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EDITORS' FEATURE

TAX PRACTICE AND PROCEDURE

Estate Planners as Return Preparers—Increased Penalty Exposure and the New Final Regulations

by Charles Rettig

Approximately six months after issuance of the proposed regulations, final regulations (T.D. 9436) concerning the Code Sec. 6694 return preparer penalties were filed with the Federal Register on December 15. As he did with the proposed regulations (see ESTATE PLANNING REVIEW, July 24, 2008), Charles Rettig, Esq. of Hochman, Salkin, Rettig, Toscher & Perez, P.C., Beverly Hills, California provides our readers with his expert analysis of these regulations along with his 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.

Recent statutory changes to Code Sec. 6694 and newly released final regulations have changed the relationship between practitioners, their clients, and the government. Many planners wrongly believe that they are not subject to Code Sec. 6694 because they do not directly prepare or sign returns and merely render tax and family wealth transfer related advice. Under Code Sec. 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 item on a Form 706, Form 709 or other return is sufficient to possibly subject the planner to Code Sec. 6694 penalties for that position.

Overview of the Law and the Final Regulations

Effective May 25, 2007, the Small Business and Work Opportunity Act of 2007 (Title VIII-B of P. L. 110-28, 121 Stat. 190; hereafter referred to as SBOWA) amended Code Sec. 6694 to: (a) broaden the scope of the tax return preparer penalties to include preparers of returns other than income tax returns, (b) revise the standards of conduct tax return preparers must satisfy regarding uncertain "tax positions" to avoid imposition of the Code Sec. 6694 penalty, and (c) 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.

The SBOWA amendments to Code Sec. 6694 did not modify the exception to the penalty when it is demonstrated that, considering all the facts and circumstances, the preparer acted in good faith and there was reasonable cause for the understatement on the return. The standards for imposing the penalty for willful or reckless conduct under Code Sec. 6694(b) were not changed. SBOWA only changed the amount of the Code Sec. 6694(b) penalty.

Treasury and the IRS released Notice 2008-13, 2008-3 IRB 282, on December 31, 2007, providing interim guidance and identifying returns and documents subject to the SBOWA amendments to Code Sec. 6694. Additional guidance was provided in Notice 2008-12, 2008-3 IRB 280, also released on December 31, 2007, with respect to the implementation of the preparer signature requirement of Code Sec. 6695(b). Notice 2008-46, 2008-18 IRB 868, was released on April 16, 2008, and added certain returns and documents to Exhibits 1, 2, and 3 of Notice 2008-13. On June 17, 2008, the Treasury published proposed regulations (REG-129243-07; the Proposed Regulations), providing proposed amendments to the regulations reflecting the amendments made by the SBOWA.

Effective October 3, 2008, the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (Div. C. of P.L. 110-343, 122 Stat. 3765; hereafter referred to as the TEAMT) modified the SBOWA amendments to Code Sec. 6694(a) to the extent of the applicable standards of conduct that

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preparers must satisfy to avoid imposition of the Code Sec. 6694(a) penalty. The definition of a "reasonable position" (i.e., conduct not subject to the preparer penalty) is now divided into three separate tiers each with its own standard to determine whether the position set forth in the return is an "unreasonable position."

a. For disclosed positions, the Code Sec. 6694(a) penalty applies unless there is or was a "reasonable basis" for the position set forth in the return (this standard now applies to returns prepared after May 25, 2007—See Notice 2009-5; 2009-3 IRB 309);

b. For undisclosed positions, the Code Sec. 6694(a) penalty applies unless there is or was "substantial authority" for the position set forth in the return (this standard now applies to returns prepared after May 25, 2007—See Notice 2009-5). Solely for purposes of Code Sec. 6694(a), "substantial authority" has the same meaning as in Reg. §1.6662-4(d)(2) (or any successor provision) of the accuracy-related penalty regulations. The analysis prescribed by Reg. §1.6662-4(d)(3)(i) through (ii) (or any successor provisions) applies for purposes of determining whether substantial authority is present. The authorities considered in determining whether there is substantial authority for a position are those authorities described in Reg. §1.6662-4(d)(3)(iii) (or any successor provision).

