

§ 1.6694-2

26 CFR Ch. I (4-1-10 Edition)

return preparation. The income derived by H with respect to the return for purposes of computing the penalty under section 6694(a) is \$16,000, and the amount of the penalty imposed under section 6694(a) is \$8,000.

Example 2. Accountants I, J, and K are employed by Firm L. I is a principal manager of Firm L and provides corporate tax advice for the taxpayer after all events have occurred subject to an engagement for corporate tax advice. J provides international tax advice for the taxpayer after all events have occurred subject to a different engagement for international tax advice. K prepares and signs the taxpayer's return under a general tax services engagement. I's advice is the source of an understatement on the return and the advice constitutes preparation of a substantial portion of the return within the meaning of §301.7701-15(b) of this chapter. I is the nonsigning tax return preparer within the firm with overall supervisory responsibility for the position on the taxpayer's return giving rise to an understatement. Thus, I is the tax return preparer who is primarily responsible for the position on the taxpayer's return giving rise to the understatement. Because K's signature as the signing tax return preparer is on the return, the IRS advises K that K may be subject to the section 6694(a) penalty. K provides credible information that I is the tax return preparer with primary responsibility for the position that gave rise to the understatement. The IRS, therefore, assesses the section 6694 penalty against I. The portion of the total amount of the penalty allocable to I does not exceed 50 percent of that part of I's compensation that is attributable to the corporate tax advice engagement. In the event that Firm L is also liable under the provisions in §1.6694-2(a)(2), the IRS assesses the section 6694 penalty in an amount not exceeding 50 percent of Firm L's firm compensation based on the engagement relating to the corporate tax advice services provided by I where there is no applicable reduction in compensation pursuant to §1.6694-1(f)(2)(iii).

Example 3. Same facts as *Example 2*, except that I provides the advice on the corporate matter when the events have not yet occurred. I's advice is the cause of an understatement position on the return, but I is not a tax return preparer pursuant to §301.7701-15(b)(2) or (3) of this chapter. K is not limited to reliance on persons who provide post-transactional advice if such reliance is reasonable and in good faith. Further, K has reasonable cause because K relied on I for the advice on the corporate tax matter. I, K and Firm L are not liable for the section 6694 penalty.

Example 4. Attorney M is an employee of Firm N with a salary of \$75,000 per year. M performs tax preparation work for Client O. Client O's return contains a position that results in an understatement subject to the

section 6694 penalty. M spent 100 hours on the position (out of a total 2,000 billed during the year). The total fees earned by Firm N with respect to the position reflected on Client O's return are \$50,000. If M is subject to the penalty, the penalty amount computed under the 50 percent of income standard is $.5 \times (100/2,000) \times \$75,000 = \$1,875$. If Firm N is subject to the penalty, the penalty amount computed under the 50% of income standard is $.5 \times \$50,000 = \$25,000$, less any penalty amount imposed against M. If a penalty of \$1,875 was assessed against M and Firm N was subject to the penalty, a penalty of \$23,125 would be the amount of penalty assessed against Firm N.

(g) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78439, Dec. 22, 2008, as amended at 74 FR 5104, Jan. 29, 2009]

§ 1.6694-2 Penalty for understatement due to an unreasonable position.

(a) *In general*—(1) *Proscribed conduct.* Except as otherwise provided in this section, a tax return preparer is liable for a penalty under section 6694(a) equal to the greater of \$1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer for any return or claim for refund that it prepares that results in an understatement of liability due to a position if the tax return preparer knew (or reasonably should have known) of the position and either—

(i) The position is with respect to a tax shelter (as defined in section 6662(d)(2)(C)(ii)) or a reportable transaction to which section 6662A applies, and it was not reasonable to believe that the position would more likely than not be sustained on its merits;

(ii) The position was not disclosed as provided in this section, the position is not with respect to a tax shelter (as defined in section 6662(d)(2)(C)(ii)) or a reportable transaction to which section 6662A applies, and there was not substantial authority for the position; or

(iii) The position (other than a position with respect to a tax shelter or a reportable transaction to which section 6662A applies) was disclosed as provided in this section but there was no reasonable basis for the position.

