



Proposed Paid Preparer Penalty Regulations
June 23, 2008



Feed address for Podcast subscription:
<http://feeds.feedburner.com/EdZollarsTaxUpdate>
Home page for Podcast: <http://ezollars.libsyn.com>
©2008 Edward K. Zollars, CPA

The TaxUpdate podcast is intended for tax professionals and is not designed for those not skilled in independent tax research. All readers and listeners are expected to do their own research to confirm items raised in this presentation before relying upon the positions presented.

The Podcast and this document may be reproduced freely so long as no fee is charged for the use of this document. Such prohibited use would include using this podcast or document as part of a CPE presentation for which a fee is charged.

This podcast is sponsored by Leimberg Information Services, located on the web at <http://www.leimbergservices.com>. Leimberg Information Services offers email newsletters on tax related matters, as well as access to a library of useful information to tax practitioners that subscribe to their services.

IRS's Ideas on How to Deal with New §6694

The IRS this past week issued the long awaited proposed regulations under §6694 and related provisions, moving to the next step the discussion of implementation for the long term the changes Congress put into the law a year ago. While there are still bills floating in Congress to change the preparer's standard to the "substantial authority" level, the IRS has released these proposed regulations with the "more likely than not" standard that, for now, is the law.

These regulations affect more than just the regulations for §6694, making changes in other preparer penalty related provisions. The IRS indicates in the preamble to the regulations that they intend to have the regulations finalized by the end of 2008, with the regulations to be effective for filings sometime after the final regulations are published, but in no event before December 31, 2008. Until that time, the guidance provided by Notice 2008-13, as modified by Notice 2008-46, will apply to the filings. That guidance was discussed back in January in an earlier podcast.

As well, the IRS indicated that there is more to come with regard to the story of preparer

penalties. As noted in the preamble:

The Treasury Department and the IRS believe that the recent amendments to the tax return preparer penalty provisions necessitate a comprehensive review and overhaul of all the tax return preparer penalties and related regulatory provisions. These proposed regulations are the first significant step in this process.

We'll consider the items in the order they are found in the proposed regulations, as noted below

Copies of Returns

The IRS starts by making a minor, but likely welcome, change to the requirement to furnish the taxpayer a copy of the return under §6107, revising Reg. §1.6107-1(a) to read as follows:

(a) Furnishing copy to taxpayer. A person who is a signing tax return preparer of any return of tax or claim for refund of tax under the Internal Revenue Code shall furnish a completed copy of the return or claim for refund to the taxpayer (or nontaxable entity) not later than the time the return or claim for refund is presented for the signature of the taxpayer (or nontaxable entity). For electronically filed Forms 1040EZ, "Income Tax Return for Single Filers and Joint Filers With No Dependents," and Form 1040A, "U.S. Individual Income Tax Return," filed for the 2009, 2010 and 2011 taxable years, the information may be provided on a replica of a Form 1040, "U.S. Individual Income Tax Return," that provides all of the information. For other electronically filed returns, the information may be provided on a replica of an official form that provides all of the information. The signing tax return preparer may, at its option, request a receipt or other evidence from the taxpayer (or nontaxable entity) sufficient to show satisfaction of the requirement of this paragraph (a).

The IRS as well provides in other related regulations that for other forms, "the information may be provided on a replica of an official form that provides all of the information." The IRS in the preamble notes that this is a step in implementing the Modernized e-file platform for the Form 1040 series of returns.

Date Return is Prepared

The IRS adopts provisions for determining the date a return is prepared that are consistent with the rules found in Notice 2008-13, providing:

(2) Date return is deemed prepared. For purposes of the penalties under section 6694, a return or claim for refund is deemed prepared on the date it is signed by the tax return preparer. If a signing tax return preparer within the meaning of §

301.7701-15(b)(1) of this chapter fails to sign the return, the return is deemed prepared on the date the return is filed. See § 1.6695-1 of this section. In the case of a nonsigning tax return preparer within the meaning of § 301.7701-15(b)(2) of this chapter, the relevant date is the date the nonsigning tax return preparer provides the tax advice with respect to the position giving rise to the understatement. This date will be determined based on all the facts and circumstances.

Note the difference in treatment for signing vs. nonsigning preparers—a signing preparer fixes the date by the date he/she actually signs the return. If the return is not signed, that date is pushed back until the date the taxpayer finally files the return.

For a nonsigning preparer (including advisers brought in solely to give advice who never do compliance work) the date advice is given controls—which means it will be important to document that date in the nonsigning preparer's files.

Defining a Preparer Within a Firm

A major change in the proposed regulations is the replacement of the “one preparer per firm” standard with a “one preparer per position” standard. The “one preparer per firm” standard did create an unusual incentive to use outside advisers if the client sought assistance. If an outside adviser was consulted on the matter, that person could become a nonsigning preparer with regard to that position, but if the same person was a member of the same firm as the signing preparer, the nonsigning adviser faced no risk of being hit with the penalty (and the signing preparer was on the hook).

In the preamble to the proposed regulations, the IRS explains its rationale as follows for making this change:

The Treasury Department and the IRS believe that the amendments to section 6694 made by the 2007 Act, together with the evolution in existing business practices and the increased complexity of the Federal tax law that has created an increased need for specialization, require reconsideration of the "one preparer per firm" rule. Specifically, the Treasury Department and the IRS believe this evolution requires the adoption of a framework that centers on the return or claim for refund on a position-by-position basis, with the focus of any penalty on the position(s) giving rise to the understatement on the return or claim for refund and any responsible parties with respect to such position(s). Thus the Treasury Department and the IRS believe that the "one preparer per firm" rule is no longer appropriate and have proposed to adopt a framework defining a preparer-per-position within a firm.

Regulation §1.6694-1(b)(1) outlines the “one preparer per position standard” and provides:

(b) Tax return preparer -- (1) In general. For purposes of this section, "tax return preparer" means any person who is a tax return preparer within the meaning of section 7701(a)(36) and § 301.7701-15 of this chapter. An individual is a tax return preparer subject to section 6694 if the individual is primarily responsible for the position(s) on the return or claim for refund giving rise to an understatement. There is only one individual within a firm who is primarily responsible for each position on the return or claim for refund giving rise to an understatement. In the course of identifying the individual who is primarily responsible for the position, the Internal Revenue Service may advise multiple individuals within the firm that it may be concluded that they are the individual within the firm who is primarily responsible. In some circumstances, there may be more than one tax return preparer who is primarily responsible for the position(s) giving rise to an understatement if multiple tax return preparers are employed by, or associated with, different firms.

Of special interest is the notation in the regulation that the IRS retains the option of initially informing multiple individuals that they may be considered a preparer for a position in question. It seems likely this means the IRS is going to cast a wide net among those involved with the return position on the return when initially proposing the penalty, since an obvious defense for each professional will be to claim another preparer in the firm is the one that truly should be liable—and to provide information to bolster that claim, making the IRS's case that much simpler against the individual they do finally move against.

As well, those in larger firms with a number of specialists are the most affected by this particular change—previously nonsigning specialists hid behind the signing preparer, but now they can be exposed.

However, the signing preparer will still be the person initially facing the greatest scrutiny under the regulations. Proposed Regulation § 1.6694-1(b)(2) provides:

(2) Responsibility of signing tax return preparer. The signing tax return preparer within the meaning of § 301.7701-15(b)(1) of this chapter will generally be considered the person who is primarily responsible for all of the positions on the return or claim for refund giving rise to an understatement. It may be concluded, however, based upon information received from the signing tax return preparer (or other relevant information from a source other than the signing tax return preparer) that another person within the signing tax return preparer's same firm was primarily responsible for the position(s) on the return or claim for refund giving rise to an understatement.

