

(1) Section 1.475(a)-2 (concerning marking a security to market upon disposition) applies to dispositions occurring on or after January 4, 1995.

(2) Section 1.475(b)-4 (concerning the identification requirements for obtaining an exemption from mark-to-market treatment) applies to identifications made on or after January 4, 1995.

Margaret Milner Richardson,

Commissioner of Internal Revenue.

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26 CFR Part 1

[IA-55-94]

RIN 1545-AT13

Accuracy-related Penalty

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations which provide guidance as to when a taxpayer may rely upon the advice of others as evidence of reasonable cause and good faith within the meaning of section 6664(c) of the Internal Revenue Code of 1986 for purposes of avoiding the accuracy-related penalty of section 6662, and what constitutes reasonable cause and good faith within the meaning of section 6664(c) as it applies to the substantial understatement penalty of section 6662(b)(2) with respect to tax shelter items of a corporation. The proposed regulations implement changes to the accuracy-related penalty under section 6662 that were made by Title VII of the Uruguay Round Agreements Act (the Act) implementing the Uruguay Round of the General Agreement on Tariffs and Trade. Finally, this document provides notice of a public hearing on the proposed amendments to the regulations.

DATES: Written comments must be received by April 7, 1995. The IRS intends to hold a public hearing on these proposed regulations on April 28, 1995, beginning at 10 a.m. Persons wishing to speak at the hearing must submit outlines of their comments by April 7, 1995.

ADDRESSES: Send submissions to: Internal Revenue Service, Attn: CC:DOM:CORP:T:R (IA-55-94), room 5228, POB 7604, Ben Franklin Station, Washington, DC 20044. The public hearing will be held in the IRS Auditorium, Internal Revenue Building,

1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT:

Concerning the regulations, David L. Meyer, 202-622-6232; concerning submissions, Christina Vasquez, 202-622-6803. (These are not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 6662 of the Internal Revenue Code (Code) imposes an accuracy-related penalty on certain underpayments of tax. Section 6664(c) provides that no accuracy-related penalty is imposed with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

Under current regulations interpreting sections 6662 and 6664, a taxpayer's good faith reliance on the advice (including an opinion) of a professional tax advisor may be taken into account for purposes of determining whether the taxpayer will be subject to an accuracy-related penalty. See, e.g., §§ 1.6662-4(g)(4)(ii) and 1.6664-4(b).

Section 6662(b)(2) of the Code imposes a penalty for a substantial understatement of income tax. An understatement is substantial if it exceeds the greater of 10 percent of the tax required to be shown on the taxpayer's return for the taxable year, or \$5,000 (\$10,000 in the case of a corporation other than an S corporation or a personal holding company). An understatement is defined as the excess of (1) the amount of tax required to be shown on the taxpayer's return, over (2) the amount of tax imposed which is shown on the return, reduced by any rebate.

The Code provides that the amount of an understatement is reduced to the extent that certain conditions are met. For example, section 6662(d)(2), prior to amendment by the Act (Pub. L. 103-465), provided that an understatement is reduced by the portion of the understatement attributable to a tax shelter item of the taxpayer (the *section 6662 tax shelter rule*) if: (1) there is substantial authority for the taxpayer's treatment of the tax shelter item; and (2) the taxpayer reasonably believed (at the time its return was filed) that its treatment of such item was more likely than not the proper treatment.

The substantial understatement penalty was first adopted in section 323 of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248. At that time, Congress believed that

the new standards would "assure that taxpayers who take highly aggressive filing positions are penalized while those who endeavor in good faith to self-assess are not penalized" and that, with respect to tax shelters, "if the principal purpose of a transaction is the reduction of tax, it is not unreasonable to hold participants to a higher standard than ordinary taxpayers." H.R. Conf. Rep. No. 97th Cong., 2d Sess. 575-76 (1982), 1982-2 C.B.650. More recently, Congress has been concerned that the substantial understatement penalty has not been effectively deterring corporate tax shelter transactions and thus, in Section 744 of the Act, eliminated the section 6662 tax shelter rule as it applies to corporations. As a result of this change, "the standards applicable to corporate tax shelters are tightened" and "in no instance [will] this modification result in a penalty not being imposed where a penalty would have been imposed under prior law." S. Rep. No. 412, 103d Cong., 2d Sess. 165 (1994); H.R. Rep. No. 826, 103d Cong., 2d Sess. 198-99 (1994). The change is effective for transactions occurring after December 8, 1994.

