

EIGHT THOUGHTS ON PREPARER PENALTIES; AND THEN SOME MORE

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EIGHT THOUGHTS ON THE NEW PREPARER PENALTIES:

- o Penalties for tax preparers are now \$1000 to up to one-half of the preparer's fee or claim for refund for unreasonable positions taken on the return to \$5000 to up to one-half of the preparer's fee for understatement due to willful or reckless conduct. Does that get your attention?
- o You don't have to sign a return to be a tax preparer; oral advice that leads to a substantial tax item on a return or claim for refund is enough.
- o Penalties for preparers now apply to more than income tax returns, even estate and gift tax returns.
- o A head's up from the IRS- Permanent regulations may be more stringent than those proposed. IRS has publicly espoused "appropriate" penalties and is less likely to remove them during the appeals and trial negotiations. Even the Tax Court is getting into the act.
- o Smart moves- Advise your client of audit hazards, potential penalties and make contemporaneous notes.
- o IRS professes not to want a disclosure form with every return but use of Form 8275 provides a lower reporting standard-reasonable basis for the position. You would be safer if you included one.
- o If you end up testifying about your advice/opinion, are you representing yourself or the client? Hint- Your client doesn't care.
- o You might need an independent opinion that states that your position is a reasonable belief that the position you took would more likely than not be sustained on the merits to protect you. It is important that the opinion be independent, researched and by a qualified source.

The Small Business and Work Opportunity Act of 2007 ("2007 Act") significantly and unexpectedly broadened the tax return preparer penalties of Code Sec. 6694¹. Generally, preparer penalties apply to any practitioner who signs a return or claim for refund or to a practitioner who does not sign a return but gives advice about a position on a tax return.² In addition to expanding the reach of the preparer penalties, Code Sec. 6694 also increased the penalties. Notably, at roughly the same time, the Treasury also proposed amendments to Circular 230 to conform the professional standards with the civil penalty standards for return preparers in Code Sec. 6694.

Prior Law

Under prior law, penalties were imposed against a return preparer if the return did not have a realistic possibility of being sustained on its merits.³ However, if the signing practitioner⁴ made adequate disclosure of the position penalties were imposed only if the position was frivolous.⁵ A non-signing practitioner qualified for the lower "non-frivolous" standard only if the practitioner advised the client about the opportunity to avoid penalties through disclosure.⁶ The standard was applied to a signing preparer on the date the return was signed, and to a non-signing preparer on the date that the preparer provided advice.⁷

New Law

The 2007 Act amended Code Sec. 6694 to elevate the general rule from a realistic possibility of success standard (i.e., a 1 in 3 standard) to a "more likely than not" (greater than 50% likelihood of success) standard to avoid penalties.⁸ If adequate disclosure of the issue is made on the return (or for a non-signing practitioner, if advice about disclosure is given), the non-frivolous standard is lowered to a reasonable basis standard.⁹

In order to take advantage of the lower reporting standard (i.e., reasonable basis standard), disclosure must be made on Form 8275 (or Form 8275-R if the position is contrary to a regulation).¹⁰ However, advice by a non-signing preparer may be adequate if the advisor notifies the taxpayer that the advice does not meet the "more likely than not" standard and advises that the taxpayer may be subject to penalty unless adequately disclosed.¹¹

Code Sec. 6694 still applies to both signing and non-signing return preparers.¹² In either case, a preparer refers only to someone who prepares or gives advice as to "all or a substantial portion" of the return.¹³ Thus, it is clear that an attorney can be, and often may be, a return preparer. The example in the regulations suggests that giving advice regarding the treatment of a "significant" item on the return constitutes preparation of a "substantial portion" of the return.¹⁴

The definition of a non-signing return preparer is an individual who only gives advice on specific issues of law.¹⁵ (Notably, the language of the regulation appears to be directly aimed at attorneys.) An important limitation is that a non-signing preparer is limited to someone who gives advice "with respect to events which have occurred at the time the advice is rendered and is not given with respect to the consequences of contemplated actions."¹⁶

Interplay with Circular 230

Circular 230 also applies to practitioners who sign returns or give advice regarding a position on a return. These positions can be as obvious as opining whether a gift has been made or as unexpected as the value of an item included on a Federal Gift Tax Return. Notably, the Circular 230 provisions do not contain the limitation that advice about a position on a return is limited to advice about transactions that have already occurred and not just contemplated transactions. Thus, a practitioner can safely avoid the preparer penalty provisions of Code Sec. 6694 but violate their obligations under Circular 230.