In essence, initial “suspicion” will fall on the person signing the return if someone in the firm is the signing preparer for the return in question. Evidence may show some other preparer is the one that should be held responsible, but signing preparers need to be aware that, initially, they are facing presumptive exposure for every position embodied in the return. Professionals in firms may end up preparing their own “protective” documentation

when they take positions on a return in reliance on the advice of another preparer in the firm—and those who give such advice may also need to document that happened to show whether, in fact, they were deeply enough involved to become the preparer for the position in question.

Nonsigning preparer standards are found at Proposed Regulation §1.6694-1(b)(3) which provides:

(3) Responsibility of nonsigning tax return preparer. If there are one or more individuals within a firm who are nonsigning tax return preparers within the meaning of § 301.7701-15(b)(2) of this chapter and there is no signing tax return preparer within the meaning of § 301.7701-15(b)(1) of this chapter for the return or claim for refund within that firm, the individual within the firm with overall supervisory responsibility for the position(s) giving rise to the understatement is the tax return preparer who is primarily responsible for the position for purposes of section 6694. Additionally, if, after the application of paragraph (b)(2) of this section, it is concluded that the signing tax return preparer is not primarily responsible for the position or the IRS cannot conclude which individual (as between the signing tax return preparer and other persons within the firm) is primarily responsible for the position, the individual within the firm with overall supervisory responsibility for the position(s) giving rise to the understatement is the tax return preparer who is primarily responsible for the position for purposes of section 6694.

While the proposed regulation refers to the “individual with overall supervisory responsibility” it does not indicate how that determination will be made—meaning it's going to be “facts and circumstances” based, and could become a matter of dispute both between the IRS and the preparers, and potentially the preparers themselves inside the firm.

The IRS does provide three examples to show how to determine who is the preparer in various fact situations.

Example 1. Attorney A provides advice to Client C concerning the proper treatment of an item with respect to which all events have occurred on C's income tax return. In preparation for providing that advice, A seeks advice regarding the proper treatment of the item from Attorney B, who is within the same firm as A, but A is the attorney who signs C's return as a tax return preparer. B provides advice on the treatment of the item upon which A relies. B's advice is reflected on C's income tax return but no disclosure was made in accordance with § 1.6694-2(c)(3). The advice constitutes preparation of a substantial portion of the return within the meaning of § 301.7701-15(b)(3) and the IRS later challenges the position taken on the tax return, giving rise to an understatement of liability. For purposes of the regulations under section 6694, A is initially considered the tax return preparer with respect to C's return and the IRS advises A that A may be

subject to the penalty under section 6694 with respect to C's return. Based upon information received from A or another source, it may be concluded that B had primary responsibility for the position taken on the return that gave rise to the understatement because B had overall supervisory responsibility for the position giving rise to an understatement.

Example 2. Same as Example 1, except that neither Attorney A nor any other attorney within A's firm signs Client C's return as a tax return preparer. Attorney B is the nonsigning tax return preparer within the firm with overall supervisory responsibility for the position giving rise to an understatement. Accordingly, B is the tax return preparer who is primarily responsible for the position on C's return giving rise to an understatement and is subject to penalty under section 6694.

Example 3. Same as Example 1, except Attorney D, who works for a different firm than A, also provides advice on the same position upon which A relies. It may be concluded that D is also primarily responsible for the position on the return.

One factor to remember when reading these regulations is that in order to be subject to these penalties one must be a preparer. As we'll discover later, these proposed regulations contain a revised definition of just who is a preparer, and the existence of certain *de minimus* exceptions may eliminate the issue for a significant number of individuals that would otherwise be nonsigning preparers.

Note that this area may be one of those most likely to be changed in the final regulations. The IRS specifically notes in the preamble:

The Treasury Department and the IRS specifically request comments regarding the approach taken in these proposed regulations and any recommendations to improve this rule.

Reliance on Information Provided by Third Party

The IRS has continued the general rule that preparers may reasonably rely on information provided to them by the taxpayer or a third party, reassuring some preparers who last year interpreted the new §6694 as now requiring preparers to independently verify information provided by the taxpayer. The proposed regulation §1.6694-1(e)(1) provides as follows:

(e) Verification of information furnished by taxpayer or other party -- (1) In general. For purposes of sections 6694(a) and (b) (including meeting the reasonable belief that the position would more likely than not be sustained on its merits and reasonable basis standards in §§ 1.6694-2(b) and (c)(2), and demonstrating reasonable cause and good faith under § 1.6694-2(d)), the tax return preparer generally may rely in good faith without verification upon information furnished by the taxpayer. A tax return preparer, however, may not rely on information provided by a taxpayer with respect to legal conclusions on

Federal tax issues. A tax return preparer may also rely in good faith and without verification upon information furnished by another advisor, another tax return preparer or other party (including another advisor or tax return preparer at the tax return preparer's firm). The tax return preparer is not required to audit, examine or review books and records, business operations, or documents or other evidence to verify independently information provided by the taxpayer, advisor, other tax return preparer, or other party. The tax return preparer, however, may not ignore the implications of information furnished to the tax return preparer or actually known by the tax return preparer. The tax return preparer must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete. Additionally, some provisions of the Code or regulations require that specific facts and circumstances exist (for example, that the taxpayer maintain specific documents) before a deduction or credit may be claimed. The tax return preparer must make appropriate inquiries to determine the existence of facts and circumstances required by a Code section or regulation as a condition of the claiming of a deduction or credit.

As always, we cannot ignore the implications of the information we know or become aware of—similar to the compilation standards in the attest arena, we aren't required generally to actively search for support for the information, but we have to keep our “eyes open” for information that would reasonably suggest the information or assertion may be flawed. As well, when the Code or regulations require the existence of certain items (like the supporting documentation to claim entertainment and travel expenses), we are required to inquire about the existence of such information. But none of this represents a change from what has been true prior to last May's law revision.

To illustrate the application of these rules, the IRS provides the following examples:

Example 1. During an interview conducted by Preparer E, a taxpayer stated that he had made a charitable contribution of real estate in the amount of \$50,000 during the tax year, when in fact he had not made this charitable contribution. E did not inquire about the existence of a qualified appraisal or complete a Form 8283, Noncash Charitable Contributions, in accordance with the reporting and substantiation requirements under section 170(f)(11). E reported a deduction on the tax return for the charitable contribution, which resulted in an understatement of liability for tax, and signed the tax return as the tax return preparer. E is subject to a penalty under section 6694.

Example 2. While preparing the 2008 tax return for an individual taxpayer, Preparer F realizes that the taxpayer did not provide a Form 1099 for a bank account that produced significant taxable income in 2008. When F inquired about any other income, the taxpayer furnished the Form 1099 to F for use in preparation of the 2008 tax return. F did not know that the taxpayer owned an additional bank account that generated taxable income for 2008 and the taxpayer

did not reveal this information to the tax return preparer notwithstanding F's general inquiry about any other income. F signed the taxpayer's return as the tax return preparer. F is not subject to a penalty under section 6694.

Example 3. In preparing a tax return, Accountant G relies on the advice of an actuary concerning the limit on deductibility under section 404(a)(1)(A) of a contribution by an employer to a qualified pension trust. On the basis of this advice, G completed and signed the tax return. It is later determined that there is an understatement of liability for tax that resulted from the incorrect advice provided by the actuary. G had no reason to believe that the advice was incorrect or incomplete, and the advice appeared reasonable on its face. G was also not aware at the time the return was prepared of any reason why the actuary did not know all of the relevant facts or that the advice was no longer reliable due to developments in the law since the time the advice was given. G is not subject to a penalty under section 6694. The actuary, however, may be subject to penalty under section 6694 if the advice given by the actuary constitutes a substantial portion of the tax return within the meaning of § 301.7701-15(b)(3) of this chapter.

Income Derived

As the amount of penalties under §6694(a) and (b) are both determined by reference to a 50% of fees derived calculation (subject to minimum amounts for each penalty of \$1,000 and \$5,000 respectively), the issue of how to calculate income derived from the engagement becomes important—and the regulations deal with that matter, dealing with both the firm's fee and that of individuals who may be employees of the firm.

