NEW YORK STATE BAR ASSOCIATION TAX SECTION

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

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TABLE OF CONTENTS

Report No. 1139

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I. INTRODUCTION

This Report[1] is this New York State Bar Association Tax Section's first report responding to two recent developments:

- first, on May 25, 2007, the "tax return preparer" rules in Sections 6694, 6695, 6696 and 7701(a)(36)[2] were significantly revised (the "May 2007 amendments");[3] and
- second, on September 24, 2007, proposed amendments to the tax return preparer and advisor rules in Section 10.34 of Circular 230[4] were released.

While these developments raise numerous issues worthy of being addressed, this Report primarily addresses the specific problems that we believe result from the expansive and vague definition of "income tax return preparer" in the existing Treasury Regulations when considered

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1 The principal drafter of this Report was Diana L. Wollman and substantial assistance was provided by Patrick C. Gallagher. The Report was prepared with the guidance and helpful comments of a working group consisting of Melissa Blades, Ellen S. Brody, Peter Connors, Michael Farber, Lawrence Hill, Elizabeth Kessenides, Stephen Land, David S. Miller, William McRae, Elliot Pisem, Joel Scharfstein, Michael Schler, David Sicular, and Bryan Skarlatos, and with the assistance of Michael J. Liu. An enormous contribution was made by Eugene K. Kim.

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

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").

4 31 C.F.R. subtitle A, Part 10 (known as "Circular 230").

in the context of the May 2007 amendments. The Report discusses several possible regulatory responses to these problems. This Report also identifies various other aspects of the existing Treasury Regulations under Sections 6694, 6695 and 7701(a)(36) that we believe should be clarified or reconsidered in response to the May 2007 amendments.

Accompanying this Report is an Appendix which contains a detailed description of (i) the relevant statutory and regulatory rules, (ii) their history, and (iii) other background. From time to time this Report refers to the Appendix. Generally we have attempted to refer the reader to the Appendix rather than repeat in the body of the Report matters that are discussed in the Appendix.

We expect that the Tax Section's second written response to these developments will address the very significant problems resulting from "preparers" being subject to one set of standards in Section 6694 (as amended) while their clients (the taxpayers) continue to be subject to entirely different (and lower) standards under Section 6662. One concern is the quantity of disclosures the Internal Revenue Service ("IRS") is likely to receive if disclosure is required for preparers to avoid Section 6694 (and possibly Circular 230) penalties for positions that are supported by "substantial authority" but are not reasonably believed to be "more likely than not" sustained on the merits (which we shall refer to as "MLTN"). We expect that this second report will be addressed primarily to the Congressional committees responsible for tax legislation.

We expect that the third part of the Tax Section's response will be a separate report addressing the recently proposed amendments to Section 10.34 of Circular 230.

We believe there is an urgent need for regulatory or other administrative guidance on revised Sections 6694, 6695, 6696 and 7701(a)(36). As explained in Appendix Part II, the May 2007 amendments radically changed these rules, and the revised rules (i) will apply to all

"classic" return preparers for returns due on or after January 1, 2008,[5] and (ii) apply currently (since May 25, 2007) to the rendering of tax advice whenever the other conditions for Section 6694 to apply to the advisor are met. From a practical perspective, this means that the new Section 6694 MLTN standard and (if that MLTN standard is not met) the new Section 6694 monetary penalty (i) applies (or will apply) to every person who (for compensation) actually prepares a return that is due on or after January 1, 2008, and (ii) potentially applies to any tax lawyer or accountant giving tax advice now.

One of the most important and pressing questions to be answered now is *who* is subject to these revised rules -- that is, what actions make (or should make) someone a "tax return preparer" for Section 6694 purposes? That issue is the primary focus of this Report.

As discussed below, we believe the existing definition of "tax return preparer" in Treas. Reg. §301.7701-15 (combined with the regulations under Section 6694 and 6695) is in part overbroad and in part unclear.[6] We recommend reconsidering the potential scope of the existing regulatory definition in light of numerous developments since the regulations were first issued in 1977, and in light of what we believe was Congress's intent – in 1976 when the rules were first enacted, in 1989 when Section 6694 was expanded to apply to conduct that was not "willful" or "reckless," and in May 2007. We also think that, because the May 2007 amendments increased

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[5] The May 2007 amendments provide that they are effective for tax returns "prepared" after May 25, 2007. The effective date described in text is pursuant to transitional relief granted by IRS Notice 2007-54, 2007-27 I.R.B. 12.

[6] Treas. Reg. §301.7701-15 currently defines "income tax return preparer", which was the statutory term prior to the May 2007 amendments. Section 6694 now applies to any "tax return preparer," as defined in Section 7701(a)(36), if certain other conditions are met. Treas. Reg. §301.7701-15 is the starting point for discussing how "tax return preparer" is to be defined, because the only change in Section 7701(a)(36) was to broaden it so that, instead of defining persons who prepare "income tax returns," it now defines persons who prepare all types of U.S. Federal tax returns. For simplicity, we will refer throughout this Report to the existing regulatory definition as the definition of "tax return preparer".

dramatically the substantive standards to which preparers are subject, the definition should be clarified so practitioners know *when* Section 6694 applies to them.

We, like many others, are quite concerned about the difference in the standards that now apply to "preparers" and their taxpayer clients.[7] That is not the focus of this Report, but we do believe the situation is extremely problematic. A tax return preparer or advisor now often must choose between, on the one hand, a course of action that protects the advisor but may subject the client to risks the client would not otherwise face, and, on the other hand, a course of action that protects the client in a way that is perfectly legal and appropriate for the client but risks subjecting the practitioner to severe monetary penalties and (if the proposed amendments to Section 10.34 of Circular 230 are adopted) possible sanctions under Circular 230.

A similar situation arose in 1997 when Congress enacted a law that is often referred to as the "Granny's Lawyer Goes to Jail Act."[8] The year before, in 1996, Congress enacted a law often referred to as the "Granny Goes to Jail Act", which made it a crime for an individual to engage in certain types of asset transfers intended to enhance the individual's qualification for Medicaid. In 1997, Congress repealed that law (thereby making it legal once again for an individual to engage in this type of "Medicaid planning"), but replaced it with a law making it a crime for a lawyer to counsel or assist an individual to engage in Medicaid-planning asset transfers. Thus, it was a crime for a lawyer to counsel a client to engage in conduct or to assist a client in engaging in conduct that was perfectly legal for the client. At least one court found this

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[7] On December 6, 2007, a bill was introduced in the House of Representatives (H.R. 4318) that would modify the Section 6694(a) preparer penalty standard in an attempt to address some of these inconsistencies. This Report does not discuss this pending bill.

[8] Section 4734 of the *Balanced Budget Act of 1997*, Pub. L. No. 105-33 (1997).

law to be a violation of the First Amendment rights of the lawyers.[9] While we are not aware of anyone making a similar claim with regard to revised Section 6694, and we do recognize that there are some differences in the two situations,[10] we believe that there are important common policy concerns that are worthy of serious consideration.[11]

Part II of this Report summarizes our recommendations. Part III discusses certain of our recommendations in greater detail.

II. SUMMARY OF RECOMMENDATIONS

This Report makes the following recommendations:

1. One preparer per return (see III.A below). We recommend revising the applicable Regulations so that the term "tax return preparer" in Section 7701(a)(36) describes at most one individual (and his or her employer, if any, whether that employer is an entity or an individual sole proprietor) with respect to any single tax return. That one preparer would be the person who the current Section 6695 Regulations (subject to the other changes recommended below) require to sign the return (the "signing preparer"). The concept of "nonsigning preparer"

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[9] New York State Bar Association v. Reno, No. 97-CV-1768 (N.D.N.Y. Sept. 15, 1998; *see also* Trial, "Medicaid Counseling Law Doesn't Apply to Lawyers" (Dec. 1998); Note, "After New York State Bar Association v. Reno: Ethical Problems in Limiting Medicaid Estate Planning", Georgetown Journal of Legal Ethics (Summer, 1999); J. Matthew Miller, "Balancing the Budget on the Backs of America's Elderly-Section 4734 of the Balanced Budget Act: Criminalization of the Attorney's Role as Advisor and Counselor", 29 U. Mem. L. Rev. 165 (Fall, 1998) (discussing the First Amendment implications in detail); New York Law Journal, "Medicare Counseling Law Struck – First Lawsuit Filed by State Bar, on Penalty for Lawyers, Is a Winner" (Sept. 23, 1998); New York State Bar Association v. Reno, 999 F. Supp. 710 (N.D.N.Y. 1998)(granting preliminary injunction).

[10] Perhaps completing a tax return is not "speech", but surely giving written or oral tax advice is.

[11] While the court struck down the "Granny's Lawyer Goes To Jail Act" on First Amendment grounds, commentators also discussed the fact that a lawyer who "temper[ed]" his speech (so as to avoid violating the Act) would be violating his ethical obligations to "provide complete and competent counsel and to advise his client to the extent necessary to allow the client to make an informed decision". J. Matthew Miller, 29 U. Mem. L. Rev. 165, n. 166.

would be removed from the Regulations (and thereby eliminated entirely, since it does not and has never appeared in the Code itself).

We believe that this is compatible with what Congress intended in 1976 when it enacted Sections 6694 and 7701(a)(36), and in 1989 when it expanded Section 6694 to cover non-"willful," non-"reckless" understatements; and that in 2007 Congress was also contemplating that Section 6694 would apply to a single person per return. We believe a one-preparer-per-return rule is not inconsistent with Section 7701(a)(36), that Section 6694 operates best on that basis, and that Section 6695 is constructed to apply to one person per return.[12] We also believe Treasury and the IRS have the authority to implement this recommendation and the other recommendations in this Report by regulation (see III.A.8 below).

Under the current Regulations, in-house staff are not considered "tax return preparers" and we assume this rule will be retained. If that is the case and a one-preparer-per-return rule is adopted, a person who gives advice or assistance to the in-house staff should not be that one preparer solely because that person has done more than anyone else who could qualify as a preparer. In other words, the fact that the in-house staff who prepared the return do not themselves qualify as a "preparers" should not cause the external advisors to be treated as preparers any more than they would have been had they given their advice to an external return preparer.

2. Pure advisors are not preparers (see III.B below). We recommend that the Regulations be revised so that the person we call the "Pure Advisor" is never a "tax return preparer." We believe that Congress never intended (in 1976, 1989 or 2007) for Pure Advisors

[12] This Report does not focus on the distinction between the types of conduct to which Sections 6694(a) and 6694(b) apply. The Section 7701(a)(36) definition of "tax return preparer" applies for both Sections 6694(a) and 6694(b).

to be subject to Sections 6694 and 6695 and that subjecting them to those rules is inappropriate and unworkable. Pure Advisors are subject to other rules and other bodies of law, including Circular 230, that are more appropriate for regulating their advice-rendering actions. The various current regimes governing advice-giving are discussed below in III.B.3. We believe this change should be made whether or not the multiple-preparer concept is retained.

3. Define "pure advisor" as someone who never reviews, drafts or discusses the actual return (see III.C below). A Pure Advisor should be defined for this purpose as someone who never gives advice about how the actual return should be completed and never assists in the preparation or review of any aspect of the return. Those would be "preparation" activities and therefore would make this person potentially a "tax return preparer".

