

§ 1.6694-1 Section 6694 penalties applicable to income tax return preparer.

(a) *Overview.* Section 6694(a) and section 6694(b) impose penalties on income tax return preparers for certain understatements of liability on a return or claim for refund. The section 6694(a) penalty is imposed for an understatement of liability with respect to tax imposed by subtitle A of the Internal Revenue Code that is due to a position for which there was not a realistic possibility of being sustained on its merits. The section 6694(b) penalty is imposed for an understatement of liability with respect to tax imposed by subtitle A of the Internal Revenue Code that is due to a willful attempt to understate tax liability or that is due to reckless or intentional disregard of rules or regulations. See § 1.6694-2 for rules relating to the penalty under section 6694(a). See § 1.6694-3 for rules relating to the penalty under section 6694(b).

(b) *Income tax return preparer—(1) In general.* Solely for purposes of the regulations under section 6694, the term “income tax return preparer” (“preparer”) means any person who is an income tax return preparer within the meaning of section 7701(a)(36) and § 301.7701-15 of this chapter, except that no more than one individual associated with a firm (for example, as a partner or employee) is treated as a preparer with respect to the same return or claim for refund. If a signing preparer is associated with a firm, that individual, and no other individual associated with the firm, is a preparer with respect to the return or claim for purposes of section 6694. If two or more individuals associated with a firm are income tax return preparers with respect to a return or claim for refund, within the meaning of section 7701(a)(36) and § 301.7701-15 of this chapter, and none of them is the signing preparer, only one of the individuals is a preparer (i.e., nonsigning preparer) with respect to that return or claim for purposes of section 6694. In such a case, ordinarily, the individual who is a preparer for purposes of section 6694 is the individual with overall supervisory responsibility for the advice given by the firm with respect to the return or claim. To

the extent provided in § 1.6694-2(a)(2) and § 1.6694-3(a)(2), an individual and the firm with which the individual is associated may both be subject to penalty under section 6694 with respect to the same return or claim for refund. If an individual (other than the sole proprietor) who is associated with a sole proprietorship is subject to penalty under section 6694, the sole proprietorship is considered a “firm” for purposes of this paragraph.

(2) *Signing and nonsigning preparers.* A “signing preparer” is any preparer who signs a return of tax or claim for refund as a preparer. A “nonsigning preparer” is any preparer who is not a signing preparer. Examples of nonsigning preparers are preparers who provide advice (written or oral) to a taxpayer or to a preparer who is not associated with the same firm as the preparer who provides the advice.

(3) *Example.* The provisions of paragraph (b) of this section are illustrated by the following example:

Example. Attorney A provides advice to Client C concerning the proper treatment of a significant item on C’s income tax return. The advice constitutes preparation of a substantial portion of the return. In preparation for providing that advice, A discusses the matter with Attorney B, who is associated with the same firm as A, but A is the attorney with overall supervisory responsibility for the advice. Neither Attorney A nor any other attorney associated with A’s firm signs C’s return as a preparer. For purposes of the regulations under section 6694, A is a preparer with respect to C’s return and is subject to penalty under section 6694 with respect to C’s return. B is not a preparer with respect to C’s return and, therefore, is not subject to penalty under section 6694 with respect to a position taken on C’s return. This would be true even if B recommends that A advise C to take an undisclosed position that did not satisfy the realistic possibility standard. In addition, since B is not a preparer for purposes of the regulations under section 6694, A may not avoid a penalty under section 6694 with respect to C’s return by claiming he relied on the advice of B. See § 1.6694-2(d)(5).

(c) *Understatement of liability.* For purposes of the regulations under section 6694, 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 subtitle A of the Internal Revenue Code, or an overstatement of the net amount creditable or refundable with respect to any tax imposed by subtitle A of the Internal Revenue Code. The net amount payable in a taxable year with respect to the return for which the preparer engaged in conduct proscribed by section 6694 is not reduced by any carryback. Tax imposed by subtitle A of the Internal Revenue Code does not include additions to the tax provided by section 6654 and section 6655 (relating to underpayments of estimated tax). Except as provided in paragraph (d) of this section, the determination of whether an understatement of liability exists may be made in a proceeding involving the preparer apart from any proceeding involving the taxpayer.

(d) *Abatement of penalty where taxpayer's liability not understated.* If a penalty under section 6694(a) or section 6694(b) concerning a return or claim for refund has been assessed against one or more 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 return or claim for refund, then—

(1) The assessment must be abated; and

(2) If any amount of the penalty was paid, that amount must 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.

(e) *Verification of information furnished by taxpayer—*(1) *In general.* For purposes of section 6694(a) and section 6694(b), the preparer generally may rely in good faith without verification upon information furnished by the taxpayer. Thus, the preparer is not required to audit, examine or review books and records, business operations, or documents or other evidence in order to verify independently the taxpayer's information. However, the preparer may not ignore the implications of information furnished to the preparer or actually known by the preparer. The preparer must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete. 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 may be claimed. The preparer must make appropriate inquiries to determine the existence of facts and circumstances required by a Code section or regulation as a condition to the claiming of a deduction.