It should become apparent that in this area, like many others in these regulations we will look at, documentation by the preparer and preparer's firm is going to become crucial to limit the potential amount of the penalty.

As this is a penalty that applies both to individual preparers and firms that prepare tax returns, the question of how to calculate the individuals' income derived from that engagement poses an initial problem. Proposed Reg. §1.6694-1(f)(1) gives us the following guidance for non-equity holder employees:

In the situation of a tax return preparer who is not compensated directly by the taxpayer, but rather by a firm that employs the tax return preparer or with whom the tax return preparer is associated, income derived (or to be derived) means all compensation the tax return preparer receives from the firm that can be reasonably allocated to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position(s) taken on the return or claim for refund that gave rise to the

understatement.

Given the \$1,000 minimum for a §6694(a) penalty, in most cases the amount of salary allocable to the engagement for a non-equity holding employee will be less than \$2,000, making the \$1,000 the true penalty that individual would face (or \$5,000 in the case of willful violation).

A different rule applies for equity holders in the firm and for the firm itself. Proposed Regulation §1.6694-1(f)(1) continues:

In the situation where a firm that employs the individual tax return preparer (or the firm of which the individual tax return preparer is a partner, member, shareholder, or other equity holder) is subject to a penalty under section 6694(a) or (b) pursuant to the provisions in §§ 1.6694-2(a)(2) or 1.6694-3(a)(2), income derived (or to be derived) means all compensation the firm receives or expects to receive with respect to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position(s) taken on the return or claim for refund that gave rise to the understatement.

The proposed regulation goes on to note that if multiple engagements are involved related to the same return or position, these engagements are aggregated for computing the fees noted above—and this is true for employees, equity holders and the firm itself.

An important limitation on computing the proper amount of fees allocable is found in this portion of the proposed regulations. The preamble notes that:

The proposed regulations also provide that only compensation for time spent on tax advice that is given with respect to events that have occurred at the time the advice is rendered and that relates to the position(s) giving rise to the understatement will be taken into account for purposes of calculating the section 6694 penalty. This rule is intended to be consistent with the definition of tax return preparer in § 301.7701-15(b)(2)(i).

Implementation of this provision is found in Proposed Regulation §1.6694-1(f)(2)(ii). As the penalty relates only to return preparation, work done before the transaction takes place does not count for these purposes—presuming the firm's records allow us to determine how much of the fee should reasonably be allocated to the “pre-transaction” period. Since for significant transactions we'd hope the client would consult with us prior to pulling the trigger on the transaction, and most of the research and advice would take place prior to consummation of the deal, this could very significantly reduce the calculation of the fees involved (note that you still would face the minimums).

And, as the above notes, a person who only consults prior to the transaction taking place will not be deemed to be tax return preparer when we get to that definition.

The proposed regulations allow that the total fee may be less than the total amount billed on what the firm saw as the engagement in question—that is, a lump sum fee will be

allocated to limit the calculation to the amount related to the position that gave rise to the understatement of tax—but it up to the firm and/or preparer to have documentation to allow for such an allocation. Proposed Regulation §1.6694-1(f)(2)(iv) provides:

(iv) Reduction of compensation. For purposes of applying paragraph (f)(1) of this section, it may be concluded based upon information provided by the tax return preparer or the tax return preparer's firm that an appropriate allocation of compensation attributable to the position(s) giving rise to the understatement on the return or claim for refund is less than the total amount of compensation associated with the engagement. For example, the number of hours of the engagement spent on the position(s) giving rise to the understatement may be less than the total hours associated with the engagement. If this is concluded, the amount of the penalty will be calculated based upon the compensation attributable to the position(s) giving rise to the understatement. Otherwise, the total amount of compensation from the engagement will be the amount of income derived for purposes of calculating the penalty under section 6694.

If both an individual preparer and the firm are held to be liable for the penalty (and, yes, both can be held liable), the combined penalty will be limited to 50% of the amount derived from the firm, with individual's penalty capped at 50% of the amount of that individual's compensation (remember that for equity holders, that's going to be identical to the firm's amount). Note that this does provide some incentive for the firm to attempt to “sacrifice” an employee preparer if it become clear the firm is going to be subject to a penalty (intra-firm finger pointing is likely going to be an unfortunate side effect of many of these rules if they go into effect).

Again the IRS gives us some examples of the application of these proposed provisions:

Example 1. Signing Tax Return Preparer H is engaged by a taxpayer and paid a total of \$21,000. Of this amount, \$20,000 relates to research and consultation regarding a transaction that is later reported on a return, and \$1,000 for the activities relating to the preparation of the return. Based on H's hourly rates, a reasonable allocation of the amount of compensation related to the advice rendered prior to the occurrence of events that are the subject of the advice is \$5,000. The remaining compensation of \$16,000 is considered to be compensation related to the advice rendered after the occurrence of events that are the subject of the advice and return preparation. The income derived by H with respect to the return for purposes of computing the penalty under section 6694(a) is \$16,000, and the amount of the penalty imposed under section 6694(a) is \$8,000.

Example 2. Accountants I, J, and K are employed by Firm L. I is a principal manager of Firm L and provides corporate tax advice for the taxpayer after all events have occurred subject to an engagement for corporate tax advice. J provides international tax advice for the taxpayer after all events have occurred subject to a different engagement for international tax advice. K prepares and

signs the taxpayer's return under a general tax services engagement. I's advice is the source of an understatement on the return and the advice constitutes preparation of a substantial portion of the return within the meaning of § 301.7701-15(b) of this chapter. I is the nonsigning tax return preparer within the firm with overall supervisory responsibility for the position on the taxpayer's return giving rise to an understatement. Thus, I is the tax return preparer who is primarily responsible for the position on the taxpayer's return giving rise to the understatement. Because K's signature as the signing tax return preparer is on the return, the IRS advises K that K may be subject to the section 6694(a) penalty against K to the understatement. K provides information that I is the tax return preparer with primary responsibility for the position that gave rise to the understatement and K formed a reasonable belief that the position would more likely than not be sustained on the merits by relying on the advice provided by I. Furthermore, K has reasonable cause because K relied on I for the advice on the corporate tax matter. The IRS, therefore, assesses the section 6694 penalty against I. The portion of the total amount of the penalty allocable to I does not exceed that part of I's compensation that is attributable to the corporate tax advice engagement. In the event that Firm L is also liable under the provisions in § 1.6694-2(a)(2), the IRS assesses the section 6694 penalty in an amount not exceeding 50 percent of Firm L's firm compensation based on the engagement relating to the corporate tax advice services provided by I where there is no applicable reduction in compensation pursuant to § 1.6694-1(f)(2)(iii).

Example 3. Same facts as Example 2, except that I provides the advice on the corporate matter when the events have not yet occurred. I's advice is the cause of an understatement position on the return but I is not a tax return preparer pursuant to § 301.7701-15(b)(2) or (3) of this chapter. K has reasonable cause because K relied on I for the advice on the corporate tax matter and K is not limited to reliance on persons who provide post-transactional advice if such reliance is reasonable and in good faith. I, K and Firm L are not liable for the section 6694 penalty.

Firm Liability

The preamble notes that the Proposed Regulation would add one addition time when the firm could be held liable for the §6694 penalties as compared with the current regulation. The “new” provision is found at Proposed Regulation §1.6694-2(a)(2)(iii) (with similar language at Proposed Regulation §1.6694-3(a)(2)(iii)):

(2) Special rule for corporations, partnerships, and other firms. A firm that employs a tax return preparer subject to a penalty under section 6694(a) (or a firm of which the individual tax return preparer is a partner, member, shareholder or other equity holder) is also subject to penalty if, and only if --

- (i) One or more members of the principal management (or principal officers) of the firm or a branch office participated in or knew of the conduct proscribed by section 6694(a);
- (ii) The corporation, partnership, or other firm entity failed to provide reasonable and appropriate procedures for review of the position for which the penalty is imposed; or
- (iii) Such review procedures were disregarded by the corporation, partnership, or other firm entity through willfulness, recklessness, or gross indifference (including ignoring facts that would lead a person of reasonable prudence and competence to investigate or ascertain) in the formulation of the advice, or the preparation of the return or claim for refund, that included the position for which the penalty is imposed.

