



Client Side Penalties—A Look at §6662 and It's Influence on Preparer Sanctions

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Taxpayer Penalties Under Section 6662

We've had a lot of discussions in the recent past about changes made to §6694's preparer penalties by Congress, and a while back similar discussions about the changes made to Circular 230 ¶10.35's requirements for "covered opinions." Both provisions are notable because they made reference to the same standard of comfort level about a tax position—the "more likely than not" standard.

That standard was found long before either of these provisions in the taxpayer penalty Section 6662—and that sections "comfort" and other standards have been the source of other items that impact both Circular 230 and the new provisions in §6694. For that reason, I thought it might be useful to review some of the provisions found in this section that provides for penalties upon the taxpayer.

Note that client penalties have always been an issue with regard to preparer sanctions as well. Those covered by Circular 230 have an obligation to discuss potential penalty exposure with the client. Circular 230 ¶10.34(b) provides specifically:

(b) Advising clients on potential penalties.

A practitioner advising a client to take a position on a tax return, or preparing or signing a tax return as a preparer, must inform the client of the penalties reasonably likely to apply to the client with respect to the position advised, prepared, or reported. The practitioner also must inform the client of any opportunity to avoid any such penalty by disclosure, if relevant, and of the requirements for adequate disclosure. This paragraph (b) applies even if the practitioner is not subject to a penalty with respect to the position.

Note that last sentence—even in the “old days” when the preparer was not subject to the revised section §6694(a), there was still a Circular 230 obligation to advise the client on penalty issues.

As well, CPAs covered by the AICPA *Statements on Standards for Tax Services* faced a similar professional obligation. SSTS No. 1, ¶2(d) provides:

When recommending tax return positions and when preparing or signing a return on which a tax return position is taken, a member should, when relevant, advise the taxpayer regarding potential penalty consequences of such tax return position and the opportunity, if any, to avoid such penalties through disclosure.

Since most state accountancy statutes and regulations give at least a presumption that the AICPA *Code of Professional Conduct* represents the standard of ethical conduct for CPAs under the state law, the fact that the *Code* recognizes the SSTSs as being standards CPAs should adhere to means that most CPAs, even if not members of the AICPA, have to deal with those standards as well. Arizona CPAs, in fact, had to deal with the tax standards as enforceable even back when the AICPA considered them solely advisory, because the Arizona Accountancy Regulations adopted the predecessor to these standards.

Finally, even disregarding these issues, most clients would likely presume they would be both informed of potential penalties and of any chance to reduce those penalties via disclosure. Even if the IRS and state board of accountancy passes on disciplining a practitioner, the practitioner may face a civil complaint that he/she gave work below the standards that a client should be able to expect from a professional.

So let’s review some parts of the specific penalty provisions under §6662. While we won’t cover the entire provision, I did want to take a look at certain specific areas where it’s clear the IRS and Congress have borrowed provisions to come up with rules directly

applicable to practitioners that have generated some heated discussions among those affected.

Section 6662

Section 6662 provides the following basic outline of the amount of a penalty, and the times which it applies, in (a) and (b) as follows:

<p>Sec. 6662. Imposition of accuracy-related penalty on underpayments</p> <p>(a) Imposition of penalty</p> <p>If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.</p> <p>(b) Portion of underpayment to which section applies</p> <p>This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:</p> <ol style="list-style-type: none">(1) Negligence or disregard of rules or regulations.(2) Any substantial understatement of income tax.(3) Any substantial valuation misstatement under chapter 1.(4) Any substantial overstatement of pension liabilities.(5) Any substantial estate or gift tax valuation understatement. <p>This section shall not apply to any portion of an underpayment on which a penalty is imposed under section 6663. Except as provided in paragraph (1) or (2)(B) of section 6662A(e), this section shall not apply to the portion of any underpayment which is attributable to a reportable transaction understatement on which a penalty is imposed under section 6662A.</p>
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We are going to concentrate in this series of podcasts on the first two categories of penalties under §6662—those dealing with negligence or disregard of the rules or regulations and substantial understatement of income taxes. The valuation misstatements referenced in §6662(b)(3) and (5) have been covered in our discussions on the changes in the Pension Protection Act of 2006 and we won't repeat that discussion in this set of podcasts. As well, we'll skip the substantial overstatement of pension liabilities issue as well.

Negligence or Disregard of Rules or Regulations

This week we'll look at the first of these penalties—the negligence or disregard of rules or regulations standard. The negligence issue of §6662(b)(1) is defined in somewhat more detail in §6662(c), which provides:

(c) Negligence

For purposes of this section, the term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term "disregard" includes any careless, reckless, or intentional disregard.

