serve the community well in providing sound financial advice, there are clearly some sharks lurking in the water. And these sharks are preying on innocent taxpayers – either through bad advice, incompetence, or downright fraud.
>
> ...
>
> The IRS and the Department of Justice need to pick up the pace on preparer cases.
>
> ...
>
> Paid preparers need to know that they will be held accountable. And the IRS and the Department of Justice need to be more proactive in getting that message across.

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[60] Available at http://www.senate.gov/~finance.

...

> We in Congress need to do more to ensure that those who are preparing returns possess the competence and ethical standards necessary to maintain the integrity of our tax system. Last year, this committee passed a bill that would regulate paid preparers and provide better taxpayer protection and assistance, but it didn't get brought up for a full Senate vote. We need to look at getting a similar bill passed this year.
>
> And while I understand that no amount of regulation is going to prevent outright fraud, it is essential that the IRS impose stringent oversight of the paid tax preparation community and, where applicable, impose penalties and prevent the practitioner from preparing returns and representing taxpayers before the IRS."

Thus, both Senators Baucus and Grassley spoke in favor of additional regulation of return preparers. Commissioner Everson testified at the hearing and expressed his opposition to this: Commissioner Everson described in detail the IRS's efforts in investigating and, where appropriate, prosecuting instances of preparer fraud and the OPR's (Office of Professional Responsibility's) efforts in investigating possible violations of Circular 230 by preparers and imposing penalties under Circular 230. Commissioner Everson concluded by stating that "Regulating the tax preparer community beyond what OPR does would be a monumental task beyond the reach of existing IRS resources. Traditionally, regulation of these types of services occurs at the state level."

The National Society of Accountants filed a Statement for the Record strongly endorsing the Federal regulation of tax preparers.[61] This statement addressed the provisions of S. 832, from the 2006 Congress, which instructed the Treasury Department to develop and administer an eligibility examination for return preparers. The NSA statement included the following: "The [Senate Finance] Committee is well aware that there is a large body of tax preparers who do not belong to any professional organization. The commitment of these individuals to ethics, professionalism, and continuing education is unknown ..."

The U.S. Government Accountability Office delivered a study entitled "2007 Tax Filing Season, Interim Results and Updates of Previous Assessments of Paid Preparers and IRS's Modernization and Compliance Efforts".[62] The study included the following statements: (internal footnotes omitted)

> "Because paid preparers prepared over 62 percent of all individual income tax returns last year, they are a critical quality control for tax administration by helping to prevent noncompliance. ...

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[61] Tax Analysts Doc 2007-9448.

[62] GAO-07-720T.

In most states, anyone can be a paid preparer regardless of education, training, or licensure.

...

Last year we reported to this Committee on errors made by commercial chain preparers, including the results of undercover visits to 19 locations.

In our visits to 19 outlets of several commercial chain preparers, we found that paid preparers made mistakes in every one of our visits, with tax consequences that were sometimes significant. The errors resulted in unwarranted extra refunds of up to almost $2,000 in five instances, while in two cases they cost the taxpayer over $1,500. Some of the most serious problems involved preparers

- not reporting business income in 10 of 19 cases;
- not asking about where a child lived or ignoring our answer to the question and, therefore, claiming an ineligible child for the earned income tax credit in 5 out of the 10 applicable cases;
- failing to take the most advantageous postsecondary education tax benefit in 3 out of the 9 applicable cases; and
- failing to itemize deductions at all or failing to claim all available deductions in 7 out of the 9 applicable cases.

At the time, IRS officials responded that, had our undercover investigators been real taxpayers filing tax returns, many of the preparers would have been subject to penalties for such things as negligence and willful or reckless disregard of tax rules and some may have risen to the level of criminal prosecution for willful preparation of a false or fraudulent return. The taxpayers in these cases would also have been potentially exposed to IRS enforcement action. ...

Because they help the majority of taxpayers prepare their returns, paid preparers are a critical quality control checkpoint for the tax system. Due diligence by paid preparers has potential to prevent non-compliance and reduce IRS's cost and intrusiveness."

Michael R. Phillips, Deputy Inspector General for Audit, Treasury Inspector General for Tax Administration, issued a statement discussing the role of tax practitioners and their regulation under Circular 230. This statement did not directly address tax return preparers.

4. April 18, 2007: Senate Finance Committee, Hearing Entitled "Examining the Administration's Plan for Reducing the Tax Gap: What are the Goals, Benchmarks and Timetables?"

Senator Grassley, the Ranking Member, announced in his Opening Statement that he believed that one of the potential solutions to the tax gap is "ensuring that paid tax preparers provide taxpayers honest and informed assistance in filing their taxes."[63]

VII. LEGISLATIVE AND REGULATORY HISTORY TO 1976 RETURN PREPARER RULES AND 1989 STATUTORY AMENDMENTS

A. Tax Reform Act of 1976.

The tax return preparer rules in Sections 6694, 6695, 7701(a)(36) were first enacted in 1976. To understand what they were intended to accomplish, we need to begin with the law in effect prior to 1976.

