

## **Something Important: Preparer and Advisor Penalties and Notice 2008-13**

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### **Introduction**

Since the Tax Reform Act of 1976, Code Sec. 6694 has imposed penalties on those who prepare income tax returns for compensation, whether or not they are lawyers or CPAs. Code Sec. 10.34 of Circular 230, which is not limited to income tax returns, has long had a counterpart for lawyers and CPAs who are Practitioners under the Circular. In May of last year, the Small Business and Work Opportunity Tax Act of 2007 (the “Act”) made substantial changes in the standards applicable under Code Sec. 6694(a). The Code Sec. imposes a penalty on return preparers who fail to comply with the standards it sets forth.

Prior to the Act, in the event that the amount of *income* tax on a tax return or a claim for refund was understated, the preparer could be subject to penalty under Code Sec. 6694 if the preparer failed to comply with the standards contained therein. For this purpose, a person was deemed to be a preparer if he or she, for compensation, (i) prepared and signed the return or claim for refund, or (ii) gave advice about a return-related or claim-related position

Code Sec. 6694(a), before it was amended, imposed its penalty if a position taken on a return or claim for refund did not have a *realistic possibility of success* (at least *a one-in-three possibility of being sustained on the merits*). However, in the case of a signing preparer, *if adequate disclosure concerning the position was made on the return, the standard was lower: no penalty was imposed if the position was not frivolous* (i.e., not patently improper). In the case of a non-signing advisor, the lower standard was applicable if the advisor had advised the client about any opportunity to avoid penalties *through disclosure* (meaning, in general attaching an IRS Form 8275 or, if the position was contrary to a regulation, IRS Form 8275R).

Under the Act, Code Sec. 6694 was amended in three ways. First, the standards have been elevated. As amended, the Code Sec. makes the penalty inapplicable if the preparer or advisor reasonably believed that the position was *more likely than not correct* (thus importing the more-likely-than-not standard from the Covered Opinion rules in Code Sec. 10.35 of the Circular). However, *if disclosure is in fact made on the return (or, in the case of a non-signing advisor, advice about disclosure is given), the penalty is not imposed if there is a reasonable basis for the position* (a standard that appears to be less rigorous than the one-in-three formulation applicable under pre-Act law). There is a pending amendment to Section 10.34 that would make it consistent with these new standards in Code Sec. 6694(a).

Second, Code Sec. 6694 will now apply to preparers and advisors outside of the income tax setting. Unlike the change in standards, this aspect of the Act should not affect day-to-day practice for any Practitioner covered by Circular 230 inasmuch as he or she presumably has been complying with the parallel obligation under Code Sec. 10.34 (which, as indicated, has not been limited to the income tax setting).

Third, the amount of the penalty has been increased from \$250 to the greater of (i) \$1,000 or (ii) one-half of the preparer's fee with respect to the return (or claim for refund). In the case of a willful or reckless understatement, the subsection b penalty is increased from \$1000 to the greater of (i) \$5000 or (ii) one-half of the preparer's fee.

Under Code Sec. 7701(a)(36) of the Code, as amended by the Act, a “tax return preparer” includes, any person who prepares for compensation a tax return or claim for refund or a substantial portion of a tax return or claim for refund. Thus, for example, as amended, Code Sec. 6694 can apply to any person preparing, as defined therein, an estate tax return. In contrast, prior to the Act, as indicated, the Code Sec. did not apply outside of the income-tax setting. As under pre-Act law, the Code Sec. applies to persons who do not actually sign or prepare the return but merely give advice about a position to be taken on the return. It might, for example, cover a divorce lawyer who advises a client that certain payments made to the client’s spouse constitute alimony deductible under Code Sec. 215 of the Code, even though that attorney never prepares returns and knows that the client’s income tax return will be prepared by another professional.

### **IRS Suspends the Section’s Effective Date through 2007**

Although those Act changes were to take effect immediately, the IRS, in essence, suspended their implementation for the balance of 2007 by the issuance of IRS Notice 2007-54. But as of January 1 of this year, the amendments have taken effect.