The IRS has now clarified that disregarding your firm's review procedures through willfulness, recklessness or gross indifference will also expose the firm to penalty.

Clearly, firms need to have well documented procedures to review positions to assure compliance with these provisions, and to insure that such procedures are actually being followed. If procedures are put in a manual that no one actually followed, or are disregarded when "inconvenient" to the engagement, the firm face liability. Consideration should be strongly given to the use of tax preparation checklists. The AICPA Tax Division provides such checklists to its members each year that include checklists for a large number of return types (including estate and gift tax returns that now are subject to these penalties), and nonmembers can purchase the checklists (along with other items of use for tax practice). Similarly, PPC offers checklists as part of their Deskbook series.

Reasonable Belief of More Likely Than Not

The "more likely than not" standard and the "reasonable belief" provision in the revised §6694 is what attracted the most attention when Congress passed the provision, and the proposed regulations explains how this standard will be defined and applied.

Proposed Regulation §1.6694-2(b) starts out describing the general rules for applying the "more likely than not" test:

- (b) Reasonable belief that the position would more likely than not be sustained on its merits -- (1) In general. A tax return preparer may "reasonably believe that a position would more likely than not be sustained on its merits" if the tax return preparer analyzes the pertinent facts and authorities, and in reliance upon that analysis, reasonably concludes in good faith that the position has a greater than 50 percent likelihood of being sustained on its merits. In reaching this conclusion, the possibility that the position will not be challenged by the Internal Revenue Service

(IRS) (for example, because the taxpayer's return may not be audited or because the issue may not be raised on audit) is not to be taken into account.

The above pretty much reiterates the prior rules, except raising the standard to “more likely than not” from “realistic possibility” but keeping the other provisions, including the audit lottery consideration prohibition.

As well, we continue to have the cross reference to the regulations under §6662 for finding the list of allowed authorities.

The analysis prescribed by § 1.6662-4(d)(3)(ii) (or any successor provision) for purposes of determining whether substantial authority is present applies for purposes of determining whether the more likely than not standard is satisfied.

Like before, the main difference between the sources that “count” for purposes of this analysis and those that count for purposes of the AICPA Statements on Standards for Tax Services relates to editorial materials—for purposes of §6694, you may not rely solely on editorial discussion of a position (including this podcast) and must rather reference back to the supporting sources.

The regulations do allow for considering a tax preparer's experience and other factors into account in making this judgment:

Whether a tax return preparer meets this standard will be determined based upon all facts and circumstances, including the tax return preparer's diligence. In determining the level of diligence in a particular situation, the tax return preparer's experience with the area of Federal tax law and familiarity with the taxpayer's affairs, as well as the complexity of the issues and facts, will be taken into account.

CPAs need to remember that despite the above, under the Code of Professional Conduct they are required to have adequate technical expertise to undertake an engagement, so that while ignorance may be helpful under the above rule, it won't help in actions brought by a State Board of Accountancy or legal action against the practitioner (and attorneys would find a similar bad result).

What about new law provisions for which authority has not been released? The IRS tells preparers that this matter can be solved, noting:

A tax return preparer may reasonably believe that a position more likely than not would be sustained on its merits despite the absence of other types of authority if the position is supported by a well-reasoned construction of the applicable statutory provision.

Preparers can also reasonably rely on the work of other preparers in coming to their reasonable belief that the position would more likely than not be sustained. The proposed regulation continues:

For purposes of determining whether the tax return preparer has a reasonable belief that the position would more likely than not be sustained on the merits, a tax return preparer may rely in good faith without verification upon information furnished by the taxpayer, advisor, other tax return preparer, or other party (including another advisor or tax return preparer at the tax return preparer's firm), as provided in § 1.6694-1(e).

Not unexpectedly, a preparer cannot base his/her position on unreasonable assumptions, either factual or legal, including those the preparer either knew or had reason to know were unreasonable [Proposed Regulation §1.6694-2(b)(2)].

We continue to rely upon the sources found at §1.6662-4(d)(3)(iii) for determining if a position is more likely than not. As we'll discover later, though, that while “administrative practice” (while the law may literally say result A is required, the taxing agency has a practice of not pursuing that position to its extreme) is not listed as one of the “authorities” found at the above citation, that will become a “reasonable basis” defense against the penalty.

The IRS offers a number of examples related to application of the “more likely than not” determination.

(4) Examples. The provisions of paragraphs (b)(1) through (b)(3) of this section are illustrated by the following examples:

Example 1. A new statute is silent as to whether the taxpayer may take advantage of certain tax benefits. The Treasury Department and the IRS have not issued any interpretative guidance for the newly enacted provision. A well-reasoned construction of the statutory text supports the position that a taxpayer may claim the tax benefits. Preparer M may avoid the section 6694(a) penalty by taking the position that M reasonably believed that the taxpayer's position would more likely than not be sustained on its merits.

Example 2. After the passage of legislation containing a new statutory provision, a taxpayer engaged in a transaction that is adversely affected by the new provision. Prior law supported a position favorable to the taxpayer. Preparer N believes that the new statute is inequitable as applied to the taxpayer's situation. The statutory language, however, is unambiguous as applied to the transaction to deny the result claimed by the taxpayer previously. In considering the new statutory provision as applied to the taxpayer's position, N may not avoid the section 6694(a) penalty by taking the position that the tax return preparer reasonably believed that the position would more likely than not be sustained on its merits.

Example 3. While preparing the taxpayer's return, Preparer O determines that a statute is silent as to whether the taxpayer may take a certain position on the taxpayer's 2007 Federal income tax return. Three private letter rulings issued to

other taxpayers in 2002 and 2003 support the taxpayer's position. Temporary regulations issued in 2004, however, are clearly contrary to the taxpayer's position. After the issuance of the temporary regulations, the earlier private letter rulings cease to be authorities and are not taken into account in determining whether the taxpayer's position satisfies the reasonable belief that the position would more likely than not be sustained on its merits standard. Preparer O may not avoid the section 6694(a) penalty by taking the position that the tax return preparer reasonably believed that the taxpayer's position would more likely than not be sustained on its merits.

Example 4. In the course of researching whether an interpretation of a phrase in the Internal Revenue Code (Code) is a position that more likely than not will be sustained on its merits, Preparer P discovers that the only relevant authorities include decisions of five U.S. courts of appeal. Three U.S. courts of appeal have construed the language as being taxpayer favorable. Two other U.S. courts of appeal, however, have construed the identical language as being favorable to the government's position. The U.S. court of appeals in the jurisdiction where the taxpayer is located has not addressed this issue. P reasonably believes that the taxpayer's facts more closely parallel the facts involved in the three U.S. courts of appeals' decisions that were taxpayer favorable. Under the analysis prescribed by § 1.6662-4(d)(3)(ii), P may avoid the section 6694(a) penalty by taking the position that the tax return preparer reasonably believed that a well-reasoned position consistent with the taxpayer favorable interpretation would more likely than not be sustained on its merits.

The date for determining whether the position was a “more likely than not” one is the date the return is prepared (or deemed prepared) under the rules proposed above. The IRS notes in Proposed Regulation §1.6694-2(b)(6):

(6) When "more likely than not" standard must be satisfied. For purposes of this section, the requirement that a position satisfies the "more likely than not" standard must be satisfied on the date the return is deemed prepared, as prescribed by § 1.6694-1(a)(2).