(2) *Special rule for corporations, partnerships, and other firms.* A firm that

employs a tax return preparer subject to a penalty under section 6694(a) (or a firm of which the individual tax return preparer is a partner, member, shareholder or other equity holder) is also subject to penalty if, and only if—

(i) One or more members of the principal management (or principal officers) of the firm or a branch office participated in or knew of the conduct proscribed by section 6694(a);

(ii) The corporation, partnership, or other firm entity failed to provide reasonable and appropriate procedures for review of the position for which the penalty is imposed; or

(iii) The corporation, partnership, or other firm entity disregarded its reasonable and appropriate review procedures through willfulness, recklessness, or gross indifference (including ignoring facts that would lead a person of reasonable prudence and competence to investigate or ascertain) in the formulation of the advice, or the preparation of the return or claim for refund, that included the position for which the penalty is imposed.

(b) *Reasonable to believe that the position would more likely than not be sustained on its merits*—(1) *In general.* If a position is with respect to a tax shelter (as defined in section 6662(d)(2)(C)(ii)) or a reportable transaction to which section 6662A applies, it is “reasonable to believe that a position would more likely than not be sustained on its merits” if the tax return preparer analyzes the pertinent facts and authorities and, in reliance upon that analysis, reasonably concludes in good faith that the position has a greater than 50 percent likelihood of being sustained on its merits. In reaching this conclusion, the possibility that the position will not be challenged by the Internal Revenue Service (IRS) (for example, because the taxpayer’s return may not be audited or because the issue may not be raised on audit) is not to be taken into account. The analysis prescribed by § 1.6662-4(d)(3)(ii) (or any successor provision) for purposes of determining whether substantial authority is present applies for purposes of determining whether the more likely than not standard is satisfied. Whether a tax return preparer meets this standard will be determined based upon all

facts and circumstances, including the tax return preparer’s diligence. In determining the level of diligence in a particular situation, the tax return preparer’s experience with the area of Federal tax law and familiarity with the taxpayer’s affairs, as well as the complexity of the issues and facts, will be taken into account. A tax return preparer may reasonably believe that a position more likely than not would be sustained on its merits despite the absence of other types of authority if the position is supported by a well-reasoned construction of the applicable statutory provision. For purposes of determining whether it is reasonable to believe that the position would more likely than not be sustained on the merits, a tax return preparer may rely in good faith without verification upon information furnished by the taxpayer and information and advice furnished by another advisor, another tax return preparer, or other party (including another advisor or tax return preparer at the tax return preparer’s firm), as provided in §§ 1.6694-1(e) and 1.6694-2(e)(5).

(2) *Authorities.* The authorities considered in determining whether a position satisfies the more likely than not standard are those authorities provided in § 1.6662-4(d)(3)(iii) (or any successor provision).

(3) *Written determinations.* The tax return preparer may avoid the section 6694(a) penalty by taking the position that the tax return preparer reasonably believed that the taxpayer’s position satisfies the “more likely than not” standard if the taxpayer is the subject of a “written determination” as provided in § 1.6662-4(d)(3)(iv)(A).

(4) *Taxpayer’s jurisdiction.* The applicability of court cases to the taxpayer by reason of the taxpayer’s residence in a particular jurisdiction is not taken into account in determining whether it is reasonable to believe that the position would more likely than not be sustained on the merits. Notwithstanding the preceding sentence, the tax return preparer may reasonably believe that the position would more likely than not be sustained on the merits if the position is supported by controlling precedent of a United States Court of Appeals to which the taxpayer has a

right of appeal with respect to the item.

(5) When “more likely than not” standard must be satisfied. For purposes of this section, the requirement that a position satisfies the “more likely than not” standard must be satisfied on the date the return is deemed prepared, as prescribed by § 1.6694-1(a)(2).

(c) [Reserved]

(d) *Exception for adequate disclosure of positions with a reasonable basis*—(1) *In general.* The section 6694(a) penalty will not be imposed on a tax return preparer if the position taken (other than a position with respect to a tax shelter or a reportable transaction to which section 6662A applies) has a reasonable basis and is adequately disclosed within the meaning of paragraph (c)(3) of this section. For an exception to the section 6694(a) penalty for reasonable cause and good faith, see paragraph (e) of this section.