On December 31, 2007, the Service issued IRS Notice 2008-13, 2008-3 I.R.B. 282 (the “Notice”). In the Notice, the Service clarified its current intentions with respect to the enforcement of Code Sec. 6694 pending further guidance (which, it indicates, will be issued during 2008). In the case of someone who for compensation signs a return or gives advice with respect to a return where there is an understatement of tax liability, the Notice provides, as does the statute itself, that the penalty is not imposed if the person had a reasonable belief that the position would more likely than not be sustained on the merits. In order to meet this standard, the preparer or advisor must analyze the appropriate authorities and, as a result, in good faith, reasonably hold the belief that the likelihood of the taxpayer succeeding is greater than 50 percent.

**Reasonable Basis Exceptions.** The absence of such a belief is not, however, necessarily fatal. The Notice makes a distinction between preparers and advisors. For preparers, no penalty is imposed if there is a reasonable basis for the position, even if the preparer does not reasonably conclude that the position is more likely

than not to be sustained, if, as discussed in part in more detail below: (1) the required disclosure form disclosing the position is in fact filed with the return; (2) there is no substantial authority for the position but the preparer provides the taxpayer with a return that includes the disclosure form (even if, apparently, the taxpayer removes it before filing the return); (3) there is substantial authority for the position and the preparer advises the taxpayer of the difference between the penalty standards applicable to the taxpayer under Code Sec. 6662 and those applicable to the preparer under Code Sec. 6694 and contemporaneously documents that this advice was given, even though apparently no disclosure form was prepared or filed; or (4) the position relates to a tax shelter (as defined in Code Sec. 6662(d)(2)(C)(ii)) and the preparer advises the taxpayer of the penalty standards applicable to the taxpayer under Code Sec. 6662(d)(2)(C) and the difference, if any, between those standards and the standards under Code Sec. 6694 and contemporaneously documents that this advice was given, even though apparently no disclosure form was prepared or filed. In the case of an advisor, on the other hand, if there is a reasonable basis, the penalty can be avoided by explaining the opportunities for the taxpayer to avoid penalties through disclosure.

**Returns Covered and Not Covered.** The Notice contains three Exhibits. The first (Exhibit 1) lists those income, estate and gift, employment and miscellaneous returns that cause someone who prepares or provides advice with respect to the return for compensation to be subject to the provisions of Code Sec. 6694(a). These include Forms 1040 (U.S. Individual Income Tax Return), 706 (U.S. Estate (and Generation-Skipping Transfer) Tax Return), 709 (U.S. Gift (and Generation-Skipping Transfer) Tax Return, and 990-PF (Return of a Private Foundation), among many others. The second (Exhibit 2) lists those information returns that cause someone who prepares the return for compensation to be subject to the provisions of Code Sec. 6694(a) if it affects an entry or entries on a tax return and constitutes a *substantial portion* of the tax return or claim for refund. These include, among several others, Forms 1065 (U.S. Return of Partnership Income), including Schedules K-1, and 1120S (U.S. Income Tax Return for an S Corporation), including Schedules K-1. The Notice interprets the term “substantial portion” to mean a schedule, entry or other portion of a tax return or claim for refund that, if adjusted or disallowed, could result in a deficiency determination (or disallowance of refund claim) that the preparer knows or reasonably should know is a significant portion of the tax liability report on the return (or, in the case of a claim for refund, a significant portion of the tax originally reported or previously adjusted. The Notice states that this interpretation “clarifies that any determination as to whether a person who 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 appears that whether the entry is substantial or not is an objective one, not based upon the belief or knowledge of the preparer of such information return that it is substantial. The third (Exhibit 3) lists forms that would not subject someone who prepares such a form for compensation to the provisions of Code Sec. 6694 unless it was prepared willfully in a manner to understate tax liability on a refund or claim for refund or in a reckless or intentional disregard of rules or regulations – which would trigger a violation of Code Sec. 6694(b). These forms include, but are not limited to, Forms 1099 and W-2.

