



Tax Reduction Letter

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Reg. Section 1.6694-3(d), Example 2

Penalty for understatement due to willful, reckless, or intentional conduct

(a) In general.

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

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

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

(2) Special rule for corporations, partnerships, and other firms. A firm that employs a tax return preparer subject to a penalty under section 6694(b) (or a firm of which the individual tax return preparer is a partner, member, shareholder or other equity holder) is also subject to penalty if, and only if-

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

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

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

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

a preparer that the taxpayer has only two dependents, and the preparer reports six dependents on the return, the preparer is subject to the penalty.

(c) Reckless or intentional disregard.

(1) Except as provided in paragraphs (c)(2) and (c)(3) of this section, a preparer is considered to have recklessly or intentionally disregarded a rule or regulation if the preparer takes a position on the return or claim for refund that is contrary to a rule or regulation (as defined in paragraph (f) of this section) and the preparer knows of, or is reckless in not knowing of, the rule or regulation in question. A preparer is reckless in not knowing of a rule or regulation if the preparer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable preparer would observe in the situation.

(2) 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 as defined in § 1.6694-2(d)(2) and is adequately disclosed in accordance with §§ 1.6694-2(d)(3)(i)(A) or (C) or 1.6694-2(d)(3)(ii). 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 in accordance with §§ 1.6694-2(d)(3)(i)(A) or (C) or 1.6694-2(d)(3)(ii), the tax return preparer must identify the regulation being challenged. For purposes of this section, disclosure on the return in accordance with an annual revenue procedure under § 1.6662-4(f)(2) is not applicable.

(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 described in § 1.6662-4(d) and is not with respect to a reportable transaction to which section 6662A applies.

(d) Examples. The provisions of paragraphs (b) and (c) of this section are illustrated by the following 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 as defined in §1.6694-2(d)(2) and will not be subject to the section 6694(b) penalty if the position is adequately disclosed in accordance with paragraph (c)(2) of this section because the position represents a good faith challenge to the validity of the regulations.

(e)Rules or regulations. 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.

(f)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.

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

(h)Burden of proof. In any proceeding with respect to the penalty imposed by section 6694(b), the Government bears the burden of proof on the issue of whether the preparer willfully attempted to understate the liability for tax. See section 7427. The preparer bears the burden of proof on such other issues as whether-

- (1) The preparer recklessly or intentionally disregarded a rule or regulation;
- (2) A position contrary to a regulation represents a good faith challenge to the validity of the regulation; and
- (3) Disclosure was adequately made in accordance with paragraph (e) of this section.