Regulation §1.6662-3 provides additional guidance on penalties under this provision. In Regulation §1.6662-3(a) we find the general definition of what constitutes negligence or disregard that would cause this penalty to apply, as well as under what circumstances the penalty may not apply.

(a) In general.

If any portion of an underpayment, as defined in section 6664(a) and §1.6664-2, of any income tax imposed under subtitle A of the Internal Revenue Code that is required to be shown on a return is attributable to negligence or disregard of rules or regulations, there is added to the tax an amount equal to 20 percent of such portion.

Options to avoid the penalty by disclosure or under the existence of reasonable cause and good faith are raised following this opening, as noted below:

The penalty for disregarding rules or regulations does not apply, however, if the requirements of paragraph (c)(1) of this section are satisfied and the position in question is adequately disclosed as provided in paragraph (c)(2) of this section (and, if the position relates to a reportable transaction as defined in §1.6011-4(b) (or §1.6011-4T(b), as applicable), the transaction is disclosed in accordance with §1.6011-4 (or §1.6011-4T, as applicable)), or to the extent that the reasonable cause and good faith exception to this penalty set forth in §1.6664-4 applies.

Finally, if a position is contrary to a revenue ruling or notice, the “realistic possibility” standard is applied to enable a taxpayer to avoid the general negligence penalty.

In addition, if a position with respect to an item (other than with respect to a reportable transaction, as defined in §1.6011-4(b) or §1.6011-4T(b), as applicable) is contrary to a revenue ruling or notice (other than a notice of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), this penalty does not apply if the position has a realistic possibility of being sustained on its merits.

See §1.6694-2(b) of the income tax return preparer penalty regulations for a description of the realistic possibility standard.

The regulation goes on to describe the basic definitions we have to work with under this provision for negligence and disregard of the rules or regulations. It reads:

(b) Definitions and rules

(1) Negligence.

The term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return. "Negligence" also includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly.

The general rule is given above that gives the basic outline to determine “negligent” conduct by the taxpayer.

A return position that has a reasonable basis as defined in paragraph (b)(3) of this section is not attributable to negligence.

We now find an exception to a finding a negligence—if a taxpayer’s position has a “reasonable basis” then it is not subject to a negligence finding. Note that “reasonable basis” is also now the minimum standard for a preparer to avoid sanction for a disclosed positio

Negligence is strongly indicated where --

- (i) A taxpayer fails to include on an income tax return an amount of income shown on an information return, as defined in section 6724(d)(1);
- (ii) A taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be "too good to be true" under the circumstances;
- (iii) A partner fails to comply with the requirements of section 6222, which requires that a partner treat partnership items on its return in a manner that is consistent with the treatment of such items on the partnership return (or notify the Secretary of the inconsistency); or
- (iv) A shareholder fails to comply with the requirements of section 6242, which requires that an S corporation shareholder treat subchapter S items on its return in a manner that is consistent with the treatment of such items on the corporation's return (or notify the Secretary of the inconsistency).

The four “presumptive” types of negligence are outlined and are ones clients need to be warned of. Preparers should be especially careful about the final two provisions that

require notification of inconsistent treatment for partnership and S corporation items. Such inconsistent treatment can arise when, for instance, a taxpayer simply does not receive the K-1 prior to wanting (or being required to) file his/her return.

As well, the “too good to be true” provision may prove useful to show to a client when they are giving the standard story about how a “friend of a friend” has told them that some odd tax treatment is perfectly acceptable.

(2) Disregard of rules or regulations.

The term "disregard" includes any careless, reckless or intentional disregard of rules or regulations. The term "rules or regulations" includes the provisions of the Internal Revenue 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.

It is important to note the list of items that constitute “rules and regulations” for the purposes of this penalty. A taxpayer who takes a position that goes against these positions faces a heightened risk of being penalized if the position is not sustained on examination.

Such rules would include documentation requirements such as those found for items like travel, entertainment and the like—a taxpayer who ignores those requirements is facing the risk of a penalty for intentional disregard of the rules.

A disregard of rules or regulations is "careless" if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is contrary to the rule or regulation. A disregard is "reckless" if the taxpayer 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 person would observe. A disregard is "intentional" if the taxpayer knows of the rule or regulation that is disregarded.

