Tax and Accounting Center

Tax Management Memorandum
2009
03/30/2009
MEMORANDUM

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The New and Improved Section 6694 Tax Return Preparer Penalty

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On May 25, 2007, Congress amended §6694 to raise the penalty standards for tax return preparers (the "2007 Amendment"). [2] The 2007 Amendment was met by criticism in the practitioner community, primarily because the amendment — which required preparers to have a reasonable belief that a position is more likely than not correct — created a higher standard for preparers than for taxpayers under §6662, which generally requires taxpayers to have substantial authority to avoid a penalty with respect to non-tax shelter transactions. [3] After the 2007 Amendment, Treasury issued a series of notices and proposed regulations interpreting and clarifying the operation of §6694, [4] but this guidance could not correct the inconsistency between the tax practitioner and the taxpayer penalty standards. Congress stepped in, and on October 3, 2008, a new amendment to §6694 (the "2008 Amendment") was enacted. [5] The 2008 Amendment reduced the general return preparer penalty standard to substantial authority, although it retained a reasonable belief/more likely than not standard for tax shelter transactions, and re-established the parity between the penalty standards for return preparers under §6694 and for taxpayers under §6662. This article discusses the facets of the new preparer penalty, including who it affects, the standards governing conduct, and the preparer's ability to rely on information and advice from others in preparing returns.

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[2] *See* §8246, U.S. Troops Readiness, Veterans Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007, P.L. 110-28 (2007). Related and conforming changes were also made to §§6695, 6696 and 7701(a)(36). All section references herein are to the Internal Revenue Code, as amended, and the regulations promulgated thereunder, unless otherwise noted.

[3] *See American Bar Association Tax Section Comments on Changes to Standards for Imposition of Certain Penalties* (Nov. 15, 2007) and *New York State Bar Association Tax Section Report on the Definition of Tax Return Preparer and Other Issues Under Code Sections 6694, 6695 and 7701(a)(36)* (Dec. 20, 2007).

[4] Notice 2008-11, 2008-3 I.R.B. 279; Notice 2008-12, 2008-3 I.R.B. 280; Notice 2008-46, 2008-18 I.R.B. 868; and REG-129243-07, 73 Fed. Reg. 34560 (6/17/08).

[5] §506(a), (b) of the Emergency Economic Stabilization Act of 2008, P.L. 110-343, 122 Stat. 3765 (2008). The changes made by the 2008 Amendment to the non-tax shelter provisions of §6694 are retroactive to the date of the 2007 Amendment and apply to returns prepared after May 25, 2007. The changes to the tax shelters provisions of §6694 apply to returns prepared for taxable years ending after Oct. 3, 2008.

THE NEW PREPARER PENALTY UNDER §6694(a)

Section 6694(a) [6] imposes a penalty equal to the greater of $1,000 or 50% of the income derived (or to be derived) by a preparer with respect to a return or claim if there is an understatement due to an "unreasonable position" of which the preparer knew or should have known. For understatements arising from non-tax shelter items, a position is an "unreasonable position" unless it is supported by: (1) substantial authority; or (2) a reasonable basis *and* the position was "adequately disclosed." For understatements arising from tax shelters or reportable transactions, a position is an "unreasonable

position" *unless* it was reasonable to believe that the position was more likely than not correct. In either case, the penalty can be avoided if the preparer can show reasonable cause and good faith.

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[6] In addition, §6694(b) imposes a penalty equal to the greater of $5,000 or 50% of the income derived (or to be derived) by a preparer with respect to the return or claim if there is an understatement on the return or claim that is attributable to (1) a willful attempt in any manner to understate the liability for tax by a person who is an income tax return preparer with respect to such return or claim, or (2) any reckless or intentional disregard of rules or regulations by any such person. The standard for imposition of this penalty was not changed in either the 2007 or 2008 Amendments, although the amount of the penalty was increased significantly.

Definition of a "Tax Return Preparer"

For purposes of §6694, a "tax return preparer" is any person who is primarily responsible for the position(s) on a return giving rise to an understatement, and who is defined as a "tax return preparer" under Regs. §301.7701-15, [7] which defines that term as "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 claim for refund..."

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[7] Regs. §1.6694-1(b)(1).