Notice 2008-13 provides interim guidance, pending the revision of regulations, regarding implementation of the preparer penalty provisions of Code Sec. 6694 and the related definitional provisions of Code Sec. 7701(a)(36). Return preparers may rely on the Notice until further guidance is issued. The guidance clarifies that "any determination as to whether a person has prepared a substantial portion of a tax return, and thus is considered a tax return preparer, will depend on the relative size of the deficiency attributable to the schedule, entry, or other portion."

It is important to be cognizant of the interplay of Circular 230 and Code Sec. 6694. Section 10.34 of Circular 230 addresses the standards for advising taxpayers with respect to tax return positions and for preparing or signing returns. Prior to an amendment effective on September 25, 2007, §10.34(a) applied a realistic possibility standard to practitioners signing a tax return or giving advice about a position on a tax return. "Realistic possibility" was defined as being "approximately a one in three, or greater, likelihood of being sustained on its merits."¹⁷

Section 10.34 was amended, as of September 25, 2007, to eliminate the provisions regarding standards (leaving the sections dealing with documents and affidavits, and regarding advising clients on potential penalties), and the IRS proposed amended sections dealing with the standards. The proposed amendment to Circular 230 conforms the professional standards of practitioners to the same general requirements of Code Sec. 6694. Under the §10.34 amendment, a practitioner may not sign a tax return as a preparer or advise a client to take a position on a return unless (1) "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;"¹⁸ or (2) "there is a reasonable basis for each position and each position is adequately disclosed."

In addition to conforming to the "more likely than not" and "reasonable basis if there is disclosure" standards of Code Sec. 6694, this amendment makes two important changes. First,

the amendment removes the statement that the reasonable basis standard is satisfied if the position has a one-in-three chance of being sustained. Instead, the amendment provides that "[r]easonable 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 has 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."

Second, Circular 230 previously provided that a practitioner who gives advice about a position taken on a return can avoid the realistic possibility standard and qualify for a lower "not-frivolous" standard by specifically advising the taxpayer about the opportunity to avoid penalties through disclosure. Merely advising a taxpayer about avoiding penalties through disclosure is no longer sufficient under the proposed amendment. Rather, the taxpayer must actually disclose the position to the IRS in order for the practitioner to qualify for the lower "reasonable basis" standard. This is an important change as it now places the tax preparer (e.g., attorney) on the hook even if the tax preparer advised the client, in writing, merely because the client did not adequately disclose.

The Circular 230 amendment will be effective for returns filed or advice provided on or after the amendment is finalized, but no earlier than January 1, 2008.

Notice 2008-13

Notice 2008-13, provides interim guidance regarding the return preparer penalties and reiterates that the standard is applied as of the date the return is signed (for a signing preparer) or the date advice is given (for a non-signing preparer). The Notice makes clear that the regulations are expected to be finalized in 2008 and may be substantially different from the rules described in this notice. Ominously, the Notice states that in some cases the regulations may be more stringent.

Highlights of the interim notice regarding the reporting standards include:

More Likely than Not Standard

The more likely than not standard is met if the preparer analyzes the pertinent facts and authorities in the manner described in the current regulations¹⁹ and reasonably concludes that there is a greater than 50% likelihood that the tax treatment of the item will be upheld if challenged. The preparer may rely in good faith without verification on information furnished by the taxpayer as provided in Treas. Reg. §1.6694-1(e) and on information furnished by another advisor, tax return preparer or other third party. The tax return preparer also must make reasonable inquiries if the information furnished by another tax return preparer (e.g., accountant) or a third party (e.g., appraiser) appears to be incorrect or incomplete.²⁰

Reasonable cause and good faith

The reasonable cause exception in the statute was not changed (i.e.,

“reasonable cause for the understatement and such person acted in good faith”). Notice 2008-13 changes the “reliance on advice” rules in Treas. Reg. §1.6694-2(d)(5). A preparer acts in good faith “when the tax return preparer relied on the advice of a third party who is not in the same firm as the tax return preparer and who the tax return preparer had reason to believe was competent to render the advice.” The advice may be written or oral (but the burden of establishing the advice is on the return preparer). However, the advisor’s reliance is not in good faith if (i) the advice is unreasonable on its face; (ii) the preparer knew or should have known that the third party was not aware of all relevant facts; or (iii) the preparer knew or should have known that the advice was no longer reliable due to developments in the law since the time the advice was given.

