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ESTATE PLANNERS AS RETURN PREPARERS

Planners sometimes believe that they are not subject to recently revised federal preparer penalties since they do not prepare or sign returns and merely render advice on tax and family wealth transfer related matters. Under amended Code 6694, a "preparer" need not even see the return leading to assertion of the penalty. For a completed transaction, advice constituting a substantial portion of a single entry on a Form 706, Form 709 or other return is sufficient to possibly subject the planner to penalties for that position.

Proposed regulations (NPRM REG-129243-07) concerning the Code Sec. 6694 return preparer penalties were issued on June 16. In the following analysis, Charles Rettig, Esq. of Hochman, Salkin, Rettig, Toscher & Perez, P.C., Beverly Hills, California presents an overview of these regulations along with expert commentary on their potential ramifications. Mr. Rettig is on the IRS Advisory Council, the National Board of Advisors for the Graduate Tax Program (LL.M. in Taxation) at the NYU School of Law, the Advisory Board of the California Franchise Board, the Board of Advisors for the CCH Journal of Tax Practice and Procedure and is an elected Fellow of the American College of Tax Counsel.

Overview

The Small Business and Work Opportunity Act of 2007 (P.L. No. 110-28, the Small Business Act) amended Code Sec. 6694 to: (1) broaden the scope of the tax return preparer penalties to include preparers of returns and refund claims involving other than income tax, (2) revise the required standards of conduct regarding uncertain "tax positions" to avoid the penalty, and (3) change the computation for the applicable monetary penalties for: (i) understatements due to unreasonable positions under Code Sec. 6694(a) from $250 to the greater of $1,000 or 50 percent of the income derived or to be derived by the return preparer from the preparation of the return or claim, and (ii) understatements due to a willful attempt to understate the tax liability or a reckless disregard or intentional disregard of rules and regulations under Code Sec. 6694(b) from $1,000 to the greater of $5,000 or 50 percent of the income derived or to be derived by the return preparer from the preparation of the return or claim.

Most planners are reasonably familiar with the "standards" that must be satisfied to avoid application of the amended Code Sec. 6694 preparer penalty. For undisclosed positions, amended Code Sec. 6694(a) replaced the "realistic possibility of success" standard with a requirement that the preparer knew (or reasonably should have known) of the position and had a "reasonable belief" that the tax treatment of the position would "more likely than not" be sustained on the merits. "More likely than not" has been the standard under various state regulations for years.

For disclosed positions, amended Code Sec. 6694(a) replaced the "non-frivolous" standard with the requirement that the preparer knew (or reasonably should have known) of the position and had a "reasonable basis" for the tax treatment of the position. Proposed regulations implementing the amendments to Code Sec. 6694 and other related provisions of the Code were recently released. Administration of amended Code Sec. 6694 by the IRS and retraining of IRS personnel will be at least as important as the rules and procedures contained within the proposed regulations

INSIDE

Return Preparer Defined

The term "return preparers" is no longer limited to preparers of income tax returns, but includes both signing preparers and nonsigning preparers, i.e., those who provide substantial advice to the taxpayer or to the signing preparer regarding a position set forth on the return. Return preparers include preparers of estate, gift, generation-skipping transfer (GST), employment and excise tax returns, and returns of exempt organizations (Proposed Reg. §301-7701-15(a)). Applicable returns are identified in Notice 2008-13, IRB 2008-3, 282, and Notice 2008-46, IRB 2008-18, 868, and include variations of Forms 706, 709, 843, 990-PF, 1041, 1041-N, and others.

Planners as Preparers

A "signing preparer" is any preparer who signs or who is required to sign a return or claim for refund (Proposed Reg. §301.7701-15(b)(1)). Planners may become nonsigning preparers if they render advice (written or oral) for a completed transaction that represents a "substantial portion" of the return (Proposed Reg. §301.7701-15(b)(2)). In determining whether a planner is a nonsigning preparer, time spent on advice that is given for a completed transaction that represents less than five percent of the aggregate time incurred by the planner with respect to the position(s) giving rise to the understatement is not relevant. The sole preparer of a fiduciary income tax return may be considered a preparer of the underlying beneficiaries' returns if the entry or entries on the fiduciary return reportable on the beneficiaries' returns constitute a substantial portion of their return (Proposed Reg. §301.7701-15(b)(3)(iii)).

The proposed regulations modify the previous "one preparer per firm" rule whereby the signing preparer—and no other person within the same firm—would be treated as the preparer. The new rule is the "preparer-per-position" rule whereby the individual having primary responsibility for the questionable return position is deemed to be the preparer of that position (Proposed Reg. §1.6694-1(b)(1)).