The proposed regulations set forth in this document address issues related to the section 6662 tax shelter rule and the reasonable cause exception of section 6664. This guidance includes, but is not limited to, rules that reflect the amendment of section 6662 by the Act.

Explanation of Provisions

Reliance on Tax Advisor

The proposed regulations set forth general rules clarifying when a taxpayer may be considered to have reasonably relied in good faith upon advice (including an opinion provided by a professional tax advisor). These rules apply to all taxpayers and to both tax shelter items and non-tax shelter items. In particular, the rules apply in determining whether reasonable cause and good faith exist for purposes of section 6664(c) and also apply in determining whether a taxpayer other than a corporation is considered to have reasonably relied in good faith on an opinion in order to satisfy the "reasonable belief" requirement of the section 6662 tax shelter rule.

In general, the proposed regulations require advice to be based on all material facts (including, for example, the taxpayer's purposes for entering into a transaction) and to relate applicable law to such facts in reaching its conclusion. The advice must not be based upon unreasonable factual or legal assumptions (including assumptions as to future events), nor

unreasonably rely on the representations, findings or agreements of the taxpayer or any other person.

Reasonable Cause for Tax Shelter Items of a Corporation

The proposed regulations provide additional guidance with respect to the application of the reasonable cause exception of section 6664(c) to a substantial understatement penalty attributable to a tax shelter item of a corporation. These changes apply only to corporations. Accordingly, no inference is intended with respect to the application of section 6664(c) to a substantial understatement penalty attributable to a tax shelter item of a taxpayer other than a corporation. Treasury and the IRS invite comments as to the need for clarification of the application of this exception to such items.

The proposed regulations provide that a corporation's legal justification may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item only if there is substantial authority for the treatment of the item and the corporation reasonably believes in good faith that such treatment is more likely than not the proper treatment. For this purpose, legal justification includes any justification relating to the treatment or characterization under the Federal tax law of the tax shelter item or of the entity, plan or arrangement that gave rise to the item. Thus, a taxpayer's belief (whether independently formed or based on the advice of others) as to the merits of the taxpayer's underlying position is a legal justification.

Satisfaction of the substantial authority and reasonable belief criteria is an important factor to be considered in determining whether the taxpayer acted with reasonable cause and in good faith. However, it is not necessarily dispositive. A corporation will qualify for the reasonable cause and good faith exception only if, under all pertinent facts and circumstances, it acted with reasonable cause and in good faith.

The proposed regulations also provide that facts and circumstances other than a corporation's legal justification may be taken into account, as appropriate, in determining whether it acted with reasonable cause and in good faith, regardless of whether the substantial authority and reasonable belief requirements are satisfied.

The provisions relating to the reasonable cause and good faith exception with respect to corporate tax shelters apply only for purposes of the substantial understatement penalty. No

inference is intended with respect to how the reasonable cause exception may apply to the negligence penalty of section 6662(b)(1). The proposed regulations do not alter the definitions of tax shelter or tax shelter items contained in § 1.6662-4(g)(2) and (3).

Conforming Changes

The proposed regulations would amend the existing regulations under section 6662 to reflect the changes made by the Act and to clarify the definition of reasonable belief under the section 6662 tax shelter rule.

In addition, the proposed regulations clarify that the determination of whether a corporate or non-corporate taxpayer acted with reasonable cause and in good faith with respect to an underpayment that is related to an item reflected on the return of a pass-through entity is made on the basis of all pertinent facts and circumstances, including the taxpayer's own actions, as well as the actions of the pass-through entity.