1. Law in Effect Prior to Tax Reform Act of 1976

Prior to the 1976 enactments, there were few rules applicable to persons who prepared returns for others for compensation.

The only real U.S. Federal law governing return preparers was in Section 7206(2), which made it a felony if one "willfully aids or assists in, or procures, counsels, or advises the preparation or presentation ... of a return, affidavit, claim or other document, which is fraudulent or false as to any material matter", whether or not the person presenting the document (*i.e.*, the taxpayer/client) was aware of or consented to the falsity. The penalty for this crime was a fine of up to $5,000 and imprisonment for not more than three years or both (plus the costs of prosecution).

The tax return forms required any person who prepared a return for another person taxpayer to sign the return, but there was no penalty for failing to do so. There were no rules requiring persons who were in the business of preparing returns for others to disclose that fact to the IRS.

At that time, there were three penalties possible for taxpayers with understatements:

(i) Section 7201 made it a felony to "willfully attempt[] in any manner to evade or defeat" any tax. The penalty was a fine of up to $10,000 and imprisonment for not more than five years or both (plus the costs of prosecution). This was the taxpayer equivalent of Section 7206(2).

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[63] Available at http://www.senate.gov/~finance.

(ii) Section 6653(a) applied if any part of an underpayment was due to "negligence (or disregard of rules or regulations)". "Negligence" was defined as "a failure to make a reasonable attempt to comply with the rules" and "disregard" was defined as "any careless, reckless, or intentional disregard". The penalty was 5 percent of the underpayment. (This is the predecessor to the current substantial understatement penalties in Section 6662, although those penalties can now apply without the taxpayer having been negligent, careless, reckless, etc.)

(iii) Section 6653(b) applied if any part of an understatement was due to civil "fraud". The penalty was 75 percent of the portion of the underpayment attributable to fraud. (This is the predecessor to the current civil fraud penalty in Section 6663.)

2. Description of 1976 Changes

In 1976, Sections 6694, 6695, 6696 and 7701(a)(36) were enacted. Sections 6694(a) and (b) read as follows:

> "(a) NEGLIGENT OR INTENTIONAL DISREGARD OF RULES AND REGULATIONS.–If any part of any understatement of liability with respect to any return or claim for refund is due to the negligent or intentional disregard of rules and regulations by any person who is an income tax return preparer with respect to such return or claim, such person shall pay a penalty of $100 with respect to such return or claim.
>
> (b) WILLFUL UNDERSTATEMENT OF LIABILITY.–If any part of any understatement of liability with respect to any return or claim for refund is due to a willful attempt in any manner to understate the liability for a tax by a person who is an income tax return preparer with respect to such return or claim, such person shall pay a penalty of $500 with respect to such return or claim. With respect to any return or claim, the amount of the penalty payable by any person by reason of this subsection shall be reduced by the amount of the penalty paid by such person by reason of subsection (a)."

The remainder of Section 6694 was the same as it is today. Section 7701(a)(36) was the same as it was up until the May 2007 changes. Thus, it read as follows:

> "(A) IN GENERAL.–The term "income 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 subtitle A or any claim for refund of tax imposed by subtitle A. 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.
>
> (B) EXCEPTIONS.–A person shall not be an "income tax return preparer" merely because such person–
>
> (i) furnishes typing, reproducing, or other mechanical assistance,
>
> (ii) 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,

(iii) prepares a return or claim for refund for any trust or estate with respect to which he is a fiduciary, or

(iv) prepares a claim for refund for a taxpayer in response to any notice of deficiency issued to such taxpayer or 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."

Thus, the initial Section 6694 applied only to preparers if the understatement resulted form the preparer acting negligently, with intentional disregard of rules and regulations, or willfully.

3. Reasons for 1976 Changes

The 1976 legislative history explains in detail the reasons for the changes made.

The IRS had determined that there had been a significant increase in the number of "persons whose business is to prepare income tax returns for individuals and families of moderate income."[64] The IRS also estimated that one-half of all returns were being prepared with professional or commercial assistance. The IRS and Congress were concerned about two different types of preparer behavior:

First, they were concerned about abusive practices by preparers. The legislative history explained that in some cases preparers had made promises to individuals (for example, that the preparer would, as a result of his/her expertise, obtain a refund for the individual) and then the preparer would claim fictitious deductions or exemptions in order to achieve the promised results. In some cases, the preparer would have the taxpayer sign a blank return so that the individual could not even review the return before it was filed.

The second concern was about preparers making "innocent" errors, based upon misinterpretations of the law or other similar mistakes.