Substantial Portion of Any Tax Return Or Claim for Refund

Before discussing the meaning of a "substantial portion" of a return or claim for refund, it is important to note a significant change in the scope of §6694. Prior to the 2007 Amendment, §6694 applied only to income tax return preparers. Now, §6694 applies to preparers of many kinds of tax returns and "other documents." [8] Rev. Proc. 2009-11 lists the returns and claims for refund that now are subject to §6694, including most income tax, estate and gift tax, employment tax, and miscellaneous excise tax returns. Moreover, a person may become a "tax return preparer" by preparing a document that is not a tax return. Rev. Proc. 2009-11 provides that preparation of documents other than tax returns, such as depreciation schedules and cost allocation studies may subject a person to §6694 if they affect an entry that is a substantial portion of the tax return. [9] This rule was designed to bring professionals, such as appraisers and transfer pricing experts, under the scope of §6694. The breadth of Rev. Proc. 2009-11 may sweep others in as well, such as a bookkeeper who prepares a schedule that affects a substantial portion of another taxpayer's return.

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[8] Regs. §1.6694-1(a).

[9] Rev. Proc. 2009-11, §3.03(3).

A person who signs or gives advice with respect to a substantial portion of an information return may become a preparer of another return if the entries reported on the information return are directly reflected on, and constitute a portion of, the other return. [10] For example, a practitioner who advises on a partnership return, and who knows or has reason to know that amounts reported on the Form 1065 will constitute a substantial portion of the individual partners' returns, will be considered a preparer of those partners' returns. Thus, a preparer of a partnership return could be deemed a preparer of a partner's return even though the preparer has no professional or contractual relationship with the partner if the preparer knew or had reason to know that the K-1 would affect a substantial portion of the partner's return.

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[10] Regs. §301.7701-15(b)(3)(iii).

Factors to consider in determining whether a portion of the return is "substantial" include the size and complexity of the portion or item in question in comparison with the taxpayer's gross income, and the size of the understatement at issue in comparison with the taxpayer's reported liability. [11] There is a de minimis safe-harbor for non-signing tax return preparers where the item involves amounts of gross income, deductions, or amounts on the basis of which credits are determined, of less than $10,000, or less than $400,000, and also less than 20% of the gross income shown on the return. [12] If more than one schedule, entry or portion of a return is involved, all such schedules, entries and portions must be

aggregated in determining whether the safe-harbor applies. [13]

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[11] Regs. §301.7701-15(b)(3)(i).

[12] Regs. §301.7701-15(b)(3)(ii)(A).

[13] Regs. §301.7701-15(b)(3)(ii)((B).

Tax Planners v. Tax Return Preparers

The regulations distinguish between tax planners, who advise clients on transactions before they occur, and non-signing tax return preparers who advise clients on how to report a completed transaction. Some commentators were concerned that tax planners would be discouraged from confirming the accuracy of their advice after a transaction had closed, but before it was reported on a tax return. Treasury recognized this concern and promulgated an exception for relatively small amounts of post-transactional advice. Specifically, time spent on post-transactional advice that is less than 5% of the aggregate time spent by the tax planner will not be considered in determining whether the tax planner is a return preparer. This exception does not apply if the planner gave the advice before the events occurred as part of a plan to avoid being classified as a tax return preparer. [14]

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[14] Regs. §301.7701-15(b)(2).

Signing and Non-Signing Preparers

The §6694 regulations create two types of preparers: signing and non-signing preparers. The signing preparer has primary responsibility for the overall substantive accuracy of the return, and, therefore, is required to sign the return. [15] A non-signing preparer is any person who is not a signing preparer but who prepares all or a substantial portion of a return by giving advice (written or oral) with respect to events that have already occurred at the time the advice is given. [16]

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[15] Regs. §§1.6695-1(b)(2) and 301.7701-15(b)(1).

[16] Regs. §301.7701-15(b)(2)(1).

Commentators have expressed concern that it is possible for an advisor to become a "tax return preparer" without ever having seen the tax return. To avoid this problem, the regulations now provide that a non-signing preparer will be deemed a "tax return preparer" only if the preparer *knew or had reason to know* that the advice related to a schedule, entry or other portion of a return that is a substantial portion of the tax required to be shown on the return. [17]

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[17] Regs. §301.7701-15(b)(3)(i).

