

TAX PREPARER PENALTIES

*Prepared by the Tax Department
of*

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LEARNING OBJECTIVES:

Course participants will gain both a foundational and nuanced understanding of tax preparer penalties under the Internal Revenue Code. Following completion of the course, participants will be familiar with circumstances in penalties may be imposed upon the tax preparer, and how to avoid these situations.

INSTRUCTIONAL DELIVERY METHOD:

Self-study.

PROGRAM KNOWLEDGE LEVEL:

The course level is basic.

PREREQUISITE EDUCATION AND EXPERIENCE:

This course is aimed primarily towards professionals with a basic understanding of tax preparation.

RECOMMENDED CPE CREDIT AND FIELD OF STUDY:

2.0 CPE credit hours—Tax

ADVANCE PREPARATION:

None required.

PROGRAM DESCRIPTION:

This course approaches tax preparer penalties from both an “aerial” view, in which the basics are discussed, including who constitutes a tax preparer. The course proceeds to a ground based examination of those penalties which the IRS may impose on a tax preparer, how liability for those penalties is determined, and how such penalties are assessed.

COURSE REGISTRATION REQUIREMENTS:

To receive credit for this course, please complete all Review Questions and the Final Examination located at the end of these materials. Instructions on requesting course credit are provided with the Final Examination.

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Table of Contents

Section One:	<u>Overview</u>	
I.	Overview	1
II.	This Course	1
Section Two:	<u>Who is a Tax Return Preparer?</u>	
I.	Overview	3
II.	Definitions	3
Section Three:	<u>§6694(a) - Penalty for Understatement Due to An Unreasonable Position</u>	
I.	Background	11
II.	Tax Return Preparer Penalties Under Code Sec. 6694(a)	12
III.	Tax Shelters and Reportable Transactions	13
IV.	Other Than Tax Shelters and Reportable Transactions	19
V.	Exception for Reasonable Cause And Good Faith	27
Section Four:	<u>§6694(b) Penalty for Understatement Due To Willful, Reckless, Or Intentional Conduct</u>	
I.	In General – Sec. 6694(b)	31
II.	Willful Attempt To Understate Liability	31
III.	Reckless Or Intentional Disregard	31
IV.	Examples	32
V.	Section 6694(b) Penalty Reduced By Section 6694(a) Penalty	33
Section Five:	<u>Who is the Responsible Tax Return Preparer?</u>	
I.	Overview	35
II.	Responsibility of the Tax Return Preparer	35
III.	Abatement of Penalty Where Taxpayer's Liability Not Understated	38
IV.	Verification of information Furnished By Taxpayer or Other Third Party	39
V.	Income Derived (or To Be Derived) With Respect to The Return Or Claim For Refund	41

Section Six:	<u>Other Assessable Penalties With Respect To The Preparation Of Income Tax Returns For Other Persons</u>	
I.	Failure To Furnish Copy To Taxpayer	47
II.	Failure To Sign Return	47
III.	Failure To Furnish Identifying Number	48
IV.	Failure To Retain Copy or Record	49
V.	Failure To File Correct Information Returns	49
VI.	Negotiation of Check	50
VII.	Tax Return Preparer Due Diligence Requirements For Determining Earned Income Eligibility	51
Section Seven:	<u>Assessment Procedure</u>	
I.	In General	55
II.	Assessment	55
III.	Notice and Demand	55
IV.	Preparers Options	55
V.	Levy or Proceeding in Court for Collections	56
VI.	Preparer Must Bring Suit In District Court To Determine Liability For Penalty	57
VII.	Suspension Of Running Of Period Of Limitations On Collection	57
	Index of Definitions	59
	Answers to Review Questions	61
	Final Exam	67

UNIT ONE – Overview

I. Tax Return Preparer Penalties.

A. The Internal Revenue Code in sec. 6694(a) and 6694(b) provides two penalty provisions which apply specifically to tax return preparers.

B. Anyone who prepares tax returns for compensation should be familiar with these provisions and what they require of the tax preparer to avoid penalty.

C. This is particularly important because recent legislation has changed the standard by which tax return preparers will be judged under these provisions.

1. In 2007 - The Small Business and Work Opportunity Tax Act (the "Small Business Act") adopted tougher standards in regard to tax preparer penalties under Code Sec. 6694. These changes were to be effective for returns prepared after May 25, 2007

2. In 2008 - The Emergency Economic Stabilization Act of 2008 (the "EES Act"), which was signed into law which repealed retroactively the changes made by the Small Business Act enacted new standards for returns prepared after May 25, 2007.

Note: The changes made by the Small Business Act and the EES Act relate only to the Code Sec. 6694(a) preparer penalty for understatements due to unreasonable positions. The heavier Code Sec. 6694(b) preparer understatement penalty for willful, reckless or intentional conduct is unaffected.

II. This Course.

Among the question to be answered by this Course are the following:

A. What are the specific penalties under Code Secs. 6694(a) and 6694(b) which apply to "tax return preparers".

B. When are you considered a "tax return preparer" subject to those Code sections.

C. What are the standards of practice that must be adhered to avoid penalty under Code sec. 6694(a) and 6694(b).

D. If there is more than one tax preparer in regard to a particular return upon whom can the penalty be imposed? And can the firm employing those preparers also be held liable?

E. What is my duty to “audit” the information provided by the taxpayer? And can I rely on information provided by other tax preparers? Or tax advisors? Or prior filed tax returns?

F. How do I conduct my practice to avoid these penalties?

G. Are there any other penalties which apply to tax return preparers under the Code.

UNIT TWO – Who is a Tax Return Preparer?

Learning Objectives.

Upon completion of this section, you will be able to:

- > Identify and understand key definitions.

I. Overview.

A. Regulations - A “*tax return preparer*” is defined by the Regulations as:

Any person who prepares for compensation or who employs one or more persons to prepare for compensation, all or a substantial portion, of any return of tax or claim for refund of tax under the Internal Revenue Code.

B. More Inclusive Definition - The definition is more inclusive than simply a person who actually prepares the physical tax return and may include advisers rendering advice related to specific items on the return.

II. Definitions.

A. Regulations

The Regulations define tax return preparers in terms of “*signing tax return preparers*”, and “*nonsigning tax return preparers*”.

B. Signing Tax Return Preparer.

A *signing tax return preparer* is the individual tax return preparer who physically signs the return and normally has the primary responsibility for the overall substantive accuracy of the preparation of such return or claim for refund.

C. Nonsigning Tax Return Preparer.

1. A *nonsigning tax return preparer* is any tax return preparer who is not a signing tax return preparer but who prepares all or a substantial portion of a return or claim for refund (as discussed in paragraph II.D., below) with respect to events that have occurred at the time the advice is rendered.

2. In determining whether an individual is a nonsigning tax return preparer, time spent on advice that is given *after events have occurred* that represents less than 5 percent of the aggregate time incurred by such individual with respect to the position(s) giving rise to the understatement shall not be taken into account.

3. Notwithstanding, time spent on advice *before the events have occurred* will be taken into account if all facts and circumstances show that:

a. The position(s) giving rise to the understatement is primarily attributable to the advice,

b. The advice was substantially given before events occurred primarily to avoid treating the person giving the advice as a tax return preparer, and

c. The advice given before events occurred was confirmed after events had occurred for purposes of preparing a tax return.

4. Examples of nonsigning tax return preparers are tax return preparers who provide advice (written or oral) to a taxpayer (or to another tax return preparer) when that advice leads to a position or entry that constitutes a substantial portion of the return.

5. Examples.

Example 1.

Attorney A, an attorney in a law firm, provides legal advice to a large corporate taxpayer regarding a completed corporate transaction. The advice provided by A is directly relevant to the determination of an entry on the taxpayer's return, and this advice leads to a position(s) or entry that constitutes a substantial portion of the return. A, however, does not prepare any other portion of the taxpayer's return and is not the signing tax return preparer of this return. *A is considered a nonsigning tax return preparer.*

Example 2.

Attorney B, an attorney in a law firm, provides legal advice to a large corporate taxpayer regarding the tax consequences of a proposed corporate transaction. Based upon this advice, the corporate taxpayer enters into the transaction. Once the transaction is completed, the corporate taxpayer does not receive any additional advice from B with

respect to the transaction. *B did not provide advice with respect to events that have occurred and is not considered a tax return preparer.*

Example 3.

The facts are the same as Example 2, except that Attorney B provides supplemental advice to the corporate taxpayer on a phone call after the transaction is completed. Attorney B did not provide advice before the corporate transaction occurred with the primary intent to avoid being treated as a tax return preparer. The time incurred on this supplemental advice by B represented less than 5 percent of the aggregate amount of time spent by B providing tax advice on the position. *B is not considered a tax return preparer.*

D. Definition of “Substantial Portion”.

1. Only a person who prepares all or a “*substantial portion*” of a return or claim for refund shall be considered to be a tax return preparer of the return or claim for refund.
2. A person who renders tax advice on a position that is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund will be regarded as having prepared that entry.
3. Whether a schedule, entry, or other portion of a return or claim for refund is a substantial portion is determined based upon whether the person knows or reasonably should know that the tax attributable to the schedule, entry, or other portion of a return or claim for refund is a substantial portion of the tax required to be shown on the return or claim for refund.
4. A single tax entry may constitute a substantial portion of the tax required to be shown on a return.
5. Factors to consider in determining whether a schedule, entry, or other portion of a return or claim for refund is a substantial portion include but are not limited to:
 - a. The size and complexity of the item relative to the taxpayer's gross income; and
 - b. The size of the understatement attributable to the item compared to the taxpayer's reported tax liability.
6. In the case of a *nonsigning tax return preparer* a schedule or other portion is not considered to be a substantial portion if

the schedule, entry, or other portion of the return or claim for refund involves amounts of gross income, amounts of deductions, or amounts on the basis of which credits are determined that are :

a. Less than \$10,000; or

b. Less than \$400,000 and also less than 20 percent of the gross income as shown on the return or claim for refund (or, for an individual, the individual's adjusted gross income).

c. If more than one schedule, entry or other portion is involved, all schedules, entries or other portions shall be aggregated in applying the de minimis rule in paragraph D6.

7. A tax return preparer with respect to one return is not usually considered to be a tax return preparer of another return merely because an entry or entries reported on the first return may affect an entry reported on the other return:

a. Unless the entry or entries reported on the first return are directly reflected on the other return and constitute a substantial portion of the other return.

b. For example, the sole preparer of a partnership return of income or small business corporation income tax return is considered a tax return 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.