The intent behind the legislation was to provide the IRS with enough information to first determine who had prepared a given return and to then determine which other returns that preparer had prepared. That way, if the IRS detected an error (whether innocent or not so innocent) on a return, the IRS could trace back to the other returns that might have that same error. The legislation was also aimed at providing the IRS with sanctions for preparers that were less severe than the criminal sanctions then available under Section 7206 (and therefore more usable). These new, non-criminal sanctions were intended to "deter preparers from engaging in improper conduct". Thus, the rules were enacted both to discourage this type of behavior (protecting both taxpayers and the fisc), and also to give the IRS tools by which they could, once

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[64] S. Rep. 94-938(I), at 349; H.R. Rep. 94-658, at 274 (substituting "average" for "moderate"); Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* (JCS-33-76), at 346.

they had identified a "bad" preparer, trace back and find all the returns he had prepared for other taxpayers (again, protecting the fisc).

Of particular relevance to us is how the 1976 legislative history describes what a "tax return preparer" is under the new law:

> "Explanation of provision... Definition of income tax return preparer...
>
> An income tax return preparer means any person who prepares, for compensation, all or a substantial portion of a tax return or claim for refund. Whether or not a portion of a return constitutes a substantial portion is to be determined by examining both the length and complexity of that particular portion of the return and the amount of tax liability involved. Generally, the filling out of a single schedule of a tax return would not be considered a substantial portion of that return unless that particular schedule was the dominant portion of the entire tax return.
>
> A person who prepared a return for compensation may be an income tax return preparer even though that person does not actually place the figures on the lines of the taxpayer's final tax return. A person who supplies to a taxpayer sufficient information and advice so that filling out the final tax return becomes merely a mechanical or clerical matter is to be considered an income tax return preparer. However, an individual who gives advice on particular issues of law or IRS policy relating to particular deductions or items of income will not have prepared a return with respect to those issues if the advice does not directly relate to any specific amounts which are to be placed on the return of the taxpayer.
>
> ...
>
> The term "income tax return preparer" includes the employer of persons who prepare the returns of others for compensation as well as the persons actually preparing returns. In cases where more than one person aids in filling out a single return under one employer, the individual who has the primary responsibility for the preparation of the entire return or of a substantial portion of the return will usually be an income tax preparer, while those persons involved only with individual portions of the return will usually not be income tax return preparers. The fact that a person who prepares an entire return or a substantial portion of the return has his work reviewed by a more senior employee does not by itself mean that the person preparing the return is not an income tax preparer."[65]

This legislative history can be interpreted as telling us several things about what Congress meant by "income tax return preparer". First, while Section 7701(a)(36), and in particular the phrase "a substantial portion," can be read literally to contemplate multiple

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[65] S. Rep. 94-938(I), at 351-2; H.R. Rep. 94-658, at 275-276; Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* (JCS-33-76), at 347-348.

preparers, the legislative history suggests that the substantial portion rule was intended to ensure that someone with the primary responsibility for preparation of the return (e.g. "the dominant portion of the entire return"), cannot escape preparer status merely because he or she did not prepare 100% of the return. Second, someone who never touches the return was supposed to be a "preparer" only in cases where that person is actually guiding and determining how the return is completed. Third, and this follows from the second, an advice-giver is not to be treated as a return preparer unless the advice giver is telling the taxpayer how to "place" "specific amounts" "on the return". ("However, an individual who gives advice on particular issues of law or IRS policy relating to particular deductions or items of income will not have prepared a return with respect to those issues if the advice does not directly relate to any specific amounts which are to be placed on the return of the taxpayer.")

4. 1976 and 1977 Regulations

The first two sets of Temporary Regulations, which came out in December 1976 and March 1977, interpreting the new law did not address the definition of "income tax return preparer".[66] The December 1976 Temporary Regulations do assume there may be more than one person performing the preparer functions, but this discussion is in the context of discussing which individual should sign the return and seems to be referring to multiple individuals all employed by the same firm. There is no suggestion in those Regulations that there could be multiple preparers from separate firms.[67]

The first set of regulations addressing the definition of "income tax return preparer" were issued April 1, 1977. [68] These Temporary Regulations (Temp. Treas. Regs. §404.7701-1), seem to be entirely faithful to the 1976 legislative history; they were in Question-and-Answer format and provided as follows:

> "Q-3: Is it required that a person complete all parts of the return in question to be considered an income tax return preparer?
>
> A-3: No. An income tax return preparer is any person who prepares, for compensation, all or a substantial portion of a tax return or claim for refund.
>
> Q-4: What constitutes a substantial portion of a return or claim for refund?
>
> A-4: Whether a portion of a return or claim constitutes a substantial portion is to be determined by comparing the length of, complexity of, and tax liability or refund involved with respect to the portion of the return or claim, to the return or claim as a whole.

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[66] T.D. 7451 (Dec. 29. 1976), 41 F.R. 56631; and T.D. 7473 (March 31, 1977), 42 FR 17124.

[67] *See* Temp. Reg. §404.6695-1(a) (T.D. 7451).

[68] T.D. 7475, 42 F.R. 17452.

Q-5: Is the filing of a single schedule of a tax return considered to be a substantial portion?

A-5: Completion of a single schedule of a tax return will not be considered a substantial portion of the return unless that particular schedule is the dominant portion of the entire tax return.