Additional complexities arise when one practitioner employs other practitioners to prepare returns. The regulations provide that there is only one practitioner within each firm who is primarily responsible for each position on a return [18] — usually, the signing preparer. [19] However, when there are also non-signing preparers within the firm, the person who is primarily responsible for the particular position at issue is considered the preparer of that position. [20] When the Service cannot determine who is primarily responsible for the position, or when there are several non-signing preparers within a firm and there is no signing preparer, the person with "overall supervisory responsibility" for the position within the firm is considered the preparer of the position. [21]

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[18] Regs. §1.6694-1(b)(1).

[19] Regs. §1.6694-1(b)(2).

[20] Regs. §1.6694-1(b)(3).

[21] *Id.*

The regulations' failure to define "overall supervisory responsibility" creates uncertainty and may be problematic because a practitioner could be deemed to be a preparer based on the practitioner's level of seniority or responsibility within a firm even though that practitioner never even saw the position at

issue. For example, the head of a law firm's tax department may have "overall supervisory responsibility" for all tax opinions issued by the firm, but may be unaware of an error in an associate's advice regarding a particular return.

STANDARDS FOR TAX RETURN PREPARERS UNDER §6694 FOR NON-TAX SHELTER ITEMS

Substantial Authority

Once the tax return preparer has been identified, the next issue is the appropriate standard of conduct for imposition of penalties. As described above, the 2008 Amendment lowered the penalty standard for non-tax shelter transactions to substantial authority. Notice 2009-5 provides that, until further guidance is issued, "substantial authority" shall have the same meaning for purposes of §6694 as it does for §6662. The substantial authority standard is an objective standard and is higher than the reasonable basis standard used for the taxpayer negligence penalty but lower than the more likely than not standard. [22]

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[22] Regs. §1.6662-4(d)(2).

Regulations under §6662 specifically list the types of legal authority which may be regarded as substantial authority, the way in which the authorities should be analyzed and balanced against each other, and the weight to be accorded each authority. [23] In general, there is substantial authority for a position if the weight of authorities supporting a position is substantial in relation to the weight of contrary authorities. [24]

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[23] Regs. §1.6662-4(d)(3).

[24] Regs. §1.6662-4(d)(3)(i).

Cases involving legal issues likely will be straightforward because they will only require an evaluation of the authorities for and against a particular position. However, most understatements do not arise from cases involving purely legal issues, but are based on factual questions, such as, for example, whether the taxpayer had a profit motive or whether an investment constituted debt or equity. It is not clear how the substantial authority standard will apply to these types of factual issues because the regulations define "substantial authority" by reference only to legal authorities

Only a few cases have addressed the application of the substantial authority standard to factual issues. First, in *Osteen v. Comr.*, [25] the Eleventh Circuit reversed a Tax Court decision imposing a substantial understatement penalty on taxpayers engaged in a horse breeding operation. The Tax Court found that the taxpayers did not have the profit motive necessary to deduct the operation's expenses, and upheld the substantial understatement penalty. On appeal, the Eleventh Circuit discussed the lack of guidance on how the substantial authority standard should be applied to factual issues. The Court reasoned that it is appropriate to evaluate the taxpayer's "evidence," as opposed to "authority" and, if the taxpayer had proffered an amount of evidence that would have been sufficient to avoid reversal under a clearly erroneous standard, the taxpayer had substantial authority for the position. Ultimately, the Court found that the taxpayer had proffered sufficient evidence of his profit motive to avoid a reversal under a clearly erroneous standard, and, therefore, there was "substantial authority" for the position. [26]

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[25] 62 F.3d 356 (11th Cir. 1995).

[26] *See also Streber v. Comr.*, 138 F.3d 216 (5th Cir. 1998) (holding that taxpayer had presented substantial factual evidence that transfer of property was a gift and, therefore, no substantial understatement penalty should be imposed).