4. Clarify meaning of "substantial portion" and increase minimum threshold (see III.D below). The regulatory definition of what constitutes a "substantial portion" of a tax return should be clarified, and the existing minimum thresholds should be increased and otherwise modified. This is intended in part to help practitioners determine when their activities may cause them to be treated as a "tax return preparer."

5. Clarify "reasonable cause and good faith" defense (see III.E below). The existing "reasonable cause and good faith" defense in Treas. Reg. §1.6694-2(d) should be revised to clarify that a preparer's ability to use the defense based upon reliance on a third party's tax advice does not depend on that third party also qualifying as a "preparer."

6. Clarify preparer's ability to rely on factual (non-legal) matters (see III.F below). The extent to which a preparer may rely upon non-legal ("factual") data, such as transfer pricing and valuation information, provided by the taxpayer and other parties should be clarified.

There are many reasons for this, one of which is to hopefully lessen somewhat the monetary cost of these new rules on taxpayers who engage third party preparers.

7. Revise Section 6694(a) disclosure requirements for signing preparers and (if applicable) nonsigning preparers (see III.G below). For a signing preparer, so long as the current disparity between the taxpayer penalty standards (Sections 6662 and 6664) and the preparer penalty standards (Section 6694) remains, filing IRS Form 8275 or Form 8275-R with the return should not be the sole means by which the preparer is permitted to satisfy the "disclosure" prong of the Section 6694(a) "reasonable basis plus disclosure" exception. Currently, disclosure is required for a taxpayer to avoid understatement penalties under Section 6662 in much narrower circumstances than those in which disclosure is required for a "tax return preparer" to avoid understatement penalties under Section 6694(a). Therefore, in any situation where disclosure would not be required for the client taxpayer to avoid a Section 6662 penalty, the signing preparer should be able to satisfy the Section 6694(a) disclosure requirement by counseling the taxpayer in writing regarding how the penalty rules applicable to the taxpayer (including the disclosure aspects of those rules) work. Such disclosure statement could be along the lines of the disclosure statement proposed for nonsigning preparers in III.G.2 below. In any situation where the taxpayer would still need disclosure to avoid the Section 6662 penalty, the signing preparer should be able to satisfy the Section 6694 disclosure requirement only when the return, as filed, also satisfies the Section 6662 disclosure requirement.

If the concept of "nonsigning preparer" is retained, there should be clear rules for how a nonsigning preparer can satisfy the Section 6694(a) "disclosure" requirement, including when the nonsigning preparer has provided only oral advice. One permissible way should be for the nonsigning preparer to explain to the taxpayer (in writing if the nonsigning preparer gave written

advice, and orally if the nonsigning preparer gave only oral advice) how the penalty rules applicable to the taxpayer (including the disclosure aspects of those rules) work. The regulations should provide an example of a specific statement that would suffice for this purpose and the Report proposes possible language.

8. Clarify what "a reasonable belief" means. Section 6694(a) applies only if "there was not a reasonable belief" of MLTN as to a return position. The Regulations should clarify what this means by explaining (i) whether it is an objective test or a subjective test (based upon what the preparer really believes) and (ii) how a preparer may establish that the reasonable belief test is met.

9. Clarify treatment of a person who prepares an information return. It is not clear currently whether information returns are covered by Section 6694. The Regulations should address this, and the regulatory Preamble should explain what other rules apply to information returns.

10. Reconsider the "Indirect Preparer" rule (see III.A.4.e below). The "Indirect Preparer" rule in Treas. Reg. §301.7701-15(b)(3) is troubling and should be eliminated or at least clarified.

11. Clarify calculation of the Section 6694 monetary penalty. Sections 6694(a) and 6694(b) impose a monetary penalty of up to "50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim." If Section 6694 is applied to practitioners who render services beyond those of a Classic Preparer or Shadow Preparer, it should be clarified that the monetary penalty is limited to 50% of the income derived from the actual return preparation and excludes fees for the other services, even if those services are rendered as part of the same engagement. In addition, consistent with the rule that advice

regarding "the consequences of contemplated actions" does not constitute return preparation (see Treas. Reg. §301.7701-15(a)(2)(i)), it should be clarified that the monetary penalty excludes fees for advice regarding transactions that have not yet occurred.

12. If nonsigning preparers are retained, revise the Section 6695 Regulations so nonsigners are not obligated to perform the Section 6695 actions. The current Section 6695 Regulations obligate all preparers (including nonsigners) to perform the Section 6695 tasks, but then provide that a nonsigning preparer will not be penalized for failing to do these tasks (presumably because the reasonable cause defense will apply). If the concept of nonsigning preparers is retained, the Section 6695 Regulations should be revised to clarify that nonsigners are simply not obligated to perform these tasks.

III. DISCUSSION

A. Recommendation 1: Replace the Current Regulatory Multi-Preparer Rule with a Single-Preparer Rule.

For the reasons discussed below, we recommend revising the applicable Regulations so that the term "tax return preparer" in Section 7701(a)(36) describes, at most, one individual (and his or her employer, if any, whether that employer is an entity or an individual sole proprietor) with respect to any single tax return. That one preparer would be the "signing preparer" under the current Section 6695 Regulations, and the concept of "nonsigning preparer" would be removed from the Regulations.

1. Existing Definitions of "Tax Return Preparer", "Signing Preparer" and "Nonsigning Preparer".

As explained in detail in Appendix Part II, Section 6694 imposes a monetary civil penalty (which the May 2007 amendments significantly increased) on a "tax return preparer" of a U.S.

Federal tax return if the return reflects an understatement and the understatement is attributable to a position that the preparer "knew (or reasonably should have known) of," *unless* one of three exceptions is met. Two of the exceptions relate to the strength of support for the position, and the third exception is that there is "reasonable cause" for the understatement and the preparer "acted in good faith".

Section 6695 requires a "tax return preparer" to do certain things, such as sign the tax return that he prepared and furnish a copy of the completed return to the taxpayer for the taxpayer's signature.

It is difficult, however, in many cases to determine *who* is a "tax return preparer" of a specific tax return. Or, said differently, it is not clear what actions make someone a "tax return preparer" for purposes of Sections 6694 and 6695.

"Tax return preparer" is defined in Section 7701(a)(36) and Treas. Reg. §301.7701-15. Section 7701(a)(36), as amended in May 2007, provides, in pertinent part:

> "In general. --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."

Prior to the May 2007 amendments, the text of Section 7701(a)(36) was almost identical except that the pre-May 2007 version defined the term "income tax return preparer".

Treas. Reg. §301.7701-15 interprets the pre-May 2007 version of Section 7701(a)(36).[13] These Regulations set forth a regime where there can be more than one "preparer" of any given

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[13] These Regulations are the starting point for discussing how "tax return preparer" is (and should be) defined, because the only change to Section 7701(a)(36) in May 2007 was to broaden it so that

[1] (Continued...)

tax return. Subsection (a) of these Regulations describes what it means to "prepare" an entry on a return; subsection (b) then explains that you must look at all the "entries" prepared by each individual and assess whether the entries prepared by that individual together constitute a "substantial portion" of the return. If so, that individual is a "preparer". Under the current Regulations there is no specified limit to the number of "preparers" of any given return; and any specific entry could have multiple preparers, since each person who gave advice on the entry and any person who physically completed the entry or reviewed the entry (or return as a whole) could be a preparer of that entry.[14]

A person can be the "preparer" of an entry even if that person never sees or discusses the tax return. Specifically, Treas. Reg. §301.7701-15(a)(2) provides that:

> "A person who only gives advice on specific issues of law shall not be considered an income tax return preparer, unless –
>
> (i) The advice is given with respect to events which have occurred at the time the advice is rendered and is not given with respect to the consequences of contemplated actions; and
>
> (ii) The advice is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund. For example, if a lawyer gives an opinion on a transaction which a corporation has consummated, solely to satisfy an accountant (not at the time a preparer of the corporation's return) who is attempting to determine whether the reserve for taxes set forth in the corporation's financial statement is reasonable, the lawyer shall not be considered a tax return preparer solely by reason of rendering such opinion."

As indicated above and in Appendix Part IV.B, Section 6695 requires the tax return preparer of a return to do certain things. When Treas. Reg. §301.7701-15 results in there being more than one preparer of a return, the Regulations under Sections 6694 and 6695 must be

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instead of applying solely to "income tax returns" it now applies to all types of U.S. Federal tax returns.

[14] See Treas. Reg. §1.1502-15(b)(1).

consulted to see what each preparer is obligated to do. These Regulations create two types of preparers: "signing preparers" and "nonsigning preparers". Specifically, Treas. Reg. §1.6695-1(b)(2) provides that if there is more than one tax return preparer of a return, "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 or claim for refund" is the person obligated to sign the return. The person who this Regulation obligates to sign is the person we refer to as the "signing preparer," even if that person does not actually sign the return. All the other preparers are given the title, by Treas. Reg. §1.6694-1(b)(2), "nonsigning preparers."

To summarize what these Regulations require:

- first, identify each person who has "prepared" any of the return entries;
- second, determine for each such person whether the entry (or entries) he has prepared are a "substantial portion" of the return, and if this is the case that person is a preparer; and
- finally, identify which one of the preparers is the "signing preparer"[15] – all of the other preparers are "nonsigning preparers".

2. Requirements to Be Satisfied for Someone to Be Treated As a "Preparer" Potentially Liable Under Section 6694(a).

If there is an understatement on a tax return as a whole, and any part of that understatement is due to a "position" taken on an entry "prepared" by a "preparer", then Section 6694(a) imposes a monetary penalty on the preparer if:

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[15] As discussed in more detail below, these rules do not necessarily work to identify a "signing preparer" in every situation, because sometimes no "preparer" has "the primary responsibility as between or among the preparers for the overall substantive accuracy of the preparation of such return or claim for refund". For example, if the return is prepared by the taxpayer's employees, none of them is a preparer (see Treas. Reg. §301.7701-15(d)(2)); but one or more other persons may be involved in various entries, each of whom qualifies as a "preparer", but none of whom has responsibility for the overall return.

"(A) the tax return preparer knew (or reasonably should have known) of the position,

(B) there was not a reasonable belief that the position would more likely than not be sustained on its merits, and

(C) (i) the position was not disclosed as provided in section 6662(d)(2)(B)(ii), or (ii) there was no reasonable basis for the position."

However, under a "reasonable cause" exception (Section 6694(a)(3)): "No penalty shall be shall be imposed under [Section 6694(a)] if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith."

Therefore, in order to determine whether a person qualifies as a "preparer" and, if so, whether that person's actions result in potential liability under Section 6694(a), a long list of requirements must be considered. When that person has only provided advice (and has not physically completed any return), determining whether certain of these requirements are met can become quite difficult. First, the meaning of some of the requirements is not entirely clear. Second, because of the nature of the services and tasks commonly performed by tax advisors, and how and when they are performed, applying many of these requirements to them can seem like trying to fit a square peg in a round hole.

A partial list of these requirements, including where they are found in the law, and some of the uncertainties in applying them to tax professionals who primarily give advice, is as follows:

(1) "Prepares for compensation" (Section 7701(a)(36) and Treas. Reg. §301.7701-15(a)). Compensation must be received *for the preparation of the return* and not for other services being provided. In many situations, the diverse nature of the services provided by advisors would make it difficult to determine what portion,

if any, of the compensation received is for services that constitute "preparation" of the return.