Proposed Effective Date

The amendments contained in this notice are proposed to be effective for returns the due date of which (determined without regard to extensions) is after the date on which final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before the adoption of these proposed regulations, consideration will be given to any written comments that are submitted timely (a signed original and eight (8) copies) to the IRS. All comments will be available for public inspection and copying in their entirety.

A public hearing will be held on April 28, 1995, in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington,

DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments, an outline of the topics to be discussed, and the time to be devoted to each topic by April 7, 1995.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is David L. Meyer, Office of Assistant Chief Counsel, Income Tax and Accounting, IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.6662-0 is amended by revising the entries for §§ 1.6662-2(d) and 1.6662-4(g) to read as follows:

§ 1.6662-0 Table of contents.

* * * * *

§ 1.6662-2 Accuracy related penalty.

* * * * *

(d) Effective date.

(1) In general.

(2) Special rules for tax shelter items.

* * * * *

§ 1.6662-4 Substantial understatement of income tax.

* * * * *

(g) Items relating to tax shelters.

(1) In general.

(i) Non-corporate taxpayers.

(ii) Corporate taxpayers.

(A) In general.

(B) Special rule for transactions occurring prior to December 9, 1994.

(iii) Disclosure irrelevant.

(iv) Cross-reference.

- (2) Tax shelter.
- (i) In general.
- (ii) Principal purpose.
- (3) Tax shelter item.
- (4) Reasonable belief.
- (i) In general.
- (ii) Facts and circumstances; reliance on tax advisor.

* * * * *

Par. 3. Section 1.6662-2 is amended by:

1. Redesignating the text of paragraph (d) following the heading as paragraph (d)(1), adding a new heading for newly designated paragraph (d)(1), and revising the second sentence of newly redesignated paragraph (d)(1).

2. Adding a new paragraph (d)(2).

The additions and revisions read as follows:

§ 1.6662-2 Accuracy-related penalty.

* * * * *

(d) *Effective date*—(1) *In general.* * * * Except as provided in the preceding sentence and in paragraph (d)(2) of this section, §§ 1.6662-1 through 1.6662-5 apply to returns the due date of which (determined without regard to extensions of time for filing) is after December 31, 1989. * * *

(2) *Special rules for tax shelter items.* Sections 1.6662-4(g)(1) and 1.6662-4(g)(4) apply to returns the due date of which (determined without regard to extensions of time for filing) is after the date on which final regulations are published in the **Federal Register**. Sections 1.6662-4(g)(1) and (4) (as contained in 26 CFR Part 1 revised April 1, 1994) apply to returns the due date of which (determined without regard to extensions of time for filing) is on or before the date on which final regulations are published in the **Federal Register** and after December 31, 1989, subject to changes resulting from Section 744 of Title VII of the Uruguay Round Agreements Act, Pub. L. 103-465 (108 Stat. 4809).

Par. 4. Section 1.6662-4 is amended by revising paragraphs (g)(1), (g)(4), and (g)(5) to read as follows:

§ 1.6662-4 Substantial understatement of income tax.

* * * * *

(g) *Items relating to tax shelters*—(1) *In general*—(i) *Non-corporate taxpayers.* Tax shelter items (as defined in paragraph (g)(3) of this section) of a taxpayer other than a corporation are treated for purposes of this section as if such items were shown properly on the return for a taxable year in computing the amount of tax shown on the return, and thus the tax attributable to such items is not included in the understatement for the year, if—

(A) There is substantial authority (as provided in paragraph (d) of this section) for the tax treatment of that item; and

(B) The taxpayer reasonably believed at the time the return was filed that the tax treatment of that item was more likely than not the proper treatment.

(ii) *Corporate taxpayers*—(A) *In general.* Except as provided in paragraph (g)(1)(ii)(B) of this section, all tax shelter items (as defined in paragraph (g)(3) of this section) of a corporation are taken into account in computing the amount of any understatement.