   There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists (Reg. §1.6662-4(d)(2)). The weight of authorities is determined in light of the pertinent facts and circumstances in the manner prescribed by Reg. §1.6662-4(d)(3)(iii). The authorities referenced in Reg. §1.6662-4(d)(3)(iii) are relevant under amended Code Sec. 6694 since the "reasonable basis" standard for disclosed positions, as interpreted in the current regulations, expressly allows for consideration of these authorities (see Notice 2009-5 and Reg. §1.6662-3(b)(3)).

c. For "tax shelters" as defined in Code Sec. 6662(d)(2)(C)(ii) and reportable transactions to which Code Sec. 6662A applies (i.e., generally listed and reportable transactions having a significant purpose of tax avoidance or tax evasion), the amended Code Sec. 6694(a) penalty generally applies unless there is or was a reasonable belief that the position set forth in the return would "more likely than not" be sustained on the merits (this standard applies to returns prepared for tax years ending after October 3, 2008—See Notice 2009-5).

The amendments to Code Sec. 6694 made by the TEAMT are retroactively effective for returns prepared after May 25, 2007, except that special rules applicable to positions with respect to tax shelters and reportable transactions to which Code Sec. 6662A applies are effective for returns prepared for tax years ending after October 3, 2008, the date of enactment of the TEAMT.

Effective December 22, 2008, Treasury published final regulations (T.D. 9436) implementing amendments to the return preparer penalties under Code Sec. 6694 made by the SBOWA and the TEAMT. At the same time, Treasury issued interim guidance (Notice 2009-5) regarding the TEAMT amendments and also released guidance (Rev. Proc. 2009-11) identifying the returns and other documents that are subject to the Code Sec. 6694 preparer penalty.

Defining the Preparer

The term "return preparers" is no longer limited to preparers of income tax returns following SBOWA and the TEAMT and includes both signing preparers and non-signing preparers, i.e., those who provide substantial advice to the taxpayer, to the signing preparer or another advisor to the taxpayer regarding a position set forth within the return. A "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 Code (Reg. §301.7701-15(a)). Return preparers subject to Code Sec. 6694 include preparers of estate, gift, generation-skipping transfer (GST), employment and excise tax returns and returns of exempt organizations.

Planners as Preparers

Planners may become non-signing preparers subject to amended Code Sec. 6694 if they render advice (written or oral) for a completed transaction that represents a "substantial portion" of the return (Reg. §301.7701-15(b)(2)(i)). In determining whether a planner is a non-signing preparer, time spent on advice that is given after events have occurred representing less than five 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. Notwithstanding the foregoing, time spent on advice before the events have occurred is taken into account if the facts and circumstances demonstrate that the position giving rise to the understatement is primarily attributable to the advice, the advice was substantially given before events occurred primarily to avoid treating the person giving the advice as a preparer, and the advice given before the events occurred was confirmed after the events had occurred for purposes of preparing a return (Reg. §301.7701-15(b)(2)(i)).

If the planner's effort solely relates to the creation of an estate plan or the formation of a family limited partnership, 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 and received. Such advice may inadvertently cause the planner to become a non-signing preparer subjected to substantial penalties under Code Sec. 6694, even if they have never actually seen the return giving rise to the penalty!

Under Reg. §301.7701-15(b)(3)(i), a single entry may constitute a substantial portion of the tax required to be shown on a return. Planners who render tax advice on a position that is directly relevant to the determination of the existence, characterization, or amount of an entry on a return are deemed to have prepared that entry. Whether an item on a return is a "substantial portion" is determined based upon whether the planner knows or reasonably should know that the tax attributable to such item is a substantial portion of the tax required to be shown on the return. Factors to consider in determining whether an item is a substantial portion include, but are not limited to the size and complexity of the item relative to the taxpayer's gross income and the size of the understatement attributable to the item compared to the taxpayer's reported tax liability.

Solely with respect to non-signing preparers (i.e., planners), the item set forth on the return is not considered to be a substantial portion if it involves amounts of gross income, amounts of deductions, or amounts on the basis of which credits are determined that are: (i) less than $10,000; or (ii) 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) (Reg. §301.7701-15(b)(3)(ii)(A) and (iii)). If more than one item is involved, all such items are to be aggregated in applying the foregoing de minimis rule to a non-signing preparer (Reg. §301.7701-15(b)(3)(ii)(B)).

A planner deemed a preparer of one return is not considered to be a preparer of another return merely because an entry reported on the first return may affect an entry reported on the other return, unless the entry reported on the first return is directly reflected on the other return (e.g., K-1 items from pass-through entities) and constitutes a substantial portion of the other return (Reg. §301.7701-15(b)(3)(i) and (iii)). For example, the sole preparer of a partnership return or S corporation return is considered a preparer of a partner's or a shareholder's return if the entry on the partnership or S corporation return reportable on the partner's or shareholder's return constitutes a substantial portion of the partner's or shareholder's return (Reg. §301.7701-15(b)(3)(iii)).