Only one person within a single firm can be considered primarily responsible for each position set forth on the return. If different firms are involved in the return preparation, there may be multiple preparers from the different firms primarily responsible for each position. If there are no signing preparers within a firm, the nonsigning preparer within the firm having overall supervisory responsibility for the position would be the preparer (Proposed Reg. §1.6694-1(b)(3)). An individual and the firm employing the individual or in which the individual is a partner, shareholder or equity member can each be subject to the penalty (Proposed Reg. §1.6694-1(b)(4)).

If the planners effort solely relates to the creation of an estate plan or formation of a family limited partnership (FLP) the planner should not likely be deemed a "preparer" subject to Code Sec. 6694. However, the client relationship typically extends beyond execution of the relevant documents. When returns are being prepared based on the underlying documents, advice from the planner is generally requested. Such advice may inadvertently cause the planner to become a nonsigning preparer subjected to substantial penalties under Code Sec. 6694, even if they have never actually seen the return giving rise to the penalty!

The foregoing provisions likely capture planners rendering post-transaction advice regarding the reporting positions emanating from the operations of an FLP, appraisers valuing FLP interests and actuaries consulted regarding the value of a decedent's interest in a retirement plan. In practice, substantially every professional rendering advice leading to positions reflected within the estate or gift tax return will likely initially be deemed a nonsigning preparer for purposes of Code Sec. 6694 under the proposed regulations. The issue regarding liability will proceed to whether the advice provided is sufficient to subject the planner to the preparer penalty.

Relevant Authority

Return positions are initially measured based on the relative possibility of success on the merits if challenged (the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue may be settled is not relevant in determining the appropriate preparer standard). This analysis dictates an evaluation of the favorable and unfavorable authorities. The weight

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of authorities is to be determined in light of all pertinent facts and circumstances (Reg. §1-6662-4(d)(3)).

A preparer is considered to have a "reasonable belief" that the tax treatment of a position is "more likely than not" the proper tax treatment if the preparer analyzes the pertinent facts and authorities and reasonably concludes, in good faith, that there is a greater than 50-percent likelihood that the tax treatment will be upheld if the IRS challenges it (Proposed Reg. §1.6694-2(b)(1)).

The requirement that a position satisfies the "more likely than not" standard must be satisfied on the date the return is deemed prepared (Proposed Reg. §1.6694-2(b)(6)). For a "nonsigning preparer," the relevant date is the date the non-signing preparer provides the tax advice with respect to the position giving rise to the understatement (Proposed Reg. §1.6694-1(a)(2)).

Reasonable Basis and Reliance Exception

Planners are frequently placed in a position of relying upon information received from others. The reasonableness of this reliance will be the issue to be determined when faced with the possibility of a preparer penalty. The preparer penalty will not apply if the return position has a "reasonable basis" and is adequately disclosed (Proposed Reg. §1.6694-2(c)(1)). A preparer may rely upon information provided by the taxpayer with the exception of legal conclusions on federal tax issues (Proposed Reg. §1.6694-1(e)). A preparer may, however, rely in good faith and without verification upon information furnished by another advisor, another preparer or other party (including another advisor or preparer at the preparer's firm) (Proposed Reg. §1.6694-1(e)(1)). The preparer must make reasonable inquiries if the information as received appears to be incorrect or incomplete.

A preparer may rely in good faith—without verification—upon a tax return that has been previously filed with the IRS (Proposed Reg. §1.6694-1(e)(2)). As such, a planner involved in the preparation of a Form 706 or a Form 709 need not verify the positions on previously filed returns that are relevant to the preparation of the Form 706 or Form 709 presently being prepared (such as whether and the amount of any prior taxable gifts). The planner, however, may not ignore the implications of information they receive or actually know. The planner must make reasonable inquiries if the information received appears to be incorrect or incomplete. Also, the planner must confirm that the position being relied upon has not been adjusted by examination or otherwise (Proposed Reg. §1.6694-1(e)(2)).

Adequate Disclosure

The disclosure, which should include all relevant facts and authorities, must be sufficient to reasonably apprise the IRS of the reason for the disclosure. A poorly drafted disclosure could itself be cause for various sanctions. All disclosures should be in writing since the preparer will have to overcome the burden of demonstrating that the disclosure occurred and that it was adequate.