(B) *Special rule for transactions occurring prior to December 9, 1994.* The tax shelter items of a corporation arising in connection with transactions occurring prior to December 9, 1994 are treated for purposes of this section as if such items were shown properly on the return if the requirements of paragraph (g)(1)(i) are satisfied with respect to such items.

(iii) *Disclosure irrelevant.* Disclosure made with respect to a tax shelter item of either a corporate or non-corporate taxpayer does not affect the amount of an understatement.

(iv) *Cross-reference.* See § 1.6664-4(e) for certain rules regarding the availability of the reasonable cause and good faith exception to the substantial understatement penalty with respect to tax shelter items of corporations.

* * * * *

(4) *Reasonable belief*—(i) *In general.* For purposes of section 6662(d) and paragraph (g)(1)(i)(B) of this section (pertaining to tax shelter items of non-corporate taxpayers), a taxpayer is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if (without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled)—

(A) The taxpayer analyzes the pertinent facts and authorities in the manner described in paragraph (d)(3)(ii) of this section, and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service; or

(B) The taxpayer reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in paragraph (d)(3)(ii) of this section and unambiguously states that the tax advisor concludes that there

is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service.

(ii) *Facts and circumstances; reliance on professional tax advisor.* All facts and circumstances must be taken into account in determining whether a taxpayer satisfies the requirements of paragraph (g)(4)(i) of this section. However, in no event will a taxpayer be considered to have reasonably relied in good faith on the opinion of a professional tax advisor for purposes of paragraph (g)(4)(i)(B) of this section unless the requirements of § 1.6664-4(c)(1) are met. The fact that the requirements of § 1.6664-4(c)(1) are satisfied will not necessarily establish that the taxpayer reasonably relied on the opinion in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

(5) *Pass-through entities.* In the case of tax shelter items attributable to a pass-through entity, the actions described in paragraphs (g)(4)(i)(A) and (B) of this section, if taken by the entity, are deemed to have been taken by the taxpayer and are considered in determining whether the taxpayer reasonably believed that the tax treatment of an item was more likely than not the proper tax treatment.

Par. 5. Section 1.6664-0 is amended by revising the entries for §§ 1.6664-1(b) and 1.6664-4 to read as follows:

§ 1.6664-0 Table of contents.

* * * * *

§ 1.6664-1 Accuracy-related and fraud penalties; definitions and special rules.

* * * * *

(b) Effective date.

(1) In general.

(2) Reasonable cause and good faith exception to section 6662 penalties.

* * * * *

§ 1.6664-4 Reasonable cause and good faith exception to section 6662 penalties.

(a) In general.

(b) Facts and circumstances taken into account.

(1) In general.

(2) Examples.

(c) Reliance on opinion or advice.

(1) Fact and circumstances; minimum requirements.

(i) All facts and circumstances considered.

(ii) No unreasonable assumptions.

(iii) Law is related to actual facts.

(2) Definitions.

(i) Advice.

- (ii) Material.
- (d) Pass-through items.
- (e) Special rules for substantial understatement penalty attributable to tax shelter items of corporations.
 - (1) In general; facts and circumstances.
 - (2) Reasonable cause based on legal justification.
 - (i) Minimum requirements.
 - (A) Authority requirement.
 - (B) Belief requirement.
 - (ii) Legal justification defined.
 - (3) Minimum requirements not dispositive.
 - (4) Other factors.
- (f) Transactions between persons described in section 482 and net section 482 transfer price adjustments. [Reserved]
- (g) Valuation misstatements of charitable deduction property.
 - (1) In general.
 - (2) Definitions.
 - (i) Charitable deduction property.
 - (ii) Qualified appraisal.
 - (iii) Qualified appraiser.

* * * * *

Par. 6. Section 1.6664-1 is amended by:

1. Redesignating the text of paragraph (b) following the heading as paragraph (b)(1), adding a heading for newly designated paragraph (b)(1), and revising the text of newly designated paragraph (b)(1).

2. Adding paragraph (b)(2).

The additions and revisions read as follows:

§ 1.6664-1 Accuracy-related and fraud penalties; definitions and special rules.