8. Example.

Accountant D prepares a schedule for an individual taxpayer's Form 1040, "U.S. Individual Income Tax Return", reporting \$4,000 in dividend income and gives oral or written advice about Schedule A, which results in a claim of a medical expense deduction totaling \$5,000, but does not sign the tax return. *D is not a nonsigning tax return preparer because the total aggregate amount of the deductions is less than \$10,000.*

E. Defining “Return” and “Claim For Refund”.

1. Definition of Return.

a. A “return” (including an amended or adjusted return) is a document filed by or on behalf of a taxpayer reporting the liability of the taxpayer for tax under the Internal Revenue Code

b. A “return” also includes any information return or other document identified in published guidance in the Internal Revenue Bulletin and that reports information that is or may be reported on another taxpayer’s return under the Code if the information reported on the information return or other document constitutes a substantial portion of the taxpayer’s return.

2. Claim For Refund.

a. A “claim for refund” of tax includes a claim for credit against tax.

b. A claim for refund also includes a claim for payment under section 6420 (the tax on gasoline used on farms), 6421 (gasoline for non-highway purposes, used by local transit, or sold for certain exempt purposes), or 6427 (fuels not used for taxable purposes).

F. Mechanical Or Clerical Assistance.

1. A person who furnishes to a taxpayer or other tax return preparer sufficient information and advice so that completion of the return or claim for refund is largely a mechanical or clerical matter is considered a tax return preparer, even though that person does not actually place or review placement of information on the return or claim for refund.

2. An individual providing only typing, reproduction, or other mechanical assistance in the preparation of a return or claim for refund.

3. The mechanical assistance exception described in this paragraph is illustrated by the following examples:

Example 1.

A reporting agent received employment tax information from a client from the client's business records. The reporting agent did not render any tax advice to the client or exercise any discretion or independent judgment on the client's underlying tax positions. The reporting agent processed the client's information, signed the return as authorized by the client pursuant to Form 8655, Reporting Agent Authorization, and filed the client's return using the information supplied by the client. The reporting agent is not a tax return preparer.

Example 2.

A reporting agent rendered tax advice to a client on determining whether its workers are employees or independent contractors for Federal tax purposes. For compensation, the reporting agent received employment tax information from the client, processed the client's information and filed the client's return using the information supplied by the client. The reporting agent is a tax return preparer.

G. Qualifications.

1. A person may be a tax return preparer without regard to educational qualifications and professional status requirements.

H. Outside The United States.

1. A person who prepares a return or claim for refund outside the United States is a tax return preparer, regardless of the person's nationality, residence, or the location of the person's place of business, if the person otherwise satisfies the definition of *tax return preparer*.

2. Notwithstanding the provisions of rules for TINs issued to foreign persons, a foreign person must secure an employer identification number if (i) the person is an employer of another tax return preparer, (ii) is a partnership in which one or more of the general partners is a tax return preparer, (iii) is a firm in which one or more of the equity holders is a tax return preparer, or (iv) is an individual not employed by another tax return preparer.

I. Persons Who Are Not Tax Return Preparers.

The following persons are not considered tax return preparers:

1. An official or employee of the Internal Revenue Service performing official duties.

2. Any individual who provides tax assistance under a Volunteer Income Tax Assistance (VITA) program established by the IRS, but only with respect to those returns prepared as part of the VITA program.

3. Any organization sponsoring or administering a VITA program established by the IRS, but only with respect to that sponsorship or administration.

4. Any individual who provides tax counseling for the elderly under a program established pursuant to section 163 of the Revenue Act of 1978, but only with respect to those returns prepared as part of that program.

5. Any organization sponsoring or administering a program to provide tax counseling for the elderly established pursuant to section 163 of the Revenue Act of 1978, but only with respect to that sponsorship or administration.

6. Any individual who provides tax assistance as part of a qualified Low-Income Taxpayer Clinic (LITC), as defined by section 7526 but only with respect to those returns and claims for refund prepared as part of the LITC program.

7. Any organization that is a qualified LITC, as defined by section 7526.

8. An individual providing only typing, reproduction, or other mechanical assistance in the preparation of a return or claim for refund.

9. An individual preparing a return or claim for refund of a taxpayer, or an officer, a general partner, member, shareholder, or employee of a taxpayer, by whom the individual is regularly and continuously employed or compensated or in which the individual is a general partner.

10. An individual preparing a return or claim for refund for a trust, estate, or other entity of which the individual either is a fiduciary or is an officer, general partner, or employee of the fiduciary. For purposes of this paragraph, an estate, guardianship, conservatorship, committee, or any similar arrangement for a taxpayer under a legal disability (such as a minor, an incompetent, or an infirm individual) is considered a trust or estate.

11. An individual preparing a claim for refund for a taxpayer in response to:

a. A notice of deficiency issued to the taxpayer; or

b. A waiver of restriction on assessment after initiation of an audit of the taxpayer or another taxpayer if a determination in the audit of the other taxpayer affects, directly or indirectly, the liability of the taxpayer for tax.

12. A person who prepares a return or claim for refund for a taxpayer with no explicit or implicit agreement for compensation, even if the person receives an insubstantial gift, return service, or favor.

J. Employee.

1. For purposes of paragraph I9, the employee of a corporation owning more than 50 percent of the voting power of another corporation, or the employee of a corporation more than 50 percent of the voting power of which is owned by another corporation, is considered the employee of the other corporation as well.

Review Question—One

Who is a signing tax return preparer?

(a) The individual tax return preparer who has the primary responsibility for the overall substantive accuracy of the preparations of such return or claim for refund.

(b) The individual tax return preparer who has the primary responsibility for the filing of such return or claim for refund.

(c) The individual tax return preparer who decides the overall accuracy of the preparation of such return or claim for refund.

(d) The individual tax return preparer who has the sole duty to file the preparation of such return or claim for refund.

Review Question—Two

Of the following, who is not considered a tax return preparer?

(a) A person who furnishes to a taxpayer or other tax return preparer sufficient information and advice so that completion of the return or claim for refund is largely a mechanical or clerical matter.

(b) A person who prepares for compensation or employs one or more persons to prepare for compensation all or a substantial portion of a return of tax or claim for refund, outside the united states.

(c) An individual providing only typing, reproduction, or other mechanical assistance in the preparation of a return of claim for refund.

(d) A person who renders tax advice on a position that is directly relevant to the determination of the existence, characterization, or amount of an entry on a return of tax or claim for refund.

UNIT THREE - §6694(a) - Penalty For Understatement Due To An Unreasonable Position

Learning Objectives.

Upon completion of this section, you will be able to:

- > Understand the impact of the Small Business Law Act.
- > Identify the various return penalties under Code Sec. 6694 (a).
- > Understand the requirements in relation to tax shelters and other reportable transactions, as well as other than tax shelters and reportable transactions.
 - > Understand “substantial authority” and “reasonable basis” standards.
- > Identify factors considered in determining whether or not there is an exception for reasonable cause and good faith.

I. Background.

A. Pre Small Business Act Law -Before the changes made by the Small Business Act the law provided the following:

1. The penalty was imposed in an amount equal to the greater of \$1,000, or 50% of the income derived (or to be derived) by the tax return preparer for the return or refund claim.

2. The penalty applied where (i) there wasn't “a realistic possibility of a position being sustained on its merits”, (ii) the preparer knew or should have known, and (iii) the position was undisclosed or frivolous.

3. The penalty also was limited to income tax return preparers and did not apply to preparers of estate, gift, employment and other tax returns.

4. A position was considered to have a “realistic possibility of being sustained on its merits” if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead him to conclude that the position had approximately a one in three, or greater, chance of being sustained

B. The Small Business Act

1. The Small Business Act provided that a tax return preparer was liable for a penalty if he prepared any return or claim for refund for which any part of an understatement of liability was due to an “unreasonable position.”

2. The standard applied, termed the “*more likely than not standard*”, provided that a position was “unreasonable” if all of the following applied:

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. The position wasn't properly disclosed or there was no reasonable basis for the position.

3. The “*more likely than not*” standard (i.e., a standard requiring a greater than 50% likelihood) created a strong backlash of criticism because it imposed a much stricter standard to tax preparer’s than the “*substantial authority standard*” which applies to taxpayers.

C. The EES Act Repeals the “More likely Than Not Standard”.

1. Repeal - The EES Act essentially repeals retroactively the “*more likely than not*” standard for returns prepared after May 25, 2007, and replaces it with a “*substantial authority standard*”, except in the cases involving tax shelters and reportable transactions and cases where adequate disclosure was made.

2. The EES Act therefore effectively eliminates the difference in standards that were created by the Small Business Act between tax preparers and taxpayers.

II. Tax Return Preparer Penalties Under Code Sec. 6694(a).

A. Sec. 6694(a).

1. A tax return preparer may be liable for a penalty under section 6694(a) equal to the greater of (i) \$1,000 or (ii) 50 percent of the income derived (or to be derived) by the tax return preparer.

2. In order to be liable for the penalty the tax return preparer must prepare a return or claim for refund that results in an understatement of tax liability due to an “unreasonable position.”

3. A position that was “adequately disclosed” is considered to be unreasonable unless there was a “reasonable basis” for the position.

4. A position that is not disclosed on the return is considered to be unreasonable unless there was “substantial authority” for the position.

5. In the case of tax shelters and reportable transactions, a position is considered to be unreasonable unless there was a “reasonable belief” that the position would “more likely than not” be sustained on its merits.

B. Requirements of Sec. 6694(a).

1. Sec. 6694(a) first requires an “understatement of tax liability”, i.e., if there is no understatement there is no penalty.

a. In General - An “understatement of liability” exists if, viewing the return or claim for refund as a whole, there is either (i) an understatement of the net amount payable with respect to any tax imposed by the Internal Revenue Code, or (ii) an overstatement of the net amount creditable or refundable with respect to any tax imposed by the Code.

b. Carryback - The net amount payable in a taxable year with respect to the return for which the tax return preparer engaged in conduct proscribed by section 6694 is not reduced by any carryback.

c. Subchapter 68 - Tax imposed by the Code does not include additions to the tax, additional amounts, and assessable penalties imposed by subchapter 68 of the Code.

d. Proceeding - The determination of whether an understatement of liability exists may be made in a proceeding involving the tax return preparer that is separate and apart from any proceeding involving the taxpayer.