(2) The entries "prepared" must be "all or a substantial portion" of the return (Section 7701(a)(36) and Treas. Reg. §§301.7701-15(a), (b)). The regulatory definition of "substantial portion" is unclear in several respects.[16] What if the advice leads to there being no entry on the return? Can a non-existent entry constitute a "substantial portion"? What if the amount entered is small, but should be larger -- is "substantial" measured based upon how much should be on the return, or how much is on the return? What if the legal analysis is complex, but there are other items on the same return that are far more complex? What if the legal analysis is the complex, but the dollar amount on the return is small? Should it matter if the person giving the advice is able to determine at the time the advice is given whether the advice will relate to entries that are a substantial portion? See III.D below for further discussion of the "substantial portion" test.

(3) The advice is "rendered" with respect to "events which have occurred" (Treas. Reg. §301.7701-15(a)(2)(i)). What if the advice is communicated partly before and partly after the events?

(4) The advice is not with respect to "contemplated events" (Treas. Reg. §301.7701-15(a)(2)(i)). What if the advice is rendered after the primary events have occurred, but relies in part on assumptions about future events?

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[16] Treas. Reg. §301.7701-15(b)(1) states that 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 of, and tax liability or refund involved in, the return or claim for refund as a whole."

(5) The advice is "directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund" (Treas. Reg. §301.7701-15(a)(2)(ii)). What does "directly relevant" mean? What does "the determination of the existence, characterization, or amount" mean? Must the return line items be discussed? Must the dollar amounts be discussed?

(6) De minimis safe harbor (Treas. Reg. §301.7701-15(b)(2)). Is this safe harbor applicable? That is, do the entries involve, 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? Is the test applied to the entries reported or the entries that should have been reported? What if the entries are losses or tax credits?

(7) Defense for "good faith" reliance on "advice of another preparer" (Treas. Reg. §1.6694-2(d)(5)). Was the other person a "preparer"? Does the reliance survive the "unreasonable on its face" and "know or should have known" tests set forth in the Regulations?

(8) The "position" must be one the preparer "knew (or reasonably should have known) of" (Section 6694(a)(2); Treas. Reg. §1.6694-2(a)(1)). What does that mean in the context of advice-givers who never see (and in many cases never even discuss) the return?

(9) "Income derived (or to be derived) by the tax return preparer with respect to the return or claim" (Section 6694(a)(1)(B)). What portion of the fee for advice was "with respect to the return or claim"?

(10) No "reasonable belief that the position would more likely than not be sustained on its merits" (Section 6694(a)(2)). Whose belief? How is "reasonableness"

determined – does it require a subjective belief plus an objective determination that this belief was reasonable? What does MLTN mean? What can be taken into account in making the MLTN determination? If the taxpayer has lost on the merits, does that prove there was no reasonable belief that the position was MLTN?

(11) Exception where there was "reasonable cause for the understatement and the tax return preparer acted in good faith" (Section 6694(a)(3); Treas. Reg. §1.6694-2(d)). What does "reasonable cause" mean? Is it satisfied if the preparer did not know about the position? What if the preparer was given false facts and had no reason to know they were false? Whose "reasonable cause" – the taxpayer's or the preparer's? How is "good faith" determined?

(12) "No reasonable basis for the position" (Section 6694(a)(2)(C)). How is this determined?

(13) "Disclosure" of position (Section 6694(a)(2)(C)). When is the disclosure requirement satisfied with respect to a particular signing or nonsigning preparer? Can the advisor prove he made "disclosure"? What was required to be said or written in the "disclosure"?

This list of requirements is not complete, nor are the short summaries above of ambiguities regarding each requirement. The list is intended primarily to illustrate the difficult questions raised by the current rules and to reveal some of the analysis that led to our recommendations, particularly the recommendation that there should be only one "preparer", which would not only be consistent with our view of Congressional intent, but would also substantially simplify the analysis and eliminate many of the difficult questions noted above.

3. Did Congress Intend There to Be More Than One Preparer of a Return?

Appendix Parts VI and VII describe the history of the rules defining a tax return preparer. We believe the history demonstrates that the current Regulations (the relevant parts of which were issued in 1977) go beyond what was intended by the 1976 legislative history to Sections 6694, 6695 and 7701(a)(36). This has not received much scrutiny previously, presumably because the statutory standards for preparers were at a level that advisors rarely go below in giving advice. Now that the Section 6694 standard has been raised to a much higher level -- and one that is above the level applicable to taxpayers in many cases -- the question of who is a preparer (and who Congress intended it to be) has come into urgent focus, and together with that is the question of the extent to which the statute contemplates the existence of multiple preparers of any given return as the Regulations currently provide.

We believe that the way Sections 6694, 6695 and 7701(a)(36) are worded, the tasks and responsibilities they impose on preparers, and the legislative history are all compatible with a framework in which there is only one preparer of any given return.

The text of Section 7701(a)(36), and in particular the phrase "a substantial portion," while it can be read literally to contemplate multiple preparers, seems intended more to ensure that someone with primary responsibility for the preparation of a return cannot escape preparer status merely because he or she did not prepare 100% of the return. As explained in Appendix Part VII.A.3, the legislative history tends to support this view.

Compelling evidence that Congress intended no more than one preparer per return, at least for certain purposes, is found in Section 6695, which obligates "[a]ny person who is a tax return preparer with respect to any return" to do certain things (such as sign the return, provide the taxpayer with a copy of the completed return, include the preparer's TIN on the return), all of

which can be performed only by a single person per return. This is why it was necessary in the Regulations under Section 6695 to provide that anyone who is a nonsigning preparer is entitled to a "reasonable cause" defense for failing to have performed these actions.[17]

We also think it is important to consider, as further discussed below, that the current multiple-preparer rules become essentially unworkable when applied to the services that professional advisors (tax lawyers and accountants) typically provide to their taxpayer clients.

To explore how the current rules work (and do not work), we describe below the different types of service providers and the services they provide to taxpayers.

4. The Cast of Characters: Five Different Types of Service-Providers.

We have identified five different types of service providers: the "Classic Preparer," the "Shadow Preparer," the "Pure Advisor," the "Schedule Preparer," and the "Indirect Preparer." In this section, we describe those persons and some of the issues raised in applying the current tax return preparer rules to each.

a. "Classic Preparer." At one extreme is the person we call the "Classic Preparer." The Classic Preparer probably does not commence work until after the tax year is closed. The taxpayer gives the Classic Preparer numerical data and documentation, and the Classic Preparer determines what numbers go on each line of the return, which schedules are required and how they should be completed, and computes the bottom line amount of tax (or refund) due. The Classic Preparer also fills out the return and may even file it for the taxpayer (after the taxpayer has signed it).

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[17] Separately, we think this is an inappropriate way of absolving a nonsigning preparer of responsibility for complying with Section 6695. This issue of course would disappear if the one-preparer rule we are recommending is adopted.

The Classic Preparer has clearly prepared all the entries that he has (physically) placed on the return and is certainly a preparer of the return. The Classic Preparer is described in Treas. Reg. §301.7701-15(a) (first sentence).

b. "Shadow Preparer." The person we call the "Shadow Preparer" is the person described in current Treas. Reg. §301.7701-15(a)(1). The Shadow Preparer does everything the Classic Preparer does, except physically fill in the return. The Shadow Preparer then basically tells someone who has the blank return and a pen (this could be the taxpayer or someone hired by the taxpayer) what numbers go on the return. The Regulations are clear that the Shadow Preparer is a preparer and that the person acting as the mere scribe is not (*see* Treas. Reg. §301.7701-15(d)(1)).

The Shadow Preparer may, in fact, be the "signing preparer" under Treas. Reg. §1.6695-1(b). We see no reason why that should not be the case, although there appears to be a common perception among practitioners that only a person who is involved in physically preparing the return could be obligated to sign it. Apart from our other recommendations, we suggest that the assignment of the obligation to sign be clarified (perhaps with examples) so that the practitioner community understands how these rules work and how these rules apply to them.

It is not clear to us how many Shadow Preparers they really are (or have been in the past). The Regulations may have initially intended this as an anti-abuse rule, although the Wall Street Journal article of July 11, 2007 quoted in III.C below suggests that this category may become more significant now as tax professionals try (perhaps unsuccessfully) to avoid Section 6694 exposure.

c. "Pure Advisor."

i. In general. At the other extreme from the Classic Preparer and the Shadow Preparer is the person we call the "Pure Advisor". This is the tax lawyer or accountant who gives legal advice without ever discussing or seeing the return. This legal advice can be rendered in various ways and settings. If the Pure Advisor is a preparer, that results from Treas. Reg. §§301.7701-15(a)(2) and (b).

To illustrate what a Pure Advisor might do, assume a U.S. corporation owns a foreign subsidiary that is subject to a foreign income tax. The U.S. corporation seeks advice from a tax lawyer addressing whether the foreign income tax is a "foreign income tax" (eligible for a credit) under Section 901. The advice does not address a number of the other matters that must be resolved in order to determine the precise amount of foreign tax credits claimed by the U.S. corporation in any specific year. For example, the advice may or may not address: the exact amount of dividends or subpart F inclusions from the foreign subsidiary that were received, the exact amount of earning and profits or foreign taxes in the subsidiary's "post-1986" pools, how the taxes and earnings are converted from foreign currency to U.S. dollars, the application of the Section 904 limitation in any particular year, or even how the foreign tax credit is claimed on a tax return (e.g., the specific form that is required).

Nevertheless, it seems possible to say that the tax lawyer's advice is "directly relevant" to determining whether the U.S. corporation claims any Section 902 (or Section 960) credits on its U.S. tax returns. In fact, the U.S. corporation is likely to rely (at least in part) upon this advice when it prepares its tax returns for many years into the future. If the tax credits that the U.S. corporation claims are considered a "substantial portion" of any of these returns, does this make the lawyer a preparer of those returns? It is not clear what the "directly relevant" language in

Treas. Reg. §301.7701-15(a)(2)(ii) and (b)(1) means. As a result, under Treas. Reg. §301.7701-15, this advice could constitute "preparation" of the foreign tax credit entry, even if the advice is oral, has a (now customary) Circular 230 "legend," or is based on numerous assumptions and qualifications.

The advice is "preparation," however, only if "the advice is given with respect to events which have occurred at the time the advice is rendered and is not given with respect to the consequences of contemplated actions."[18] Therefore, apparently, the Pure Advisor could only be the preparer of the entry on the return for any foreign taxes paid or accrued before the advice was rendered, but not for any foreign taxes paid or accrued after the advice was rendered. But, since the foreign tax is paid by the U.S. taxpayer's foreign subsidiary and only becomes creditable to the U.S. corporate shareholder when the subsidiary pays a dividend or generates a subpart F inclusion, does that mean that the advice is not preparation until those events also have occurred? As explained in the following section, the "before/after"-the-events dichotomy makes applying the tax return preparer definition to Pure Advisors extremely complicated.

ii. Advice given "before" vs. "after" the events: examples of transactional tax structuring advice. The following examples are intended to highlight the lack of clarity in the Regulations as to advice given "before" vs. "after" the events have occurred.