* * * * *

(b) *Effective date*—(1) *In general.* Sections 1.6664-1 through 1.6664-3 apply to returns the due date of which (determined without regard to extensions of time for filing) is after December 31, 1989.

(2) *Reasonable cause and good faith exception to section 6662 penalties.* Section 1.6664-4 applies to returns the due date of which (determined without regard to extensions of time for filing) is after the date on which the final regulations are published in the **Federal Register**. Section 1.6664-4 (as contained in 26 CFR Part 1 revised April 1, 1994) applies to returns the due date of which (determined without regard to extensions of time for filing) is on or before the date on which the final regulations are published in the **Federal Register** and after December 31, 1989, subject to changes resulting from Section 744 of Title VII of the Uruguay Round Agreements Act, Pub. L. 103-465 (108 Stat. 4809).

Par. 7. Section 1.6664-4 is amended by:

1. Revising the last sentence of paragraph (a).

2. Revising paragraph (b)(1).

3. Revising the introductory language of paragraph (b)(2) and *Example 1.*

4. Redesignating paragraphs (c), (d) and (e) as paragraphs (d), (f) and (g), respectively.

5. Revising newly designated paragraph (d).

6. Adding new paragraphs (c) and (e).

The revisions and additions read as follows:

§ 1.6664-4 Reasonable cause and good faith exception to section 6662 penalties.

(a) * * * Rules for determining whether the reasonable cause and good faith exception applies are set forth in paragraphs (b) through (g) of this section.

(b) *Facts and circumstances taken into account*—(1) *In general.* The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. (See paragraph (e) of this section for certain rules relating to a substantial understatement penalty attributable to tax shelter items of corporations.) Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge and education of the taxpayer. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. (See paragraph (c) of this section for certain rules relating to reliance on the advice of others.) For example, reliance on erroneous information (such as an error relating to the cost or adjusted basis of property, the date property was placed in service, or the amount of opening or closing inventory) inadvertently included in data compiled by the various divisions of a multidivisional corporation or in financial books and records prepared by those divisions generally indicates reasonable cause and good faith, provided the corporation employed internal controls and procedures,

reasonable under the circumstances, that were designed to identify such factual errors. Reasonable cause and good faith ordinarily is not indicated by the mere fact that there is an appraisal of the value of property. Other factors to consider include the methodology and assumptions underlying the appraisal, the appraised value, the relationship between appraised value and purchase price, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer or to the activity in which the property is used. (See paragraph (g) of this section for certain rules relating to appraisals for charitable deduction property.) A taxpayer's reliance on erroneous information reported on a Form W-2, Form 1099 or other information return indicates reasonable cause and good faith, provided the taxpayer did not know or have reason to know that the information was incorrect. Generally, a taxpayer knows or has reason to know that the information on an information return is incorrect if such information is inconsistent with other information reported or otherwise furnished to the taxpayer, or with the taxpayer's knowledge of the transaction. This knowledge includes, for example, the taxpayer's knowledge of the terms of his employment relationship or of the rate of return on a payor's obligation.

(2) *Examples.* The following examples illustrate this paragraph (b). They do not involve tax shelter items. (See paragraph (e) of this section for certain rules relating to the substantial understatement penalty in connection with the tax shelter items of corporations.)

Example 1. A, an individual calendar year taxpayer, engages B, a professional tax advisor, to give A advice concerning the deductibility of certain state and local taxes. A provides B with full details concerning the taxes at issue. B advises A that the taxes are fully deductible. A, in preparing his own tax return, claims a deduction for the taxes. Absent other facts, and assuming the facts and circumstances surrounding B's advice and A's reliance on such advice satisfy the requirements of paragraph (c) of this section, A is considered to have demonstrated good faith by seeking the advice of a professional tax advisor, and to have shown reasonable cause for any underpayment attributable to the deduction claimed for the taxes. However, if A had sought advice from someone that A knew, or should have known, lacked knowledge in the relevant aspects of Federal tax law, or if other facts demonstrate that A failed to act reasonably or in good faith, A would not be considered to have shown reasonable cause or to have acted in good faith.