2. Secondly, the section’s “unreasonable” position standard prescribes a different standard of conduct depending on the circumstances giving rise to the understatement.

a. The initial question is whether or not the transaction involves a “*tax shelter*” or a “*reportable transaction*” – if it does - the position must satisfy the most stringent “*more likely than not*” standard.

b. If the transaction does not involve a tax shelters or reportable transaction - then the next question is whether the position was “*adequately disclosed*” or not –

(1) *If the position was properly disclosed* - then there must be a “*reasonable basis*” for the position in order to avoid penalty

(2) *If it was not* then there must be “*substantial authority*” for the position.

III. Tax Shelters and Reportable Transactions.

A. Overview.

1. In the case of “tax shelters” and “reportable transactions”, a position is considered to be unreasonable unless there was a “reasonable belief” that the position would “more likely than not” be sustained on its merits.

2. Several questions present themselves in the application of this part of Sec. 6694(a):

a. First - what is the definition of a “tax shelter”? And, what is the definition of a “reportable transaction”?

b. Secondly – what is required for a position to satisfy the “more likely than not” standard.

Note: That if the transaction involves a tax shelter or a reportable transaction that whether the transaction is adequately disclosed or not is irrelevant the “more likely than not standard still applies.

B. The Definition of a Tax Shelter and Reportable Transaction.

1. Under sec. 6694(a) the “more likely than not” standard applies to only to tax shelters and reportable transactions – how are those terms defined?

2. Code Sec. 6662(d)(2)(C)(ii), defines “tax shelter” as:

a. A partnership or other entity, any investment plan or arrangement, or any other plan or arrangement;

b. Which has as a significant purpose the avoidance or evasion of federal income tax.

3. A “reportable transaction” is defined as any transaction for which information must be included with a return or statement because, as determined under regulations issued under Code Sec. 6011, the transaction has a potential for tax avoidance or evasion.

C. The “More Likely Than Not” Standard.

1. If a position is with respect to a tax shelter or a reportable transaction it must be “reasonable to believe that a position would more likely than not be sustained on its merits”. In practical terms what does this mean?

2. As a general rule the tax return preparer in analyzing the pertinent facts and authorities and, in reliance upon that analysis, must reasonably conclude in good faith that the position has a *greater than 50 percent* likelihood of being sustained on its merits.

3. In reaching this conclusion, the possibility that the position will not be challenged by the 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.

4. The analysis prescribed under the Regulations for purposes of determining whether substantial authority is present applies for purposes of determining whether the more likely than not standard is satisfied.¹

¹ 1.6662-4(d)(3) (ii) provides the following : *“The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue.*

An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from which information has been deleted, such as a private letter ruling, is

5. In Notice 2009-5, 2009-3 IRB the Service provided that solely for purposes of §6694, a position with respect to a tax shelter will not be deemed an “unreasonable position” if there is substantial authority for the position and the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer in the event that the transaction is deemed to have a significant purpose of Federal tax avoidance or evasion.²

D. Facts and Circumstances.

1. Whether a tax return preparer meets the standard will be determined based upon all facts and circumstances, including the tax return preparer's diligence.

2. In determining the level of diligence in a particular situation, the tax return preparer's experience with the area of Federal tax

diminished to the extent that the deleted information may have affected the authority's conclusions.

The type of document also must be considered. For example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue. An older private letter ruling, technical advice memorandum, general counsel memorandum or action on decision generally must be accorded less weight than a more recent one. Any document described in the preceding sentence that is more than 10 years old generally is accorded very little weight. However, the persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account along with the age of the document. There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.”

² The advice to the taxpayer must explain that, if the position has a significant purpose of tax avoidance or evasion, there needs to be at a minimum substantial authority for the position, the taxpayer must possess a reasonable belief that the tax treatment was more likely than not the proper treatment in order to avoid an accuracy-related penalty under §6662(d) as applicable, and disclosure in accordance with Regs. §1.6662-4(f) will not protect the taxpayer from assessment of an accuracy-related penalty if §6662(d)(2)(C) applies to the position. The preparer must contemporaneously document the advice in the tax return preparer's files. If a nonsigning tax return preparer provides advice to another tax return preparer regarding a position with respect to a tax shelter, the position will not be deemed an “unreasonable position” if there is substantial authority for the position and the nonsigning tax return preparer provides a statement to the other tax return preparer about the penalty standards applicable to the tax return preparer under §6694.

law and familiarity with the taxpayer's affairs, as well as the complexity of the issues and facts, will be taken into account.

3. 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).

E. Qualifying Authority.

1. In determining whether a position satisfies the "more likely than not standard" only a limited body of "authority" may be considered – specifically those authorities enumerated in §1.6662-4(d)(3)(iii) of the Regulations.

2. The Regulations in §1.6662-4(d)(3) (iii) provides only the following qualify as "authority":

- a. Applicable provisions of the Internal Revenue Code and other statutory provisions;
- b. Proposed, temporary and final regulations construing such statutes;
- c. Revenue rulings and revenue procedures;
- d. Tax treaties and regulations there under,
and
- e. Treasury Department and other official explanations of such treaties; court cases;
- f. Congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers;
- g. General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book);
- h. Private letter rulings and technical advice memoranda issued after October 31, 1976;
- i. Actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general

counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin);

j. Internal Revenue Service information or press releases; and

k. Notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin.

3. 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.

4. Notably conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority.

5. 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 this - 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.

F. Written Determinations.

1. 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 the Regulations.

2. Regulation §1.6662-4(d)(3)(iv)(A) provides that :

"There is substantial authority for the tax treatment of an item by a taxpayer if the treatment is supported by the conclusion of a ruling or a determination letter issued to the taxpayer, by the conclusion of a technical advice memorandum in which the taxpayer is named, or by an affirmative statement in a revenue agent's report with respect to a prior taxable year of the taxpayer ("written determinations")."

G. When the Standard Must Be Satisfied.

1. 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.

2. For purposes of the penalties under section 6694, a return or claim for refund is deemed prepared on the date it is signed by the tax return preparer.

3. If a signing tax return preparer fails to sign the return, the return or claim for refund is deemed prepared on the date the return or claim is filed.

4. In the case of a nonsigning tax return preparer the relevant date is the date the nonsigning tax return preparer provides the tax advice with respect to the position giving rise to the understatement.

5. This date will be determined based on all the facts and circumstances.

IV. Other Than Tax Shelters and Reportable Transactions.

A. General Rule. If the transaction does not involve a tax shelters or reportable transaction - then the first question is whether the position was “adequately disclosed” or not - *if the position was properly disclosed* - then there must be a “reasonable basis” for the position in order to avoid penalty– *if it was not* then there must be “substantial authority” for the position.

B. What does “Adequate Disclosure” Mean?

1. Signing Tax Return Preparers.

In the case of a signing tax return preparer disclosure of a position is adequate if the tax return preparer meets any of the following standards:

a. The position may be disclosed on a properly completed and filed Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, as appropriate, or on the tax return in accordance with the annual adequate disclosure revenue procedure

b. The tax return preparer provides the taxpayer with the prepared tax return that includes the disclosure in accordance with §1.6662-4(f).³; and

c. For tax returns or claims for refund that are subject to penalties other than the accuracy-related penalty for substantial understatements of income tax under §6662 - the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer under §6662, and contemporaneously documents the advice in the tax return preparer's files.⁴

2. Nonsigning Tax Return Preparers.

In the case of a nonsigning tax return preparer disclosure of a position is adequate if the tax return preparer meets any of the following standards:

a. The position if it is disclosed 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;

b. If the non-signing tax preparer advises the taxpayer of all opportunities to avoid penalties under §6662 that could apply to the position and advises the taxpayer of the standards for disclosure to the extent applicable; or

³ 1.6662-4(f)(2) Disclosure On Return provides that the Commissioner may by annual revenue procedure (or otherwise) prescribe the circumstances under which disclosure of information on a return (or qualified amended return) in accordance with applicable forms and instructions is adequate. If the revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275-R, as appropriate, attached to the return for the year or to a qualified amended return.

⁴ Code Sec. 6662 deals with the imposition of accuracy related penalties which are applicable to tax payers. Under that Code Section a 20% penalty applies to any portion of an underpayment for which there is a substantial understatement of income tax. Any understatement is reduced to the extent it is attributable to an item for which there is "substantial authority" or with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or a statement attached to the return.

c. Advises another tax return preparer that disclosure under §6694(a) may be required.

Note: Nonsigning preparers must also document contemporaneously in their files that the information or advice was provided.

3. Advice To Taxpayers.

a. If a nonsigning tax return preparer provides advice to the taxpayer with respect to a position 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.

b. The tax return preparer must also contemporaneously document the advice in the tax return preparer's files.

c. 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.⁵

4. Advice To Another Tax Return Preparer.

a. 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.

b. The tax return preparer must also contemporaneously document the advice in the tax return preparer's files.

c. 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.

d. If the advice is to another nonsigning tax return preparer within the same firm, contemporaneous documentation is satisfied if there is a single instance of contemporaneous documentation within the firm.⁶

5. Requirements For Advice.

a. For purposes of satisfying the disclosure standards, 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.

b. 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.

c. The tax return preparer is required to contemporaneously document the fact that the advice was provided.

d. 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 likelihood that a position will be sustained on the merits and the potential application of penalties as a result of that position.

e. Tax return preparers, however, may rely on established forms or templates in advising clients regarding the

⁶ ⁶ Contemporaneously prepared documentation in the nonsigning tax return preparer's files is sufficient to establish that the statement was given to the other tax return preparer. If a nonsigning tax return preparer and other tax return preparer are employed by the same firm, contemporaneous documentation of advice provided by any tax return preparer in that firm to the taxpayer regarding applicable penalty standards also is sufficient to establish that the statement was given by a nonsigning tax return preparer to the other tax return preparers within the firm.

operation of the penalty provisions of the Internal Revenue Code.

f. 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.