Note that taxpayers cannot remain intentionally ignorant, and they are charged with making a reasonable effort to determine what the law is. In recent cases, such as the *Neonatology Associates, P.A* case (115 TC No. 5, *affd.* CA3, 299 F.3d 221) taxpayers have been held accountable when failing to seek independent advice from advisers who did not stand to have a vested interest in seeing a transaction go forward.

Nevertheless, a taxpayer who takes a position (other than with respect to a reportable transaction, as defined in §1.6011-4(b) or §1.6011-4T(b), as applicable) contrary to a revenue ruling or notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits.

It is interesting to note that the “realistic basis” test, which is found in old law §6694(a), is used as the test here. Note that under the regulations for §6694, to meet that level of comfort there needs to be a 1/3 chance of the position prevailing. It’s also important to note that, unless the IRS changes these regulations, that will continue to be the test for taxpayers on the negligence penalty if their position is contrary to a revenue ruling or notice.

Since “reasonable basis” overrides this particular subset of the §6662 penalties, the IRS defines that level of assurance next in the regulation.

(3) Reasonable basis.

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 set forth in section 1.6662-4(d)(3)(iii) (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 as defined in section 1.6662-4(d)(2). (See section 1.6662-4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty.) In addition, the reasonable cause and good faith exception in section 1.6664-4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard.

The list of authorities found at Reg. §1.662-4(d)(3)(iii) contains the following:

- Applicable provisions of the Internal Revenue Code and other statutory provisions;
- Proposed, temporary and final regulations construing such statutes;
- Revenue rulings and revenue procedures;
- Tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties;
- Court cases;
- 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;

- General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book);
- Private letter rulings and technical advice memoranda issued after October 31, 1976;
- 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);
- Internal Revenue Service information or press releases; and
- Notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin.

The regulation referenced also goes on to indicate how these authorities need to be weighted, but for now it's important to note that your authority needs to be derived from something on this list.

Of special importance is the note immediately following that list in Reg. §1.6694-4(d)(3)(iii) which provides: "Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority." While the regulation goes to note that the authorities relied upon by the authors of any of the above may constitute authority, the professional must examine such authorities directly to determine if they meet the test.

What that means is that the following do not, by themselves, constitute "authority"

- Explanations found in single volume tax services (such as the *CCH Master Tax Guide*, *RIA Federal Tax Handbook*, *QuickFinders*, etc.)
- Editorial explanations found in more detailed tax services (such as *CCH Standard Federal Tax Reporter*, *RIA Federal Tax Coordinator 2d*, *BNA Tax Portfolios*, etc.)
- Articles appearing in tax magazines
- Continuing education manuals and positions taken by CPE instructors at various courses
- Even podcast discussions and materials like this one would be excluded

Again, these sources can lead you to authority—but they are not authority by themselves.

The §6662 regulations go on to note the proper positioning of this standard as compared to another found (or, beginning May 25, 2007, previously found) in §6694.

(i) In general. [Reserved].

(ii) Relationship to other standards.

The reasonable basis standard is significantly higher than the not frivolous standard applicable to preparers under section 6694 and defined in section 1.6694-2(c)(2).

Disclosure of Position

From time to time the various rules and regulations mentioned above are held to be invalid in court (the telephone excise tax is one such example of a Revenue Ruling that the IRS finally had to admit was invalid after being hammered multiple times in court). So it may be reasonable to take a position contrary to such a rule or regulation, and this regulation recognizes that fact by allowing for an exception to the penalty for disregarding rule or regulation if there is adequate disclosure.

The disclosure rule is described in §1.6662-3(c) which provides:

(c) Exception for adequate disclosure.

(1) In general.

No penalty under section 6662(b)(1) may be imposed on any portion of an underpayment that is attributable to a position contrary to a rule or regulation if the position is disclosed in accordance with the rules of paragraph (c)(2) of this section (and, if the position relates to a reportable transaction as defined in §1.6011-4(b) (or §1.6011-4T(b), as applicable), the transaction is disclosed in accordance with §1.6011-4 (or §1.6011-4T, as applicable)) and, in case of a position contrary to a regulation, the position represents a good faith challenge to the validity of the regulation.

We have the general rule outlined above. Note if the transaction in question is a reportable transaction under §6011, then complying with the requirements of that section is required. As well, a taxpayer will not escape this penalty if the challenge to the regulation is not a “good faith” challenge to the regulation in question—so a taxpayer can’t ignore regulations at random and escape penalty if they place disclosures on the return.

This disclosure exception does not apply, however, in the case of a position that does not have a reasonable basis or where the taxpayer fails to keep adequate books and records or to substantiate items properly.