* * * * *

(c) *Reliance on opinion or advice*—(1) *Facts and circumstances; minimum requirements.* All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan or arrangement) under Federal tax law. However, in no event will a taxpayer be considered to have reasonably relied in good faith on advice unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a professional tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

(i) *All facts and circumstances considered.* The advice must be based upon all material facts and circumstances, including, for example, the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner.

(ii) *No unreasonable assumptions.* The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows or has reason to know is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner.

(iii) *Law is related to actual facts.* The advice must be based on the law as it relates to the actual facts.

(2) *Definitions*—(i) *Advice.* Advice is any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the section 6662 accuracy-related penalty. Advice does not have to be in any particular form.

(ii) *Material.* A fact is material if it reasonably could be expected, based upon information available at the time the advice is given, to be relevant to the

proper tax treatment of the item or the taxpayer's exposure to the accuracy-related penalty under section 6662.

(d) *Pass-through items.* The determination of whether a taxpayer acted with reasonable cause and in good faith with respect to an underpayment that is related to an item reflected on the return of a pass-through entity shall be made on the basis of all pertinent facts and circumstances, including the taxpayer's own actions, as well as the actions of the pass-through entity.

(e) *Special rules for substantial understatement penalty attributable to tax shelter items of corporations*—(1) *In general; facts and circumstances.* The determination of whether a corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item (as defined in § 1.6662-4(g)(3)) is based on all pertinent facts and circumstances. Paragraphs (e)(2), (3) and (4) of this section set forth rules which apply, in the case of a penalty attributable to a substantial understatement of income tax (within the meaning of section 6662(d)), in determining whether a corporation acted with reasonable cause and in good faith with respect to a tax shelter item.

(2) *Reasonable cause based on legal justification*—(i) *Minimum requirements.* A corporation's legal justification (as described in paragraph (e)(2)(ii) of this section) may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item only if the authority requirement of paragraph (e)(2)(i)(A) of this section and the belief requirement of paragraph (e)(2)(i)(B) of this section are satisfied (the *minimum requirements*). Thus, a failure to satisfy the minimum requirements will preclude a finding of reasonable cause and good faith based (in whole or in part) on the corporation's legal justification.

(A) *Authority requirement.* The authority requirement is satisfied only if there is substantial authority (within the meaning of § 1.6662-4(d)) for the tax treatment of the item.

(B) *Belief requirement.* The belief requirement is satisfied only if, based on all facts and circumstances, the corporation reasonably believed, at the time the return was filed, that the tax treatment of the item was more likely than not the proper treatment. For purposes of the preceding sentence, a corporation is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if (without taking into account the possibility that a return will not be audited, that an issue will not be raised

on audit, or that an issue will be settled)—

(1) The corporation analyzes the pertinent facts and authorities in the manner described in § 1.6662-4(d)(3)(ii), and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service; or

(2) The corporation reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in § 1.6662-4(d)(3)(ii) and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service. (See paragraph (c) of this section for certain rules governing reliance upon the opinion of a professional tax advisor.)

(ii) *Legal justification defined.* For purposes of this paragraph (e), *legal justification* includes any justification relating to the treatment or characterization under the Federal tax law of the tax shelter item or of the entity, plan or arrangement that gave rise to the item. Thus, a taxpayer's belief (whether independently formed or based on the advice of others) as to the merits of the taxpayer's underlying position is a legal justification.

(3) *Minimum requirements not dispositive.* Satisfaction of the minimum requirements of paragraph (e)(2) of this section is an important factor to be considered in determining whether a corporation acted with reasonable cause and in good faith, but is not necessarily dispositive.

(4) *Other factors.* Facts and circumstances other than a corporation's legal justification may be taken into account, as appropriate, in determining whether the corporation acted with reasonable cause and in good faith with respect to a tax shelter item regardless of whether the minimum requirements of paragraph (e)(2) of this section are satisfied.

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Margaret Milner Richardson,

Commissioner of Internal Revenue.

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