6. Pass-Through Entities.

Disclosure in the case of items attributable to a pass-through entity is adequate if made at the entity level.⁷

7. 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

⁷ 1.6662-4(f)(5) provides as follows: "Disclosure in the case of items attributable to a pass-through entity (pass-through items) is made with respect to the return of the entity, except as provided in this paragraph (f)(5). Thus, disclosure in the case of pass-through items must be made on a Form 8275 or 8275-R, as appropriate, attached to the return (or qualified amended return) of the entity, or on the entity's return in accordance with the revenue procedure described in paragraph (f)(2) of this section, if applicable. A taxpayer (i.e., partner, shareholder, beneficiary, or holder of a residual interest in a REMIC) also may make adequate disclosure with respect to a pass-through item, however, if the taxpayer files a properly completed Form 8275 or 8275-R, as appropriate, in duplicate, one copy attached to the taxpayer's return (or qualified amended return) and the other copy filed with the Internal Revenue Service Center with which the return of the entity is required to be filed. Each Form 8275 or 8275-R, as appropriate, filed by the taxpayer should relate to the pass-through items of only one entity. For purposes of this paragraph (f)(5), a pass-through entity is a partnership, S corporation (as defined in section 1361(a)(1)), estate, trust, regulated investment company (as defined in section 851(a)), real estate investment trust (as defined in section 856(a)), or real estate mortgage investment conduit ("REMIC") (as defined in section 860D(a)).

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. 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.

C. "Reasonable Basis" Standard.

1. In General.

a. The section 6694(a) penalty will not be imposed on a tax return preparer if the position taken has a reasonable basis and is adequately disclosed.

b. For an exception to the section 6694(a) penalty for reasonable cause and good faith, see section III below.

2. The “Reasonable Basis” Standard.

a. According to the Regulations “reasonable basis” is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper.

b. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim.

c. If a return position is reasonably based on one or more of the authorities as referenced paragraph II.C., above (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the “substantial authority” standard.

d. 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).

D. “Substantial Authority” Standard.

1. In General.

a. The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts.

b. The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard.

c. The “authority” considered relevant to the question is the same body of authority relevant to the application of the more likely than not standard and the reasonable basis standard listed in paragraph III.E., above.

d. The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied.

2. Evaluation Of Authorities.

a. There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment.

b. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists.

c. The weight of authorities is determined in light of the pertinent facts and circumstances in the manner prescribed by paragraph 3, below.

d. There may be substantial authority for more than one position with respect to the same item.

e. Because the substantial authority standard is an objective standard, the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment.

3. Nature Of Analysis.

a. The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority - for example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue.

b. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its

conclusion by cogently relating the applicable law to pertinent facts.

c. The weight of an authority from which information has been deleted, such as a private letter ruling, is diminished to the extent that the deleted information may have affected the authority's conclusions.

d. The type of document also must be considered - for example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue.

e. An older private letter ruling, technical advice memorandum, general counsel memorandum or action on decision generally must be accorded less weight than a more recent one.

f. Any document described in the preceding sentence that is more than 10 years old generally is accorded very little weight.

g. However, the persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account along with the age of the document.

h. There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

Review Question—Three

The new small business act law retains the “more likely than not standard” for _____.

- (a) Only other than tax shelters.
- (b) Other than tax shelters and reportable transactions.
- (c) Only tax shelters.
- (d) Tax shelters and reportable transactions.

V. Exception For Reasonable Cause And Good Faith.

A. In General - 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.

B. Factors to consider include:

1. Nature Of The Error Causing The Understatement.

a. 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.

b. 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.

a. The understatement was the result of an isolated error (such as an inadvertent mathematical or clerical error) rather than a number of errors.

b. 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.

c. 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.

a. The understatement was not material in relation to the correct tax liability.

b. The reasonable cause and good faith exception generally applies if the understatement is of a relatively immaterial amount.

c. 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.

a. 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.

b. 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.

c. 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.

a. 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).

(1) 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.

(2) 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.

b. A tax return preparer is not considered to have relied in good faith if—

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

(2) 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

(3) 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.

a. 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.

b. 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.

Review Question—Four

What is true about the “understatement of liability”?

(a) The net amount payable in a taxable year with respect to the return for which the tax return preparer engaged in conduct proscribed by section 6694 can be reduced by carryback.

(b) It exists if when viewing the return or claim for refund as a whole, there is an overstatement of the net amount creditable or refundable with respect to any tax imposed by the Code.

(c) Tax imposed by the Code does include additions to the tax, additional amounts, and assessable penalties imposed by subchapter 68 of the Code

(d) The determination of whether an understatement of liability exists may be made in a proceeding involving the tax return preparer that is separate and apart from any proceeding involving the taxpayer.

Review Question—Five

In regards to section 6694 (a) & (b), a tax return preparer may rely in good faith without verification upon a tax return that has been previously prepared by a taxpayer or another tax return preparer and filed with the IRS and _____.

(a) The tax return preparer can ignore the implications of information furnished to the tax return preparer or actually known by the tax return preparer.

(b) A tax return preparer who prepares an amended return (including a claim for refund) need not verify the positions on the original return.

(c) The tax return preparer need not make inquiries if the information as furnished appears to be incorrect or incomplete.

(d) The tax return preparer need not confirm that the position being relied upon has not been adjusted by examination or otherwise.

UNIT FOUR - §6694(b) Penalty For Understatement Due To Willful, Reckless, Or Intentional Conduct.

Learning Objectives.

Upon completion of this section, you will be able to:

- > Identify the penalty under Sec. 6694 (b).
- > Understand what is meant by “willful attempt to understate liability.”
- > Understand the effect of Section 6694 (b) penalty reduction by Section 6694 (a) penalty.

I. In General -Sec. 6694(b).

A. The Penalty. 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

B. The Basis. In order for the penalty to apply – any part an understatement of liability for a return or claim for refund that is prepared by the tax return preparer must due to:

1. 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
2. Any “reckless or intentional disregard” of rules or regulations by a tax return preparer.

II. Willful Attempt To Understate Liability.

A. 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.

B. 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.

C. 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.

III. Reckless Or Intentional Disregard

A. In General - Except as provided in paragraphs B and C below, a preparer is considered to have recklessly or intentionally disregarded a rule or regulation if:

1. The preparer takes a position on the return or claim for refund that is contrary to a rule or regulation and the preparer knows of, or is reckless in not knowing of, the rule or regulation in question.

2. A preparer is reckless in not knowing of a rule or regulation if the preparer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable preparer would observe in the situation.

3. The term "*rules or regulations*" includes the provisions of the Internal Revenue Code (Code), temporary or final Treasury regulations issued under the Code, and revenue rulings or notices (other than notices of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin.

B. Exceptions.

1. A tax return preparer is not considered to have recklessly or intentionally disregarded a rule or regulation if the position contrary to the rule or regulation has a reasonable basis and is adequately disclosed.

2. In the case of a position contrary to a regulation, the position must represent a good faith challenge to the validity of the regulation and, when disclosed, the tax return preparer must identify the regulation being challenged.

3. In the case of a position contrary to a revenue ruling or notice (other than a notice of proposed rulemaking) published by the Internal Revenue Service in the Internal Revenue Bulletin, a tax return preparer also is not considered to have recklessly or intentionally disregarded the ruling or notice if the position meets the substantial authority standard and is not with respect to a reportable transaction.

C. Burden Of Proof.

1. In the case of a penalty based on the preparer's willful attempt to understate a tax liability, the burden of proving willfulness is on the IRS.

2. On the other hand, the preparer bears the burden of proof with respect to other issues, such as whether the preparer acted recklessly or intentionally disregarded a rule or regulation, whether a position contrary to a regulation represents a good faith challenge to the validity of the regulation, and whether disclosure was adequately made.

IV. Examples.

Example 1

A taxpayer provided Preparer T with detailed check registers reflecting personal and business expenses. One of the expenses was for domestic help, and this expense was identified as personal on the check register. T knowingly deducted the expenses of the taxpayer's domestic help as wages paid in the taxpayer's business. T is subject to the penalty under section 6694(b).

Example 2

A taxpayer provided Preparer U with detailed check registers to compute the taxpayer's expenses. U, however, knowingly overstated the expenses on the return. After adjustments by the examiner, the tax liability increased significantly. Because U disregarded information provided in the check registers, U is subject to the penalty under section 6694(b).

Example 3

Preparer V prepares a taxpayer's return in 2009 and encounters certain expenses incurred in the purchase of a business. Final regulations provide that such expenses incurred in the purchase of a business must be capitalized. One U.S. Tax Court case decided in 2006 has expressly invalidated that portion of the regulations. There are no courts that ruled favorably with respect to the validity of that portion of the regulations and there are no other authorities existing on the issue. Under these facts, V will have a reasonable basis for the position and will not be subject to the section 6694(b) penalty if the position is adequately disclosed because the position represents a good faith challenge to the validity of the regulations.

V. Section 6694(b) Penalty Reduced By Section 6694(a) Penalty.

The amount of any penalty to which a tax return preparer may be subject under section 6694(b) for a return or claim for refund is reduced by any amount assessed and collected against the tax return preparer under section 6694(a) for the same position on a return or claim for refund.

Review Question—Six

If other than a tax shelter is involved and the position is disclosed, _____.

- (a) The no “substantial authority” standard applies.
- (b) The “more likely than not” standard applies.
- (c) The “no reasonable basis” standard applies.
- (d) The “realistic possibility” standard applies.

Review Question—Seven

In the case of a non-signing tax return preparer, 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 _____.

- (a) 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)).
- (b) With respect to that position, the tax return preparer complies with the provisions of paragraph C3 or C4, whichever is applicable.
- (c) None of the above.
- (d) Answers A and B.

UNIT FIVE – Who is Responsible for the Tax Return Preparer?

Learning Objectives.

Upon completion of this section, you will be able to:

- > Identify and describe who may be considered a tax return preparer.
 - > Identify the responsibilities of tax return preparers.
- > Understand abatement of penalty where liability is not understated.
- > Identify verification requirements when information is furnished by taxpayer or third party.

I. Overview.

A. To this point we have in this Course defined the penalties which may imposed against a tax return preparer under sec. 6694, and also discussed the issue of just who is a fact meets the definition of a “tax return preparer under that Code section.

B. In many situations there may be more than tax return preparer in regard to a particular return or refund claim.

C. In this Unit we will address the question of who is the tax return preparer responsible for the penalties under sec. 6694.

II. Responsibility of the Tax Return Preparer.

A. In General.

1. An individual is a tax return preparer subject to sec. 6694 penalty if the individual is *primarily responsible* for the position(s) on the return or claim for refund giving rise to an understatement.

2. There is only one individual within a firm who is primarily responsible for each position on the return or claim for refund giving rise to an understatement.

3. In some circumstances, there may be more than one tax return preparer who is primarily responsible for the position(s) giving rise to an understatement if multiple tax return preparers are employed by, or associated with, different firms.

B. Responsibility Of Signing Tax Return Preparer.

1. If there is a signing tax return preparer within a firm, the signing tax return preparer generally will be considered the person who is primarily responsible for all of the positions on the return or claim for refund giving rise to an understatement.