## More About the Notice

The Notice is more generous than Code Sec. 6694 itself in requiring that disclosure forms be attached to returns where the preparer does not reasonably conclude the return position is more likely than not correct. This seems to reflect a potential conflict of interest where the preparer, to avoid the Code Sec. 6694(a) penalty wants the disclosure form filed, but the taxpayer does not want it to apply (because, in many cases, such as for negligence or understatement of value for estate or gift tax purposes), disclosure will not cause the taxpayer's penalty to abate and the taxpayer, to reduce the risk of audit or otherwise, does not want the form attached.

Nevertheless, cautious preparers and advisors may recommend the attachment of a disclosure form in many cases where there is considerable uncertainty as to the proper treatment of an item. A case might be with respect to the allowance on the income tax return of a trust or estate for investment advisory fees and other expenses now that the Supreme Court has ruled in *Knight v. Commissioner*, (No. 06-1286) 467 F. 3d 149, affirmed. (2008) that many, but not all, investment advisory fees incurred by a fiduciary are subject to the two percent disallowance floor of Code Sec. 67(a).

At least five things need to be emphasized. First, whether a position is reasonable or not seems to be an objective determination, not one based upon the belief of the preparer or advisor. Hence, practitioners should be careful to record their reasons for their conclusion. Second, although a reasonable belief that the position is more likely than not correct seems to be one based upon belief, the IRS may contend, in some cases, that the belief was not reasonable. This suggests that any close question should be researched and the research discovered (and reasoning used by the preparer or advisor) should be recorded. Third, in many cases, both the taxpayer and the preparer will be well served by filing the disclosure form even if technically, under the Notice, it may not be due. It may help establish the taxpayer acted in good faith allowing the taxpayer to avoid any Code Sec. 6662 penalty by reason of Code Sec. 6664(c) which abates the penalty if the taxpayer had reasonable cause for the position and acted in good faith. Similarly, because Code Sec. 6694 itself has an overriding exception to that section's penalty if there is a reasonable cause for the understatement of tax and he preparer or advisor acted in good faith, the preparer may want to have the disclosure form attached. In other words, for both the taxpayer and the preparer/advisor, attaching the form may help establish at least good faith—indeed, some may wish to state their reasoning for the position right on Form 8275 (or 8295R) to try to establish a reasonable basis for it. Finally, it must be remembered that the Notice is only temporary guidance and it warns the final guidance may not be as generous. Finally, as indicated, the definition of preparer is very broad and could include a person who prepares an appraisal that will be part of an estate or gift tax return. It may be that appraisers, therefore, need to be prepared to give advice about penalties although they are not tax professionals. If the appraiser believes his or her appraisal is more likely than not correct (so no disclosure form need be attached to the return or advise about penalties be given as long as the belief is reasonable), it might be appropriate for him or her to so state in writing.

## Sample Language for Engagement Letters

As indicated above, conflicts between a return preparer or advisor, on the one hand, and the client, on the other, could arise, such as where the preparer or advisor, to protect himself or herself from penalty under Code Sec. 6694 wishes a disclosure form to be attached to the return and where the client does not want it attached. As indicated above, merely attaching the disclosure form to the return should protect the preparer, under Notice 2008-13, even if the client removes it. But, in some cases, it seems that the preparer or advisor should, in many cases, provide the taxpayer with information about penalties. Although in some cases, oral information will be sufficient, it seems that a written record is better. In fact, it may be appropriate to include a statement in the engagement letter with the client which can be referred to when appropriate. Here is a sample that some practitioners may find useful:

In connection with our representation, we may be providing you advice about one or more positions with respect to a tax return you may file or we may prepare or may participate in the preparation of such a return. In certain circumstances, Circular 230 (a Treasury Department Regulation) will require that we advise you about certain penalties that may apply with respect to such a return and circumstances under which you may be able to avoid one or more tax penalties, or we could face sanctions under the Circular. Also, section 6694 of the Internal Revenue Code of 1986, as amended, imposes penalties on preparers of certain Federal tax returns and on those who provide advice with respect to such returns. We intend, in representing you, to comply fully with Circular 230 and to render any advice with respect to any tax return you may file and to prepare or participate in the preparation of any such return in a manner so that no penalty is imposed upon us by section 6694.