Assume a tax lawyer works with a U.S. corporate client for many months on planning, negotiating and executing an international joint venture. The tax lawyer's services include (but are not limited to) giving advice about the tax treatment for the U.S. corporation of forming the joint venture and the future-years' tax consequences to the U.S. corporation of owning an interest in the joint venture, given its expected operations (including, for example, the application of

[18] Treas. Reg. §301.7701-15(a)(2), which is quoted in full in III.A.1 above.

Sections 704(c) and 197 as a result of the acquisition of assets by the joint venture on the closing date). There are many different possibilities as to when and how the tax lawyer provides this advice, including the following:

- Tax lawyer #1 gives this advice only up until the closing and is never contacted by the client thereafter.

- Tax lawyer #2 gives 95% or more of the advice before the closing and then after the closing is contacted from time to time with follow-up questions.

- Tax lawyer #3 is the same as #2 but also delivers a formal written opinion summarizing the advice, and this opinion is delivered pre-closing.

- Tax lawyer #4 is the same as #3 but the opinion is delivered post-closing.

The possible application of the existing Regulatory definition to these tax lawyers is as follows:

Tax lawyer #1 is not a preparer because he gave no advice after the events occurred. All his advice was given prior to the closing.

Tax lawyer #2 is more difficult. One approach would treat all the advice given collectively as "the advice," and because some of that advice was given after the events occurred, the "after" requirement is met. That seems unreasonable, however, since the bulk of the time was spent pre-closing, and the pre-closing advice probably was the substantial, definitive advice that was most significant to the client claiming the return position(s). Perhaps a better approach is to ask whether the post-closing advice, standing alone, was "directly relevant to the determination of" the return position. The example in Treas. Reg. §301.7701-15(a)(2)(ii) (quoted in III.A.1 above) addressing legal tax advice given to support the financial statement reporting seems to indicate that "relevant to the determination of" the return position means that the advice must have *influenced* the taking of the return position (as opposed to simply addressing whether the return position was accurate or well-supported).

Tax lawyer #3 documented his pre-closing advice with a formal written opinion delivered pre-closing. It therefore seems easier for tax lawyer #3 to prove that the advice that was "relevant" to the claiming of the return position was delivered before the events occurred, but tax lawyer #3 still gave some advice post-closing, so his situation remains unclear.

Tax lawyer #4 was identical to #3 except for the delay in delivering the written opinion. Tax lawyer #4 gave the substantive advice that guided the taxpayer's actions pre-closing, but then confirmed it in writing post-closing. In determining if the "directly relevant" requirement is met with respect to the post-closing "advice," does it matter what the taxpayer intended to use the written advice for? The example in Treas. Reg. §301.7701-15(a)(2)(ii) suggests that it may. Therefore, if the taxpayer wanted the written opinion as support for a Section 6664 defense to penalties, then is the opinion "directly relevant" to the return position? Or should the focus be on whether the advice was intended primarily to assist the taxpayer in deciding whether or not to execute the transaction and in planning and closing the transaction? Under that view, the advice was for the purpose of completing the transaction, not for the purpose of completing the tax return.

If any of these tax lawyers is a preparer as to the return for the year in which the closing occurs, could he also be a preparer of future year return items that result from the joint venture formation and other closing date transactions (such as Section 704(c) allocations or Section 197 deductions)?

These examples highlight not only the before/after confusion, but also that the current Regulations are unclear as to (1) when advice is "directly relevant," (2) whether the taxpayer must have relied on the advice in deciding what position to take on the return, and (3) whether the advisor must be aware that the taxpayer would rely on the advice in determining the

taxpayer's return position. Section 6694(a)(2) itself requires that the preparer "knew (or reasonably should have known)" of the return position. Did Congress intend for that to mean that the preparer knew her advice influenced the decision to claim that return position? If that were required, then presumably that requirement would be met by every lawyer who gives a substantial authority or MLTN opinion, because arguably the lawyer knows that she is doing that to assist the client in determining whether to take the return position.

We think that all these questions can be answered by returning to what Congress intended in 1976, in 1989, and in 2007 for the scope of Section 6694: we think Congress intended that Section 6694 apply to persons who received the raw data from the taxpayer and turned that raw data into a completed tax return, either by directly preparing the return (the "Classic Preparer") or by telling someone else what entries to place on the return (the "Shadow Preparer"). We do not think it was intended to, or should, apply to any of the Pure Advisors described above, even if those advisors discuss dollar amounts with the taxpayer.

d. "Schedule Preparer." The person we call the "Schedule Preparer" is a tax lawyer or accountant who usually is a Pure Advisor, but has been asked to assist in the preparation of some schedule to the return that relates to the advice being given. Examples are a Form 8564 (a Section 1060 allocation), a Treas. Reg. §1.368-3 reorganization disclosure, or a Form 5471 (foreign corporation information return). Could the items on one of these schedules alone turn the Schedule Preparer into a preparer? Consider a person who prepares a Section 83(b) election or a check-the-box election form. If reflecting such an election on the return impacts "a substantial portion" of the return, then is the Schedule Preparer who advises on the election form a preparer? Another example (now out of date, but useful as an example

nevertheless) is someone who advises on a Section 965 dividend and helped the taxpayer draft the Dividend Reinvestment Plan.

The Schedule Preparer usually cannot control what is in the final schedule as filed, never sees the final return and has no way of verifying what was in the final schedule as filed. Based upon our experience, we think that persons who otherwise are Pure Advisors often act as Schedule Preparers (as we are defining the term). Another troubling thought is that, depending on the materiality of the schedule, a Schedule Preparer might even be the person required by Section 6695 to sign the entire return (i.e., the "signing preparer").

The Schedule Preparer presumably could be a preparer, as it would seem logical that the Schedule Preparer would be treated as having "prepared" the entries on the schedule or derived from (or resulting from) the schedule or other attachment or election.

Treas. Reg. §301.7701-15 is oddly worded because it never specifically states that the person who prepares a schedule is treated as having "prepared" that schedule. (In contrast, Treas. Reg. §301.7701-15(a)(1) and (2) specifically state that the Shadow Preparer and Pure Advisor are treated as having "prepared" certain entries.) Instead, the Schedule Preparer is, in essence, assumed to be "the preparer" of the schedule and is only mentioned in Treas. Reg. §301.7701-15(b), which addresses how to determine if the entries prepared by any particular individual constitute a "substantial portion" of the return. It would be helpful if the analysis of the Schedule Preparer's status was clarified.

The idea of the Schedule Preparer being a preparer came from the 1976 legislative history, which stated that "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."[19] This language is further support for our position that Congress's interpretation of the "substantial portion" rule is compatible with there being one single preparer of each return, not multiple preparers.

e. "Indirect Preparer." The "Indirect Preparer" is someone who completes one return (such as an information return) where the data on that first return is used by a taxpayer to prepare that taxpayer's own income tax return. This person (the Indirect Preparer) might be treated as the "preparer" of that income tax return under Treas. Reg. §301.7701-15(b)(3), which provides:

> "A preparer of a return is not considered to be a preparer of another return merely because an entry or entries reported on the return may affect an entry reported on the other return, unless the entry or entries reported on the prepared return are directly reflected on the other return and constitute a substantial portion of the other return. For example, the sole preparer of a partnership return of income or a small business corporation income tax return is considered a preparer of a partner's or a shareholder's return if the entry or entries on the partnership or small business corporation return reportable on the partner's or shareholder's return constitute a substantial portion of the partner's or shareholder's return."

As we read this, a "preparer" of a Form W-2, Form 1099 or Schedule K-1 could easily be the "preparer" of the income tax return filed by the recipient of the Form W-2, Form 1099 or Form K-1.

Consider this example. A tax lawyer advises X Corporation regarding the income tax consequences of stock option exercise by X Corporation's employees, and those consequences are then reflected on the Form W-2's that X Corporation prepares for the exercising employees. Is the tax lawyer deemed to have "prepared" each employee's Form W-2 and (if the option income is significant enough) each employee's entire Form 1040? Or consider a tax lawyer who advises the tax matters partner of a partnership as to how to treat a particular item on the

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[19] S. Rep. 94-938(I), at 351(1976); H.R. Rep. 94-658, at 275 (1976) (emphasis added).

partnership's Form 1065, where this item is a "substantial portion" of the Form 1065 and is reflected on the Schedule K-1 issued to each partner. For each partner for which the item is a "substantial portion" of his/her return, is the tax lawyer who advised the partnership a preparer of that partner's individual return?

We recommend that consideration be given to alleviating or eliminating the Indirect Preparer rule.

5. Who Is the Signing Preparer When a Pure Advisor or Schedule Preparer Gives Advice to Another Preparer?

When a return is prepared by a Classic Preparer, and that Classic Preparer receives advice from a Pure Advisor or Schedule Preparer (hired by the taxpayer), one would think that the Classic Preparer is the signing preparer and that the Pure Advisor and Schedule Preparer either are not preparers at all or are "nonsigning preparers". This is not necessarily clear, however, if the Classic Preparer is relying upon these other persons for the substantive accuracy of the most significant items on the return. Recall that the Section 6695 Regulations assign the signature obligation to the "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."[20] If the Pure Advisor or the Schedule Preparer is being relied upon by the Classic Preparer (and the taxpayer) for only a few items, but those items are the most significant ones on the return (in dollar amount, or complexity), whereas all the other items are being determined by the Classic Preparer, which of the three is the "signing preparer"? Identifying the "signing preparer" is particularly relevant if satisfaction of the Section 6694 "disclosure" requirement is different for the "signer" and the "nonsigners".

[20] Treas. Reg. §1.6695-1(b).

If, instead, the Pure Advisor or Schedule Preparer is giving advice to in-house staff who are preparing their employer's tax return themselves, it is even more confusing. In-house staff can never be preparers of their employer's return, according to Treas. Reg. §301.7701-15(d)(2). If the employer's return is prepared in-house and a single tax lawyer gives advice relating to a single entry, that person would seem to be the only possible preparer, though presumably only if that entry is a "substantial portion" of the return.[21] Suppose that single entry *is* a substantial portion, but that all the other entries (prepared entirely in-house) outweigh this one in terms of number of entries, dollars at stake and complexity. Notwithstanding all of that, is this outside advisor (who might even be a Pure Advisor) the signing preparer? The current Section 6695 Regulations would absolve the individual of facing a penalty under Section 6695 for failure to sign if the individual is a Pure Advisor, but if he was a Schedule Preparer then apparently he could be the one required to sign and face the Section 6695 penalty for failure to do so (since the absolution in the Section 6695 Regulations applies only to Pure Advisors).[22]

6. The Current Multiple-Preparer Rules Are Unworkable.

We believe the foregoing discussion demonstrates that the current multiple-preparer rules are unworkable. Service providers should know when they are providing services whether or not they are subject to Section 6694 and what their obligations are under Section 6695. Not only is that desirable as a matter of fairness, but it also seems to us that these provisions will not serve their purpose if people do not know when they apply to them. The IRS and Treasury might decide that as a policy matter each service provider (including mere advice givers) should live with the possibility that he may be subject to Section 6694 at all times. We believe that this

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[21] See Treas. Reg. §301.7701-15(b)(1), first sentence.