The Sixth Circuit reached a somewhat different conclusion in *Kluener Est. v. Comr.*, [27] where the issue was whether the taxpayer had a non-tax business purpose for transferring certain appreciated assets to a wholly-owned corporation so that gain on the sale of the assets could be offset by the corporation's net operating losses. The Tax Court found that the taxpayer did not have a non-tax business purpose, and upheld the substantial understatement penalty. On appeal, the Sixth Circuit analyzed whether the taxpayer had substantial authority for treating the corporation as the owner of the assets even though the Tax Court had already determined that there was no business purpose for the transfer. The Sixth Circuit generally agreed with the decision in *Osteen* that factual evidence can

constitute substantial authority, but disagreed with *Osteen*'s analysis of the meaning of "substantial," on the ground that "'substantial authority' requires a taxpayer to present considerable or ample authority," not merely "some evidence." [28] The Sixth Circuit found that the taxpayer had presented "considerable" factual evidence of a valid, non-tax business purpose, and, therefore, had substantial authority for purposes of avoiding the substantial understatement penalty.

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[27] 154 F.3d 630 (6th Cir. 1998).

[28] 154 F.3d at 639.

In contrast, in *Long Term Capital Holdings v. U.S.*, [29] a federal district court rejected the holdings in *Osteen* and *Kleuner* and held that it would not consider factual evidence in determining whether a taxpayer had substantial authority for a position. The court found that the taxpayer did not have a business purpose for the transaction at issue, and there were no *legal* authorities supporting the taxpayer's position absent a business purpose. The court found that the §6662 regulations unambiguously define authority to include only legal authorities and do not permit "consideration as authority rejected evidence offered by the taxpayer, even in cases in which the merits of the taxpayer's tax liability and the threshold application of a substantial understatement penalty are decided jointly merely by making fact findings." [30]

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[29] 330 F. Supp.2d 122 (D. Conn. 2004).

[30] 330 F. Supp.2d. at 203.

These decisions highlight the difficulty that return preparers may face in applying the substantial authority standard in daily practice. In contrast to a taxpayer who has first-hand knowledge of the relevant facts, a return preparer, in most cases, must rely on the taxpayer's representations. The penalty analysis thus should focus on what the return preparer actually knew (or should have known), and whether he or she performed adequate due diligence and reasonably relied on the taxpayer's representations.

Reasonable Basis and Adequate Disclosure

Section 6694(a)(2)(B) also provides that prepares will not be subject to the §6694 penalty for understatements arising from non-tax shelter positions that have a reasonable basis and are adequately disclosed.

First, the regulations define "reasonable basis" by reference to Regs. §1.6662-3(b)(3) which provides that a return position that is based on one or more of the authorities listed in the §6662 regulations concerning substantial authority will generally satisfy the reasonable basis standard, even though it may not satisfy the substantial authority standard. [31] However, the reasonable basis standard is not satisfied by a return position that is merely an arguable or colorable claim. [32]

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[31] Regs. §1.6694-2(d)(2).

[32] Regs. §1.6662-3(b)(3).

The regulations also contain detailed rules defining adequate disclosure under §6694. Under these rules, "disclosure" means disclosure from the preparer to the client regarding applicable penalty standards as opposed to disclosure from the preparer to the Service of a particular return position. This method of disclosure shows Treasury's acknowledgment of the fact that a tax return preparer is not primarily responsible for the taxpayer's tax return, and does not control the taxpayer's disclosures to the Service.

Signing preparers may make adequate disclosure with respect to non-tax shelter positions by (i) complying with Regs. §1.6662-4(f) which provides for the filing of a Form 8275 or making proper disclosure on the return in accordance with the applicable revenue procedures, (ii) by providing the taxpayer with a completed tax return that contains the disclosure outlined in Regs. §1.6662-4(f), or (iii) for returns that are subject to penalties other than the §6662(b)(2) substantial understatement penalty, by advising the taxpayer of the applicable §6662 penalty standards and contemporaneously documenting such advice. [33] Non-signing preparers may make adequate disclosure with respect to non-tax shelter positions (i) by making the disclosure outlined in Regs. §1.6662-4(f), (ii) by advising

the taxpayer of any opportunity to avoid §6662 penalties that could apply, the standards for disclosure if applicable, and contemporaneously documenting such advice, or, (iii) in cases involving advice given to other return preparers, by advising the other return preparer that disclosure under §6694(a) may be required, and contemporaneously documenting such advice. [34]

[33] Regs. §1.6694-2(d)(3)(i).

[34] Regs. §1.6694-2(d)(3)(ii).

The regulations do not outline the exact words the preparer should use when making disclosure to the client or another preparer. This raises a question of how detailed and concrete the disclosure must be. And, it is not certain whether the disclosure can be used against a taxpayer on audit as evidence of the weakness of the position, or whether the disclosure constitutes an admission by a practitioner that he or she is a tax return preparer.