(2) *Example.* The provisions of paragraph (e) of this section are illustrated by the following example:

Example. A taxpayer, during an interview conducted by the preparer, stated that he had paid \$6,500 in doctor bills and \$5,000 in deductible travel and entertainment expenses during the tax year, when in fact he had paid smaller amounts. On the basis of this information, the preparer properly calculated deductions for medical expenses and for travel and entertainment expenses which resulted in an understatement of liability for tax. The preparer had no reason to believe that the medical expense and travel and entertainment expense information presented was incorrect or incomplete. The preparer did not ask for underlying documentation of the medical expenses but inquired about the existence of travel and entertainment expense records. The preparer was reasonably satisfied by the taxpayer's representations that the taxpayer had adequate records (or other sufficient corroborative evidence) for the deduction of \$5,000 for travel and entertainment expenses. The preparer is not subject to a penalty under section 6694.

(f) *Effective date.* Sections 1.6694-1 through 1.6694-3 are generally effective for documents prepared and advice given after December 31, 1991. However, § 1.6694-3(c)(3) (which provides that a preparer is not considered to have recklessly or intentionally disregarded a revenue ruling or notice if the position contrary to the ruling or notice has a realistic possibility of being sustained on its merits) is effective for documents prepared and advice given after December 31, 1989. Except as provided in the preceding sentence, section 6694 and the existing rules and regulations thereunder (to the extent not inconsistent with the statute as amended by the Omnibus Budget Reconciliation Act of 1989), and Notice 90-20, 1990-1 C.B. 328, apply to documents prepared and advice given on or before

December 31, 1991. For the effective date of § 1.6694-4, see § 1.6694-4(d).

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

(a) *In general*—(1) *Proscribed conduct.* Except as otherwise provided in this section, if any part of an understatement of liability relating to a return of tax under subtitle A of the Internal Revenue Code or claim for refund of tax under subtitle A of the Internal Revenue Code is due to a position for which there was not a realistic possibility of being sustained on its merits, any person who is a preparer with respect to such return or claim for refund who knew or reasonably should have known of such position is subject to a penalty of \$250 with respect to such return or claim for refund.

(2) *Special rule for employers and partnerships.* An employer or partnership of a preparer subject to penalty under section 6694(a) is also subject to penalty only if—

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

(ii) The employer or partnership failed to provide reasonable and appropriate procedures for review of the position for which the penalty is imposed; or

(iii) Such review procedures were disregarded in the formulation of the advice, or the preparation of the return or claim for refund, that included the position for which the penalty is imposed.

(b) *Realistic possibility of being sustained on its merits*—(1) *In general.* A position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits (realistic possibility standard). In making this determination, the possibility that the position will not be challenged by the Internal Revenue Service (e.g., because the tax-

payer's return may not be audited or because the issue may not be raised on audit) is not to be taken into account. The analysis prescribed by § 1.6662-4(d)(3)(ii) for purposes of determining whether substantial authority is present applies for purposes of determining whether the realistic possibility standard is satisfied.

(2) *Authorities.* The authorities considered in determining whether a position satisfies the realistic possibility standard are those authorities provided in § 1.6662-4(d)(3)(iii).

(3) *Examples.* The provisions of paragraphs (b)(1) and (b)(2) of this section are illustrated by the following examples:

Example 1. A new statute is unclear as to whether a certain transaction that a taxpayer has engaged in will result in favorable tax treatment. Prior law, however, supported the taxpayer's position. There are no regulations under the new statute and no authority other than the statutory language and committee reports. The committee reports state that the intent was not to adversely affect transactions similar to the taxpayer's transaction. The taxpayer's position satisfies the realistic possibility standard.

Example 2. A taxpayer has engaged in a transaction that is adversely affected by a new statutory provision. Prior law supported a position favorable to the taxpayer. The preparer believes that the new statute is inequitable as applied to the taxpayer's situation. The statutory language is unambiguous as it applies to the transaction (e.g., it applies to all manufacturers and the taxpayer is a manufacturer of widgets). The committee reports do not specifically address the taxpayer's situation. A position contrary to the statute does not satisfy the realistic possibility standard.

Example 3. The facts are the same as in *Example 2*, except the committee reports indicate that Congress did not intend to apply the new statutory provision to the taxpayer's transaction (e.g., to a manufacturer of widgets). Thus, there is a conflict between the general language of the statute, which adversely affects the taxpayer's transaction, and a specific statement in the committee reports that transactions such as the taxpayer's are not adversely affected. A position consistent with either the statute or the committee reports satisfies the realistic possibility standard. However, a position consistent with the committee reports constitutes a disregard of a rule or regulation and, therefore, must be adequately disclosed in order to avoid the section 6694(b) penalty.