Q-6: May a person be considered an income tax return preparer even though that person does not actually place or review placement of the figures on the taxpayer's return?

A-6: Yes. A person who supplies to a taxpayer sufficient information and advice so that completing the tax return becomes merely a mechanical or clerical matter is to be considered an income tax return preparer.

Q-7: Does the definition of income tax return preparer include an individual who only gives advice on particular issues of law or Internal Revenue Service policy?

A-7: An individual who only gives advice on particular issues of law or Internal Revenue Service policy relating to particular deductions or items of income will not have prepared a return if the advice does not directly relate to, or is given without regard to or consideration of, any specific amounts which are to be placed on the return of the taxpayer. Furthermore, an individual will not have prepared a return if the advice is not given in connection with the preparation of a return."

These Q&A's appear to us to follow quite closely the legislative history quoted above. Q&A-3 emphasizes that someone who completed "a substantial portion," but not all, of a return could not disclaim liability under Section 6694 on grounds of having not prepared "all" of the return. Q&A-5 suggests that a Schedule Preparer was not intended to be a 6694 Preparer unless the schedule was "the dominant portion" of the return. Q&A-7 suggests several things about the Pure Advisor: first, that the Pure Advisor was not intended to be a 6694 Preparer unless the Pure Advisor was really a Shadow Preparer; and second, that the Pure Advisor could be a 6694 Preparer only if the Pure Advisor gave the advice as part of the return-preparation process.

Only four months later, on August 3, 1977, new Proposed Regulations were issued,[69] which radically changed the scope of the definition. Notably, the preamble to the August 1977 regulations failed to even acknowledge these radical changes, although they did refer to the April Temporary Regulations. The August 3, 1977 Proposed Regulations were almost identical to the Regulations in effect currently (and the portions that are relevant to the issues addressed in our report were in all substantive respects identical). These Proposed Regulations were finalized in November of 1977. [70]

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[69] 42 F.R. 39227.

[70] T.D. 7519, 42 F.R. 59961 (Nov. 23, 1977).

In 1980 and 2002 amendments were made to add explicit exclusions for persons who prepare returns as part of low-income taxpayer clinics.[71]

B. 1989 Legislative Amendments

1. Law in Effect Prior to 1989 Amendments.

As explained above, when Section 6694 was first enacted in 1976, Section 6694(a) applied a penalty only if the preparer was "negligent" or intentionally disregarded rules or regulations, and Section 6694(b) applied if the preparer "willfully understated" a taxpayer's liability. Thus, Treasury and the IRS issued the August 1977 version of Treas. Regs. §301.7701-15 (*i.e.*, the version that survives to this day) at a time when being an "income tax return preparer" subjected a person to liability under Section 6694 only if that person acted in a manner that was deficient and unprofessional. Broadening those regulations as was done in August 1977 to apply them to what we call Pure Advisors perhaps seemed defensible at that time since the behavior had to be fairly egregious to be sanctionable under Section 6694.

2. Summary of 1989 Changes

In 1989, Section 6694 was significantly revised. The "intentional disregard or rules and regulations" was moved from Section 6694(a) to Section 6694(b), so that (b) now covers understatements that arise from willfulness or intentional disregard of rules and regulations. The "negligent" understatement concept was removed and (a) was refashioned to apply to understatements based upon whether there was a requisite substantive level of support. (The same concept was added for taxpayers in Section 6662.) Thus, Section 6694(a) applied unless the understatement arose from a position that either (1) had a RPSM or (2) was not frivolous and was adequately disclosed.

3. Reason for Changes

The 1989 legislative history explains that the House Ways and Means Committee had determined that it was appropriate to perform a comprehensive review and overhaul of the penalties rules applicable to preparers, promoters and tax protesters, since those rules had been enacted over the years on a piecemeal basis. With respect to the preparer penalties, the House Report explains: "The committee has adopted this new standard because it generally reflects the professional conduct standards applicable to lawyers and to certified public accountants."

This legislative history is referring to the formal positions that had been adopted by the ABA (in 1985) and the AICPA (in 1987). It appears from the legislative history that Congress determined that the Code should reflect the same standards as the professional organizations had decided should apply to their members. The penalty at this time was raised from $100 to $250.

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[71] T.D. 7675, 1980-1 C.B. 318; and T.D. 9026, 2003-1 C.B. 366.

4. Regulations Responding to 1989 Amendments

To reflect these amendments, the Regulations under Section 6694 were amended to read as they do today.[72]

VIII. SECTION 6662 AND 6664 SUBSTANTIAL UNDERSTATEMENT PENALTY RULES APPLICABLE TO TAXPAYERS

Because preparers have taxpayer as clients, it is important to understand the penalty standards that apply to taxpayers when they have understatements on their returns.