2. This is unless, based upon credible information, it is concluded that the signing tax return preparer is not primarily responsible for the position(s) on the return or claim for refund giving rise to an understatement.

3. In the case where a signing tax return preparer is considered not primarily responsible, a nonsigning tax return preparer within the signing tax return preparer's firm will be considered the tax return preparer who is primarily responsible for the position(s) on the return or claim for refund giving rise to an understatement.

C. Responsibility Of Nonsigning Tax Return Preparer.

1. If there is no signing tax return preparer for the return or claim for refund within the firm or if, after the application of paragraph B above, it is concluded that the signing tax return preparer is not primarily responsible for the position, the nonsigning tax return preparer with overall supervisory responsibility for the position(s) giving rise to the understatement generally will be considered the tax return preparer who is primarily responsible for the position for purposes of section 6694.

2. That is unless, based upon credible information from any source, it is concluded that another nonsigning tax return preparer within that firm is primarily responsible for the position(s) on the return or claim for refund giving rise to the understatement.

D. Responsibility Of Signing And Nonsigning Tax Return Preparer.

If the information presented would support a finding that, within a firm, either the signing tax return preparer or a nonsigning tax return preparer is primarily responsible for the position(s) giving rise to the understatement, the penalty may be assessed against either one of the individuals, but not both, as the primarily responsible tax return preparer.

E. Tax Return Preparer and Firm Responsibility.

1. An individual and the firm that employs the individual, or the firm of which the individual is a partner, member, shareholder, or other equity holder, *both may be subject to penalty under section 6694*

with respect to the position(s) on the return or claim for refund giving rise to an understatement.

2. If an individual (other than the sole proprietor) who is employed by a sole proprietorship is subject to penalty under section 6694, the sole proprietorship is considered a “firm” for purposes of this paragraph.

3. A firm that employs a tax return preparer subject to a penalty under section 6694(a) or (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:

a. 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) or (b);

b. 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

c. 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

F. Examples.

Example 1.

Attorney A provides advice to Client C concerning the proper treatment of an item with respect to which all events have occurred on C's tax return. In preparation for providing that advice, A seeks advice regarding the proper treatment of the item from Attorney B, who is within the same firm as A, but A is the attorney who signs C's return as a tax return preparer.

B provides advice on the treatment of the item upon which A relies. B's advice is reflected on C's tax return but no disclosure was made. The advice constitutes preparation of a substantial portion of the

return. The IRS later challenges the position taken on the tax return, giving rise to an understatement of liability.

A is initially considered the tax return preparer with respect to C's return, and the IRS advises A that A may be subject to the penalty under section 6694 with respect to C's return. Based upon information received from A or another source, it may be concluded that B, rather than A, had primary responsibility for the position taken on the return that gave rise to the understatement and may be subject to penalty under section 6694 instead of A.

Example 2.

Same as Example 1, except that neither Attorney A nor any other source produce credible information that Attorney B had primary responsibility for the position on the return giving rise to an understatement. Attorney A is the tax return preparer who may be subject to penalty under section 6694 with respect to C's return.

Example 3.

Same as Example 1, except that neither Attorney A nor any other attorney within A's firm signs Client C's return as a tax return preparer. Attorney B is the nonsigning tax return preparer within the firm with overall supervisory responsibility for the position giving rise to an understatement. Accordingly, B is the tax return preparer who is primarily responsible for the position on C's return giving rise to an understatement and may be subject to penalty under section 6694.

Example 4.

Same as Example 1, except Attorney D, who works for a different firm than A, also provides advice on the same position upon which A relies. It may be concluded that D is also primarily responsible for the position on the return and may be subject to penalty under section 6694.

Example 5.

Same as Example 1, except Attorney B is able to present credible information that A is also responsible for the position on C's return giving rise to an understatement. The IRS may conclude between A and B, the two responsible persons for the position, who is primarily responsible and may assess a section 6694 penalty against A or B, but not both, as the primarily responsible tax return preparer.

III. Abatement Of Penalty Where Taxpayer's Liability Not Understated.

A. In General - If a penalty under section 6694(a) or (b) concerning a return or claim for refund has been assessed against one or more tax return preparers, and if it is established at any time in a final administrative determination or a final judicial decision that there was no understatement of liability relating to the position(s) on the return or claim for refund, then the assessment shall be abated.

B. Refund - If any amount of the penalty was paid, that amount shall be refunded to the person or persons who so paid, as if the payment were an overpayment of tax, without consideration of any period of limitations.

IV. Verification of Information Furnished By Taxpayer Or Other Third Party.

A. In General.

1. For purposes of sections 6694(a) and (b) the tax return preparer generally may rely in good faith without verification upon information furnished by the taxpayer.

2. A tax return preparer also may rely in good faith and without verification upon 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).

3. The tax return preparer is not required to audit, examine or review books and records, business operations, documents, or other evidence to verify independently information provided by the taxpayer, advisor, other tax return preparer, or other party.

4. The tax return preparer, however, may not ignore the implications of information furnished to the tax return preparer or actually known by the tax return preparer.

5. The tax return preparer must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete.

6. Additionally, some provisions of the Code or regulations require that specific facts and circumstances exist (for example, that the taxpayer maintain specific documents) before a deduction or credit may be claimed.

7. The tax return preparer must make appropriate inquiries to determine the existence of facts and circumstances required by a Code section or regulation as a condition of the claiming of a deduction or credit.

B. Verification of Information On Previously Filed Returns.

1. For purposes of section 6694(a) and (b), a tax return preparer may rely in good faith without verification upon a tax return that has been previously prepared by a taxpayer or another tax return preparer and filed with the IRS.

2. For example, a tax return preparer who prepares an amended return (including a claim for refund) need not verify the positions on the original return.

3. The tax return preparer, however, may not ignore the implications of information furnished to the tax return preparer or actually known by the tax return preparer.

4. The tax return preparer must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete.

5. The tax return preparer must confirm that the position being relied upon has not been adjusted by examination or otherwise.

C. Examples.

Example 1.

During an interview conducted by Preparer E, a taxpayer stated that he had made a charitable contribution of real estate in the amount of \$50,000 during the tax year, when in fact he had not made this charitable contribution. E did not inquire about the existence of a qualified appraisal or complete a Form 8283, Noncash Charitable Contributions, in accordance with the reporting and substantiation requirements under section 170(f)(11). E reported a deduction on the tax return for the charitable contribution, which resulted in an understatement of liability for tax, and signed the tax return as the tax return preparer. E is subject to a penalty under section 6694.

Example 2.

While preparing the 2008 tax return for an individual taxpayer, Preparer F realizes that the taxpayer did not provide a Form 1099-INT, "Interest Income", for a bank account that produced significant taxable income in 2007. When F inquired about any other income, the taxpayer furnished the Form 1099-INT to F for use in preparation of the 2008 tax return. F did not know that the taxpayer owned an additional bank account that generated taxable income for 2008, and the taxpayer did not reveal this information to the tax return preparer notwithstanding F's

general inquiry about any other income. F signed the taxpayer's return as the tax return preparer. F is not subject to a penalty under section 6694.

Example 3.

In preparing a tax return, for purposes of determining the deductibility of a contribution by an employer for a qualified pension plan, Accountant G relies on a computation of the section 404 limit on deductible amounts made by the enrolled actuary for the plan.

On the basis of this calculation, G completed and signed the tax return. It is later determined that there is an understatement of liability for tax that resulted from the overstatement of the section 404 limit on deductible amounts made by the actuary. G had no reason to believe that the actuary's calculation of the limit on deductible contributions was incorrect or incomplete, and the calculation appeared reasonable on its face.

G was also not aware at the time the return was prepared of any reason why the actuary did not know all of the relevant facts or that the calculation of the limit on deductible contributions was no longer reliable due to developments in the law since the time the calculation was given. G is not subject to a penalty under section 6694. The actuary, however, may be subject to penalty under section 6694 if the calculation provided by the actuary constitutes a substantial portion of the tax return.

V. Income Derived (or To Be Derived) With Respect To The Return Or Claim For Refund.

A. In General.

1. For purposes of sections 6694(a) and (b), "income derived" (or to be derived) means all compensation the tax return preparer receives or expects to receive with respect to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position(s) taken on the return or claim for refund that gave rise to the understatement.

2. In the situation of a tax return preparer who is not compensated directly by the taxpayer, but rather by a firm that employs the tax return preparer or with which the tax return preparer is associated, income derived (or to be derived) means all compensation the tax return preparer receives *from the firm* that can be reasonably allocated to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the

position(s) taken on the return or claim for refund that gave rise to the understatement.

3. In the situation where a firm that employs the individual tax return preparer (or the firm of which the individual tax return preparer is a partner, member, shareholder, or other equity holder) is subject to a penalty under section 6694(a) or (b) income derived (or to be derived) means all compensation the firm receives or expects to receive with respect to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position(s) taken on the return or claim for refund that gave rise to the understatement.

B. Compensation.

1. Multiple Engagements.

For purposes of applying paragraph A1, if the tax return preparer or the tax return preparer's firm has multiple engagements related to the same return or claim for refund, only those engagements relating to the position(s) taken on the return or claim for refund that gave rise to the understatement are considered for purposes of calculating the income derived (or to be derived) with respect to the return or claim for refund.

2. Reasonable Allocation.

a. For purposes of applying paragraph A, only compensation for tax advice that is given with respect to events that have occurred at the time the advice is rendered and that relates to the position(s) giving rise to the understatement will be taken into account for purposes of calculating the section 6694(a) and (b) penalties.

b. If a lump sum fee is received that includes amounts not taken into account under the preceding sentence, the amount of income derived will be based on a reasonable allocation of the lump sum fee between the tax advice giving rise to the penalty and the advice that does not give rise to the penalty.

3. Fee Refunds.

a. For purposes of applying paragraph A, a refund to the taxpayer of all or part of the amount paid to the tax

return preparer or the tax return preparer's firm will not reduce the amount of the section 6694 penalty assessed.

b. A refund in this context does not include a discounted fee or alternative billing arrangement for the services provided.

4. Reduction Of Compensation.

a. For purposes of applying paragraph A, it may be concluded based upon information provided by the tax return preparer or the tax return preparer's firm that an appropriate allocation of compensation attributable to the position(s) giving rise to the understatement on the return or claim for refund is less than the total amount of compensation associated with the engagement.

b. For example, the number of hours of the engagement spent on the position(s) giving rise to the understatement may be less than the total hours associated with the engagement.

c. If this is concluded, the amount of the penalty will be calculated based upon the compensation attributable to the position(s) giving rise to the understatement.

d. Otherwise, the total amount of compensation from the engagement will be the amount of income derived for purposes of calculating the penalty under section 6694.