[22] See Treas. Reg. §1.6695-1(a)(1).

would not be appropriate, however, and that Circular 230, not Section 6694, is the proper means for establishing standards of behavior for Pure Advisors, as further discussed in III.B.3 below.

7. If the Definition of "Tax Return Preparer" Continues to Include Pure Advisors, Pure Advisors Will Need to Take Steps To Protect Themselves From Section 6694 Liability.

If the definition of "tax return preparer" continues to include Pure Advisors, what might cautious tax advisors do to protect themselves and their firms?

A Pure Advisor will be inclined to assume that any post-transaction advice he gives, whether written or oral, could relate to a "substantial portion" of a return and thus potentially make him a "preparer" of that return. Even when that Pure Advisor is giving advice before the underlying events have occurred, he might assume that the "after the events" requirement will be met, since this pre-transaction advice might well be followed by some post-transaction advice and the two might be linked together for Section 6694 purposes.

A Pure Advisor could avoid this with certainty only by refusing to give any advice after the transaction has closed (including answering even a narrow follow-up post-closing question posed by a client). We do not think that it would be good tax policy to have rules that encouraging advisors to impose these types of restrictions, nor do we think that clients would find such restrictions acceptable.

The Pure Advisor dealing with the continuing specter of possible "preparer" status may not even be sure that he would be a mere "nonsigner" as opposed to the "signing preparer". But assume he decides, out of practicality if nothing else, that he is at most a nonsigning preparer.

In some cases, this Pure Advisor may be comfortable that he has satisfied the MLTN requirement, though this may be perilous unless he is giving a formal MLTN opinion, based

upon a full and complete vetting of all the facts. Otherwise, the Pure Advisor will be inclined to rely upon the disclosure plus reasonable basis defense. Assuming the Section 6694 regulations provide that disclosure can be satisfied for a nonsigning preparer through some type of verbal explanation to the client, this advisor could adopt some type of Section 6694(a) "disclosure legend" saying whatever the Section 6694(a) regulations defined to be "disclosure". This legend could become commonplace on written advice, similar to the so-called "Circular 230 legends" widely adopted in response to the 2004 expansion of Circular 230. See III.G below for possible section 6694(a) disclosure language. Given the Circular 230 experience, the prospect of such legends alone is reason to exclude Pure Advisors from the application of Section 6694.

In addition, the tax advisor might seek protection from Section 6694 liability (including the risk of unknowingly being treated as the signing preparer) through a standard engagement letter that each advisor requires new and old clients to enter into in which the client agrees to indemnify the advisor for any liabilities incurred by the advisor under Section 6694 or otherwise in the event the advisor is determined to be a preparer (signing or nonsigning) with respect to a client return. It is unclear whether this would be effective, or more importantly whether a client would even agree to it.

For oral advice, the Pure Advisor could read the client the "disclosure" legend and then, as verification that this has happened, either draft a memo to files recounting that he has done so or send an unsolicited email to the client that includes the disclosure legend.

We do not believe that Congress intended to disrupt in this way the day-to-day advice-giving dialogue and professional relationship between tax practitioners and their clients.

8. Reducing Taxpayer Costs.

The May 2007 amendments to Sections 6694 and 7701 will likely increase (in some cases, perhaps significantly) the cost to taxpayers of having third parties prepare their returns, and may also increase the cost of obtaining pure advice and advice on attachments and schedules to their returns.[23] Adopting a one-preparer-per-return rule should help to manage these costs.

We anticipate at least three sources of increased costs.

First, Classic Preparers may raise their fees (i.e., charge more for the same services they previously provided) to compensate for the enhanced risks they face under Section 6694 (including with respect to preparation of non-income-tax returns, which previously were not covered by Section 6694). The enhanced risks include the possibilities (i) of a monetary penalty under Section 6694 (or Circular 230, if the preparer is also subject to Circular 230), (ii) that a violation of Section 6694 will result in an automatic referral to the Office of Professional Responsibility, a state licensing or regulatory body, or both, (iii) that any determination that the preparer violated Section 6694 (or any such other rules) could result in a decline in business, and (iv) that the preparer will face increased costs in defending against an asserted violation of Section 6694 (or any such other rules). Pure Advisors and Schedule Preparers will face similar increased risks and may be forced to take that into account in setting their fees.

Second, all types of preparers are likely to charge for the additional work they must do to reduce the chances that they *are* found to have violated Section 6694. This would include additional work in gathering facts from their taxpayer clients, in researching and analyzing return positions (even those that the preparer has a strong belief are supported by MLTN), and in

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[23] See Tax Foundation, "Special Report No. 138: The Rising Cost of Complying with the Federal Income Tax", Dec. 2005 (detailing the compliance costs for taxpayers in 2005).

internal review, controls and documentation of the preparer's processes to minimize the chances of being found liable for having violated Section 6694. Preparers are also likely to incur additional time in counseling taxpayer clients about understatement penalties and the possible positive and negative consequences of filing a disclosure statement with their tax returns.

Third, preparers will certainly charge for the time they spend preparing Form 8275's that would not otherwise (prior to these changes in the law) have been filed. Form 8275 is not easy to fill out. Part II of the form requires "1. A description of the relevant facts and the nature of the controversy affecting tax treatment of the time," and "2. A concise description of the legal issues presented by these facts."[24] In addition, the form is not considered complete (and thus "disclosure" is not accomplished) unless these descriptions are factually and legally complete. A taxpayer who is told by its Classic Preparer that it must or should include Form 8275 with its return may also seek advice from another tax professional, thereby incurring additional costs.

9. Treasury and the IRS Have the Authority to Revise the Regulations Defining "Preparer".

We believe Treasury and the IRS have the authority to revise the existing Regulations under Sections 6694 and 7701(a)(36) so as to adopt a one-preparer rule, to exclude Pure Advisors, and to make the other changes we are recommending.

We have considered that Treas. Reg. §301.7701-15 has been in place since 1977 and that Congress has twice amended the statute (Section 6694 in 1989 and 2007, and Section 7701(a)(36) in 2007) without indicating that it wanted Treasury to revise the existing Regulations. We do not think this means that the existing rules have been "Congressionally re-

[24] We note that the instructions to the Form seem to contain an error in that they place an "or" between these two requirements, whereas the remainder of the instructions indicate clearly that both 1. and 2. are required.

enacted." Congress never addressed the existing Regulations in its legislative history and never suggested that it intended Treasury to retain the existing Regulations. As explained in Appendix Parts VI and VII, the legislative history in fact suggests that Congress did not focus on the breadth of the current regulatory definition, either in 1989 or in 2007. The events leading up to the 2007 amendments do not give any indication that Congress was aware of the multiple-preparer rules or wanted Section 7701(a)(36), 6694 or 6695 to apply to more than one person or to advice givers. Moreover, as discussed in III.A.3 above, we believe the statutory language itself, supported by the legislative history, can be read in a manner consistent with their being only one preparer for purposes of Sections 7701(a)(36), 6694 and 6695.

B. Recommendation 2: The Regulations Should Not Define Preparer to Include Pure Advisors.

As discussed in Appendix Part VII, in III.A.3 above and in this section, we believe that the current Regulations go beyond Congressional intent by defining "tax return preparers" to include Pure Advisors. Before the May 2007 amendments were enacted, Pure Advisors and Schedule Preparers were not very concerned about the overly-broad definition, because as a matter of professionalism they did not engage in conduct that would have subjected them to a Section 6694 or 6695 penalty (*i.e.*, they would not advise a client to take an undisclosed position that had less than a realistic possibility of success on the merits). In addition, to our knowledge the IRS did not actively pursue Pure Advisors or Schedule Preparers for violations of Section 6694(a), and therefore there was no focus in the tax community on how easy it might be for such persons to actually be preparers.

Now that the Section 6694 standard has become more stringent and problematic, it is appropriate to reconsider whether Pure Advisors should be covered by Section 6694 and the Regulations thereunder.

1. Section 6694 Is Not Suitable for Pure Advisors.

We believe that Section 6694 was not aimed at (or designed to apply to) Pure Advisors (see III.B.2 below) and, for that reason, in many ways it is simply a "bad fit" as applied to them. We also are of the view that Section 6694 was not intended to create a liable person for every understatement and that there does not need to be a preparer for every return or every item on a return. The discussion in this section is intended to show how the design of Sections 6694 and 7701(a)(36) makes Section 6694 an inappropriate tool to regulate Pure Advisor behavior.

The Section 6694 penalty may be imposed only if a number of conditions are met, and these conditions may result in essentially arbitrary results, including having some "bad" advisor behavior escape any Section 6694 liability all together. For example, a Section 6694 penalty may be imposed only if there is an "understatement" on the taxpayer's return taken as a whole. If the position that the advisor advised upon led to an understatement, but there is no overall understatement (because, for example, the taxpayer otherwise has net losses or excess credits, or because the taxpayer had overstatements that offset this understatement), then no Section 6694 penalty is imposed. This is so regardless of how "inappropriate" the advisor's actions might have been.

This "overall understatement" requirement has some logic when the penalty is applied to someone who prepares the entire return. It makes little sense, however, to apply it to someone who advises on only part of the return. The advisor's behavior is worthy of sanction or it is not, and whether this entry when combined with the remainder of the return results in an

understatement should have no bearing on the matter. This illustrates how Section 6694 was simply never intended to apply to Pure Advisors.

Another condition is that the items that the advisor gives advice on must together constitute a "substantial portion" of the return. This means that the advisor behavior is either covered by Section 6694 or not based in part upon what is on the remainder of the return. The advice at issue may involve a very complicated issue, but it may amount to a relatively small amount of money compared to the return as a whole. Or the advice may involve a sizeable amount of money, but still be dwarfed by the return as a whole. In addition, the very same advice may constitute a "substantial portion" in one year, but not in another year; or it may constitute a "substantial portion" for taxpayer #1 but not a substantial portion for taxpayer #2. If the advisor's behavior is being regulated, the rule should apply based on that behavior (as Circular 230 does, for example -- see III.B.3 below) and not on these extraneous factors.

In order for the "substantial portion" requirement to be met, something must be reflected on the taxpayer's return. If the advice that is given supports the taxpayer's reporting no gain or loss on the return – for example, advice that a transaction qualifies as a tax-free Section 1031 exchange – there would appear to be no item on the return, in which case the advisor would not have prepared an entry. (Some believe that the Regulations could be interpreted to apply the "substantial portion" test to the item that should have been, but was not, reflected on the return.) Similarly, it is not clear how the "substantial portion" test applies if the item reflected on the return is less than the IRS determines it should be – for example, if the taxpayer reports an amount of gain that is relatively insubstantial, but the correct amount of gain would have been a substantial item on the return.

Another aspect of the rules is that "preparation" occurs only if the events underlying the entry have already occurred. This makes sense if the rules are limited to persons who complete a return or who explain how to do so. However, from the perspective of the advice-giver, there is often little distinction between advice that is given before a transaction has occurred and advice that is given afterwards. Because advisors often do not advise on actual facts or numbers, but instead on the application of the law to an assumed set of facts, it makes little difference to an advisor whether the facts have occurred, and it would be anomalous to impose a penalty on an advisor whose advice happens to relate to a transaction that has closed, but exempt another advisor whose advice relates to a transaction that has not yet closed.