A taxpayer can be liable for a penalty if the taxpayer's return has a "substantial understatement". An "understatement" equals (i) the amount that *should* have been shown on the return minus (ii) the amount that *was* shown on the return. An understatement is "substantial" if it exceeds either (x) 10% of the amount of tax required to be shown on the return or (y) $5000 (for an individual) and $10 million (for a corporation).

A taxpayer has three possible defenses. Each position that led to an understatement is tested separately for the applicability of a defense. If a defense is available, the understatement of taxes resulting from that position is ignored in determining if there is a "substantial understatement". This impacts both the possibility that the substantial understatement hurdle will be surpassed and also means that there is no penalty as to that position because the penalty is equal to 20% times the amount of "understatements".

The three different possible defenses available to a taxpayer are:

-- Section 6662(d)(2)(B)(i): there was or is "substantial authority" for the taxpayer's position;

-- Section 6662(d)(2)(B)(ii): there is a "reasonable basis" for the taxpayer's position and the position was adequately disclosed on an IRS Form 8275 filed with the return; and

-- Section 6664(c)(1): there was substantial authority for the taxpayer's position plus there was a "reasonable cause" for the underpayment and the taxpayer acted in "good faith".

If the transaction or arrangement giving rise to the tax item has "a significant purpose of ... the avoidance or evasion of Federal income tax" (a phrase used in Section 6662(d), but never defined), then the first two defenses are not available. Section 6662(d) refers to any such transaction or arrangement as a "tax shelter". We will refer to it in this report as a "6662(d) tax shelter". For items arising from a 6662(d) tax shelter, the only possible defense to penalties is the third defense – the "reasonable cause and good faith" defense.

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[72] *See* T.D. 8382 (Dec. 30, 1991).

Therefore, if an understatement arises from a 6662(d) tax shelter, the taxpayer will get no penalty-defense benefits from filing a Form 8275 disclosure statement.[73]

Substantial authority: The substantial authority standard is an objective standard based on an analysis of the law and application of the law to relevant facts. Regulations explain that it is less stringent than the more likely than not standard, but more stringent than the reasonable basis standard.[74]

Reasonable basis plus disclosure: Reasonable basis is a standard "significantly higher" than not frivolous or not patently improper, and is not met by a position that is merely arguable or a colorable claim.[75] Disclosure requires a completed Form 8275 or 8275-R to be attached to the return.[76]

Substantial authority plus reasonable cause and good faith: Substantial authority is applied using the same objective standard summarized above. Determination of whether a taxpayer acted in reasonable cause and good faith is made a case-by-case standard, taking into account all pertinent facts and circumstances. Generally, the most important factor is "the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." Facts that the Regulations indicate may be persuasive are honest and reasonable misunderstandings of law or fact, or reliance on professional advice, but no single factor is dispositive.[77]

IX. ABA 2000 STATEMENT ON ETHICAL OBLIGATIONS OF TAX RETURN PREPARERS WITH RESPECT TO DISCLOSURE

In 2000 the ABA Section of Taxation Committee of Standards of Tax Practice issued Statement 2000-1 (posted December 4, 2000) addressing whether the differences between the accuracy standards for taxpayers and lawyers created a conflict of interest for lawyer and, if so, the ethical options available to the lawyer in such a situation.[78] This statement presents 12 hypothetical situations and analyses the conflict, if any, in each case for the nonsigning preparer and the signing preparer. There is a conflict in five of the hypotheticals because in each of those disclosure would benefit the lawyer but would not benefit the taxpayer (either because the taxpayer has penalty protection without it or would not gain any penalty protection by having it).

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[73] The legislative history to Sections 6662(d) and 6664 discusses this but provides no clarity as to the rationale behind this.

[74] Treas. Regs. §1.6662-4(d)(2)

[75] Treas. Regs. §1.6662-3(b)(3)

[76] Treas. Regs. §1.6662-4(f)(1)

[77] Treas. Regs. §1.6664-4(b)

[78] Located at http://www.abanet.org/tax/groups/stp/stmt00-1.html.

Statement 2000-1 says that the nonsigner preparer or advisor would be acting in compliance with Section 6694, Circular 230 and his professional responsibilities if he advised the client regarding the ability to avoid penalties through disclosure. The Statement goes on to say the following with respect to the signing preparer:

> "If the lawyer acts as signing preparer of the return in any of the five situations where a conflict exists between client and lawyer, the lawyer should advise the client fully concerning the penalty aspects of adopting the proposed return position and the fact that adequate disclosure will not benefit the taxpayer. The lawyer should advise the client that the client's decision regarding disclosure will affect the lawyer's ability to sign the return as preparer, as well as the reasons why that decision impacts the lawyer's ability to act in these capacities. However, the lawyer must make it clear to the taxpayer that disclosure will not advance the client's interests and may even be detrimental to those interests. The lawyer should advise the client that it may be in the client's best interests to seek independent legal counsel on the question whether to make adequate disclosure of the tax return position. [n.8] The lawyer may not advise the client to make adequate disclosure where the only purpose is to benefit the lawyer. See Model Rule 1.7(b), relative to conflicts of interest attributable to the lawyer's own interests.
>
> If the client seeks independent counsel, the client and lawyer should be guided by the opinion of that counsel. If the client, after having been fully informed, declines to seek independent counsel and decides to make adequate disclosure, the lawyer may proceed with the representation. If the client, after having been fully informed, determines, either with or without the advice of independent counsel, not to make adequate disclosure, the lawyer must withdraw from further assisting the client with regard to the tax return engagement in question. To proceed in situations where the taxpayer does not disclose the position and the position either disregards a rule or regulation or does not satisfy the realistic possibility standard and the taxpayer does not disclose the position would cause the lawyer to violate both professional standards and penalty standards. See Model Rule 1.16(a), relative to withdrawal from representations in violation of the rules of professional conduct.
>
> n 8: We do not believe that a lawyer consulted solely to advise a taxpayer whether to disclose a tax return position should be viewed as an income tax return preparer under section 6694 or be subject to Circular 230 §10.34 with respect to that issue. To conclude otherwise effectively would deprive the taxpayer of the opportunity to seek legal counsel from a lawyer free of conflicts of interest."

X. CIRCULAR 230

A. 1976 Rules Did Not Apply to Return Preparation

In 1976, when Section 6694 was first enacted, Circular 230 was far more limited than it is today. Most significantly, Circular 230 expressly stated that the conduct that it regulated ("practice before the Internal Revenue Service") did not include the preparation of tax returns.

Specifically, Sections 10.0 and 10.1(b) made it clear that Circular 230 regulated only "practice before the Internal Revenue Service"; and Section 10.2(a) provided that "the preparation of a tax return" was *not* "practice before the Internal Revenue Service". Section 10.2(a) defined "practice before the Internal Revenue Service" as including all types of presentations to the IRS, including the preparation and filing of documents, correspondence and representation of clients at meetings, *but excluding* the preparation of tax returns.

Nevertheless, a practitioner could be disciplined under Circular 230 if the practitioner (i) provided "false or misleading" facts in a Federal tax return, knowing those facts to be false or misleading, (ii) participated in any way in evading or attempting to evade any Federal tax, knowingly counseling or suggesting to a client or prospective client "an illegal plan to evade Federal taxes", or concealing assets of another to evade Federal taxes. In each case, the only possible discipline was a suspension of disbarment from "practice before the Internal Revenue Service".[79]

B. 1977: Circular 230 Section 10.31

On July 28, 1977, Circular 230 was amended to add a new Section 10.31 which banned any practitioner who "is an income tax return preparer" from endorsing or otherwise negotiating any tax refund check issued to another person. Again, however, the only sanction was suspension or disbarment from "practice before the IRS" which still was defined as excluding tax return preparation. The Term "income tax return preparer" was used in this new Section 10.31 but not defined.

C. 1984 and 1989

In 1984, the definition of "practice before the IRS" was revised to drop the explicit exclusion of tax return preparation. In 1989 when Section 6694 was amended, Circular 230 still had no provisions regulating return preparation.

D. Origins of RPSM Standard and Circular 230 Section 10.34

1. 1985: ABA Formal Opinion 85-352 and Birth of RPSM

The RPSM standard originated in ABA Formal Opinion 85-352, issued by the ABA in 1985. This formal opinion provided:

> "In summary, a lawyer may advise reporting a position on a return even where the lawyer believes the position probably will not prevail, there is no 'substantial authority' in support of the position, and there will be no disclosure of the position in the return. However, the position to be asserted must be one which the lawyer in good faith believes is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law. This requires that there is some realistic possibility of success if the matter is litigated."

[79] *See* Circular 230, Sections 10.50 and 10.51(b) and (d).

This was a more stringent standard than the "reasonable basis" standard the ABA had adopted in 1965 (in ABA Formal Opinion 314).

2. 1987: AICPA Adopts RPSM

In 1987 the AICPA made a similar revision to its Statement on Responsibilities in Tax Practice, moving from a "reasonable support" standard to a "realistic possibility" standard.

3. 1986: Proposed Circular 230 Amendment

In 1986, Treasury proposed to add to Circular 230 a provision prohibiting a practitioner from advising or preparing a return position unless the practitioner determined that the position would not subject the taxpayer to the substantial understatement penalty. This proposal was criticized on the grounds that it would result in practitioners being disciplined every time a client had an understatement penalty and it was never finalized. See NPRM, 57 FR 46356 (Oct. 8, 1992) (recounting history of 1986 proposal).

4. 1994: Circular 230 Section 10.34 Is Adopted Covering Return Preparation and Advice

Congress revised Section 6694 in 1989 to match more closely the ABA and AICPA standards. In 1994, Treasury added to Circular 230 for the first time a provision governing return preparation and the giving of advice on return positions. This provision intentionally matched the standards adopted by the ABA and AICPA and used in Section 6694. 57 FR 46356; 59 FR 31523 (June 20, 1994); 64 FR 31994 (June 15, 1999).