If the entry on a related return constitutes a substantial portion of such return, a practitioner (whether a preparer signing a flow-through return or a non-signing preparer providing advice) may be a "return preparer" subjected to substantial penalties under Code Sec. 6694 even if they have never seen the related return giving rise to the penalty! As such, the sole preparer of a fiduciary income tax return will be considered a preparer of the underlying beneficiaries' returns if the entries on the fiduciary return reportable on the beneficiaries' returns constitute a substantial portion of their return.

The regulations likely capture planners rendering post-transaction advice regarding the reporting positions emanating from the operations of a family limited partnership (FLP), appraisers valuing FLP interests, actuaries consulted regarding the value of a decedent's interest in a retirement plan, and others. In practice, substantially every professional rendering advice leading to positions reflected in the estate or gift tax return will likely initially be deemed a non-signing preparer for purposes of Code Sec. 6694 under the final regulations.

One Preparer Per Position Per Firm

Planners often tend to specialize within a relatively narrow practice area and are frequently asked for advice on specific issues that may find their way onto a return. The 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 of the return for purposes of Code Sec. 6694. For non-signing preparers, the person with overall supervisory responsibility for the return within the firm would be the preparer. The regulations focus on the return positions giving rise to the understatement and the persons responsible for each position(s). As such, Reg. §1.6694-1(b)(1) replaced the "one-preparer-per-firm" rule with the "one-preparer-per-position-per-firm" rule whereby an individual having primary responsibility for the questionable return position is deemed to be the preparer.

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 a single return position (Reg. §1.6694-1(b)(1)). The signer of the return is generally the person responsible for all positions set forth on the return under Reg. §1.6694-1(b)(2). However, in the current environment, the person signing the return may not actually have

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detailed knowledge of a questionable return position and may have reasonably relied upon others within the same firm having greater expertise with respect to particular issues.

If there are no signing preparers within a firm or it is determined that the signing preparer within the firm is not primarily responsible for the questionable position, the non-signing preparer within the firm having overall supervisory responsibility for the questionable position(s) would be the preparer (Reg. §1.6694-1(b)(3)). If the information presented would support a finding that, within a firm, either the signing preparer or a non-signing preparer is primarily responsible for the position(s) giving rise to the understatement, the Code Sec. 6694 penalty may be assessed against either one of the individuals, but not both, as the primarily responsible preparer (Reg. §1.6694-1(b)(4)). It is expected that the IRS will assess the penalty under Code Sec. 6694 against the preparer with the greatest amount of responsibility for the position based upon the best information available to the IRS.

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 (Reg. §1.6694-1(b)(5)). A firm that employs a planner subject to a penalty under Code Sec. 6694(a) (or a firm of which the individual preparer is a partner, member, shareholder or other equity holder) is also subject to the 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 Code Sec. 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 (Reg. §1.6694-2(a)(2)).

Reasonable Basis 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 final regulations expand the ability of preparers to rely upon others due to the heightened standards imposed on preparers by amended Code Sec. 6694 and the increased complexity of the tax law, which often requires signing and non-signing preparers to rely on the work of others in ensuring compliance. The Code Sec. 6694(a) penalty will not apply if the return position has a "reasonable basis" and is adequately disclosed.

A planner is not required to verify or review items reported on tax returns, schedules, or other third-party documents to determine if the appropriate standard is satisfied. Reg. §1.6694-1(e)(1) and Reg. §1.6694-2(b) allow the planner to generally rely in good faith without verification upon information furnished by the client/taxpayer. Further, a planner may 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) (Reg. §1.6694-1(e)(1) and Reg. §1.6694-2(b)).

The planner is not required to audit, examine or review books and records, business operations, or documents or other evidence to independently verify information provided by the taxpayer/client, advisor, other preparer, or other party (Reg. §1.6694-1(e)(1)). The "no reliance on legal conclusions by taxpayers" language from Proposed Reg. §1.6694-1(e)(1) was not included in the final regulations. However, the planner may not ignore the implications of information received or actually known by the planner. The planner must make reasonable inquiries if the information as received appears to be incorrect or incomplete (Reg. §1.6694-1(e)(1)). A planner may not be intentionally ignorant of relevant facts in attempting to defeat imposition of the Code Sec. 6694 penalty.