C. Individual And Firm Allocation.

1. If both an individual within a firm and a firm that employs the individual (or the firm of which the individual is a partner, member, shareholder, or other equity holder) are subject to a penalty under section 6694(a) or (b), the amount of penalties assessed against the individual and the firm shall not exceed *50 percent of the income derived (or to be derived) by the firm from the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position(s) taken on the return or claim for refund that gave rise to the understatement.*

2. The portion of the total amount of the penalty assessed against the individual tax return preparer *shall not exceed 50*

percent of the individual's compensation as determined under paragraphs A and B.

D. Examples.

Example 1.

Signing Tax Return Preparer H is engaged by a taxpayer and paid a total of \$21,000. Of this amount, \$20,000 relates to research and consultation regarding a transaction that is later reported on a return, and \$1,000 is for the activities relating to the preparation of the return. Based on H's hourly rates, a reasonable allocation of the amount of compensation related to the advice rendered prior to the occurrence of events that are the subject of the advice is \$5,000. The remaining compensation of \$16,000 is considered to be compensation related to the advice rendered after the occurrence of events that are the subject of the advice and 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. 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, 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..

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. 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 $.5 \times (100/2000) \times \$75,000 = \$1,875$. 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.

Review Question—Eight

If a preparer disregards information concerning certain items of taxable income furnished by the taxpayer or other persons, the preparer is considered to have _____.

- (a) Willfully attempted to understate liability.
- (b) Recklessly disregarded a rule.
- (c) Intentionally disregarded a regulation.
- (d) Willfully attempted to disregard a regulation.

UNIT SIX - Other Assessable Penalties With Respect To The Preparation Of Income Tax Returns For Other Persons.

Learning Objectives.

Upon completion of this section, you will be able to:

- > Understand the penalty for failure to furnish a copy of the return to the taxpayer.
 - > Identify the penalties for failure to sign returns.
 - > Identify ta return preparer due diligence requirements.

I. Failure To Furnish Copy To Taxpayer.

A. In General - A person who is a signing tax return preparer of any return of tax or claim for refund of tax under the Internal Revenue Code (Code), and who fails to satisfy the requirements imposed by section 6107(a) and §1.6107-1(a) to furnish a copy of the return or claim for refund to the taxpayer (or nontaxable entity):

1. Shall be subject to a penalty of \$50 for such failure, with a maximum penalty of \$25,000 per person imposed with respect to each calendar year,
2. Unless it is shown that the failure is due to reasonable cause and not due to willful neglect.

B. Exceptions - No penalty may be imposed under section 6695(a) and the rules of paragraph A upon a tax return preparer who furnishes a copy of the return or claim for refund to taxpayers:

1. Who hold an elected or politically appointed position with the government of the United States or a state or political subdivision thereof; and
2. In order to faithfully carry out their official duties, have so arranged their affairs that they have less than full knowledge of the property that they hold or of the debts for which they are responsible, if information is deleted from the copy in order to preserve or maintain this arrangement.

II. Failure To Sign Return.

A. In General.

1. An individual who is a signing tax return preparer with respect to a return of tax or claim for refund of tax that is signed electronically shall sign the return or claim for refund after it is completed and before it is presented to the taxpayer (or nontaxable entity) for signature.

2. If the signing tax return preparer is unavailable for signature, another tax return preparer shall review the entire preparation of the return or claim for refund, and then shall sign the return or claim for refund.

3. The tax return preparer shall sign the return in the manner prescribed by the Commissioner in forms, instructions, or other appropriate guidance.

B. Electronically Signed.

1. In the case of electronically signed tax returns, the signing tax return preparer need not sign the return prior to presenting a completed copy of the return to the taxpayer.

2. The signing tax return preparer, however, must furnish all of the information that will be transmitted as the electronically signed tax return to the taxpayer contemporaneously with furnishing the Form 8879, "IRS e-file Signature Authorization," or other similar Internal Revenue Service (IRS) e-file signature form.

3. The information may be furnished on a replica of an official form. The signing tax return preparer shall electronically sign the return in the manner prescribed by the Commissioner in forms, instructions, or other appropriate guidance.

C. The Penalty

An individual required to sign a return or claim for refund:

1. Shall be subject to a penalty of \$50 for each failure to sign, with a maximum of \$25,000 per person imposed with respect to each calendar year, unless it is shown that the failure is due to reasonable cause and not due to willful neglect.

2. If the tax return preparer asserts reasonable cause for failure to sign, the IRS will require a written statement to substantiate the tax return preparer's claim of reasonable cause.

3. For purposes of this section, "*reasonable cause*" is cause that arises despite ordinary care and prudence exercised by the individual tax return preparer.

III. Failure To Furnish Identifying Number.

A. The Penalty - A person who is a signing tax return preparer of any return of tax under the Code or claim for refund of tax under the Code, and who fails to furnish one or more identifying numbers of signing tax return preparers or persons employing the signing tax return preparer (or with which the signing tax return preparer is associated) on a return or claim for refund after it is completed and before it is presented to the taxpayer (or nontaxable entity) for signature:

1. Shall be subject to a penalty of \$50 for each failure, with a maximum of \$25,000 per person imposed with respect to each calendar year,

2. Unless it is shown that the failure is due to reasonable cause and not due to willful neglect.

B. Restrictions - No more than one penalty of \$50 may be imposed under section 6695(c) and the regulations thereunder with respect to a single return or claim for refund.

IV. Failure To Retain Copy Or Record.

A. A person who is a signing tax return preparer of any return of tax under the Code or claim for refund of tax under the Code, and who fails to retain and make available for inspection a copy of the return or claim for refund, or to include the return or claim for refund in a record of returns and claims for refund and make the record available for inspection:

1. Shall be subject to a penalty of \$50 for the failure,

2. Unless it is shown that the failure is due to reasonable cause and not due to willful neglect.

B. A person may not, for returns or claims for refund presented to the taxpayers (or nontaxable entities) during each calendar year, be subject to more than \$25,000 in penalties under section 6695(d) and the regulations thereunder.

V. Failure To File Correct Information Returns.

A. A person who is subject to the employs one or more signing tax preparers to prepare tax returns of claims for refunds must:

1. Retaining a record of the name, taxpayer identification number, and principal place of work during the return period of each tax return preparer employed by the person at any time during that period; and

2. Making that record available for inspection upon request by the Commissioner.

B. The record described above must be retained and kept available for inspection for the 3-year period

C. Any such person fails to satisfy these requirements:

1. Shall pay a penalty of \$50 for each such failure, with a maximum of \$25,000 per person imposed for each calendar year,

2. Unless such failure was due to reasonable cause and not due to willful neglect.

VI. Negotiation Of Check.

A. No person who is a tax return preparer may endorse or otherwise negotiate, directly or through an agent, a check (including an electronic version of a check) for the refund of tax under the Code that is issued to a taxpayer other than the tax return preparer if the person was a tax return preparer of the return or claim for refund which gave rise to the refund check.

B. A tax return preparer will not be considered to have endorsed or otherwise negotiated a check for purposes of this solely as a result of having affixed the taxpayer's name to a refund check for the purpose of depositing the check into an account in the name of the taxpayer or in the joint names of the taxpayer and one or more other persons (excluding the tax return preparer) if authorized by the taxpayer or the taxpayer's recognized representative.

C. This penalty does not apply to a tax return preparer-bank that:

1. Cashes a refund check and remits all of the cash to the taxpayer or accepts a refund check for deposit in full to a taxpayer's account, so long as the bank does not initially endorse or negotiate the check (unless the bank has made a loan to the taxpayer on the basis of the anticipated refund); or

2. Endorses a refund check for deposit in full to a taxpayer's account pursuant to a written authorization of the taxpayer (unless the bank has made a loan to the taxpayer on the basis of the anticipated refund).

D. A tax return preparer-bank may also subsequently endorse or negotiate a refund check as a part of the check-clearing process through the financial system after initial endorsement or negotiation.

E. The tax return preparer shall be subject to a penalty of \$500 for each endorsement or negotiation of a check prohibited under section 6695(f) and the regulations thereunder.

VII. Tax Return Preparer Due Diligence Requirements For Determining Earned Income Credit Eligibility.

A. Penalty For Failure To Meet Due Diligence Requirements.

A person who is a signing tax return preparer of a tax return or claim for refund under the Internal Revenue Code with respect to determining the eligibility for, or the amount of, the earned income credit (EIC) under section 32 and who fails to satisfy the due diligence requirements listed below will be subject to a penalty of \$100 for each such failure.

B. Due Diligence Requirements.

1. A preparer must satisfy the following due diligence requirements:

a. Completion Of Eligibility Checklist - The preparer must either--

(1) Complete Form 8867, "Paid Preparer's Earned Income Credit Checklist," or such other form and such other information as may be prescribed by the Internal Revenue Service (IRS)(Eligibility Checklist); or

(2) Otherwise record in the preparer's paper or electronic files the information necessary to complete the Eligibility Checklist (Alternative Eligibility Record). The Alternative Eligibility Record may consist of one or more documents containing the required information.

b. The preparer's completion of the Eligibility Checklist or Alternative Eligibility Record must be based on

information provided by the taxpayer to the preparer or otherwise reasonably obtained by the preparer.

2. Computation Of Credit.

a. The preparer must either:

(1) Complete the Earned Income Credit Worksheet in the Form 1040 instructions or such other form and such other information as may be prescribed by the IRS (Computation Worksheet); or

(2) Otherwise record in the preparer's paper or electronic files the preparer's EIC computation, including the method and information used to make the computation (Alternative Computation Record). The Alternative Computation Record may consist of one or more documents containing the required information.

b. The preparer's completion of the Computation Worksheet or Alternative Computation Record must be based on information provided by the taxpayer to the preparer or otherwise reasonably obtained by the preparer.

3. Knowledge.

a. The tax return preparer must not know, or have reason to know, that any information used by the tax return preparer in determining the taxpayer's eligibility for, or the amount of, the EIC is incorrect.

b. The tax return preparer may not ignore the implications of information furnished to, or known by, the tax return preparer, and must make reasonable inquiries if the information furnished to the tax return preparer appears to be incorrect, inconsistent, or incomplete.

c. A tax return preparer must make reasonable inquiries if a reasonable and well-informed tax return preparer knowledgeable in the law would conclude that the information furnished to the tax return preparer appears to be incorrect, inconsistent, or incomplete.

d. The tax return preparer must also contemporaneously document in the files the reasonable inquiries made and the responses to these inquiries.