(2) *Reasonable basis.* For purposes of this section, “reasonable basis” has the same meaning as in § 1.6662-3(b)(3) or any successor provision of the accuracy-related penalty regulations. For purposes of determining whether the tax return preparer has a reasonable basis for a position, a tax return preparer may rely in good faith without verification upon information furnished by the taxpayer and information and advice furnished by another advisor, another tax return preparer, or other party (including another advisor or tax return preparer at the tax return preparer’s firm), as provided in §§ 1.6694-1(e) and 1.6694-2(e)(5).

(3) *Adequate disclosure*—(i) *Signing tax return preparers.* In the case of a signing tax return preparer within the meaning of § 301.7701-15(b)(1) of this chapter, disclosure of a position (other than a position with respect to a tax shelter or a reportable transaction to which section 6662A applies) for which there is a reasonable basis but for which there is not substantial authority is adequate if the tax return preparer meets any of the following standards:

(A) The position is disclosed in accordance with § 1.6662-4(f) (which permits disclosure on a properly completed and filed Form 8275, “Disclosure Statement,” or Form 8275-R, “Regulation Disclosure Statement,” as appro-

priate, or on the tax return in accordance with the annual revenue procedure described in § 1.6662-4(f)(2));

(B) The tax return preparer provides the taxpayer with the prepared tax return that includes the disclosure in accordance with § 1.6662-4(f); or

(C) For returns or claims for refund that are subject to penalties pursuant to section 6662 other than the accuracy-related penalty attributable to a substantial understatement of income tax under section 6662(b)(2) and (d), the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer under section 6662. The tax return preparer must also contemporaneously document the advice in the tax return preparer’s files.

(ii) *Nonsigning tax return preparers.* In the case of a nonsigning tax return preparer within the meaning of § 301.7701-15(b)(2) of this chapter, disclosure of a position (other than a position with respect to a tax shelter or a reportable transaction to which section 6662A applies) that satisfies the reasonable basis standard but does not satisfy the substantial authority standard is adequate if the position is disclosed in accordance with § 1.6662-4(f) (which permits disclosure on a properly completed and filed Form 8275 or Form 8275-R, as applicable, or on the return in accordance with an annual revenue procedure described in § 1.6662-4(f)(2)). In addition, disclosure of a position is adequate in the case of a nonsigning tax return preparer if, with respect to that position, the tax return preparer complies with the provisions of paragraph (c)(3)(ii)(A) or (B) of this section, whichever is applicable.

(A) *Advice to taxpayers.* If a nonsigning tax return preparer provides advice to the taxpayer with respect to a position (other than a position with respect to a tax shelter or a reportable transaction to which section 6662A applies) for which there is a reasonable basis but for which there is not substantial authority, disclosure of that position is adequate if the tax return preparer advises the taxpayer of any opportunity to avoid penalties under section 6662 that could apply to the position, if relevant, and of the standards for disclosure to the extent applicable.

The tax return preparer must also contemporaneously document the advice in the tax return preparer's files. The contemporaneous documentation should reflect that the affected taxpayer has been advised by a tax return preparer in the firm of the potential penalties and the opportunity to avoid penalty through disclosure.

(B) *Advice to another tax return preparer.* If a nonsigning tax return preparer provides advice to another tax return preparer with respect to a position (other than a position with respect to a tax shelter or a reportable transaction to which section 6662A applies) for which there is a reasonable basis but for which there is not substantial authority, disclosure of that position is adequate if the tax return preparer advises the other tax return preparer that disclosure under section 6694(a) may be required. The tax return preparer must also contemporaneously document the advice in the tax return preparer's files. The contemporaneous documentation should reflect that the tax return preparer outside the firm has been advised that disclosure under section 6694(a) may be required. In addition, disclosure of a position is adequate in the case of a nonsigning tax return preparer if, with respect to that position, the tax return preparer complies with the provisions of paragraph (d)(3)(ii)(A) or (B) of this section, whichever is applicable.

(iii) *Requirements for advice.* For purposes of satisfying the disclosure standards of paragraphs (d)(3)(i)(C) and (ii) of this section, each return position for which there is a reasonable basis but for which there is not substantial authority must be addressed by the tax return preparer. The advice to the taxpayer with respect to each position, therefore, must be particular to the taxpayer and tailored to the taxpayer's facts and circumstances. The tax return preparer is required to contemporaneously document the fact that the advice was provided. There is no general pro forma language or special format required for a tax return preparer to comply with these rules. A general disclaimer will not satisfy the requirement that the tax return preparer provide and contemporaneously document advice regarding the likeli-

hood that a position will be sustained on the merits and the potential application of penalties as a result of that position. Tax return preparers, however, may rely on established forms or templates in advising clients regarding the operation of the penalty provisions of the Internal Revenue Code. A tax return preparer may choose to comply with the documentation standard in one document addressing each position or in multiple documents addressing all of the positions.