Reasonable Basis

What if the position won't clear the “most likely than not” standard? Now we look to the lower level standard, which was also changed by last May's law change. Previously, a preparer could escape the penalty if the position were properly disclosed on the return and the position was one that was not frivolous—an extraordinarily low standard. The new law raised that level to “reasonable basis” and that is what the next portion of the regulations deals with.

Proposed Regulation §1.6694-3(c)(2) contains the definition of what constitutes “reasonable basis” the new minimum standard even for disclosed positions. That provision provides:

(2) Reasonable basis. For purposes of this section, "reasonable basis" has the same meaning as in § 1.6662-3(b)(3) or any successor provision of the accuracy-related penalty regulations. For purposes of determining whether the tax return preparer has a reasonable basis for a position, a tax return preparer may rely in good faith without verification upon information furnished by the taxpayer, advisor, other tax return preparer, or other party (including another advisor or tax return preparer at the tax return preparer's firm), as provided in § 1.6694-1(e).

The definition found in Regulation §1.6662-3(b)(3) reads as follows:

(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.

(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).

Once we have determined that we have a position that meets the above standard but does not rise to the level of “more likely than not” we need to look at Proposed Regulation §1.6694-3(c)(3) for how to comply—and the IRS has chosen basically to continue the solution they brought out in Notice 2008-13.

The issue, as we have discussed previously, is that taxpayers under §6662 only gain

benefits from disclosing positions that fail to meet the substantial authority standard, which is lower than “more likely than not” though not an extremely lower standard—but the difference creates a clear conflict between the interests of the preparer, who needs disclosure earlier, and the client, who is not required to attach a disclosure for positions until they fail to meet the substantial authority level.

The IRS solutions are listed in Proposed Regulation §1.6694-3(c)(3)(i), beginning with the signing return preparer:

(3) Adequate disclosure -- (i) Signing tax return preparers. In the case of a signing tax return preparer within the meaning of § 301.7701-15(b)(1) of this chapter, disclosure of a position for which there is a reasonable basis but for which the tax return preparer does not have a reasonable belief that the position would more likely than not be sustained on the merits is adequate if the tax return preparer meets any of the following standards:

(A) The position is disclosed in accordance with § 1.6662-4(f) (which permits disclosure on a properly completed and filed Form 8275, "Disclosure Statement," or Form 8275-R, "Regulation Disclosure Statement," as appropriate, or on the tax return in accordance with the annual revenue procedure described in § 1.6662-4(f)(2)).

(B) For income tax returns, if the position would not meet the standard for the taxpayer to avoid a penalty under section 6662(d)(2)(B) without disclosure (no substantial authority), the tax return preparer provides the taxpayer with the prepared tax return that includes the disclosure in accordance with § 1.6662-4(f).

(C) For income tax returns, if the position would otherwise meet the standard for nondisclosure under section 6662(d)(2)(B)(i) (substantial authority), the tax return preparer advises the taxpayer of all the penalty standards applicable to the taxpayer under section 6662. The tax return preparer must also contemporaneously document the advice in the tax return preparer's files.

(D) For income tax returns, if section 6662(d)(2)(B) does not apply because the position may be described in section 6662(d)(2)(C) or section 6662A (a tax shelter, reportable transaction with a significant purpose of tax avoidance or evasion, or a listed transaction), the tax return preparer advises the taxpayer that there needs to be at a minimum substantial authority for the position, that the taxpayer must possess a reasonable belief that the tax treatment was more likely than not the proper treatment in order to avoid a penalty under section 6662(d) or section 6662A as applicable, and that disclosure will not protect the taxpayer from assessment of an accuracy-related penalty if either section 6662(d)(2)(C) or 6662A applies to the position. The tax return preparer must also contemporaneously document the advice in the tax return preparer's files.

(E) For returns or claims for refund that are subject to penalties pursuant to section 6662 other than the substantial understatement penalty under section 6662(b)(2) and (d), the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer under sections 6662. The tax return preparer must also contemporaneously document the advice in the tax return preparer's files.

Nonsigning preparers have an obvious problem—they don't have access to the return itself to attach a disclosure to.

Proposed Regulation §1.6694-3(c)(3)(ii) deals with the nonsigning preparer, noting first that if an 8275 or 8275-R does get attached to the return all is well:

(ii) Nonsigning tax return preparers. In the case of a nonsigning tax return preparer within the meaning of § 301.7701-15(b)(2) of this chapter, disclosure of a position that satisfies the reasonable basis standard but does not satisfy the reasonable belief that a position would more likely than not be sustained on its merits standard is adequate if the position is disclosed in accordance with § 1.6662-4(f) (which permits disclosure on a properly completed and filed Form 8275 or Form 8275-R, as appropriate, or on the return in accordance with an annual revenue procedure described in § 1.6662-4(f)(2)).

However, since that preparer can't really control that matter, the regulations provide alternative methods a nonsigning preparer can use to fulfill his/her responsibility. The Proposed Regulations note different rules when the advice was provided directly to the taxpayers as opposed to being provided to another tax preparer:

In addition, disclosure of a position is adequate in the case of a nonsigning tax return preparer if, with respect to that position, the tax return preparer complies with the provisions of paragraph (c)(3)(ii)(A) or (B) of this section, whichever is applicable.

(A) Advice to taxpayers. If a nonsigning tax return preparer provides advice to the taxpayer with respect to a position for which there is a reasonable basis but for which the nonsigning tax return preparer does not have a reasonable belief that the position would more likely than not be sustained on the merits, disclosure of that position is adequate if the tax return preparer advises the taxpayer of any opportunity to avoid penalties under section 6662 that could apply to the position, if relevant, and of the standards for disclosure to the extent applicable. The tax return preparer must also contemporaneously document the advice in the tax return preparer's files.

(B) Advice to another tax return preparer. If a nonsigning tax return preparer provides advice to another tax return preparer with respect to a position for which

there is a reasonable basis but for which the nonsigning tax return preparer does not have a reasonable belief that the position would more likely than not be sustained on the merits, disclosure of that position is adequate if the tax return preparer advises the other tax return preparer that disclosure under section 6694(a) may be required. The tax return preparer must also contemporaneously document the advice in the tax return preparer's files.

Note that, as the proposed regulations make clear, a professional can become subject to this penalty when providing advice to another preparer.

The IRS also learned from professional's reaction to the covered opinion rules in Circular 230 issued back in 2005, and this time wanted to stop advisers from firing up the automatic signature rules in Outlook or the use of AutoText in Word to "solve" the disclosure problem by putting boilerplate everywhere. The "you can't fix this with boilerplate" provision is found in Proposed Regulation §1.6694-2(c)(3)(iii), which provides:

(iii) Requirements for advice. For purposes of satisfying the disclosure standards of paragraphs (c)(3)(i) and (ii) of this section, each return position for which there is a reasonable basis but for which the tax return preparer does not have a reasonable belief that the position would more likely than not be sustained on the merits must be addressed by the tax return preparer. The advice to the taxpayer with respect to each position, therefore, must be particular to the taxpayer and tailored to the taxpayer's facts and circumstances. The tax return preparer is required to contemporaneously document the fact that the advice was provided. There is no general pro forma language or special format required for a tax return preparer to comply with these rules. No form of a general boilerplate disclaimer, however, is sufficient to satisfy these standards. A tax return preparer may choose to comply with the documentation standard in one document covering each position, or in multiple documents covering all of the positions.