4. Examples.

Example 1.

A 22 year-old taxpayer wants to claim two sons, ages 10 and 11, as qualifying children for purposes of the EIC. Preparer A must make additional reasonable inquiries regarding the relationship between the taxpayer and the children as the age of the taxpayer appears inconsistent with the ages of the children claimed as sons.

Example 2.

An 18 year-old female taxpayer with an infant has \$3,000 in earned income and states that she lives with her parents. Taxpayer wants to claim the infant as a qualifying child for the EIC. This information appears incomplete and inconsistent because the taxpayer lives with her parents and earns very little income. Preparer B must make additional reasonable inquiries to determine if the taxpayer is the qualifying child of her parents and, therefore, ineligible to claim the EIC.

Example 3.

Taxpayer asks Preparer C to prepare his tax return and wants to claim his niece and nephew as qualifying children for the EIC. Preparer C should make reasonable inquiries to determine whether the children meet EIC qualifying child requirements and ensure possible duplicate claim situations involving the parents or other relatives are properly considered.

Example 4.

Taxpayer asks Preparer D to prepare her tax return and tells D that she has a Schedule C business, that she has two qualifying children and that she wants to claim the EIC. Taxpayer indicates that she earned \$10,000 from her Schedule C business, but that she has no expenses. This information appears incomplete because it is very unlikely that someone who is self-employed has no business expenses. D must make additional reasonable inquiries regarding taxpayer's business to determine whether the information regarding both income and expenses is correct.

C. Exception To Penalty.

1. The section 6695(g) penalty will not be applied with respect to a particular tax return or claim for refund if the tax return preparer can demonstrate to the satisfaction of the Internal Revenue Service that, considering all the facts and circumstances, the tax return preparer's normal office procedures are reasonably designed and routinely followed to ensure compliance with the due diligence requirements above, and

2. The failure to meet the due diligence requirements above with respect to the particular return or claim for refund was isolated and inadvertent.

Review Question—Nine

No penalty may be imposed under section 6695(a) and the rules of paragraph A upon a tax return preparer who furnishes a copy of the return or claim for refund to taxpayers who hold an elected or politically appointed position with the government of the United States or a state or political subdivision thereof; and _____.

(a) In order to faithfully carry out their official duties, are engaged in overseas travel and are therefore unavailable for signature.

(b) In order to faithfully carry out their official duties, have so arranged their affairs that they have less than full knowledge of the property that they hold or of the debts for which they are responsible, if information is deleted from the copy in order to preserve or maintain this arrangement.

(c) In order to faithfully carry out their official duties, have neglected their tax preparation due to time constraints caused by their elected or politically appointed position.

(d) Due to their elected or politically appointed position, they are not subject to common tax code procedures, including the penalties imposed under section 6695(a).

UNIT SEVEN – Assessment Procedure

Learning Objectives.

Upon completion of this section, you will be able to:

- > Understand the procedure for assessing penalties.
- > Identify the tax preparer's options upon notice and demand.
- > Understand, generally, levy or other proceedings in court for collections.

I. In General.

The Internal Revenue Service will investigate the preparation by a tax return preparer of a return of tax under the Code or claim for refund of tax under the Code and will send a report of the examination to the tax return preparer before the assessment of either:

A. A penalty for understating tax liability due to a position for which either (i) it was not reasonable to believe that the position would more likely than not be sustained on its merits under section 6694(a), or (ii) no substantial authority, as applicable (or not a reasonable basis for disclosed positions); or

B. A penalty for willful understatement of liability or reckless or intentional disregard of rules or regulations under section 6694(b).

II. Assessment.

A. Unless the period of limitations (if any) under section 6696(d) may expire without adequate opportunity for assessment, the IRS will also send, before assessment of either penalty, a 30-day letter to the tax return preparer notifying him of the proposed penalty or penalties and offering an opportunity to the tax return preparer to request further administrative consideration and a final administrative determination by the IRS concerning the assessment.

B. If the tax return preparer then makes a timely request, assessment may not be made until the IRS makes a final administrative determination adverse to the tax return preparer.

III. Notice and Demand

If the IRS assesses either of the two penalties described in section 6694(a) and section 6694(b), it will send to the tax return preparer a statement of notice and demand, separate from any notice of a tax deficiency, for payment of the amount assessed.

IV. Preparers Options.

A. In General.

1. Within 30 days after the day on which notice and demand of either of the two penalties described in section 6694(a) and section 6694(b) is made against the tax return preparer, the tax return preparer must either—

a. Pay the entire amount assessed (and may file a claim for refund of the amount paid at any time not later than 3 years after the date of payment); or

b. Pay an amount which is not less than 15 percent of the entire amount assessed with respect to each return or claim for refund and file a claim for refund of the amount paid.

2. A claim for refund of a preparer penalty is made by filing a Form 6118 (Claim for Refund of Income Tax Return Preparer Penalties), signed under penalties of perjury. The claim must identify (by type, amount and document) the preparer penalties to which the claim relates, and include a detailed statement setting forth each ground for asserting that the preparer penalty has been overpaid and facts sufficient to apprise the IRS of the exact basis of the claim.

B. Special Procedures Regarding Understatement Penalties.

1. A special procedure allows a §6694 preparer to contest an understatement penalty without first having to pay the entire penalty.

2. Before assessing a preparer understatement penalty under §6694(a) or (b), the IRS will send a report of its examination to the preparer.

3. Unless the three-year statute of limitations on assessing the penalty is about to expire, the IRS issues a 30-day letter before the penalty is assessed.

4. The preparer can then request an Appeals conference and receive a final administrative determination without first having to pay the penalty

V. Levy or Proceeding in Court for Collections

If the tax return preparer pays an amount and files a claim for refund, the IRS may not make, begin, or prosecute a levy or proceeding in court for collection of the unpaid remainder of the amount assessed until the later of:

A. A date which is more than 30 days after the earlier of—

1. The day on which the tax return preparer's claim for refund is denied; or

2. The expiration of 6 months after the day on which the tax return preparer filed the claim for refund.

B. "Final resolution" of a proceeding includes any settlement between the IRS and the tax return preparer, any final determination by a court (for which the period for appeal, if any, has expired) and, generally, the types of determinations provided under section 1313(a) (relating to taxpayer deficiencies).

VI. Preparer Must Bring Suit In District Court To Determine Liability For Penalty.

The IRS may proceed with collection of the amount of the penalty not paid under the provisions requiring 15% payment if the return preparer fails to begin a proceeding for refund in the appropriate United States district court within 30 days after the earlier of—

A. The day on which the preparer's claim for refund of their 15% payment is denied; or

B. The expiration of 6 months after the day on which the preparer filed the claim for refund.

VII. Suspension Of Running Of Period Of Limitations On Collection.

The running of the period of limitations provided in section 6502 on the collection by levy or by a proceeding in court of the unpaid amount of a penalty or penalties described in section 6694(a) or section 6694(b) is suspended for the period during which the IRS may not collect the unpaid amount of the penalty or penalties by levy or a proceeding in court.

Review Question—Ten

Which of the following is not true about the due diligence requirements, computation of credit?

(a) The Alternative Computation Record may consist of one or more documents containing the required information.

(b) The preparer's completion of the Computation Worksheet or Alternative Computation Record must be based on information provided by the taxpayer to the preparer or otherwise reasonably obtained by the preparer.

(c) The preparer must either complete Form 8867 or otherwise record in the preparer's paper or electronic files the preparer's EIC computation, including the method and information used to make the computation (Alternative Computation Record).

(d) The preparer must either complete the Earned Income Credit Worksheet in the Form 1040 instructions of such other form and such other information as may be prescribed by the IRS; or otherwise record in the preparer's paper or electronic files the preparer's EIC computation, including the method and information used to make the computation.

INDEX OF DEFINITIONS

Claim for Refund:	A document for credit against tax.
Nonsigning Tax Return Preparer:	Any tax return preparer who is not a signing tax return preparer but who prepares all or a substantial portion of a return or claim for refund.
Reckless Or Intentional Disregard:	A position on the return or claim for refund that is contrary to a rule or regulation and the preparer knows of, or is reckless in not knowing of, the rule or regulation in question; no knowing of a rule or regulation if the preparer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable preparer would observe in the situation.
Reportable Transaction:	Any transaction for which information must be included with a return or statement because, as determined under regulations issued under Code Sec. 6011, the transaction has potential for tax avoidance or evasion.
Return:	A document (including an amended or adjusted return) filed by or on behalf of a taxpayer reporting the liability of the taxpayer for tax under the Internal Revenue Code.
Signing Tax Return Preparer:	The individual tax return preparer who physically signs the return and normally has the primary responsibility for the overall substantive accuracy of the preparation of such return or claim for refund.
“Substantial Authority” Standard:	An objective standard involving an analysis of the law and application of the law to relevant facts; less stringent than the more likely than not standard.
Tax Shelter:	A partnership or other entity, any investment plan or arrangement, or any other plan or arrangement; which has a significant purpose for the avoidance or evasion of federal income tax.

Tax Return Preparer: Any person who prepares for compensation or who employs one or more persons to prepare for compensation; all or a substantial portion of; any return of tax or claim for refund of tax under the Internal Revenue Code.

The "Reasonable Basis" Standard: A relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper; the reasonable basis is not satisfied by a return position that is merely arguable or that is merely a colorable claim.

Willful Attempt: Attempt 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.

Answers to Review Questions

Question 1.

(a) Correct. A signing tax return preparer is the individual tax return preparer who has the primary responsibility for the overall substantive accuracy of the preparation of such return or claim for refund.

(b) Incorrect. While the signing tax return preparer might have the responsibility to file a return or claim for refund, this is not what makes them a signing tax return preparer.

(c) Incorrect. The signed tax return preparer is not the one who ultimately decides the overall accuracy. The signing tax return preparer has the primary responsibility for the overall substantive accuracy of the return or claim for refund, the IRS will decide whether they have fulfilled their responsibility.

(d) Incorrect. The signing tax return preparer has the primary responsibility for the overall substantive accuracy of the return or claim for refund. While one of their duties may be to file the return or claim for refund, that is not what qualifies them as a signing tax return preparer.

Question 2.