For the taxpayer, advice obtained before the transaction is likely to have a significant impact on what is reflected on the return, because the advice often not only will determine how the transaction is structured and reported but may also be a pre-condition to undertaking the transaction.

If these rules apply to Pure Advisors only for advice given after the events have occurred, some lawyers may prefer to deliver transactional advice before the closing, rather than after the closing, whenever possible. It is simply bad for the tax system and taxpayers to have rules that encourage this kind of behavior, because taxpayers will be far better served if they are able to receive advice after, and not merely before, a transaction has occurred and the final facts are known.

To illustrate the foregoing points, consider the following example: "P", the practitioner, advises "Client" in 2000 that a tax imposed by Country X is a Section 901 creditable tax. This advice is given after Client 1 has paid its 1999 Country X taxes and before it has paid its 2000 Country X taxes. Client claims Section 901 tax credits for the Country X taxes on its 1999 U.S.

Federal tax return and its 2000 U.S. Federal tax return. Under the current rules, P would not be a preparer of the 2000 return, and P would be a preparer of the 1999 return, but only if the credits Client claimed constitute a "substantial portion" of Client's 1999 return.

Assume the same facts except that, in 2001, before Client files its 2000 return, it casually asks P whether there have been any developments that would impact the advice P gave the year before. Could P now be a preparer of Client's 2000 return (if the credits claimed by Client are a substantial portion of that return)?

These examples demonstrate that Section 6694 is both overinclusive and underinclusive as applied to Pure Advisors, and the factors that determine whether it applies or not appear unrelated to the advisor's behavior.

The Section 6694 Regulations have a "one-per-firm" rule (Treas. Reg. §1.6694-1(b)(1)). Under this rule, if more than one person at a firm worked on a particular return, the firm plus one individual qualify as the "preparer". All the other persons at that firm are not "preparers". Such a rule makes sense if one thinks of the original purpose of the Section 6694 rules (*i.e.*, to enable the IRS, when it finds a return with errors, to trace back to the preparer and then find other returns prepared by the same preparer). It makes little sense if the purpose is to regulate professional behavior.

We also believe it does not further the goals of Section 6694 if the advisor has no way of knowing whether he is subject to Section 6694. A Pure Advisor (and often a Schedule Preparer) will often (and perhaps most of the time) have no way of knowing whether the issues he is advising on relate to items that are a "substantial portion" of the return.

It is also unfair to subject someone to Section 6694 liability when that person will not have a meaningful opportunity to control (or even verify) how the taxpayer's return finally

reflects the items advised on. We do not believe that requiring Pure Advisors and Schedule Preparers to verify clients' tax returns would serve any useful purpose. Perhaps the IRS would apply the reasonable cause and good faith exception in a case where the advisor was not fully aware of what was on the final return, or say that the preparer did not "know" of the return position, but under current law that is not clear.

There also seems to be no requirement of a correlation between the advice given and the reason why the entry resulted in an understatement. Assume a tax advisor advises a corporation as to the proper year in which a foreign income tax liability accrues and thus may normally be claimed as a credit. The taxpayer claims the credit in the proper year, and the advice was directly relevant to that entry appearing on the return. But the IRS determines that the tax was not a "foreign income tax" (an issue which was not within the scope of the advisor's advice) and thus the credit was not appropriate. Perhaps the IRS (or a court) would say that the advisor is not liable due to the reasonable cause and good faith exception, but the existing Regulatory guidance on that exception do not appear to give much comfort.

2. The History Indicates That Section 6694 Was Intended to Apply to Classic Preparers, Not Pure Advisors.

The history to Section 6694 is described in detail in Appendix Part VII. Section 6694 was first enacted in 1976. The 1976 legislative history explains in detail the "problems" that Section 6694 was enacted to address. The problems arose from the behavior of "persons whose business is to prepare income tax returns" – in other words persons who physically prepared returns. The first problem identified in the legislative history was that in some cases preparers were making promises to individuals (for example, that the preparer would, as a result of his/her expertise, obtain a refund for the individual) and then claiming fictitious deductions or

exemptions to achieve the promised results. Sometimes the preparer would have the taxpayer sign a blank return so that the taxpayer could not even review the return before it was filed. Prior to the enactment of Section 6694, the only sanctions the IRS had against this type of behavior were the criminal sanctions then available under Section 7206. Because these new non-criminal sanctions were more likely to be used by the IRS, it was hoped that they would "deter preparers from engaging in improper conduct."[25]

The second problem was that some preparers made "innocent" errors, based upon misinterpretations of the law or other similar mistakes. The legislation was intended to provide the IRS with enough information to determine, first, who had prepared a given return, and then which other returns that preparer had prepared. That way, if the IRS detected an error on a return (whether innocent or not), the IRS could trace back to other returns that might have similar errors.

The legislative history (1) suggests that the "all or a substantial portion" rule was intended less to result in multiple preparers, than to ensure that someone who is primarily responsible for preparing a return, but who does not prepare 100% of the return, would be treated as a preparer,[26] and (2) indicates that advice-givers were not to be considered "preparers" unless they were "advising" the taxpayer on the specific amounts to put on the return, presumably to prevent someone from trying to avoid Section 6694 by merely "dictating" the return to the preparer instead of physically preparing it (*i.e.*, acting as a Shadow Preparer).[27] In fact, as is seen in Appendix Part VII.A.3, the 1976 legislative history supports quite strongly that Section 6694

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[25] S. Rep. 94-938(I), at 351 (1976); H.R. Rep. 94-658, at 275 (1976).

[26] This view is consistent with how the Section 6695 Regulations determine which individual within a single firm is the "preparer" within that firm. See Treas. Reg. §1.6695-1(b).

[27] See S. Rep. 94-938(I), at 351 (1976); H.R. Rep. 94-658, at 275-276 (1976).

is not intended to apply to Pure Advisors. The 1976 Regulations (described in Appendix Part VII.A.4) reflected this exactly and, notably, did not apply to Pure Advisors.

Several months after the 1976 Regulations were issued, the 1977 Regulations were issued. These 1977 Regulations are the Regulations in effect today (except for some non-relevant amendments made over the years), and they define "preparer" to include Pure Advisors. We have been told in informal conversations with persons involved at the time that a decision was made within Treasury and the IRS after the 1976 Regulations came out to revise those regulations to draw in Pure Advisors, notwithstanding the clear language in the 1976 legislative history; we were told that this departure from the legislative history was considered acceptable, because at that time the Section 6694 penalty applied only to egregious conduct (negligent or intentional disregard of the law, or willful understatement) and the monetary penalty was very small.

There have, of course, been numerous changes to Section 6694 and other rules governing advisor conduct since 1977. In light of those developments, we think it is appropriate now to reconsider how the regulations should interpret the statutory definition of "tax preparer."

The exclusion of in-house personnel, which was in the initial 1976 legislation, demonstrates that (i) Section 6694 was always aimed at Classic Preparers and not to all service-providers and (ii) importantly, that Congress did not intend to create a preparer for every return.

3. Circular 230 and Numerous Other Bodies of Rules Apply to Pure Advisors and Are a More Appropriate Means of Regulating Advisor Conduct.

Pure Advisors are currently subject various rules and regulations that govern the nature of the advice they provide. These rules are intended to protect these advisors' clients, the fisc, and the integrity of the U.S. tax system. We believe that these rules and the avenues they provide for

additional rules, if additional rules are determined to be necessary, are a better way of regulating and disciplining Pure Advisors than Section 6694(a). Various rules and regulations that currently apply to Pure Advisors and to the advice they give are summarized below. It is particularly instructive that the ethical rules and professional standards described below do not apply to Classic Preparers who are not lawyers or accountants, and no other rules like these apply to such persons. In fact, Congress has been considering recently various proposals to require the IRS to regulate such "unenrolled preparers" (see also Appendix Part XII).[28]

a. Circular 230. We believe the government's regulation of tax advice (as distinguished from return preparation) is most appropriately handled under Circular 230. Several provisions in Circular 230 currently regulate advice-giving. As discussed in Appendix Part X, these include Circular 230 Sections 10.21, 10.22, 10.27, 10.29, 10.34, 10.35, 10.37 and 10.51(l). (Consider also Circular 230 Section 10.33.)

The scope of Circular 230 and its substantive standards are more comprehensive and multi-faceted than Section 6694(a). For example, the application of Circular 230 is not conditioned on the advice-giver being a "tax return preparer" under Section 7701(a)(36) and the Regulations thereunder, or on the advice being given after rather than before the relevant events have occurred.

In addition, the available sanctions for violating any Circular 230 provision include not only monetary penalty (up to 100% of the practitioner's gross income from the offending conduct), but also censure, suspension from practice before the IRS, and disbarment from such practice, and therefore are potentially far more severe than the consequences of violating enhanced Section 6694(a) or (b). Thus Circular 230 is not only a more targeted, specific and

[28] The issues raised by such proposals are beyond the scope of this Report.

expansive set of rules applicable to advisors, it also wields a much larger stick than the revised Section 6694.

Finally, the procedural rules for violations of Circular 230 are more appropriate for Pure Advisors and Schedule Preparers than the procedural rules for violations of Sections 6694 and 6695. The procedures for the imposition and contesting of penalties under Section 6694 are in Sections 6694(c), 6694(d) and 6696 and Treas. Reg. §1.6694-4 and are described in Appendix Part XI. The procedures that apply in enforcing Circular 230 are also described in Appendix Part XI and are very different. Circular 230 is more suitable for penalizing inappropriate Pure Advisor behavior because it incorporates an established procedure for investigation, internal review, multiple checks and multiple opportunities for the individual practitioner to present his case *before* the matter is brought before a public court of law. By contrast, if the IRS wants to charge a preparer with a Section 6694 violation, the preparer may (or may not) be offered an administrative review before the IRS issues the assessment, and after the assessment the preparer has a limited opportunity to seek an administrative review and then may contest the assessment only by going to a Federal District Court. When the quality of the services provided by a professional are at issue, it is more appropriate to have a comprehensive and fair administrative review and appeals process before the assessment is made, and certainly before the matter is escalated to a public litigation setting.

If Treasury and the IRS believe that advice-giving is not sufficiently regulated under Circular 230 and the other rules described in this III.B.3 and that the IRS needs additional tools to regulate advice-giving, we believe this should be accomplished through the provisions of Circular 230. As indicated above, we do not address in this Report the proposed amendments to Section 10.34 of Circular 230, but we intend to do so in a subsequent report. Regardless of the

scope of Section 10.34, other provisions of Circular 230 also govern advice-giving, and we believe that if any new tools are needed they should be added to Circular 230, not to Section 6694 or other provisions of the Code.

b. ABA Formal Opinions and AICPA Standards. The ABA has issued two formal opinions governing tax advisors (see Appendix Part X.D.1 for a discussion of what the ABA opinions say about tax return positions and advice and return preparation) and other announcements and rulings governing tax advisors (see Appendix Part IX for one example). While these opinions, announcements and rulings are not themselves binding on lawyers, they are often relied upon by state bars as setting the appropriate standards that lawyers should adhere to and are often looked to by both practitioners and disciplinary bodies as establishing proper standards of conduct for tax practitioners. The AICPA has issued similar formal statements of standards.

c. State Bar and State CPA licensing organizations rules. Tax practitioners are subject to regulation by their licensing authorities: state bar rules for lawyers, and AICPA and state CPA standards for accountants.

d. Other Code Sections. Numerous other Code Sections regulate advisor behavior, including Section 6700 (promoting abusive tax shelters), Section 6701 (aiding, assisting, procuring or advising with respect to any document, knowing that the presentation of that document would result in an understatement), and 7206(2) (aiding or assisting in, or procuring, counseling, or advising the preparation of any document that is fraudulent or false as to any material matter).

e. Client-related controls over advisor behavior. Clients may pursue claims against tax advisors for poor conduct under professional liability statutes or state

deceptive trade practice statutes, or through Federal private RICO and causes of action, breach of contract claims, or common law claims such as negligence, professional malpractice and fraud.