Again, the IRS provides examples to outline how to apply these provisions:

(v) Examples. The provisions of paragraph (c)(3) of this section are illustrated by the following examples:

Example 1. An individual taxpayer hires Accountant Q to prepare its income tax return. Q does not reasonably believe that a particular position taken on the tax return would more likely than not be sustained on its merits although there is substantial authority for the position. Q prepares and signs the tax return without disclosing the position taken on the tax return, but advises the individual taxpayer of the penalty standards applicable to the taxpayer under section 6662, and contemporaneously documents in Q's files that this advice was provided. The individual taxpayer signs and files the tax return without disclosing the position because the position meets the standards for nondisclosure under section 6662(d)(2)(B)(i). The IRS later challenges the position taken on the tax return,

resulting in an understatement of liability. Q is not subject to a penalty under section 6694.

Example 2. Attorney R advises a large corporate taxpayer concerning the proper treatment of complex entries on the corporate taxpayer's tax return. R has reason to know that the tax attributable to the entries is a substantial portion of the tax required to be shown on the tax return within the meaning of § 301.7701-15(b)(3). When providing the advice, R concludes that one position with respect to these entries does not meet the reasonable belief that the position would more likely than not be sustained on the merits standard and also does not have substantial authority, although the position meets the reasonable basis standard. R, in good faith, advises the corporate taxpayer that the position lacks substantial authority and the taxpayer will be subject to an accuracy-related penalty under section 6662 unless the position is disclosed in a disclosure statement included in the return. R also documents the fact that this advice was contemporaneously provided to the corporate taxpayer at the time the advice was provided. Neither R nor any other attorney within R's firm signs the corporate taxpayer's return as a tax return preparer, but the advice by R constitutes preparation of a substantial portion of the tax return and R is the individual with overall supervisory responsibility for the position giving rise to the understatement. Thus, R is a tax return preparer for purposes of section 6694. R, however, will not be subject to a penalty under section 6694.

Reasonable Cause and Good Faith

Even if the IRS were to determine the position failed the more likely than not test, there still is an exception to the penalty available to the preparer. Proposed Regulation §1.6694-3(d) begins:

(d) Exception for reasonable cause and good faith. The penalty under section 6694(a) will not be imposed if, considering all the facts and circumstances, it is determined that the understatement was due to reasonable cause and that the tax return preparer acted in good faith.

The proposed regulations give a list of factors that can be considered.

(1) Nature of the error causing the understatement. The error resulted from a provision that was complex, uncommon, or highly technical and a competent tax return preparer of tax returns or claims for refund of the type at issue reasonably could have made the error. The reasonable cause and good faith exception, however, does not apply to an error that would have been apparent from a general review of the return or claim for refund by the tax return preparer.

This factor seems to be looking at the “good faith” portion of the exception—that the preparer simply ended up with the wrong answer not due to bad intention or intentional

disregard of the rules, but just because the area in question was complex.

(2) Frequency of errors. The understatement was the result of an isolated error (such as an inadvertent mathematical or clerical error) rather than a number of errors. Although the reasonable cause and good faith exception generally applies to an isolated error, it does not apply if the isolated error is so obvious, flagrant, or material that it should have been discovered during a review of the return or claim for refund. Furthermore, the reasonable cause and good faith exception does not apply if there is a pattern of errors on a return or claim for refund even though any one error, in isolation, would have qualified for the reasonable cause and good faith exception.

In this case, the IRS is noting that the penalty won't apply to isolated errors that are not so egregious or frequent that it appears there is a lack of concern about quality control.

(3) Materiality of errors. The understatement was not material in relation to the correct tax liability. The reasonable cause and good faith exception generally applies if the understatement is of a relatively immaterial amount. Nevertheless, even an immaterial understatement may not qualify for the reasonable cause and good faith exception if the error or errors creating the understatement are sufficiently obvious or numerous.

As well, the existence of an immaterial error will generally be considered excusable, even if the position fails to meet the more likely than not standard. The IRS understands that requiring preparers to thoroughly research positions that have no significant impact on taxes would make tax preparation prohibitively expensive with little benefit to the Treasury.

(4) Tax return preparer's normal office practice. The tax return preparer's normal office practice, when considered together with other facts and circumstances, such as the knowledge of the tax return preparer, indicates that the error in question would rarely occur and the normal office practice was followed in preparing the return or claim for refund in question. Such a normal office practice must be a system for promoting accuracy and consistency in the preparation of returns or claims for refund and generally would include, in the case of a signing tax return preparer, checklists, methods for obtaining necessary information from the taxpayer, a review of the prior year's return, and review procedures. Notwithstanding these rules, the reasonable cause and good faith exception does not apply if there is a flagrant error on a return or claim for refund, a pattern of errors on a return or claim for refund, or a repetition of the same or similar errors on numerous returns or claims for refund.

The firm's system of quality control for tax practice is a defense against the penalty. Note that the IRS indicates that such a system should include checklists, methods for obtaining information from the taxpayer (such as organizers), a review of prior year returns and other review procedures. It would seem reasonable to presume that the IRS would interpret the

lack of such items to be a negative in the decision making process for applying this penalty.

(5) Reliance on advice of others. For purposes of demonstrating reasonable cause and good faith, a tax return preparer may rely without verification upon advice and information furnished by the taxpayer or other party, as provided in § 1.6694-1(e). The tax return preparer may reasonably rely in good faith on the advice of, or schedules or other documents prepared by, the taxpayer, another advisor, another tax return preparer, or other party (including another advisor or tax return preparer at the tax return preparer's firm), and who the tax return preparer had reason to believe was competent to render the advice or other information. The advice or information may be written or oral, but in either case the burden of establishing that the advice or information was received is on the tax return preparer. A tax return preparer is not considered to have relied in good faith if --

(i) The advice or information is unreasonable on its face;

(ii) The tax return preparer knew or should have known that the other party providing the advice or information was not aware of all relevant facts; or

(iii) The tax return preparer knew or should have known (given the nature of the tax return preparer's practice), at the time the return or claim for refund was prepared, that the advice or information was no longer reliable due to developments in the law since the time the advice was given.

Preparers can rely on other preparers, so long as that reliance is reasonable.

(6) Reliance on generally accepted administrative or industry practice. The tax return preparer reasonably relied in good faith on generally accepted administrative or industry practice in taking the position that resulted in the understatement. A tax return preparer is not considered to have relied in good faith if the tax return preparer knew or should have known (given the nature of the tax return preparer's practice), at the time the return or claim for refund was prepared, that the administrative or industry practice was no longer reliable due to developments in the law or IRS administrative practice since the time the practice was developed.

This exception recognizes reality—sometimes, to aid in administration of the tax law, the IRS and other taxing agencies don't force taxpayers to strictly follow the rules per the letter of the law when to do so would not be cost effective either for the taxpayer or the taxing agency. Such administrative practice rules have been recognized in FIN48 for financial reporting, and now the IRS has given a nod to this practice in applying the Section 6694 penalties.

However, preparers looking to make use of this provision need to remain aware of whether such a practice is still in place, and it would seem reasonable that the preparer would want

to document some rationale for the belief that practice was as the item was reported.

Burden of Proof

Because the preparer is in the position to show the reasonableness of his/her position, it's not surprising the IRS holds the preparer has the burden of proof. Proposed Regulation §1.6694-2(e) provides:

- (e) Burden of proof. In any proceeding with respect to the penalty imposed by section 6694(a), the issues on which the tax return preparer bears the burden of proof include whether --
- (1) The tax return preparer knew or reasonably should have known that the questioned position was taken on the return;
 - (2) There is reasonable cause and good faith with respect to such position; and
 - (3) The position was disclosed adequately in accordance with paragraph (c) of this section.

Reckless or Intentional Disregard

Under Proposed Regulation §1.6694-3(c)(2) deals with intentional disregard, and breaks the rule into two pieces for avoiding the application. If the matter involves Code or Regulation, §1.6694-3(c)(2) gives the details for avoiding the penalty with requires disclosure in all cases.