(a) Incorrect. A person who furnishes to a taxpayer or other tax return preparer sufficient information and advice so that completion of the return or claim for refund is largely a mechanical or clerical matter, is a tax return preparer.

(b) Incorrect. A person who prepares a return or claim for refund outside the United States is a tax return preparer regardless of the person's nationality, residence, or the location of the person's place of business, if the person otherwise satisfies the definition of *tax return preparer*.

(c) Correct. An individual providing only typing, reproduction, or other mechanical assistance in the preparation of a return or claim for refund is not a tax return preparer since they do not prepare for compensation or employ one or more persons to prepare for compensation all or a substantial portion of a return of tax or claim for refund.

(d) Incorrect. A person who renders tax advice on a position that is directly relevant to the determination of the existence, characterization, or amount of

an entry on a return or claim for refund will be regarded as having prepared that entry, thus they are a tax return preparer.

Question 3.

(a) Incorrect. Anything other than a tax shelter would be assessed under the “substantial authority” standard.

(b) Incorrect. Although reportable transactions are assessed with the “more likely than not standard”, anything other than a tax shelter is assessed under the “substantial authority standard”.

(c) Incorrect. While tax shelters are assessed under the “more likely than not standard,” reportable transactions are also assessed using this standard. This answer is incomplete.

(d) Correct. The new law retains the “more likely than not standard,” but only for tax shelters and reportable transactions.

Question 4.

(a) Incorrect. The net amount payable in a taxable year with respect to the return for which the tax return preparer engaged in conduct proscribed by section 6694 is not reduced by any carryback.

(b) Correct. An “understatement of liability” exists if, viewing the return or claim for refund as a whole, there is an understatement of the net amount payable with respect to any tax imposed by the Internal Revenue Code, or an overstatement of the net amount creditable or refundable with respect to any tax imposed by the Code.

(c) Incorrect. Tax imposed by the Code **does not** include additions to the tax, additional amounts, and assessable penalties imposed by subchapter 68 of the Code.

(d) Incorrect. The determination of whether an understatement of liability exists may be made in a proceeding involving the tax return preparer that is separate and apart from any proceeding involving the taxpayer.

Question 5.

(a) Incorrect. The tax return preparer **may not** ignore the implications of information furnished to the tax return preparer or actually known by the tax return preparer.

(b) Correct. Since the original return was previously prepared by a taxpayer or another tax return preparer and filed with the IRS, a tax return preparer may rely in good faith without verification.

(c) Incorrect. The tax return preparer **must make** reasonable inquiries if the information as furnished appears to be incorrect or incomplete.

(d) Incorrect. The tax return preparer **must** confirm that the position being relied upon has not been adjusted by examination or otherwise.

Question 6.

(a) Incorrect. The “no substantial authority” standard applies when something other than a tax shelter is involved and the position is undisclosed.

(b) Incorrect. The “more likely than not” standard applies only when tax shelters and reportable transactions are involved.

(c) Correct. When something other than a tax shelter is involved and the position is disclosed, the “no reasonable basis” standard applies. Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities taking into account the relevance and persuasiveness of the authorities, and subsequent developments, the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard.

(d) Incorrect. The EES Act does not reinstate the pre-Small Business Act law which provided for a “realistic possibility” standard.

Question 7.

(a) Incorrect. This is an incomplete answer. The position is adequate also if the tax return preparer complies with the provisions of paragraph C3 or C4, whichever is applicable (answer B).

(b) Incorrect. This is an incomplete answer. The position is adequate also 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)) (answer A).

(c) Incorrect. Both Answer A and B are correct.

(d) Correct. In the case of a nonsigning tax return preparer, 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)) (answer A) and with respect to that position, the tax return preparer complies with the provisions of paragraph C3 or C4, whichever is applicable.

Question 8.

(a) Correct. 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.

(b) Incorrect. A preparer is considered to have recklessly or intentionally disregarded a rule or regulation if (1) 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 (2) 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 regulation exists, under circumstances which demonstrate a substantial deviation from

the standard of conduct that a reasonable preparer would observe in the situation.

(c) Incorrect. A preparer is considered to have recklessly or intentionally disregarded a rule or regulation if (1) 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 (2) 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 regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable preparer would observe in the situation.

(d) Incorrect. This is merely a combination of the two ways a penalty for understatement due to willful, reckless, or intentional conduct – to willfully attempt to understate liability or recklessly or intentionally disregarded a rule or regulation.

Question 9.

(a) Incorrect. Whether the elected or politically appointed official in country to prepare the return, is not important regarding section 6695(a). The penalty under section 6695(a) is due to an understatement due to an unreasonable position, not a failure to sign.

(b) Correct. If the elected or politically appointed official has so arranged their affairs that they have less than full knowledge of the property that they hold or of the debts for which they are responsible, no penalty may be imposed under section 6695(a).

(c) Incorrect. Section 6695(a) does not involve failure to prepare taxes. The penalty under section 6695(a) is due to an understatement due to an unreasonable position.

(d) Incorrect. Section 6695(a) would not include anyone who is “not subject to common tax code procedures”. The penalty may not be imposed if the elected or politically appointed official, in order to faithfully carry out their official duties, have so arranged their affairs that they have less than full knowledge of the property that they hold or of the debts for which they are responsible, if information is deleted from the copy in order to preserve or maintain this arrangement.

Question 10.

(a) Incorrect. In regard to the computation of credit the Alternative Computation Record **may** consist of one or more documents containing the required information.

(b) Incorrect. In regard to the computation of credit the preparer's completion of the Computation Worksheet or Alternative Computation Record **must** be based on information provided by the taxpayer to the preparer or otherwise reasonably obtained by the preparer.

(c) Correct. The preparer must either Complete the Earned Income Credit Worksheet in the Form 1040 instructions or such other form and such other information as may be prescribed by the IRS (Computation Worksheet); or otherwise record in the preparer's paper or electronic files the preparer's EIC computation, including the method and information used to make the computation (Alternative Computation Record). Form 8867 is used for the eligibility checklist not for computation of credit.

(d) Incorrect. The preparer **must either** Complete the Earned Income Credit Worksheet in the Form 1040 instructions or such other form and such other information as may be prescribed by the IRS (Computation Worksheet); **or** otherwise record in the preparer's paper or electronic files the preparer's EIC computation, including the method and information used to make the computation (Alternative Computation Record).

Final Examination Instructions

In order to obtain CPE credit, you must complete the following Final Examination. Credit can be obtained by two means:

(1) Complete the Final Examination by **circling** the answers you believe are correct. Remove or print the Final Examination portion of this booklet and mail to:

YourOnlineProfessor, LLC
c/o Gibson & Perkins, P.C.
100 W. Sixth Street, Suite 204
Media, PA 19063

Your Final Examination will be graded and your results will be sent to you by regular mail or e-mail.

(2) Go to www.youronlineprofessor.org and under the “Course Info” section select “Final Examination.” On that page, select “Your Appeal Rights Before the IRS” and follow the instructions to electronically submit your Answers to the Final Examination.

Final Examination

1. The Pre-Small business act provided for a penalty of _____.

- (a) the greater of \$1,000, or 50% of the income derived (or to be derived).
- (b) at least 50% of the tax payers income derived (or to be derived).
- (c) the greater of \$500 or 20% of the income derived (or to be derived).
- (d) at least 20% of the tax payers income derived (or to be derived).

2. Within 30 days after the day on which notice and demand of either of the two penalties described in section 6694(a) and section 6694(b) is made against the tax return preparer, the tax return preparer must:

- (a) Pay the entire amount assessed (and may file a claim for refund of the amount paid at any time not later than 3 years after the date of payment).
- (b) Pay an amount which is not less than 15 percent of the entire amount assessed with respect to each return or claim for refund and file a claim for refund of the amount paid.
- (c) None of the Above.
- (d) Either A or B.

3. A person who is a signing tax return preparer of any return of tax or claim for refund of tax under the Internal Revenue Code (Code), and who fails to satisfy the requirements imposed by section 6107(a) and §1.6107-1(a) to furnish a copy of the return or claim for refund to the taxpayer (or nontaxable entity) is subject to _____.

- (a) A penalty of \$100 for such failure.
- (b) A penalty of \$50 for such failure, with a maximum penalty of \$25,000 per person imposed with respect to each calendar year.

- (c) A penalty of 50% of the income derived.
- (d) A penalty of at least 20% of the income derived

4. True or False. In lieu of completing Form 8867, "Paid Preparer's Earned Income Credit Checklist," or such other form and such other information as may be prescribed by the Internal Revenue Service (IRS)(Eligibility Checklist), a tax preparer can prepare an Alternative Eligibility Record.

- (a) True.
- (b) False.

5. The changes to the small business act are effective for returns prepared after:

- (a) December 31, 2000.
- (b) August 3, 1997.
- (c) May 25, 2007.
- (d) May 5, 2002.

6. The substantial authority standard is less stringent than the "more likely than not" standard, but more stringent than the _____.

- (a) "Realistic Possibility" standard.
- (b) "Insubstantial Authority" standard.
- (c) "Understandable Basis" standard.
- (d) "Reasonable Basis" standard.

7. True or false. The definition of a tax return preparer does not include advisers rendering advice related to specific items on the return.

- (a) True.

(b) False.

8. An individual preparing a claim for refund for a taxpayer in response to a notice of deficiency issued to the taxpayer is _____.

- (a) A nonsigning tax preparer.
- (b) A signing tax preparer.
- (c) Not a tax preparer.
- (d) Either A or B, more information is needed.

9. One of the factors in deciding if a penalty will be imposed under section 6694(a) is the nature of the error. Which one of the following is not an example of an acceptable error?

- (a) The error occurred due to a numerical typo which would have been apparent in a review of the return.
- (b) The error resulted from the complexity of a highly technical provision. Any competent tax preparer could have reasonably made this error.
- (c) The error occurred due to a competent tax preparer's unfamiliarity with an uncommon provision.
- (d) The error resulted from a reasonable miscalculation due to a complex provision. This miscalculation would not be apparent in a review of the return.

10. If the signing tax return preparer is unavailable for signature _____.

- (a) The return should be filed without signature; any return signed by a person other than the signing tax return preparer will not be accepted.
- (b) The return should be filed with attached documentation explaining the preparer's inability to sign.

(c) Another tax return preparer shall review the entire preparation of the return or claim for refund, and then shall sign the return or claim for refund.

(d) The tax payer's return cannot be filed until the preparer's return and will be subject to a failure to file penalty.