Note that these additional conditions also apply to any attempt to make use of the disclosure exception. The “reasonable basis” standard is also invoked—that is a minimum level with disclosure for “disregard” positions. Remember that for negligence issues, the reasonable basis merely had to exist. For disregard positions that level of support for the position must exist and there must be adequate disclosure.

As well, disclosure will not excuse the taxpayer from the penalty if the issue is the failure to keep adequate books or records or have proper substantiation.

(2) Method of disclosure.

Disclosure is adequate for purposes of the penalty for disregarding rules or regulations if made in accordance with the provisions of sections 1.6662-4(f)(1), (3), (4), and (5), which permit disclosure on a properly completed and filed Form 8275 or 8275-R, as appropriate. In addition, the statutory or regulatory provision or ruling in question must be adequately identified on the Form 8275 or 8275-R, as appropriate. The provisions of section 1.6662-4(f)(2), which permit disclosure in accordance with an annual revenue procedure for purposes of the substantial understatement penalty, do not apply for purposes of this section.

Note that the 8275 and 8275-R constitute the exclusive means of disclosure for these items—the annual Revenue Procedure (now 2006-48) listing alternative disclosures won't work for purposes of escaping a penalty in this case. As well, the specific provision or ruling must be cited on the Form 8275 or 8275-R.

Reasonable Cause

There is one more potential out—§6664(c)(1) provides the following:

(1) In general

No penalty shall be imposed under section 6662 or 6663 with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

Regulation 1.6664-4 outlines the requirements to meet the good faith exception. Facts and circumstances to be considered are outlined in Reg. §1.6664-4(b)(1):

(b) Facts and circumstances taken into account

(1) In general.

The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. (See paragraph (e) of this section for certain rules relating to a substantial understatement penalty attributable to tax shelter items of corporations.) Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability.

Considering this is a “throw yourself on the mercy of the IRS” type of provision, it's key that the taxpayer appear to have made a reasonable attempt to get things right. That is, it's important that you don't have a client whose conduct “smells bad” on the matter at hand.

Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer.

The above gives a basic list of the facts the IRS will be looking to see outlined to justify relief from the penalty. While the sentence doesn't suggest this list is exhaustive, it would be best to have your facts fit into one of those categories for the best chance of a positive outcome.

An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith.

The above sentence is a bit of a double edged sword—it does offer relief from what appears to be a straightforward error, even if large. However, if the return has more than an “isolated” error of the sort noted, the sentence seems to imply that may argue against reasonable cause. It would appear likely the author thought that if enough errors are made, the taxpayer should have realized something was amiss and that the failure to worry about the errors itself would constitute negligence that shouldn't be rewarded.

Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect.

The regulation makes clear that while the above facts may be used to demonstrate reasonable cause and good faith, they are not adequate in and of themselves to establish that fact.

Reliance on an information return, professional advice, or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. (See paragraph (c) of this section for certain rules relating to reliance on the advice of others.) For example, reliance on erroneous information (such as an error relating to the cost or adjusted basis of property, the date property was placed in service, or the amount of opening or closing inventory) inadvertently included in data compiled by the various divisions of a multidivisional corporation or in financial books and records prepared by those divisions generally indicates reasonable cause and good faith, provided the corporation employed internal controls and procedures, reasonable under the circumstances, that were designed to identify such factual errors.

The example seems to suggest that the IRS doesn't want to encourage turning a blind eye or not having any concern over the reliability of the information used. But if the taxpayer

took reasonable steps to obtain reliable information and there was simply some failure that was not noticed, that would be acceptable.

Reasonable cause and good faith ordinarily is not indicated by the mere fact that there is an appraisal of the value of property. Other factors to consider include the methodology and assumptions underlying the appraisal, the appraised value, the relationship between appraised value and purchase price, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer or to the activity in which the property is used. (See paragraph (g) of this section for certain rules relating to appraisals for charitable deduction property.)

Note that with the increased concerns raised by the Congress with regard to valuation issues, including increased penalties on appraisers, it seems likely that the above provision is one that needs to be emphasized. Merely obtaining an appraisal is not, in and of itself, a perfect “insurance policy” against a negligence penalty.

A taxpayer's reliance on erroneous information reported on a Form W-2, Form 1099, or other information return indicates reasonable cause and good faith, provided the taxpayer did not know or have reason to know that the information was incorrect. Generally, a taxpayer knows, or has reason to know, that the information on an information return is incorrect if such information is inconsistent with other information reported or otherwise furnished to the taxpayer, or with the taxpayer's knowledge of the transaction. This knowledge includes, for example, the taxpayer's knowledge of the terms of his employment relationship or of the rate of return on a payor's obligation.