- (2) A tax return preparer is not considered to have recklessly or intentionally disregarded a rule or regulation if the position contrary to the rule or regulation has a reasonable basis as defined in § 1.6694-2(c)(2) and is adequately disclosed in accordance with § 1.6694-2(c)(3). In the case of a position contrary to a regulation, the position must represent a good faith challenge to the validity of the regulation and, when disclosed in accordance with § 1.6694-2(c)(3), the tax return preparer must identify the regulation being challenged. For purposes of this section, disclosure on the return in accordance with an annual revenue procedure under § 1.6662-4(f)(2) is not applicable.

Contrast this with the rule for matters that are contrary to a Revenue Ruling or Notice:

- (3) In the case of a position contrary to a revenue ruling or notice (other than a notice of proposed rulemaking) published by the Internal Revenue Service in the Internal Revenue Bulletin, a tax return preparer also is not considered to have recklessly or intentionally disregarded the ruling or notice if the tax return preparer reasonably believes that the position would more likely than not be sustained on its merits in accordance with § 1.6694-2(b).

The IRS gives examples of applying this standard:

Example 1. A taxpayer provided Preparer S with detailed check registers reflecting personal and business expenses. One of the expenses was for domestic help, and this expense was identified as personal on the check register. S knowingly deducted the expenses of the taxpayer's domestic help as wages paid in the taxpayer's business. S is subject to the penalty under section 6694(b).

Example 2. A taxpayer provided Preparer T with detailed check registers to compute the taxpayer's expenses. T, however, knowingly overstated the expenses on the return. After adjustments by the examiner, the tax liability increased significantly. Because T disregarded information provided in the check registers, T is subject to the penalty under section 6694(b).

Example 3. Preparer U prepares a taxpayer's return and encounters certain expenses incurred in the purchase of a business. Final regulations provide that such expenses incurred in the purchase of a business must be capitalized. One U.S. Tax Court case has expressly invalidated that portion of the regulations. Under these facts, U will have a reasonable basis for the position as defined in § 1.6694-2(c)(2) and will not be subject to the section 6694(b) penalty if the position is adequately disclosed in accordance with paragraph (c)(2) of this section because the position represents a good faith challenge to the validity of the regulations.

What Are Rules and Regulations?

For purposes of §6694(b), the term “rules and regulations” is defined in Proposed Regulation §1.6694-3(e) as follows:

(e) 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.

For purposes of this paragraph, there shall be excluded from consideration employees described in subparagraph (A) or (C) of section 410(b)(3). For purposes of any arrangement described in subsection (k)(6), any employee who is eligible to have employer contributions made on the employee's behalf under such arrangement shall be treated as if such a contribution was made.

Who is a Tax Return Preparer?

Since all of the above penalties apply only to tax return preparers, a key regulation that is

found later in this set of proposed regulations is Proposed Regulation §301.7701-15, which establishes new criteria for who is a preparer, especially a nonsigning preparer.

The general definition is found at Proposed Regulation §301.7701-15(a) which provides:

(a) In general. A tax return preparer is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any return of tax or any claim for refund of tax under the Internal Revenue Code (Code).

The simpler definition is the one for a signing preparer, since that person is very simply the one that signs the return. That definition is found in Proposed Regulation §301.7701-15(b)(1) which holds:

(b) Definitions -- (1) Signing tax return preparer. A signing tax return preparer is any tax return preparer who signs or who is required to sign a return or claim for refund as a tax return preparer pursuant to § 1.6695-1(b) of this chapter.

For nonsigning preparers things get more complicated. But it's important to note at this point that while we'll discuss *de minimus* exceptions for the nonsigning preparer, no such exception exists for the signing preparer.

To deal with nonsigning preparers, we start with the beginning of the definition at Proposed Regulation §301.7701-15(b)(2) which holds:

(2) Nonsigning tax return preparer -- (i) In general. A nonsigning tax return preparer is any tax return preparer who is not a signing tax return preparer but who prepares all or a substantial portion of a return or claim for refund within the meaning of paragraph(b)(3) of this section with respect to events that have occurred at the time the advice is rendered.

Note that, again, the advice must be for prior events—if the advice relates to a proposed transaction and no post transaction advice is given, the person is not a preparer even if the item in question actually ends up reported on the return.

The first *de minimus* exception covers that person called in prior to the transaction who does some minimal amount of work (such as answering a phone question) after the transaction takes place. The IRS creates a 5% rule in this case as we continue reading in the Proposed Regulation:

In determining whether an individual is a nonsigning tax return preparer, time spent on advice that is given after events have occurred that represents less than 5 percent of the aggregate time incurred by such individual with respect to the position(s) giving rise to the understatement shall not be taken into account.

The IRS next gives us examples of the application of these rules (ignoring the fact that, for now, we don't have a definition of what constitutes a “substantial portion”). These examples, found at Proposed Regulation §301.7701-15(b)(2)(ii), read as follows:

(ii) Examples. The provisions of this paragraph (b)(2) are illustrated by the following examples:

Example 1. Attorney A, an attorney in a law firm, provides legal advice to a large corporate taxpayer regarding a completed corporate transaction. The advice provided by A is directly relevant to the determination of an entry on the taxpayer's return and this advice constitutes a substantial portion of the return. A, however, does not prepare any other portion of the taxpayer's return and is not the signing tax return preparer of this return. A is considered a tax return preparer.

Example 2. Attorney B, an attorney in a law firm, provides legal advice to a large corporate taxpayer regarding the tax consequences of a proposed corporate transaction. Based upon this advice, the corporate taxpayer enters into the transaction. Once the transaction is completed, the corporate taxpayer does not receive any additional advice from B with respect to the transaction. B did not provide advice with respect to events that have occurred and is not considered a tax return preparer.

Example 3. The facts are the same as Example 2, except that Attorney B provides supplemental advice to the corporate taxpayer on a phone call after the transaction is completed. The time incurred on this supplemental advice by B represented less than 5 percent of the aggregate amount of time spent by B providing tax advice on the position. B is not considered a tax return preparer.

Again, to make use of the 5% rule, good contemporaneous records need to be kept by the person providing advice to show the time involved in providing the advice, and how much took place prior to the transaction taking place.

Another key term is the question of what is a substantial portion of a return can become a nonsigning preparer, so the definition of that term becomes extremely important for all potential nonsigning preparers (which is essentially all of us). Proposed Regulation §301.7701-15(b)(3). The general definition of a substantial portion reads as follows:

(3) Substantial portion. (i) Only a person who prepares all or a substantial portion of a return or claim for refund shall be considered to be a tax return preparer of the return or claim for refund. A person who renders tax advice on a position that is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund will be regarded as having prepared that entry. Whether a schedule, entry, or other portion of a return or claim for refund is a substantial portion is determined based upon whether the person knows or reasonably should know that the tax attributable to the schedule, entry, or other portion of a return or claim for refund is a substantial portion of the tax required to be shown on the return or claim for refund. A single tax entry may constitute a substantial portion of the tax required to be shown on a return. Factors

to consider in determining whether a schedule, entry, or other portion of a return or claim for refund is a substantial portion include but are not limited to --

(A) the size and complexity of the item relative to the taxpayer's gross income; and

(B) the size of the understatement attributable to the item compared to the taxpayer's reported tax liability.

It is important to note that the nonsigning preparer needs to either be aware this was a substantial item or reasonably should have been so aware. As well, the regulation makes clear that if the advice is limited to a single line item on a return, it may nevertheless rise to the level of substantial.

However, the IRS gives us another set of *de minimus* rules that are available to a nonsigning preparer to avoid being subject to the \$6694 penalty. Those rules, found in Proposed Regulation §301.7701-15(b)(3)(ii)(A), give us the following potential exceptions:

(ii)(A) For purposes of applying the rules of paragraph (b)(3)(i) of this section to a nonsigning tax return preparer within the meaning of paragraph (b)(2) of this section only, if the schedule, entry, or other portion of the return or claim for refund involves amounts of gross income, amounts of deductions, or amounts on the basis of which credits are determined that are --

(1) Less than \$10,000; or

(2) Less than \$400,000 and also less than 20 percent of the gross income as shown on the return or claim for refund (or, for an individual, the individual's adjusted gross income), then the schedule or other portion is not considered to be a substantial portion.