Disclosure requirements for signing preparers are set forth in Proposed Reg. §1.6694-2(c)(3)(i) and generally include: (i) disclosure in accordance with Reg. §1.6662-4(f), which permits disclosure on a properly completed and filed Form 8275 or 8275-R, as appropriate, or within the return itself in accordance with the annual revenue procedure described in Reg.§1.6662-4(f)(2) (See Rev. Proc. 2008-14, IRB 2008-7, 435); if there is no substantial authority for the position, providing the taxpayer with the prepared return that includes the disclosure; if there is substantial authority for the position, advising the taxpayer of the difference between the penalty standards applicable to the taxpayer under Code Sec. 6662 and the penalty standards applicable to the preparer under Code Sec. 6694; and for returns or claims for refund that are subject to penalties pursuant to Code Sec. 6662 other than the substantial understatement penalty under Code Sec. 6662(b)(2) and (d), the preparer must advise the taxpayer of the penalty standards applicable to the taxpayer under Code Sec. 6662 (such as having reasonable basis for the return position, etc.). Generally, the preparer must also contemporaneously document the advice in the preparer's files.

Disclosure requirements for nonsigning preparers are set forth in Proposed Reg. §1.6694-2(c)(3)(ii) and generally provide that disclosure is adequate: (i) if the position is disclosed in accordance with Reg. §1.6662-4(f); (ii) for advice to taxpayers, disclosure is adequate if the preparer advises the taxpayer of any opportunity to avoid penalties under Code Sec. 6662 that could apply to the position, if relevant, and of the standards for disclosure to the extent applicable; (iii) for advice to another preparer, if the preparer advises the other preparer that disclosure under Code Sec. 6694(a) may be required. Generally, the preparer must also contemporaneously document the advice in the preparer's files.

Disclosure in the case of items attributable to a pass-through entity is adequate if made at the entity level. Advice to the taxpayer with respect to each position must be specific to the taxpayer and tailored to the taxpayer's specific facts and circumstances. There is no general pro forma language or special format required for a preparer to comply with these rules. However, boilerplate lan-

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guage will constitute a sufficient disclaimer. Generally, all advice regarding disclosure should be in writing, especially since the preparer will have the burden of demonstrating compliance with the regulations.

Disclosure is merely disclosure—it should not impact the viability of return positions. Planners involved in the preparation of a return should recommend disclosures for substantially every position that may be subject to question by the government.

Reasonable Cause and Good Faith Exception

For the planner, the most relevant penalty issue may be the reasonableness of their belief in the advice provided, not the likelihood it will prevail. The penalty under Code Sec. 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 planner acted in good faith (Proposed Reg. §1.6694-2(d)). The reasonable cause exception to the Code Sec. 6694(a) penalty requires a review of all applicable facts and circumstances with reference to the nature of the error, the frequency and materiality of the errors, the planner's normal office practice, reliance on another preparer's advice, and reliance on generally accepted administrative of industry practice (Proposed Reg. §1.6694-2(d)).

A planner will be deemed to have acted in good faith when the planner relied on the advice of a third party believed competent to render the advice. A planner is not considered to have relied in good faith if: (i) the advice is unreasonable on its face; (ii) the planner knew or should have known that the third party advisor was not aware of all relevant facts; or (iii) the planner knew or should have known (given the nature of the tax return preparer's practice), at the time the return was prepared, that the advice was no longer reliable due to developments in the law since the time the advice was given (Proposed Reg. §1.6694-2(d)(5)).

Income Derived

In the situation of a planner who works within a firm engaged by the taxpayer, income derived (or to be derived) means all compensation the planner receives from the firm that can be reasonably allocated to the engagement of preparing the return or providing tax advice (including research and consultation), with respect to events that have occurred at the time the advice is rendered, regarding respect to the position(s) taken on the return that gave rise to the understatement (Proposed Reg. §6694-1(f)). At the firm level, 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 providing tax advice (including research and consultation) with respect to the position(s) taken on the return that gave rise to the understatement (Proposed Reg. §6694-1(f)).

It may be possible to demonstrate 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. If so, the penalty is to 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 (Proposed Reg. §6694-1(f)(2)(iv)).

Looking to the Future

Preparer penalty issues will most often arise during or at the conclusion of an IRS examination of the taxpayer's return when some or all of an undisclosed or improperly disclosed position has been disallowed. Is it reasonable to believe that an agent, having disallowed a questionable position, will be convinced the planner could reach a "more likely than not" basis for the reported position? Maintain the appearance of cooperation and reasonableness when representing clients in a tax dispute. Also, most positions are comprised of several sub-positions. If each sub-position has a 51-percent chance of success on the merits, the primary position will not likely also have a 51-percent chance of success on the merits (51 percent of 51 percent of 51 percent is not 51 percent overall).