Disclosure for Signing Preparers

The interim guidance gives some additional exceptions (in addition to disclosure on a Form 8275 or 8275-R) to satisfy the disclosure requirement in order to lower the standard to the reasonable basis standard:

(1) providing the taxpayer with the prepared return that includes the appropriate disclosure (presumably even if the taxpayer does not actually include the disclosure with the return that the taxpayer actually files);

(2) “If the position would otherwise meet the requirement for non-disclosure under section 6662(d)(2)(B)(i) (i.e., if there is “substantial authority,” which is the standard for the taxpayer to avoid penalty without disclosure), the tax return preparer advises the taxpayer of the difference between the penalty standards applicable to the taxpayer under section 6662 and the penalty standards applicable to the tax return preparer under section 6694, and contemporaneously documents in the tax return preparer’s files that this advice was provided;” or

(3) “If section 6662(d)(2)(B) does not apply because the position may be described in section 6662(d)(2)(C) (i.e., “tax shelters”), the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer under section 6662(d)(2)(C) and the difference, if any, between these standards and the standards under section 6694, and contemporaneously documents in the tax return preparer’s files that this advice was provided.”

The last requirement appears to be the IRS’s response to the ethical problem that professionals have raised in light of the inherent conflict that preparers have in representing clients because the standard for the preparer to avoid penalties is higher than the standard for the taxpayer to avoid penalties. If the “substantial authority” standard is satisfied, so that the taxpayer does not have to disclose to avoid penalties, the preparer can avoid penalties by merely advising the taxpayer of the difference between the penalty standards applicable to taxpayers and preparers (i.e., the substantial authority and more likely than not standards). Stated differently, if the preparer advises the taxpayer of the difference between the

taxpayer and preparer penalty standards, the standard for the preparer effectively is reduced from a “more likely than not” standard to a “substantial authority” standard. The safest course of action appears to be to routinely give clients this notice.²¹

Disclosure for Non-signing Preparers

The non-signing return preparer can use the lower reasonable basis standard if the advice to the taxpayer includes a statement informing the taxpayer of any opportunity to avoid penalties under Code Sec. 6662.

This appears to be the most helpful aspect of this Notice because the advisor otherwise would have to assume that the higher “more likely than not” standard always applies. It is unlikely that a non-signing preparer has any way of guaranteeing that the return, as actually filed, includes the proper disclosure. However, it is interesting that this option was effectively removed from the analogous Circular 230 rules under the amendments proposed last fall. Hopefully, the IRS will add this provision back into the revisions of §10.34(a) of Circular 230 and remove the requirement that the taxpayer actually disclose in order to reap the benefit of the lower reasonable basis standard.

If a non-signing preparer gives advice to another preparer, the non-signing preparer can use the lower standard “if the advice to the tax return preparer includes a statement that disclosure under section 6694(a) may be required.” If the advice is in writing, the statement must also be in writing, but the advice and statement may both be oral. “Contemporaneously prepared documentation in the non-signing tax return preparer’s files is sufficient to establish that the statement was given to the taxpayer or other tax return preparer.”

Applicable to All Practitioners

Code Sec. 6694 has also been broadened to apply to all matters and not just income tax matters. While Code Sec. 6694 under prior law applied only to income tax returns, Circular 230, §10.34 imposed a similar obligation on all tax advisors.

Increased Penalty Amounts

The penalty for unreasonable positions is increased from \$250 to the greater of \$1,000 or one-half ($\frac{1}{2}$) of the preparer’s fee for the return (or a claim for refund).²² The penalty for an understatement due to willful or reckless conduct is increased from \$1,000 to the greater of \$5,000 or one-half ($\frac{1}{2}$) of the preparer’s fee for the return.²³

Reasonable Cause Exception

Unless the understatement is due to willful or reckless conduct, there is a reasonable cause exception to the penalty if the practitioner acted in good faith.²⁴

Unrealistic Standard

The major concern is that a “more likely than not” standard is

unrealistic in the tax world where there are so many factual and legal uncertainties. This is particularly a problem for factual issues. Since many factual issues may reasonably be viewed in more than one way, as long as the position taken by the return preparer was solidly grounded in the facts, there was little risk that the preparer would be subject to a penalty even if the IRS ultimately determined that there was an understatement of liability.²⁵

Presumption of Preparer Penalty

If the IRS wants to get ugly with preparers,²⁶ in effect there would seem to be an initial presumption that a preparer penalty could be imposed whenever the IRS disagrees with a position taken on a return (that is sustained).²⁷ How will the preparer rebut the return position was more likely than not correct when a determination has already been made that the position was, in fact, not correct?

