



Rolling Changes: Final and Proposed Changes to Circular 230 §10.34  
September 26, 2007



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## **Circular 230 §10.34 Gets Two Changes**

The IRS this week gave us a “one-two” punch in terms of changes to §10.34 of Circular 230, along with other changes. The reason for the dual set of changes is that the IRS was ready to go final with the proposed changes to Circular 230 that had been floating around for a while, but realized that they now also needed to modify §10.34 so that there wouldn’t be a lower standard of conduct under Circular 230 than under the IRC for preparers in general.

Thus, we have three versions of §10.34 we’ll want to look at for now—the original version that was what we had until September 26, though with proposed changes released September 25, the September 26 changes (which are final regulations now) and the proposed regulation changes of September 25 which are proposed to become effective on January 1, 2008.

## **The “Old” §10.34**

Prior to either of these revisions, §10.34 of Circular 230 read as follows:

§10.34 Standards for advising with respect to tax return positions and for preparing or signing returns.--

(a) Realistic possibility standard. A practitioner may not sign a tax return as a preparer if the practitioner determines that the tax return contains a position that does not have a realistic possibility of being sustained on its merits (the realistic possibility standard) unless the position is not frivolous and is adequately disclosed to the Internal Revenue Service. A practitioner may not advise a client to take a position on a tax return, or prepare the portion of a tax return on which a position is taken, unless--

(1) The practitioner determines that the position satisfies the realistic possibility standard; or

(2) The position is not frivolous and the practitioner advises the client of any opportunity to avoid the accuracy-related penalty in section 6662 of the Internal Revenue Code by adequately disclosing the position and of the requirements for adequate disclosure.

(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.

(c) Relying on information furnished by clients. A practitioner advising a client to take a position on a tax return, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

(d) Definitions. For purposes of this section--

(1) Realistic possibility. A position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well informed analysis of the law and the facts 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. The authorities described in 26 CFR 1.6662-4(d)(3)(iii), or any successor provision, of the substantial understatement penalty regulations may be taken into account for purposes of this analysis. The possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account.

(2) Frivolous. A position is frivolous if it is patently improper.

In the final regulations, the IRS modifies the subsections of this regulation slightly, adding a new “(b)” between the current “(a)” and “(b)” and then updating the letters as appropriate. In addition, due to the changes made by Congress to §6694 earlier this year, the IRS listed as “reserved” the “(a)” paragraph (which deals with standards for positions taken) and the old “(d)” definitions (now to be redesignated as “(e)” due to the addition of the new “(b)” section.

We will take a look at the changes made by the finalized portion of the regulations issued on September 26, and then look at the proposed changes.

### ***New Standard on “Documents, Affidavits and Other Papers”***

In the final regulations, the following new paragraph “(b)” is inserted into §10.34:

(b) Documents, affidavits and other papers

(1) A practitioner may not advise a client to take a position on a document, affidavit or other paper submitted to the Internal Revenue Service unless the position is not frivolous.

(2) A practitioner may not advise a client to submit a document, affidavit or other paper to the Internal Revenue Service --

(i) The purpose of which is to delay or impede the administration of the Federal tax laws;

(ii) That is frivolous; or

(iii) That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.

The new provision expands the reach of the “position” standards beyond tax returns themselves to any document submitted to the IRS. Thus, even if the practitioner is not deemed to be the preparer, the practitioner still must assure that, at the very minimum, any position clears the “not frivolous” standard and that such documents not be submitted with a purpose of delaying or impeding the administration of the Federal tax laws.

As well, the standard now also requires that if a practitioner advises a client to take a

position contrary to a rule or regulation, the practitioner must also advise the client to submit a document that shows a good faith challenge to the rule or regulation in question.

There's little doubt that this provision was added to keep practitioners from attempt to get around the standards by attempting to avoid being the preparer, but rather have the client (or some other, perhaps less skilled) preparer create the document that takes the position. Of course, this means that anything that might be considered "advice" is going to be covered by this provision—so CPAs, attorneys and EAs will find that almost everything they do is going to, directly or indirectly, be governed by §10.34 if the matter in question has a tax angle.

### **Penalty Advice Revision**

The IRS also modified the old §10.34(b), which is now §10.34(c). While much of the change is putting the old single paragraph into an outline format, there are changes meant to conform this rule to the new broaden universe of documents covered by §10.34:

- (c) Advising clients on potential penalties
  - (1) A practitioner must inform a client of any penalties that are reasonably likely to apply to the client with respect to --
    - (i) A position taken on a tax return if --
      - (A) The practitioner advised the client with respect to the position; or
      - (B) The practitioner prepared or signed the tax return; and
    - (ii) Any document, affidavit or other paper submitted to the Internal Revenue Service.
  - (2) The practitioner also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.
  - (3) This paragraph (c) applies even if the practitioner is not subject to a penalty under the Internal Revenue Code with respect to the position or with respect to the document, affidavit or other paper submitted.

The key change is the broadening of the requirement to advise a client about penalty issues even if the item in question is a document other than a tax return.