The judgment of the preparer and other tax advisors, not the client, should be the determining factor regarding positions set forth on the return and disclosure. All disclosures should be in writing, clearly indicate the reason for the disclosure and, in most situations, be on a Form 8275 attached to the return. Establish a system of checklists for preparation and advice—and follow the system. Timely "CYA" letters are better than your historical recollection that may differ from that of your client who is attempting to "rely" on your prior advice to avoid imposition of a penalty against the client. Know that many states have requirements for a licensee to notify the state licensing authority in the event of a preparer penalty.

It is not necessary to see the return for the planner to be deemed a preparer subjected to penalties. A planner who renders advice which 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. There can be more than one preparer for each return.

Planners are engaged for the purpose of appropriately minimizing taxes for their clients. For the planner, the most relevant penalty issue will be the reasonableness of their belief in the reported position, not the likelihood it will prevail. Resolution of possible preparer penalty issues will likely depend upon the effort expended in determining, analyzing and documenting the relevant facts and legal authorities. Be a prepared preparer!

Charitable Trusts

Consequences of CRT Division Addressed

In Rev. Rul. 2008-41, the IRS has presented two factual situations in which either a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT) was divided into separate trusts. In Scenario 1, the trust was divided, pro rata, into as many separate and equal trusts as necessary to provide a separate trust for each recipient living at the time of the division. In Scenario 2, the trust was divided into two separate trusts pursuant to a divorce. In both scenarios, each of the separate trusts has similar governing provisions to the original trust and the same recipients and beneficiaries, collectively, as the original trust. In Scenario 1, each recipient and remainder beneficiary had the same beneficial interest both before and after the division.

The IRS has provided taxpayers with guidelines on the effect that a division of a charitable remainder trust (CRT) into two or more separate and equal trusts will have on the trust's qualification as a CRT under Code Sec. 664.

The IRS explained that a transfer from a deceased recipient's separate trust to a surviving recipient's separate trust in Scenario 1 would not be treated as a transferred remainder interest in violation of Code Sec. 664(d) and would not be treated as a prohibited additional contribution to a CRAT under Reg. §1.664-2(b). In Scenario 2, following the division of the trust, the total annuity amount or unitrust percentage remained the same as it was under the terms of the original trust, except that the survivorship right to the annuity or unitrust payment was relinquished. In both situations, the IRS ruled that the division of the trust into separate trusts did not cause the trust or any of the separate trusts to fail to qualify as a CRT under Code Sec. 664(d).

In addition, the IRS made several other rulings on the income and excise tax consequences of the division of a CRT. The following determinations were made: (1) the division was not a sale, exchange, or other disposition producing gain or loss; (2) the basis under Code Sec. 1015 of each separate trust's share of each asset was the same share of the basis of that asset in the hands of the trust immediately before the division; (3) each separate trust's holding period for assets transferred to it by the original trust included the holding period of the asset as held by the original trust immediately before the division; (4) the division of the CRT did not terminate the trust's status as a trust described in, and subject to, the private foundation rules of Code Sec. 4947(a)(2); (5) the division did not result in the imposition of an excise tax under Code Sec. 507(c); and (6) the division did not constitute an act of self-dealing under Code Sec. 4941 or a taxable expenditure under Code Sec. 4945.

Return Procedures

Automatic Filing Extension Regs Finalized

In T.D. 9407, the IRS has adopted final regulations under Code Sec. 6081, addressing the procedures to obtain automatic extensions of time to file federal gift and generation-skipping transfer (GST) tax returns. Pursuant to Code Sec. 6075(b)(2), a donor who requests an extension of time to file his or her income tax return is also considered to have an automatic extension to file a gift tax return. Under the final regulations, a donor who does not request an extension of time to file his or her income tax return may request an automatic six-month extension of time to file a gift tax return. The donor must complete Form 8892, Payment of Gift/GST Tax and/or Application for Extension of Time to File Form 709. In accordance with the regulations, neither a signature nor an explanation will be required in order to receive the extension of time. In addition, the final regulations allow a skip person distributee required to file Form 706-GS(D), Generation-Skipping Transfer Tax Return for Distributions, or a trustee required to file Form 706-GS(T), Generation-Skipping Transfer Tax Return for Terminations, to apply for a six-month automatic extension to file. To request an extension, the skip person distributee or trustee should file Form

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