(iv) *Pass-through entities.* Disclosure in the case of items attributable to a pass-through entity is adequate if made at the entity level in accordance with the rules in §1.6662-4(f)(5) or at the entity level in accordance with the rules in paragraphs (d)(3)(i) or (ii) of this section.

(v) *Examples.* The provisions of paragraph (d)(3) of this section are illustrated by the following examples:

Example 1. An individual taxpayer hires Accountant R to prepare its income tax return. A particular position taken on the tax return does not have substantial authority although there is a reasonable basis for the position. The position is not with respect to a tax shelter or a reportable transaction to which section 6662A applies. R prepares and signs the tax return and provides the taxpayer with the prepared tax return that includes the Form 8275, "Disclosure Statement," disclosing the position taken on the tax return. The individual taxpayer signs and files the tax return without disclosing the position. The IRS later challenges the position taken on the tax return, resulting in an understatement of liability. R is not subject to a penalty under section 6694.

Example 2. Attorney S advises a large corporate taxpayer concerning the proper treatment of complex entries on the corporate taxpayer's tax return. S has reason to know that the tax attributable to the entries is a substantial portion of the tax required to be shown on the tax return within the meaning of §301.7701-15(b)(3). When providing the advice, S concludes that one position does not have substantial authority, although the position meets the reasonable basis standard. The position is not with respect to a tax shelter or a reportable transaction to which section 6662A applies. S advises the corporate taxpayer that the position lacks substantial authority and the taxpayer may be subject to an accuracy-related penalty under section 6662 unless the position is disclosed in a disclosure statement included in the return. S also documents the fact that this advice was

contemporaneously provided to the corporate taxpayer at the time the advice was provided. Neither S nor any other attorney within S's firm signs the corporate taxpayer's return as a tax return preparer, but the advice by S constitutes preparation of a substantial portion of the tax return, and S is the individual with overall supervisory responsibility for the position giving rise to the understatement. Thus, S is a tax return preparer for purposes of section 6694. S, however, will not be subject to a penalty under section 6694.

(e) *Exception for reasonable cause and good faith.* The penalty under section 6694(a) will not be imposed if, considering all the facts and circumstances, it is determined that the understatement was due to reasonable cause and that the tax return preparer acted in good faith. Factors to consider include:

(1) *Nature of the error causing the understatement.* The error resulted from a provision that was complex, uncommon, or highly technical, and a competent tax return preparer of tax returns or claims for refund of the type at issue reasonably could have made the error. The reasonable cause and good faith exception, however, does not apply to an error that would have been apparent from a general review of the return or claim for refund by the tax return preparer.

(2) *Frequency of errors.* The understatement was the result of an isolated error (such as an inadvertent mathematical or clerical error) rather than a number of errors. Although the reasonable cause and good faith exception generally applies to an isolated error, it does not apply if the isolated error is so obvious, flagrant, or material that it should have been discovered during a review of the return or claim for refund. Furthermore, the reasonable cause and good faith exception does not apply if there is a pattern of errors on a return or claim for refund even though any one error, in isolation, would have qualified for the reasonable cause and good faith exception.

(3) *Materiality of errors.* The understatement was not material in relation to the correct tax liability. The reasonable cause and good faith exception generally applies if the understatement is of a relatively immaterial amount. Nevertheless, even an immaterial understatement may not qualify for the

reasonable cause and good faith exception if the error or errors creating the understatement are sufficiently obvious or numerous.

(4) *Tax return preparer's normal office practice.* The tax return preparer's normal office practice, when considered together with other facts and circumstances, such as the knowledge of the tax return preparer, indicates that the error in question would occur rarely and the normal office practice was followed in preparing the return or claim for refund in question. Such a normal office practice must be a system for promoting accuracy and consistency in the preparation of returns or claims for refund and generally would include, in the case of a signing tax return preparer, checklists, methods for obtaining necessary information from the taxpayer, a review of the prior year's return, and review procedures. Notwithstanding these rules, the reasonable cause and good faith exception does not apply if there is a flagrant error on a return or claim for refund, a pattern of errors on a return or claim for refund, or a repetition of the same or similar errors on numerous returns or claims for refund.