Reaction of Professionals; Either Extreme Conservatism or "Over disclosure"²⁸

There has been a strong adverse reaction to these new rules by the tax professional community. One complaint is that substantial preparer penalties may apply even though there is only a very small tax deficiency. Another complaint is that tax professionals are put in an inherent conflict situation with their clients and may lead to extreme conservatism.²⁹

"The new Section 6694 makes practitioners the insurer of the accuracy of their clients' returns. Practitioners likely will react very cautiously to this change in the law. Indeed, some practitioners may conclude that they are better off disclosing every position taken on a return on Form 8275 of 8275-R rather than risk the penalty, and the IRS will be flooded with returns disclosing, on a line-by-line basis, that there is no certainty that each number reflected on the return is more likely than not correct. The Service would be swamped by disclosures, effectively eliminating some of the benefit of the amendment to Section 6694 by offsetting administrative costs. Other practitioners may become more circumspect in the advice they give their clients, which ultimately may lead to less compliance."³⁰

The concern of respectable professional tax advisors goes far beyond the monetary penalties that may apply. Well respected professionals point out that the effect with the most impact may be the stigma attached to having preparer penalties being assessed rather than the direct money penalty. Another fear is that an attorney may be censured, possibly publicly, by the IRS or, even worse, have their license to practice before the IRS revoked.

Conclusion

To minimize the impact of the preparer penalties, we should advise our clients of their opportunities to avoid penalties under Code Sec. 6694. In the gift and estate tax context, this can be done by advising our clients about full disclosure or filing Form 8275, or 8275-R as the case may be, whenever there is a valuation issue. Although Notice 2008-13 permits non-written disclosure, the better practice is to reduce the disclosure to writing. Remember to stay tuned for final IRS guidance and "be careful out there."

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ENDNOTES

1. Code Sec. 6694.
2. Code Sec. 6694; circular 230, §10.34(a).
3. Generally, this means a 1 in 3 or greater likelihood of prevailing on the merits. Code Sec. 6694; Treas. Reg. § 1.6694-2(b)(1); ABA Formal Opinion 85-352 also used a one-in three standard.
4. Described in Cod Sec. 6662(d)(2)(B)(ii).
5. Code Sec. 6694(a)(3).
6. Circular 230, § 10.34(a)(2).
7. Treas. Reg. § 1.6694-2(b)(5).
8. Code Sec. 6694(a)(2)(B).
9. Code Sec. 6694(a)(2)(C).
10. Treas. Reg. § 1.6694-2(c)(3).
11. Treas. Reg. § 1.6694-2(c)(3)(ii)
12. Treas. Reg. § 1.6694-1(b)(2).
13. Code Sec. 7701(a)(36)(A); Treas. Reg. § 301-7701-15(a).
14. Treas. Reg. § 1.6694-1(b)(3). Notably, the IRS does not describe what is a "substantial portion."; but see examples in IRS Notice 2008-13, 2008-3 I.R.B. 282.
15. Treas. Reg. § 301.7701-15(a)(2).
16. Id. Emphasis added.
17. Circular 230, § 10.34(d)(1).
18. Note the more likely than not standard.
19. Treas. reg. §1.6662-4(d)(3)(iii).
20. Note, Circular 230 requires "the relying practitioner's opinion must identify the other opinion and set forth the conclusions reached in the other opinion." In addition, "the practitioner must be satisfied that the combined analysis of the opinions, taken as a whole, and the overall conclusion, if any, satisfy the requirements of this section." Circular 230, 10.35(d).
21. Keep in mind, however, that the IRS warned that the final regulations may adopt rules more stringent than the rules described in the Notice.
22. Code Sec. 6694(a)(1).
23. Code Sec. 6694(b)(1).
24. Code Sec. 6694(a)(3).
25. What Hath Congress Wrought? Amended 6694 Will Cause Problems for Everyone, Lipton, Journal of Taxation(August 2007)
26. It should be noted that the IRS has been getting ugly in other contexts. Some practitioners have been criminally charged in close situations, some accounting firms have been required to pay significant penalties and at least one law firm

was forced out of business. In one well publicized case the government was excoriated for using strong hand tactics and threatened to dismiss a criminal case. "White shoe" firms like Sidley, Austin, Brown, & Wood have not been immune from the IRS's heavy hand. In informal conversations with Cono Namorato, formerly Director, IRS Office of Professional Responsibility, the IRS believes that attorneys have been one of the root causes of aggressive tax planning. The IRS's "trust me" position is not comforting.

27. Based on personal conversations with Jonathon Blattmachr of Milbank, Tweed, Hadley & McCoy LLP, one California attorney who had a history of winning FLP audits, was

charged with a Circular 230 violation during an audit simply to silence the attorney.

28. The majority of this section is based upon personal conversations of one of the authors with attorneys at large firms while at University of Miami's 2008 Heckerling Institute of Estate Planning.
29. The Changing Face of Compliance, Adams, Trusts and Estates (January 2008).
30. What Hath Congress Wrought? Amended 6694 Will Cause Problems for Everyone, Lipton, Journal of Taxation (August 2007)