It's useful to note that these exceptions carve out different classes of returns. Returns with gross income (or, for individuals, adjusted gross income) of less than \$10,000 cannot have a nonsigning preparer (not a huge advantage), for returns with adjusted gross income of less than \$50,000 only items of more than \$10,000 are going to be able to have nonsigning preparers (again, not likely to be very many), for those with gross income from \$50,000 to \$2,000,000 the 20% limit will apply, while for those with gross income above \$2,000,000 \$400,000 will be the trigger level.

For most practitioners in local practices, it's not likely that many returns will end up with nonsigning preparers who could be subject to this penalty. However, remember that signing preparers are not covered by these exceptions—so a signing preparer could still face a \$6694 penalty on a return with gross income of less than \$10,000.

However, it should be noted that we do have to aggregate the total of all items affected by

a preparer's advice in determining the question of whether the nonsigning preparer can utilize the *de minimus* exception [Proposed Regulation §301.7701-15(c)(3)(ii)(B)].

Preparers of pass through entity returns can become nonsigning preparers of the ultimate taxpayers' returns, per Proposed Regulation §301.7701-15(c)(3)(iii), which notes:

(iii) A tax return preparer with respect to one return is not considered to be a tax return preparer of another return merely because an entry or entries reported on the first return may affect an entry reported on the other return, unless the entry or entries reported on the first return are directly reflected on the other return and constitute a substantial portion of the other return. For example, the sole preparer of a partnership return of income or small business corporation income tax return is considered a tax return preparer of a partner's or a shareholder's return if the entry or entries on the partnership or small business corporation return reportable on the partner's or shareholder's return constitute a substantial portion of the partner's or shareholder's return.

Given that, in general, preparers are allowed to “reasonably rely” on the work of another preparer, preparers of K-1s will likely be the nonsigning preparer for their entries as reflected on the owner's return if the amounts clear the *de minimus* levels for that owner.

The IRS provides the following examples of the application of these proposed provisions:

(iv) Examples. The provisions of this paragraph (b)(3) are illustrated by the following examples:

Example 1. Accountant C prepares a Form 8886, "Reportable Transaction Disclosure Statement", that is used to disclose reportable transactions. C does not prepare the tax return or advise the taxpayer regarding the tax return reporting position of the transaction to which the Form 8886 relates. The preparation of the Form 8886 is not directly relevant to the determination of the existence, characterization, or amount of an entry on a tax return or claim for refund. Rather, the Form 8886 is prepared by C to disclose a reportable transaction. C has not prepared a substantial portion of the tax return and is not considered a tax return preparer under section 6694.

Example 2. Accountant D prepares a schedule for an individual taxpayer's Form 1040, "U.S. Individual Income Tax Return", reporting \$4,000 in dividend income and gives oral or written advice about Schedule A, which results in a claim of a medical expense deduction totaling \$5,000, but does not sign the tax return. D is not a tax return preparer because the total aggregate amount of the deductions is less than \$10,000.

The IRS defines a return in Proposed Regulation §301.7701-15(b)(4)(i), which gives us the following guidance:

(4) Return and claim for refund -- (i) Return. For purposes of this section, a return

of tax is a return (including an amended or adjusted return) filed by or on behalf of a taxpayer reporting the liability of the taxpayer for tax under the Code, if the type of return is identified in published guidance in the Internal Revenue Bulletin. A return of tax also includes any information return or other document identified in published guidance in the Internal Revenue Bulletin, and that reports information that is or may be reported on another taxpayer's return under the Code if the information reported on the information return or other document constitutes a substantial portion of the taxpayer's return within the meaning of paragraph (b)(3) of this section.

Currently Notice 2008-13 (as modified) contains the list of “returns” for §6694 purposes. The Proposed Regulation indicates that such a list, updated every so often, will continue to be used to define what is covered by this provision.

A similar provision is used to define a claim for refund for other penalty purposes. That definition, found at Proposed Regulation §301.7701-15(b)(4)(ii) reads as follows:

(ii) Claim for refund. For purposes of this section, a claim for refund of tax includes a claim for credit against any tax that is included in published guidance in the Internal Revenue Bulletin. A claim for refund also includes a claim for payment under section 6420, 6421, or 6427.

If you tell the client where to “fill in the blanks” or have someone else fill in the blanks after you've essentially done all of the heavy lifting, you are still a tax return preparer even though you never actually touched the return. Proposed Regulation §301.7701-15(c) provides:

(c) Mechanical or clerical assistance. A person who furnishes to a taxpayer or other tax return preparer sufficient information and advice so that completion of the return or claim for refund is largely a mechanical or clerical matter is considered a tax return preparer, even though that person does not actually place or review placement of information on the return or claim for refund. See also paragraph (b)(3) of this section.

The reference to (b)(3) is meant to remind preparers of the nonsigning preparation of a substantial portion of a return, a standard that would also serve to cause these returns to be considered prepared by the preparer noted above—in fact, arguably the above is more of an emphasis of the position that the IRS isn't going to mess with those who try and come up with “cute” ways out of being the preparer, and to clarify that “assisting” a person in finishing their return can very well turn the person into a preparer.

The preparer penalties apply to all preparers, not just those who are authorized to practice before the IRS. Proposed Regulation §301.7701-15(d) notes that:

(d) Qualifications. A person may be a tax return preparer without regard to educational qualifications and professional status requirements.

Anyone that prepares a return, even if not a CPA, EA or attorney may still be penalized

under the preparer penalty rules.

Proposed Regulation §301.7701-15(e) makes clear that locating outside the United States won't remove an individual from being a preparer subject to these rules, and entities located outside the United States who hire individuals to function as tax return preparers will, regardless of any other factor, be required to obtain an employer identification number.

Finally, Proposed Regulation §301.7701-15(f) provides a list of individuals who are deemed not to be tax return preparers. That list includes, among others:

- IRS employees performing their official duties
- VITA volunteers for returns prepared under the VITA program
- Organizations sponsoring or administering VITA programs with respect to that program
- Certain tax assistance clinics authorized by the IRC
- Individuals providing only typing, reproduction or other mechanical assistance in preparation
- Employees who are preparing the return of their employer
- Fiduciaries preparing the trust or estate return for a trust or estate of which the person or entity is a fiduciary
- Persons preparing claims for refund for a taxpayer in response to notice of deficiency or a waiver of restriction on assessment after initiation of an audit
- A person who prepares a return or claim for refund for a taxpayer with no explicit or implicit agreement for compensation, even if the person receives an insubstantial gift, return service, or favor

The IRS gives the following two examples of applying these rules:

(6) Examples. The mechanical assistance exception described in paragraph (f)(1)(viii) of this section is illustrated by the following examples:

Example 1. A reporting agent received employment tax information from a client from the client's business records. The reporting agent did not render any tax advice to the client or exercise any discretion or independent judgment on the client's underlying tax positions. The reporting agent processed the client's information, signed the return as authorized by the client pursuant to Form 8655, Reporting Agent Authorization, and filed the client's return using the information supplied by the client. The reporting agent is not a tax return preparer.

Example 2. A reporting agent rendered tax advice to a client on determining whether its workers are employees or independent contractors for Federal tax

purposes. For compensation, the reporting agent received employment tax information from the client, processed the client's information and filed the client's return using the information supplied by the client. The reporting agent is a tax return preparer.

Overview

These proposed regulations will not become effective until December 31, 2008 at the earliest, so until then we will continue to work under Notice 2008-13 (as clarified). As well, these regulations in most cases work the same as Notice 2008-13. A most significant change is the removal of the “one preparer per firm” standard, and its replacement with a “one preparer per position” standard.