While a taxpayer normally can accept information reporting forms, the above notes that the taxpayer cannot ignore other information he/she has that would indicate the form is in error. Similarly, as should go without saying, the mere fact that a payor fails to prepare an information reporting form does not excuse the taxpayer from having to report the income, nor does it allow the taxpayer to escape a negligence penalty for such a failure.

Reliance on An Adviser

Reasonable cause can also be established by reliance on an adviser—but only if the requirements of Reg. §1.6664-4(c) are met. The regulation provides in general:

(c) Reliance on opinion or advice

(1) Facts and circumstances; minimum requirements.

All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. For example, the taxpayer's education,

sophistication and business experience will be relevant in determining whether the taxpayer's reliance on tax advice was reasonable and made in good faith.

Since, presumably, we are in this position because the advice proved not to be correct, there arises the question of whether the reliance was reasonable for a number of reasons. The regulation notes that the taxpayer's own sophistication is going to have an impact on whether the taxpayer should have reasonably realized that the advice was flawed.

We would expect a person trained as a tax attorney with years of experience to be held to a much higher standard if he/she claims to have relied upon another professional's advice than would someone with little education or business acumen. Advice that would be reasonable for the second taxpayer to rely upon would not come close to meeting the standard for the first. That is, not all taxpayers are created equal in this arena.

In no event will a taxpayer be considered to have reasonably relied in good faith on advice (including an opinion) unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied, however, will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

A fact that we often see is the requirement that taxpayers must consider whether their adviser was, in fact, qualified. In *Neonatology* the fact that the promoters of the transactions, while claiming that the transactions were valid under the tax laws, did not seem to possess the skills or education to make such a judgment was held against the taxpayers when they claimed reliance on those professionals who had all of the facts.

Similarly, as noted earlier, taxpayers have to consider whether the advisor is truly an unbiased source of advice. That means, in most cases, an adviser who will only receive compensation if a transaction takes place will not normally pass the "smell" test for the taxpayer to be deemed to reasonably have relied on his/her advice.

(i) All facts and circumstances considered.

The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.

Taxpayers often try to claim that since they had their CPA prepare the return, that should establish that they reasonably relied upon a qualified professional. That fact was argued in *Neonatology* as an additional argument—here was a second set of professionals the taxpayers claimed to have relied upon. However, as noted above, the taxpayer must show that they provided the professional with all information they knew or should have known would be relevant.

Similarly, a qualified professional likely would make inquiries about potentially relevant facts if asked specifically for advice on the matter. Clients should expect such inquiries, and the lack of such inquiries would seem to indicate either that a) the taxpayer did not truly ask for or want the advice of this professional on this matter or b) the professional was not qualified and the taxpayer should have known that.

(ii) No unreasonable assumptions.

The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner.

Unreasonable assumptions are specifically treated as invalidating any advice. If the advice relies on such assumptions, including those provided by the client, then it cannot be used to escape the penalty.

(iii) Reliance on the invalidity of a regulation.

A taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith unless the taxpayer adequately disclosed, in accordance with §1.6662-3(c)(2), the position that the regulation in question is invalid.

As you might expect, a taxpayer must comply with the requirements to disclose the position that a regulation is invalid even if they have professional advice to that effect.

(2) Advice defined.

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

Note that advice does not need to take any particular form in order count for these purposes. However, it is important to note that the blanket disclaimers many CPAs, EAs and attorneys began using on all written correspondence in response to the covered opinion rules of Circular 230 ¶10.35 would seem to invalidate those communications for the purposes of escaping these penalties, even though the advice might not actually involve an item that would have required a reliance opinion. We'll look at that issue in more detail on the next podcast when we look at the substantial understatement penalties and the tax shelter rules.

(3) Cross- reference.

For rules applicable to advisors, see e.g., sections 1.6694-1 through 1.6694-3 (regarding preparer penalties), 31 CFR 10.22 (regarding diligence as to accuracy), 31 CFR 10.33 (regarding tax shelter opinions), and 31 CFR 10.34 (regarding standards for advising with respect to tax return positions and for preparing or signing returns).

This particular reference is a bit off now since Circular 230 now has a slightly different numbering scheme. In particular, ¶10.33 no longer covers tax shelter opinions (it now is the best practices section), so likely you need to look at ¶10.35 (the covered opinion rules) instead.