It continues to require that taxpayers be informed of the ability to limit the application of certain penalties via disclosure, as well as noting that whether or not the preparer would be subject to penalty is not relevant—thus, even if the practitioner is not a preparer of the return subject to §6694, that individual nevertheless can be disciplined under §10.34. Thus, at least in theory, the OPR could subject a nonsigning CPA in a CPA firm to sanction if this information was not disclosed to the taxpayer, even if another CPA (or

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attorney for that matter) is the signing practitioner and, under firm policy, generally handles all client contact.

### ***Relying on Client Information***

This provision is basically unchanged from its predecessor, except for now being labeled “(d)” instead of “(c)” under the final regulations. That section reads:

(d) Relying on information furnished by clients.

A practitioner advising a client to take a position on a tax return, document, affidavit or other paper submitted to the Internal Revenue Service, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

As before, we have an “eyes open” standard that is similar to what CPAs face in compilation engagements—while the practitioner is not required to independently verify what the client tells him/her, the practitioner cannot ignore the implications of knowledge the CPA has that suggests the client’s information is incorrect.

### **IRS Proposed Regulations**

The IRS has now issued proposed regulations that extend the application of the “more likely than not” standard to §10.34 of Circular 230, which impacts when a tax preparer can sign a tax return without disclosure, as well as raising the standard to “reasonable basis” for being able to sign a return even with disclosure. The regulations, if finalized, would apply beginning January 1, 2008.

What these rules do is bring Circular 230 into line with §6694’s new requirements, so that no longer would a preparer face the situation where they could sign the return under Circular 230 but could be subjected to penalties under the IRC.

### **Proposed Regulations**

The new regulations start by changing the level of the standards. The new §10.34 will start out stating:

§ 10.34 Standards with respect to tax returns and documents, affidavits and other papers.

(a) Tax returns. A practitioner may not sign a tax return as a preparer unless the practitioner has a reasonable belief that the tax treatment of each position on the

return would more likely than not be sustained on its merits (the more likely than not standard), or there is a reasonable basis for each position and each position is adequately disclosed to the Internal Revenue Service. A practitioner may not advise a client to take a position on a tax return, or prepare the portion of a tax return on which a position is taken, unless --

- (1) The practitioner has a reasonable belief that the position satisfies the more likely than not standard; or
- (2) The position has a reasonable basis and is adequately disclosed to the Internal Revenue Service.

This merely brings the standard back into line with the §6694 standards, as it had been prior to the changes last May. The regulations go on to give us the definition of each item.

## More Likely Than Not

In proposed §10.34(e)(1), we are presented with a definition for “more likely than not” for Circular 230 purposes.

(1) *More likely than not.* A practitioner is considered to have a reasonable belief that the tax treatment of a position is more likely than not the proper tax treatment if the practitioner analyzes the pertinent facts and authorities, and based on that analysis reasonably concludes, in good faith, that there is a greater than fifty-percent likelihood that the tax treatment will be upheld if the IRS challenges it. The authorities described in 26 CFR 1.6662-4(d)(3)(iii), or any successor provision, of the substantial understatement penalty regulations may be taken into account for purposes of this analysis.

Like under §6694, the test here will be whether the preparer had a reasonable belief that “more likely than not” the position would be sustained. As noted, the authorities described in for this section referenced Reg. §1.1662-4(d)(3)(iii), which provides:

(iii) Types of authority.

Except in cases described in paragraph (d)(3)(iv) of this section concerning written determinations, only the following are authority for purposes of determining whether there is substantial authority for the tax treatment of an item: 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. Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority. The authorities underlying such expressions of opinion where applicable to the facts of a particular case, however, may give rise to substantial authority for the tax treatment of an item. Notwithstanding the preceding list of authorities, an authority does not continue to be an authority to the extent it is overruled or modified, implicitly or explicitly, by a body with the power to overrule or modify the earlier authority. In the case of court decisions, for example, a district court opinion on an issue is not an authority if overruled or reversed by the United States Court of Appeals for such district. However, a Tax Court opinion is not considered to be overruled or modified by a court of appeals to which a taxpayer does not have a right of appeal, unless the Tax Court adopts the holding of the court of appeals. Similarly, a private letter ruling is not authority if revoked or if inconsistent with a subsequent proposed regulation, revenue ruling or other administrative pronouncement published in the Internal Revenue Bulletin.

As we've noted before, editorial commentary does not suffice for this purpose. But these authorities do give you the types of authority you will need to show to the IRS to demonstrate that you had a reasonable belief that goes to the more likely than not level.

## **Reasonable Basis**

The new regulations also contain a definition for "reasonable basis", which provides:

(2) *Reasonable basis.* A position is considered to have a reasonable basis if it is reasonably based on one or more of the authorities described in 26 CFR 1.6662-4(d)(3)(iii), or any successor provision, of the substantial understatement penalty regulations. 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. The possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account.

Again, we are referred to Reg. §1.1662-4(d)(3)(iii) for the list of authorities we can make

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use of for this purpose.

## **Future Developments**

Note that the IRS did not release proposed regulations dealing with §6694 itself, including the troubling matters for nonsigning preparers. But the move to bring Circular 230 into conformity with §6694 is, while arguably not required, also is clearly not an unexpected move.