STANDARDS FOR TAX RETURN PREPARERS UNDER §6694 FOR TAX SHELTER ITEMS

Section 6694(a)(2)(C) provides that if an understatement arises from a tax shelter or a reportable transaction, a penalty will be imposed on the return preparer unless "it is reasonable to believe that the position would more likely than not be sustained on its merits." A "tax shelter" is defined in §6662 (d)(2)(C)(iii) as "any partnership, entity, plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax." This definition requires inquiry into the taxpayer's subjective intentions, and, in many cases, a return preparer may not be able to determine why a taxpayer engaged in certain conduct, or to what degree tax reduction influenced the taxpayer's decision to engage in such conduct.

In order to satisfy the reasonable basis/more likely than not standard, the preparer must analyze the facts and authorities and reasonably conclude in good faith that the position has a greater than 50% likelihood of being sustained on its merits. [35] Although §6694 does not provide an exception for adequate disclosure for tax-shelter items, Notice 2009-5 provides that a non-signing preparer who gives advice to another preparer with respect to a tax shelter is not subject to a §6694 penalty if there is substantial authority for the position, and the non-signing preparer makes an adequate disclosure as set forth in the notice. Adequate disclosure requires that the preparer advise the taxpayer that if the transaction is determined to be a tax shelter (other than a listed or reportable transaction), the taxpayer can avoid a penalty only if there is substantial authority for the position reported, and he or she reasonably believed that the position was more likely than not correct. The preparer must also advise the taxpayer that adequate disclosure will not protect the *taxpayer* from a penalty.

[35] Regs. §1.6694-2(b)(1) and (2). The same types of authorities and analysis that are considered for purposes of the substantial authority standard under §6662 apply for purposes of this standard.

TAX RETURN PREPARERS' RELIANCE ON OTHERS

Because many penalty determinations under §6694 may be based on the preparer's knowledge of the underlying facts, the rules regarding a preparer's reliance on the taxpayer and others are very important. For purposes of determining whether a position satisfies the substantial authority and the reasonable belief/more likely than not standards, and for purposes of demonstrating reasonable cause and good faith, a return preparer may rely in good faith without verification upon information furnished by the taxpayer or other party. [36] A preparer is not required to audit or examine or review books and records, business operations, documents or other evidence to independently verify information. However, the preparer may not ignore the implications of information furnished to the preparer or actually known by the preparer, and must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete. [37] A preparer also may rely in good faith and without verification on a previously-filed tax return. For purposes of reasonable cause and good faith standards where the preparer is relying on another practitioner or the taxpayer, a preparer may rely in good faith on advice, or schedules or other documents prepared by the taxpayer or other party only if the preparer has reason to believe the taxpayer or other party was competent to render the advice or provide the information. [38] Further, the burden of establishing that the advice or information was received is on the preparer. A preparer is not considered to have relied in good faith if the advice or information is unreasonable on its face, the preparer knew or should have known that the party

providing the advice or information was not aware of all the relevant facts, or the preparer knew or should have known that the advice or information was, at the time the return was prepared, no longer reliable due to changes in the law since the advice was given.

[36] Regs. §§1.6694-1(e), -2(b), (d)(2).

[37] Regs. §1.6694-1(e) also provides that if a provision of the Code or regulations requires that specific facts or circumstances exist before a deduction or credit may be claimed, the preparer must make appropriate inquires to determine the existence of the required facts or circumstances.

[38] Regs. §1.6694-2(e)(5).

CONCLUSION

The §6694 penalty can apply to a wide array of tax practitioners if their advice turns out to be wrong. Government officials have stated publicly that the penalty is intended to be asserted only in the most egregious cases. However, the authority to assert the penalty will be in the hands of thousands of revenue agents across the country and it will be up to them to decide whether the penalty applies, at least in the first instance. Only time will tell whether a discussion regarding the penalty becomes a routine part of most audits involving a deficiency or whether the specter of the penalty is raised only in cases involving truly egregious conduct. One thing that is certain is that the recent attention on tax return preparer standards already has served to sensitize tax practitioners to the quality of tax return positions and the advisability of disclosing such positions. In the end, this increased focus on quality and transparency is a very positive development for the tax system.

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ISSN Pending

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