Section 10.34 as enacted in 1994 read as follows:

> "Section 10.34–Standards for advising with respect to tax return positions and for preparing or signing returns.
>
> (a) Standards of conduct-
>
> (a)(1) Realistic possibility standard. A practitioner may not sign a return as a preparer if the practitioner determines that the 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 Service. A practitioner may not advise a client to take a position on a return, or prepare the portion of a return on which a position is taken, unless-
>
> (a)(1)(i) The practitioner determines that the position satisfies the realistic possibility standard; or
>
> (a)(1)(ii) The position is not frivolous and the practitioner advises the client of any opportunity to avoid the accuracy-related penalty in section 6662 of the Internal Revenue Code of 1986 by adequately disclosing the position and of the requirements for adequate disclosure.

(a)(2) Advising clients on potential penalties. A practitioner advising a client to take a position on a return, or preparing or signing a return as a preparer, must inform the client of the penalties reasonably likely to apply to the client with respect to the position advised, prepared, or reported. The practitioner also must inform the client of any opportunity to avoid any such penalty by disclosure, if relevant, and of the requirements for adequate disclosure. This paragraph (a)(2) applies even if the practitioner is not subject to a penalty with respect to the position.

(a)(3) Relying on information furnished by clients. A practitioner advising a client to take a position on a return, or preparing or signing a return as a preparer, generally may rely in good faith without verification upon information furnished by the client. However, the practitioner may not 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, or incomplete.

(a)(4) Definitions. For purposes of this section:

(a)(4)(i) Realistic possibility. 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. The authorities described in 26 CFR 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. The possibility that a position will not be challenged by the Service (e.g., because the taxpayer's return may not be audited or because the issue may not be raised on audit) may not be taken into account.

(a)(4)(ii) Frivolous. A position is frivolous if it is patently improper.

(b) Standard of discipline. As provided in §10.52, only violations of this section that are willful, reckless, or a result of gross incompetence will subject a practitioner to suspension or disbarment from practice before the Service."

5. 2002: Revisions to Circular 230 Section 10.34

Section 10.34 was revised in 2002 to read as follows:

"Section 10.34 Standards for advising with respect to tax return positions and for preparing or signing returns.

(a) Realistic possibility standard. 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. 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--

(a)(1) The practitioner determines that the position satisfies the realistic possibility standard; or

(a)(2) The position is not frivolous and the practitioner advises the client of any opportunity to avoid the accuracy-related penalty in section 6662 of the Internal Revenue Code by adequately disclosing the position and of the requirements for adequate disclosure.

(b) Advising clients on potential penalties. A practitioner advising a client to take a position on a tax return, or preparing or signing a tax return as a preparer, must inform the client of the penalties reasonably likely to apply to the client with respect to the position advised, prepared, or reported. The practitioner also must inform the client of any opportunity to avoid any such penalty by disclosure, if relevant, and of the requirements for adequate disclosure. This paragraph (b) applies even if the practitioner is not subject to a penalty with respect to the position.

(c) Relying on information furnished by clients. A practitioner advising a client to take a position on a tax return, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. 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.

(d) Definitions. For purposes of this section--

(d)(1) 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. The authorities described in 26 CFR 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. The possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account.

(d)(2) Frivolous. A position is frivolous if it is patently improper."

Interestingly, the preamble to the proposed regulations explained:

> "Because Circular 230's role in regulating practitioner conduct differs from the role played by the ABA and AICPA guidelines and Internal Revenue Code penalties, the proposed amendments provide that a practitioner may be disciplined under Circular 230 only if the failure to comply with the realistic possibility standard

is willful, reckless, or a result of gross incompetence."[80] The Preamble to the final regulations reiterated this.[81]

Section 10.34 was revised in July 2002,[82] to clarify that practitioners must make reasonable inquiries into the facts, and that in order to have RPSM, the reasonable and well-informed analysis must be based on the law and the facts (and not on ancillary issues such as possibility of settlement).

XI. PROCEDURAL RULES

A. Procedures for Penalties under Sections 6694 and 6695

The procedures for the imposition and contesting of penalties under Section 6694 are in Section 6694(c) and (d) and 6696 and Treas. Regs. §1.6694-4. The procedures that apply in the case of a potential Section 6694 penalty differ significantly from those that apply in the case of a potential Circular 230 violation or a potential Section 6662 understatement penalty.

First, there is a statute of limitations for Section 6694(a) penalties: the penalty must be assessed within 3 years after the date the return was filed.[83] (There is no statutory or regulatory statute of limitations for Circular 230 penalties that we are aware of.)

Second, the "deficiency procedures" that apply to taxpayers (*i.e.*, notice of proposed adjustment, 30-day letter, 90-day letter) do not apply to preparers. Instead, the first step in the process is that the IRS conducts an investigation, and prior to making any assessment under Section 6694, the IRS sends to the preparer a report regarding the investigation. The Regulations do not give any details about what the report must contain. It appears that the prior to the issuance of this report there is no right for the preparer to be informed of the investigation or provide evidence or refute evidence provided by others.