(5) *Reliance on advice of others.* For purposes of demonstrating reasonable cause and good faith, a tax return preparer may rely without verification upon advice and information furnished by the taxpayer and information and advice furnished by another advisor, another tax return preparer or other party, as provided in § 1.6694-1(e). The tax return preparer may rely in good faith on the advice of, or schedules or other documents prepared by, the taxpayer, another advisor, another tax return preparer, or other party (including another advisor or tax return preparer at the tax return preparer's firm), who the tax return preparer had reason to believe was competent to render the advice or other information. The advice or information may be written or oral, but in either case the burden of establishing that the advice or information was received is on the tax return preparer. A tax return preparer is not considered to have relied in good faith if—

(i) The advice or information is unreasonable on its face;

(ii) The tax return preparer knew or should have known that the other party providing the advice or information was not aware of all relevant facts; or

(iii) The tax return preparer knew or should have known (given the nature of the tax return preparer's practice), at the time the return or claim for refund was prepared, that the advice or information was no longer reliable due to developments in the law since the time the advice was given.

(6) *Reliance on generally accepted administrative or industry practice.* The tax return preparer reasonably relied in good faith on generally accepted administrative or industry practice in taking the position that resulted in the understatement. A tax return preparer is not considered to have relied in good faith if the tax return preparer knew or should have known (given the nature of the tax return preparer's practice), at the time the return or claim for refund was prepared, that the administrative or industry practice was no longer reliable due to developments in the law or IRS administrative practice since the time the practice was developed.

(f) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78442, Dec. 22, 2008, as amended at 74 FR 5104, Jan. 29, 2009]

§ 1.6694-3 Penalty for understatement due to willful, reckless, or intentional conduct.

(a) *In general*—(1) *Proscribed conduct.* A tax return preparer is liable for a penalty under section 6694(b) equal to the greater of \$5,000 or 50 percent of the income derived (or to be derived) by the tax return preparer if any part of an understatement of liability for a return or claim for refund that is prepared is due to—

(i) A willful attempt by a tax return preparer to understate in any manner the liability for tax on the return or claim for refund; or

(ii) Any reckless or intentional disregard of rules or regulations by a tax return preparer.

(2) *Special rule for corporations, partnerships, and other firms.* A firm that employs a tax return preparer subject

to a penalty under section 6694(b) (or a firm of which the individual tax return preparer is a partner, member, shareholder or other equity holder) is also subject to penalty if, and only if—

(i) One or more members of the principal management (or principal officers) of the firm or a branch office participated in or knew of the conduct proscribed by section 6694(b);

(ii) The corporation, partnership, or other firm entity failed to provide reasonable and appropriate procedures for review of the position for which the penalty is imposed; or

(iii) The corporation, partnership, or other firm entity disregarded its reasonable and appropriate review procedures through willfulness, recklessness, or gross indifference (including ignoring facts that would lead a person of reasonable prudence and competence to investigate or ascertain) in the formulation of the advice, or the preparation of the return or claim for refund, that included the position for which the penalty is imposed.

(b) *Willful attempt to understate liability.* A preparer is considered to have willfully attempted to understate liability if the preparer disregards, in an attempt wrongfully to reduce the tax liability of the taxpayer, information furnished by the taxpayer or other persons. For example, if a preparer disregards information concerning certain items of taxable income furnished by the taxpayer or other persons, the preparer is subject to the penalty. Similarly, if a taxpayer states to a preparer that the taxpayer has only two dependents, and the preparer reports six dependents on the return, the preparer is subject to the penalty.

(c) *Reckless or intentional disregard.* (1) Except as provided in paragraphs (c)(2) and (c)(3) of this section, a preparer is considered to have recklessly or intentionally disregarded a rule or regulation if the preparer takes a position on the return or claim for refund that is contrary to a rule or regulation (as defined in paragraph (f) of this section) and the preparer knows of, or is reckless in not knowing of, the rule or regulation in question. A preparer is reckless in not knowing of a rule or regulation if the preparer makes little or no effort to determine whether a rule or