In some situations, we will be required to advise you about certain tax penalties and how disclosure of a return position may avoid the imposition of penalties. Many penalties are imposed by section 6662. The penalties under section 6662 are imposed on any portion of an underpayment of tax required to be shown on a return if the underpayment is attributable to one of more of (1) negligence or disregard of rules or regulations, (2) any substantial underpayment of income tax, (3) any substantial valuation misstatement for income tax purposes, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. The penalty for negligence does not apply if the taxpayer's position has a reasonable basis or the position has substantial authority. The penalty for disregard of rules or regulations does not apply if the position is disclosed on the return and there is a reasonable basis for the position. Similarly, the penalty for substantial understatement of income tax will not be imposed if the position is disclosed and it is determined that the position has a reasonable basis. The substantial-understatement penalty can also be avoided if there

is substantial authority for the position. However, neither the substantial-authority nor the disclosure exception will apply if the transaction constitutes a tax shelter within the meaning of section 6662(d)(2)(C). It is important to note, however, that under section 6664(c), no penalty under section 6662 is imposed if there was a reasonable cause and the taxpayer acted in good faith. There are many other penalties that may be imposed on a taxpayer under the Internal Revenue Code. For example, a penalty on taxpayers (not preparers or advisors) under section 6676 is imposed for filing an erroneous claim for income tax refund or credit.

As indicated above, section 6694 imposes penalties on return preparers and advisors when the return understates the tax actually due where preparer or advisor was aware (or should have been aware) that the position in question was taken on the return. The penalty is not imposed, however, if the preparer or advisor had a reasonable belief that the position would more likely than not be sustained on the merits or there was a reasonable basis for the position and it was adequately disclosed on the return. There may be cases in which a preparer or advisor can avoid the section 6694 penalty even though the more-likely-than-not standard is not satisfied and disclosure is not made by the client provided that the preparer/advisor provides the client with information about the opportunities to avoid taxpayer penalties by making disclosure. For example, the preparer/advisor will not be subject to penalty under 6694 if there is substantial authority for the position and the preparer advises the taxpayer of the difference between the penalty standards applicable to the taxpayer under section 6662 and those applicable to the preparer under section 6694 and contemporaneously documents that this advice was given. If the position relates to a tax shelter, the preparer will not be subject to the section provided that the preparer advises the taxpayer of the penalty standards applicable to the taxpayer under section 6662(d)(2)(C) and the difference, if any, between those standards and the standards under section 6694 and contemporaneously documents that this advice was given. In the case of an advisor, if there is a reasonable basis for the tax position, the section 6693 penalty can be avoided by explaining the opportunities for the taxpayer to avoid penalties through disclosure. We anticipate that the IRS will change the standards for avoiding penalties in the future. As a general rule, the defenses for both taxpayers and preparers/advisors that require disclosure mean that a properly completed IRS Form 8275 or 8275R must be attached to the return. We specifically note to you that, in some cases, it will be in the best interests of the preparer or advisor for the disclosure form to be attached to the return so he or she may avoid the penalty imposed by section 6694 but the taxpayer may not be required to have the disclosure form attached to avoid a penalty under section 6662 or will not wish to do so even if it would avoid a penalty under that section.

We appreciate that these rules are complex. Nevertheless, to avoid penalties it is necessary in some cases for us to have advised you about them. Accordingly, we may refer you to this discussion from time to time during our representation of us. Needless to say, if you have any question about penalties or any related matter, please contact us.