In addition, a number of rules (including Treas. Reg. §1.6664-4(f)(2)(i)(B)(2) and Section 6662A) limit a taxpayer's ability to use a pure advisor's opinion to avoid the substantial understatement penalty unless the opinion satisfies certain requirements, and these rules indirectly "police" advisors.

4. There Is No Indication That the May 2007 Amendments Were Aimed at Pure Advisors.

The events leading up to the enactment of H.R. 2206 do not indicate that Congress intended the 2007 amendments to Section 6694 and 7701(a)(36) to apply to persons who only give advice. There is no evidence that Congress was reacting to misbehavior by Pure Advisors. Nor does it seem that Congress intended to police the relationship between Pure Advisors and their clients or to limit the dialogue or information flow between them (by, for example, adopting rules that discourage advisors from discussing issues when they are uncertain whether their final view will be that there is MLTN-level support for the position under discussion).

When Congress passed the revisions to Sections 6694 and 7701(a)(36) in May, it retained all of the Section 7701(a)(36) definition except that it expanded the definition from applying to only income tax returns to apply to all tax returns. Based upon the 2007 legislative history and the events leading up to H.R. 2206,[29] we believe that Congress understood a "preparer" to be a person who compiles the data, computes the entries and places the entries on the return (or communicates the information to the taxpayer so that the taxpayer can, without much independent thought, place the entries on the return). As explained above, we also believe that

[29] See Appendix Part VI for a detailed description.

the initial intent of Section 6694 was not to regulate pure advisors or turn them into gatekeepers or disciplinarians.

For all of these reasons, we believe that the term "preparer" should be defined in a way that does not include a "Pure Advisor".

C. Recommendation 3: A Pure Advisor Should Be Defined As Someone Who Never Drafts, Reviews or Discusses the Actual Return.

For purposes of any rule that defines "preparer" as excluding Pure Advisors (or applies the preparer rules differently to Pure Advisors), we recommend that Pure Advisor be defined as someone who never drafts, reviews, or discusses the actual return. We reached this recommendation after extended consideration of the practical and policy issues involved.

If "preparer" is defined to exclude a class of persons because they only give advice, it becomes necessary to draw a line distinguishing these pure advice-giving activities from those "other activities" that should be considered return preparation activities. At one extreme is the Pure Advisor who never discusses numbers or return lines at all. At the opposite extreme is the Shadow Preparer who in effect prepares 99% of the return without actually filling it out. In between is the Schedule Preparer who advises on a schedule, but may not actually fill it out. Where on this spectrum should an advisor become a preparer?[30]

We believe it is important to clarify what a Pure Advisor must do to be a potential preparer. The current regulatory definition is not very clear, and we think that a better rule would turn on whether the advisor discusses or reviews the actual return. If such a rule were

[30] We found this question quite difficult to answer, and in trying to do so we asked what Sections 6694 and 6695 were intended to achieve. This led back to our conclusion, discussed in III.A.3 above, that Congress seems to have intended the phrase "a substantial portion" in Section 7701(a)(36) mainly to address a situation where someone who is primarily responsible for the preparation of a return claims he or she is not a preparer because he or she did not prepare 100% of the return.

adopted, the question then arises how much discussion or review is necessary. We believe that drawing distinctions at that point would be a futile exercise and that it would be better to say that any discussion or any review (provided it takes place after the underlying events have occurred) is sufficient to constitute "preparation" activities.

We think it would be unhelpful to taxpayers and the IRS, and unrealistic, to distinguish Pure Advisors from true preparers based upon whether they ever discuss the amount, timing or character of a tax item or on what year's return the item should be reflected on. Instead, we believe that an advisor ceases to be a Pure Advisor once he assists in preparing or reviewing a draft or final version of the return or a schedule to the return, or discusses specifically what should go on the return or where something should go on the return. Such a rule would at least provide practitioners with a reasonably objective test to help them determine whether they might be a preparer. This would assure a Pure Advisor who never discussed the return itself that he is not subject to Section 6694 (and thus would not need to provide to the client an extended "disclosure" of the type outlined in III.G below).

This proposal has some drawbacks: (i) it might discourage an advisor from giving advice or engaging in discussion that the advisor thinks might get too close to a discussion of the return itself and thus expose the advisor to potential Section 6694 liability, which could deny taxpayers useful and helpful advice; (ii) many advisors might remain concerned about crossing the preparer line and therefore take the same precautions they would have if Pure Advisors were subject to Section 6694; (iii) it may divert practitioner focus as advisors try to insure that there is sufficient proof that they are not crossing the preparer line. Nevertheless, we think this proposal has the compelling advantage of drawing a clear line that an advisor most likely will know when he is crossing, and that it is superior to the current, more ambiguous, definition.

To illustrate how our proposal might work, consider the following report from the Wall Street Journal,[31] discussing the revisions to Section 6694:

> "Ms. Hill says she recently spent three hours with a new client who had asked her to review two years of returns he had prepared for himself. 'There were three obvious issues he had taken' that could raise questions, Ms. Hill says. When she explained the new law, 'he quickly figured out that I could not prepare his returns taking those aggressive positions without full disclosure,' but that he could do so on his own.
>
> "Ms. Hill says she is now considering the client's request to engage her merely to 'consult' on his returns, not to prepare them. 'I have to figure out at what point advice I give about a return becomes "return preparation,"' she says."

How would our definition apply in this case? If by "consult" on the return, Ms. Hill means that she would discuss what goes on the return and in what places, then under our proposal she would no longer be a Pure Advisor. Depending upon how much she does, she is either a Schedule Preparer or a Shadow Preparer (in which case, she might even be the person obligated to sign the return).

In developing our recommendations, we considered alternative approaches to the problem of defining "tax return preparer." One idea we considered was the "6694 Letter," which would work as follows. Every return has, initially, only a single preparer. That would be the Classic Preparer or the Shadow Preparer, *i.e.*, the "signing preparer" as determined under Section 6695. That person is initially responsible for every entry on the return. If the Classic Preparer or Shadow Preparer relies upon advice from another person (a Pure Advisor or Schedule Preparer)

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[31] Tom Herman, The IRS Has A New Weapon: Your Tax Pro -- Law 'Deputizes' Preparers To Police Their Clients; Higher Fees a Likely Result, Wall St. J., July 11, 2007, at D1.

in making an entry on the return, that other person is not a preparer unless that person delivers a "6694 Letter" accepting the role of preparer as to that entry, and the letter would relieve the primary preparer of Section 6694 responsibility for that item. Similarly, for a return prepared in-house (where the person who puts together the return is never a "preparer" because of the exception for employees of the taxpayer), the Pure Advisor is not the preparer (even though there is no other preparer) unless the Pure Advisor delivers a 6694 Letter to the in-house client.

Practically, would a Pure Advisor or Schedule Preparer ever be willing to provide a 6694 Letter? We imagine that he/she might do so at the taxpayer's request, just as an advisor will provide a MLTN opinion on a particular issue knowing the taxpayer intends to use it for Section 6664 purposes. A taxpayer might want this because it may be more efficient and reduce the taxpayer's professional fees if only one outside advisor needs to become comfortable with that particular position. This proposal is not about making sure there is at least one preparer of each entry. It is about creating certainty for the advisors and the IRS as to who the preparer of each entry is, and perhaps reducing the costs of amended Section 6694 for taxpayers.

We decided against the 6694 letter approach because the current Regulations already interpret the Section 6694 "reasonable cause and good faith" defense to include reliance by the preparer on another person.[32] We think this existing reliance defense (which we believe it is important to retain, with clarifications described in III.E below)[33] limits the utility of the 6694 letter approach to the point where the additional complexity this approach would introduce is on balance not warranted.

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[32] Treas. Reg. §1.6694-2(d)(5).

[33] As indicated below, we think the current Regulation should be revised so that the person whose advice is relied upon need not be a "preparer" in order for this defense to be available.

D. Recommendation 4: Clarify "Substantial Portion" Rule and Increase Minimum Threshold.

Another issue in need of attention is the lack of clarity and (in our view) overbreadth of the "substantial portion" test in Treas. Reg. §301.7701-15(b). The current Regulation is, we believe, very difficult to apply and may lead to some odd results. Assume, for example, that an advisor gives extensive advice on a complicated question where the amount at issue ends up being a small percentage of the total income reported on the return. Is that a "substantial portion" because of the complexity, even though numerically it is a small portion?

It is also not at all clear what "substantial" means in numerical terms. Consider for example Treas. Reg. §1.279-3(c)(2) which indicates that for purposes of Section 279, "substantial" may be as little as 5%. At the opposite extreme is the possibility that "substantial" means something similar to "substantially all" (*i.e.*, 80% or more).

Currently Treas. Reg. §301.7701-15(b)(2) has a safe harbor which provides that if the entries a person prepared are together "(i) less than $2,000, or (ii) less than $100,000 and also less than 20 percent of the gross income (or adjusted gross income if the taxpayer is an individual) as shown on the return or claim for refund," then that person is not a preparer.

As to the de minimis dollar amount in clause (i), we think it should be increased.

As to the clause (ii) test, we recommend that it be converted into a simple percentage test without a dollar cap. We looked to the Section 6662 substantial understatement thresholds for guidance. We propose providing that a "substantial portion" means that the entries (i) exceed a de minimis dollar threshold and (ii) involve amounts of gross income or deductions that are at least 20% of the gross income or deductions, respectively, shown on the return, or involve tax credits that are at least 10% of the total pre-credit taxes.

One weakness with this approach is that it still does not completely solve the problem that the Pure Advisor or Schedule Preparer often has no way to know at the time advice is provided the gross income/credit "percentage" represented by the entries that he or she is providing advice on, and hence whether he or she is subject to Section 6694. Nevertheless, having a higher de minimis dollar threshold and a higher gross income/credit percentage test, as we are recommending, should help with this.

Finally, where the understatement involves an item of income or gain, we believe the substantial portion analysis should be performed by comparing what *should have been* on the return with respect to that item (rather than what was in fact shown) to the remainder of the return; and for an understatement involving a loss or credit, the substantial portion analysis should be based upon comparing what was shown on the return with respect to the loss or credit to the remainder of the return.

We believe a definition of substantial portion should be retained even if the government adopts a one-preparer rule, because in certain cases the test would be needed to determine whether someone who contributes to a return, but does not complete 100% of it, is the one preparer. Any de minimis rule or safe harbor should not apply to someone who completes the entire return.