A planner may rely in good faith without verification upon a tax return that has been previously prepared by a taxpayer or another preparer and filed with the IRS (Reg. §1.6694-1(e)(2)). As such, a planner involved in the preparation of a Form 706 or a Form 709 need not generally 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). Further, a planner involved in the preparation of an amended return need not verify the positions set forth on the originally filed return. The planner, however, may not ignore the implications of information furnished to the planner or actually known by the planner. Accordingly, the planner must make reasonable inquiries if the information received appears to be incorrect or incomplete and must confirm that the position being relied upon has not been adjusted by examination or otherwise (Reg. §1.6694-1(e)(2)).

Adequate Disclosure

The Code Sec. 6694(a) penalty will not apply if the return position (other than a position with respect to a tax shelter or a reportable transaction to which Code Sec. 6662A ap-

plies) has a reasonable basis and is "adequately disclosed" as set forth in Reg. §1.6694-2(d)(3) (Reg. §1.6694-2(d)(1)). 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. Don't be cute!

A recommendation for a disclosure should likely be in writing because the preparer will have to overcome the burden of demonstrating that the disclosure occurred and that it was adequate. Disclosures attached to the return should generally be set forth on IRS Form 8275, Disclosure Statement. Some disclosures may be adequate if set forth on an income tax return in accordance with the annual revenue procedure described in Reg. §1.6662-4(f)(2) (see e.g., Rev. Proc. 2008-14).

Under Reg. §1.6694-2(d)(3)(ii), a "non-signing preparer" is deemed to satisfy the disclosure requirements of Code Sec. 6694 with respect to a position (other than a position with respect to a tax shelter or a reportable transaction to which Code Sec. §6662A applies) for which there is a reasonable basis but for which there is not substantial authority, if: (a) the position is disclosed in accordance with Reg. §1.6662-4(f), which permits disclosure on a properly completed and filed Form 8275, Disclosure Statement, or 8275-R, Regulation Disclosure Statement, as appropriate, or within the return itself in accordance with the annual revenue procedure described inReg. §1.6662-4(f)(2) (Reg. §1.6694-2(d)(3)(ii)); (b) 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. The preparer must also contemporaneously document the advice in the preparer's files. The contemporaneous documentation should reflect that the affected taxpayer has been advised by a preparer in the firm of the potential penalties and the opportunity to avoid penalty through disclosure (Reg. §1.6694-2(d)(3)(ii)(A)); (c) the preparer advises the other preparer that disclosure under Code Sec. 6694(a) may be required. The preparer must also contemporaneously document the advice in their files. The contemporaneous documentation should reflect that the preparer outside the firm has been advised that disclosure under Code Sec. 6694(a) may be required. If the advice is to another non-signing preparer within the same firm, contemporaneous documentation is satisfied if there is a single instance of contemporaneous documentation within the firm (Reg. §1.6694-2(d)(3)(ii)(B)).

Planners who may be deemed preparers under Code Sec. 6694 should insist on disclosures for substantially every position that may be questioned by the government. Clients often believe that a disclosure is a "red flag" essentially requesting an examination and that it represents some type of concession on the underlying merits of the return position. Disclosure, however, is merely disclosure—it should not impact the viability of return positions.

Reasonable Cause and Good Faith Exception

For the planner, the most relevant penalty issue may the reasonableness of their belief in the reported position, not the likelihood that it will prevail. A planner will be deemed to have acted in good faith when they relied on the advice of a third party who they had reason to believe was competent to render the advice. 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 preparer acted in good faith (Reg. §1.6694-2(e)). Factors to consider include the nature of the error causing the understatement, frequency of errors, materiality of errors, preparer's normal office practice, reliance on advice of others, and reliance on generally accepted administrative or industry practice (Reg. §1.6694-2(e)(1)-(5)).

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 tax return or claim for refund was prepared, that the advice was no longer reliable due to developments in the law since the time the advice was given.

Looking to the Future

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.

Estate planners are sophisticated specialists operating in a complex world of statutory and case authorities monitored by a government that historically respected their dedication and professionalism. It should not be assumed that the government representative has the same degree of expertise within a narrow practice field. If the position is disclosed, the information in the disclosure must be complete and accurate. In life, everything seems okay until it is not. Be a prepared preparer. When in doubt, recommend disclosure. ✦

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