The Regulations state that "unless the period of limitations ... may expire without adequate opportunity for assessment", the IRS will also send the preparer a 30-day letter notifying him of the proposed penalty and offering him an opportunity to request "further administrative consideration and a final administrative determination". If the request is made, the assessment will not be made until a final administrative determination has been made. The Regulations do not specify how the IRS decides whether or not there is sufficient time to go through this procedure before the statute of limitation expires, or grant the preparer any grievance procedures regarding how this decision is made. Thus, there is clearly no definitive right to an administrative review before the assessment is made.

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[80] NPRM, 57 FR 46356 (Oct. 8, 1992).

[81] 59 FR 31523 (June 20, 1994).

[82] T.D. 9011, 67 F.R 48760, July 26, 2002

[83] Section 6696(d).

Once the IRS has made the assessment, the preparer can follow one of three paths:

(i) pay the entire assessment and then either do nothing further or sue the IRS in U.S. Federal district court for a refund,

(ii) within 30 days of the assessment, pay at least 15% of the assessment and file an administrative claim for refund and if that is denied then, within 30 days of that denial, begin a proceeding in U.S. Federal district court for a judicial determination of whether the penalty is warranted (Section 6694(c)); if no judicial proceeding is commenced within that 30 day period, the IRS can levy to collect the assessment;

(iii) not pay the assessment and face an IRS levy to collect the assessment, and thereafter do nothing further or institute a new suit for a refund. In the levy proceeding, the merits of the assessment will not be litigated.

A claim for refund must be filed within 3 years of the date the penalty was paid.[84]

In determining whether a position had a realistic possibility of being sustained on its merits, the relevant date is, for the signing preparer, "the date the preparer signs and dates" the return or claim for refund, or if the signing preparer did not date the return, then the relevant date is the date the taxpayer "signed and dated" the return; or, if the taxpayer also did not date the return, then the relevant date is the date the return or claim for refund was filed.[85] For a nonsigning preparer, the relevant date is "the date the preparer provides the advice," which is determined "based on all the facts and circumstances."[86]

Interestingly, the IRS may assess the penalty even if there has been no administrative or judicial proceeding or determination involving the taxpayer.[87] Thus, the underlying "understatement" on which the Section 6694 penalty is based may, at this point, be nothing more than the IRS's view. There is not even any requirement that the IRS in fact be pursuing the taxpayer. However, if there is a "final administrative determination" or a "final judicial decision" that there was no understatement, the assessment will be abated and any penalty paid by a preparer will be refunded.[88]

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[84] Section 6696(d)(2).

[85] Treas. Regs. §1.6694-2(b)(5)(i).

[86] Treas. Regs. §1.6694-2(b)(5)(ii). For a taxpayer to be treated as having substantial authority under Section 6662, there must be substantial authority either at the time the return is filed or on the last day of the year to which the return relates. Treas. Regs. §1.6662-4(d)(3)(iv)(C). For the taxpayer to be treated as having a reasonable belief that the position was MLTN, the belief must exist at the time the return is filed and be based on the facts and law in existence at that time. Section 6664(d)(3)(A)(i) and Treas. Regs. §1.6664-4(f)(2)(i)(B).

[87] Section 6694(e).

[88] Section 6694(d).

B. Procedures for Investigating Circular 230 Violations and Imposition of Penalties under Circular 230

The first step is that any person (an IRS agent or a non-IRS employee or official) reports a suspected violation to the OPR.[89]

The Director of OPR then investigates; the OPR may confer with the practitioner at which point the practitioner may consent to a penalty in lieu of having the OPR institute or continue a proceeding. The OPR then has two choices: reprimand the practitioner or institute a proceeding for a more serious penalty. Such a proceeding occurs as follows: OPR must serve a detailed complaint on the practitioner, the practitioner must answer and the OPR may file a reply to that answer. The proceeding occurs before an Administrative Law Judge who conducts a mini-trial and issues a written opinion. An appeal of the ALJ's opinion is filed with the Secretary of the Treasury. The decision of the ALJ will be reversed only if the appellant establishes that the decision is clearly erroneous in light of the evidence in record and applicable law. The Secretary reviews issues of law de novo, but the facts are those adduced at the ALJ level – and the Secretary can send it back to the ALJ for more fact-finding.

XII. LICENSING PREPARERS

There have been various proposals to license tax return preparers.[90] We do not comment on these proposals. However, we note that many persons providing return preparation service are not "practitioners" subject to Circular 230, and that if the problem Congress is reacting to is the behavior of these unregulated individuals then the solution is not to amend the rules that apply to the giving of tax advice by lawyers and accountants.

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89 31 CFR 10.53.

90 Most recently, for example, The Taxpayer Advocacy Panel recommended licensing return preparers in its 2006 Annual Report. *See* Tax Analysts Doc 2007-19179.