E. Recommendation 5: Clarify "Reasonable Cause and Good Faith" Defense.

Treas. Reg. §1.6694-2(d) provides a "reasonable cause and good faith" exception from a preparer's Section 6694 liability in certain circumstances. This exception applies to the extent "the preparer relied in good faith on the advice of [or schedules prepared by] another preparer (or a person who would be considered a preparer under §1.6694-1(b) had the advice [or schedules]

constituted preparation of a substantial portion of the return or claim for refund)," provided certain other conditions are satisfied.[34]

As a corollary to our other recommendations (e.g., that there be only one preparer of a return, and that Pure Advisors are not preparers), we recommend revising the reasonable cause and good faith exception to clarify that a preparer's ability to use this defense based on reliance upon a third party's advice does not depend on that third party qualifying as a "preparer." We acknowledge that this could result in no person having Section 6694 liability for a particular return entry (or possibly for an entire return). However, that can already result under current law since, as the quoted language indicates, the third party advisor is not required to have prepared "a substantial portion" of the return and hence may not be a preparer. We think this is not a problem from a policy perspective, because Section 6694 is not designed to ensure that there is always at least one preparer for every understated item. Rather, Section 6694 was enacted to impose some constraints on Classic Preparers. This is evidenced by the fact that an in-house preparer is not a Section 7701(a)(36) preparer, and that an outside advisor to the in-house preparer is not always a preparer (as noted earlier). This is the case even if the outside advisor is the "preparer" of a specific entry (but less than "a substantial portion" of a return). [35]

The reasonable cause and good faith exception of Treas. Reg. §1.6694-2(d) generally applies "if considering all the facts and circumstances, it is determined that the understatement was due to reasonable cause and that the preparer acted in good faith." The Regulation lists several "factors to consider." It does not list as a mitigating factor that a practitioner did not

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[34] Treas. Reg. §1.6694-2(d)(5).

[35] In addition, a person who prepares a return without compensation is not a "preparer". Treas. Reg. §301.7701-15(a)(4)

know (and had no reason to know) that he was subject to Section 6694, e.g., because he had no reason to suppose that his advice concerned "a substantial portion" of a return. Presumably that would not be a good defense, though the Regulations might clarify this.

F. Recommendation 6: Clarify Preparer's Ability to Rely on Factual (Non-Legal) Information Provided by the Taxpayer or Other Advisors.

Treas. Reg. §1.6694-1(e) states that a preparer "generally may rely in good faith without verification upon information furnished by the taxpayer," except that the preparer (i) "may not ignore the implications of information furnished to the preparer or actually known by the preparer," (ii) "must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete," and (iii) "must make appropriate inquiries to determine the existence of facts and circumstances required by a Code section or regulation as a condition to the claiming of a deduction."

The expanded preparer definition and heightened preparer standard under the May 2007 amendments to Sections 6694 and 7701(a)(36) increase the importance of a practitioner's ability to rely on facts provided by the taxpayer. While we generally support the basic rule described in the Regulations, we suggest that the Regulations clarify, perhaps by one or more additional examples, the application of this rule to valuation and transfer pricing information in particular, which is often relied upon by practitioners of all types in advising taxpayers and preparing their returns (see, for example, the discussion of Schedule Preparers in III.A.4.d above). In addition, we recommend clarifying that the rule covers not only information furnished directly by the taxpayer, but also information furnished by others retained by the taxpayer (such as an appraiser). These clarifications to the diligence obligations imposed on preparers with respect to

factual information not only will be helpful to practitioners but also may reduce the monetary cost of the new rules for taxpayers who engage third party preparers (see III.A.8 above).

G. Recommendation 7: Revise Section 6694(a) Disclosure Requirements for Signing Preparers and (If the Concept is Retained) Nonsigning Preparers.

As explained above and in Appendix Part II, if there is an understatement, then under Section 6694(a) the preparer's defenses to a penalty are: (i) there was "a reasonable belief" that the position causing the understatement was supported by MLTN, or (ii) there was a "reasonable basis" for the position and the position was "disclosed as provided in section 6662(d)(2)(B)(ii)."[36] The current Section 6694 Regulations provide that this disclosure requirement is met for the signing preparer only if a Form 8275 (or Form 8275-R) is filed with the return.[37] For a nonsigning preparer, the requirement may be met by either the Form 8275/8275-R filing or by the preparer providing, along with his advice, a statement (which must be in writing if the advice is in writing, but may be oral if the advice is oral) about what disclosure will achieve for the client under Section 6662.[38]

1. Signing preparers. For a signing preparer, so long as the current disparity between the taxpayer penalty standards (Sections 6662 and 6664) and the preparer penalty standards (Section 6694) remains, filing a Form 8275 or Form 8275-R with the return should not be the sole means by which the preparer is permitted to satisfy the "disclosure" prong of the Section 6694(a) "reasonable basis plus disclosure" exception. Currently, the situations where a taxpayer would need disclosure to avoid a Section 6662 penalty are more limited than those

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[36] Section 6694(a)(2). The preparer also has the reasonable cause and good faith defense, but our focus here is on the defenses based upon the strength of the position.

[37] Treas. Reg. §1.6694-2(c)(3)(i).

[38] Treas. Reg. §1.6694-2(c)(3)(ii).

where the preparer would need disclosure for Section 6694 purposes. In other words, if the position is supported by only "substantial authority", the taxpayer may be able to avoid the penalty (without disclosures) based upon that fact alone, whereas the preparer would instead need disclosure as well.

Therefore, as long as the current Section 6662 and 6664 rules permit a taxpayer to avoid penalties in cases where the preparer would face a Section 6694(a) penalty, the signing preparer should not have to disadvantage his client to protect himself.[39] Accordingly, in a situation where the disclosure would not be required for the client taxpayer to avoid a Section 6662 penalty, the signing preparer should be able to satisfy the Section 6694(a) disclosure requirement by counseling the taxpayer *in writing* regarding how the penalty rules applicable to the taxpayer (including the disclosure aspects of those rules) work.[40] Such disclosure statement could be along the lines of the disclosure statement proposed for nonsigning preparers who give their advice in writing (in III.G.2 below). By contrast, where the taxpayer would still need disclosure to avoid the Section 6662 penalty, the signing preparer should be able to satisfy the Section 6694 disclosure requirement only if the return, as filed, also satisfies the Section 6662 disclosure requirement.

We also note that the instructions to the Form 8275 (last revised February 2006) need to be revised to reflect the new law, since they describe old Section 6694 in several places.

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[39] See the discussion in I above of the "Granny's Lawyer Goes to Jail" case and the Georgetown Law Review article, and the discussion in Appendix Part IX of the ABA Tax Section Statement 2000-1.

[40] We believe the Treasury and IRS have regulatory authority under the Code to expand the permitted Section 6694(a) "disclosure" for a signing preparer in this manner, in part because Treas. Reg. §1.6694-2(c)(3)(ii)(A) has permitted a nonsigning preparer to satisfy the disclosure requirement using a written (or, for oral advice, oral) statement since 1977, and those Regulations have never been considered invalid. See III.A.9 for further discussion of regulatory authority to implement our recommendations in this Report.

2. Nonsigning preparers. If the concept of "nonsigning preparer" is retained, there should be clear rules for how a nonsigning preparer can satisfy the Section 6694(a) "disclosure" requirement. As further discussed below, one permissible way should be for the nonsigning preparer to explain to the taxpayer (in writing, or orally if the advice was given entirely orally) how the penalty rules applicable to the taxpayer (including the disclosure aspects of those rules) work. The Regulations should provide an example of a specific statement that would suffice for this purpose. The statement that the current Section 6694 Regulations call for would not be appropriate, because it is based upon a regime where the taxpayer needs disclosure in more situations than the advisor does. If that same statement were used today, the advisor would be in many cases giving false advice.[41]

If the definition of "tax return preparer" continues to include Pure Advisors, as explained in III.A.7 above a cautious tax advisor will be inclined to assume that any advice he gives, whether written or oral, could be part of post-transaction advice and relate to a "substantial portion" of a return and thus potentially make him a "preparer" of that return. For written advice, the advisor could add a uniform Section 6694 "disclosure legend" saying whatever the Section 6694 Regulations require for "disclosure" by a nonsigning preparer.[42]

A possible legend might look like the following:

"You should be aware that if you have an understatement of tax on a U.S. Federal income tax return, you could face an understatement penalty (under IRC Section 6662) and that under certain circumstances, filing a properly completed IRS Form

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[41] See Appendix Part VIII for a description of the rules applicable to taxpayers.

[42] This of course was the reaction of practitioners to the 2004 expansion of Circular 230, leading to widespread adoption of the so-called "Circular 230 legend," including on emails.

8275 (or Form 8275-R) disclosure statement with your U.S. Federal return may assist you in avoiding that penalty. There are three possible defenses to the Section 6662 understatement penalty: (1) the position that resulted in the understatement was supported by "substantial authority" within the meaning of IRC Section 6662; (2) the position was supported by "a reasonable basis" within the meaning of IRC Section 6662 and you included with your income tax return a properly completed Form 8275 (or, if applicable, Form 8275-R) disclosing that position; or (3) you satisfy the requirements for the "reasonable cause and good faith defense" in IRC Section 6664. However, if it is determined that there was "a significant purpose" of avoiding or evading U.S. Federal income tax, then the first two defenses would not be available to you, and including a Form 8275 (or Form 8275-R) disclosure statement with your return would not assist you in satisfying any defense to the penalty. We do not address other possible penalties that may apply to you, whether under U.S. Federal law, or state, local or foreign law."[43]

We note that some practitioners may find this type of legend troubling because it does not provide a thorough explanation of all the applicable rules and how they might apply to the particular taxpayer.

Oral advice is another problem area that advisors would need to address. An advisor could be a "preparer" simply because oral advice relates to a "substantial portion" of a return. If the "preparer" definition continues to include Pure Advisors, we recommend that future guidance

[43] Practitioners advising on Federal taxes other than income taxes would need to modify this disclosure statement to reflect the penalty rules applicable to those taxes.

clarify how a practitioner may satisfy the disclosure requirement for oral advice contemplated by Treas. Reg. §1.6694-2(c)(3)(ii) given the new statutory scheme.[44]

A legend of the type described above would work only if the current regulatory version of Section 6694(a) disclosure for a nonsigning preparer is retained – i.e., only if a written (or, for oral advice, oral) "speech," in lieu of the taxpayer filing a Form 8275 with its return, still qualifies. While we understand that the Treasury and the IRS may find the use of such a legend troubling, some relief or safe harbor for advisors is needed, and it would not be feasible or fair to require nonsigning preparers to be responsible for the filing of a Form 8275 with a return over which they have no control and which they often will not even see.

While we see numerous downsides to the "legending" concept, it is good policy to encourage an advisor to explain to a client the penalty rules applicable to taxpayers understatements, including the role of disclosure. Consider the signing preparer who determines that there is substantial authority for the client's position and thus no disclosure is required for the taxpayer to avoid a Section 6662 penalty. Perhaps the preparer has judged incorrectly and there is not substantial authority, or perhaps the taxpayer is more risk-adverse and would prefer including a disclosure in case the preparer is not correct. It would be beneficial for the taxpayer to be told of the rules and of the available options and their pluses and minuses.

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[44] See III.A.7 above for other possible responses by advisors to potential Section 6694 exposure.