unreasonably rely on the representations, findings or agreements of the taxpayer or any other person.

Reasonable Cause for Tax Shelter Items of a Corporation

The proposed regulations provide additional guidance with respect to the application of the reasonable cause exception of section 6664(c) to a substantial understatement penalty attributable to a tax shelter item of a corporation. These changes apply only to corporations. Accordingly, no inference is intended with respect to the application of section 6664(c) to a substantial understatement penalty attributable to a tax shelter item of a taxpayer other than a corporation. Treasury and the IRS invite comments as to the need for clarification of the application of this exception to such items.

The proposed regulations provide that a corporation's legal justification may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item only if there is substantial authority for the treatment of the item and the corporation reasonably believes in good faith that such treatment is more likely than not the proper treatment. For this purpose, legal justification includes any justification relating to the treatment or characterization under the Federal tax law of the tax shelter item or of the entity, plan or arrangement that gave rise to the item. Thus, a taxpayer's belief (whether independently formed or based on the advice of others) as to the merits of the taxpayer's underlying position is a legal justification. Satisfaction of the substantial authority and reasonable belief criteria is an important factor to be considered in determining whether the taxpayer acted with reasonable cause and in good faith. However, it is not necessarily dispositive. A corporation will qualify for the reasonable cause and good faith exception only if, under all pertinent facts and circumstances, it acted with reasonable cause and in good faith.

The proposed regulations also provide that facts and circumstances other than a corporation's legal justification may be taken into account, as appropriate, in determining whether it acted with reasonable cause and in good faith, regardless of whether the substantial authority and reasonable belief requirements are satisfied.

The provisions relating to the reasonable cause and good faith exception with respect to corporate tax shelters apply only for purposes of the substantial understatement penalty. No

inference is intended with respect to how the reasonable cause exception may apply to the negligence penalty of section 6662(b)(1). The proposed regulations do not alter the definitions of tax shelter or tax shelter items contained in § 1.6662-4(g)(2) and (3).

#### Conforming Changes

The proposed regulations would amend the existing regulations under section 6662 to reflect the changes made by the Act and to clarify the definition of reasonable belief under the section 6662 tax shelter rule.

In addition, the proposed regulations clarify that the determination of whether a corporate or non-corporate taxpayer acted with reasonable cause and in good faith with respect to an underpayment that is related to an item reflected on the return of a pass-through entity is made on the basis of all pertinent facts and circumstances, including the taxpayer's own actions, as well as the actions of the pass-through entity.

#### Proposed Effective Date

The amendments contained in this notice are proposed to be effective for returns the due date of which (determined without regard to extensions) is after the date on which final regulations are published in the Federal Register.

### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small **Business Administration for comment** on its impact on small business.

### Comments and Public Hearing

Before the adoption of these proposed regulations, consideration will be given to any written comments that are submitted timely (a signed original and eight (8) copies) to the IRS. All comments will be available for public inspection and copying in their entirety.

A public hearing will be held on April 28, 1995, in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington,

DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3)

apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments, an outline of the topics to be discussed, and the time to be devoted to each topic by April 7,

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### **Drafting Information**

The principal author of these proposed regulations is David L. Meyer, Office of Assistant Chief Counsel, Income Tax and Accounting, IRS. However, other personnel from the IRS and Treasury Department participated in their development.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Proposed Amendments to the** Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

# PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.6662-0 is amended by revising the entries for §§ 1.6662-2(d) and 1.6662-4(g) to read as follows:

## §1.6662-0 Table of contents.

§ 1.6662-2 Accuracy related penalty.

- (d) Effective date.
  - (1) In general.
  - (2) Special rules for tax shelter items.

§ 1.6662-4 Substantial understatement of income tax.

- (g) Items relating to tax shelters.
- (1) In general.
- (i) Non-corporate taxpayers.
- (ii) Corporate taxpayers.
- (A) In general.
- (B) Special rule for transactions occurring prior to December 9, 1994.
- (iii) Disclosure irrelevant.
- (iv) Cross-reference.