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Estate Planners as Return Preparers: Increased Penalty Exposure and the New Proposed Regulations*

*By Charles P. Rettig***

Recent statutory changes to Code Sec. 6694 and newly released proposed regulations (NPRM REG-129243-07) are changing 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 prepare or sign returns and merely render tax and family wealth transfer related advice. Under amended 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 entry on a Form 706, Form 709 or other return is sufficient to possibly subject the planner to penalties for that position. There is little real-world practical guidance available for planners or the government agent charged with administering the new Code Sec. 6694 preparer penalty regime.

Overview of Amended Code Sec. 6694 and the Proposed Regulations.

Effective May 25, 2007, the Small Business and Work Opportunity Tax Act of 2007 (P. L. No. 110-28, the "Act") amended Code Sec. 6694 to: (1) broaden the scope of the tax return preparer penalties to include preparers of returns other than income tax returns, (2) revise the standards of conduct tax return preparers must satisfy regarding uncertain "tax positions" to avoid imposition of the Code Sec. 6694 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.

The 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 is reasonable cause for the understatement on the return. The standards for imposing the penalty for willful or reckless conduct under Code Sec. 6694(b) have not changed, only the amount of the Code Sec. 6694(b) penalty has been changed.

Proposed regulations implementing the amendments to Code Sec. 6694 and other related provisions of the IRC were recently released (June 16, 2008). The proposed regulations represent an attempt to balance the interests of the government in curtailing the activities of noncompliant preparers against the burdens imposed on all preparers in complying with amended Code Sec. 6694 and the proposed regulations. 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.

Return Preparer Defined

The term "return preparers" is no longer limited to preparers of income tax returns. It now 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. 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 (Proposed Reg. §301-7701-15(a)). Return preparers include preparers of estate, gift, GST, employment and excise tax returns, as well as returns of exempt organizations.

Planners as Preparers

A "signing preparer" is any preparer who signs or who is required to sign a return or claim for refund as a tax return preparer pursuant to Proposed Reg. §1.6695-1(b) (Proposed Reg. §301.7701-15(b)(1)). If more than one preparer is involved in the preparation of the return or claim for refund, the individual preparer who has the primary responsibility as between or among the preparers for the overall substantive accuracy of the preparation of such return or claim for refund shall be considered to be the signing preparer for purposes of

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Reg. §301.7701-15(b)(1). Any other preparer is not required to sign the return or claim for refund.

Planners may become nonsigning 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 (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. As such, if the planner's effort solely relates to the creation of an estate plan or 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 nonsigning preparer subjected to substantial penalties under Code Sec. 6694, even if they have never actually seen the return giving rise to the penalty!

A person who renders 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 (Proposed Reg. §301.7701-15(b)(3)). 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 (Proposed Reg. §301.7701-15(b)(3)(i)). 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, the size of the understatement attributable to the item compared to the taxpayer's reported tax liability (Proposed Reg. §301.7701-15(b)(3)(i)).

A preparer with respect to one return is not considered to be a 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 (Proposed Reg. §301.7701-15(b)(3)(iii)). As such, the sole preparer of a fiduciary income tax return will 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.

The foregoing provisions 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, 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 will then become whether the advice provided is sufficient to subject the planner to the preparer penalty.

One Preparer Per Position

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 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 proposed regulations focus on the return positions giving rise to the understatement and the parties responsible for the position(s). As such, Proposed Reg. §1.6694-1(b)(1) replaces the "one preparer per firm" rule with the "preparer-per-position" 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 each return position. The signer of the return is generally the person responsible for all positions set forth on the return under Proposed Reg. §1.6694-1(b)(2). However, in the current environment, the person signing the return may not actually have 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, the nonsigning preparer within the firm having overall supervisory responsibility for the questionable position(s) 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)). In a sole proprietorship, if an individual (other than the sole proprietor) working for a sole proprietorship is subject to the penalty, the sole proprietorship can also be subject to the penalty (Proposed Reg. §1.6694-1(b)(4)).

A firm that employs a preparer 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 (Proposed Reg. §1.6694-2(a)(2)).

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Relevant Authority

Return positions or the appropriate tax treatment of an item under Code Sec. 6694 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 relevant to the tax treatment of an item, which are taken into account in determining whether the appropriate standard exists.

The weight of authorities is to be determined in light of all pertinent facts and circumstances (Reg. §1-6662-4(d)(3)(i)). The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority (Reg. §1-6662-4(d)(3)(ii)).

The authorities considered in determining whether a position satisfies the appropriate standard are described in (Reg. §1.6662-4(d)(3)(iii)). Conclusions reached in treaties, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority (Reg. §1.6662-4(d)(3)(iii)).

Relevant standards of conduct include:

- *Reasonable Basis—20 to 25 percent.* If a return position is reasonably based on at least one of the authorities set forth in Reg. §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.

- *Realistic Possibility of Success—33 percent.* A position is considered to satisfy the realistic possibility standard if a reasonable and well-informed analysis by a person knowledgeable in tax law would lead that person to conclude that the position has approximately a one-in-three, or greater, likelihood of being sustained on its merits (Reg. §1.6694-2(b)(1)).

- *Substantial Authority—40 to 45 percent.* 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 substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts including an evaluation of the relevant authorities, nature of the analysis and types of authority. There may be substantial authority for more than one position with respect to the same item.

- *More Likely Than Not—more than 50 percent.* 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 based on that analysis 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)).

Whether a preparer satisfies the "more likely than not" standard will be determined based upon all facts and circumstances, including the preparer's diligence (Proposed Reg. §1.6694-2(b)(1)). For purposes of determining whether the preparer has a reasonable belief that the position would more likely than not be sustained on the merits, a 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) (Proposed Reg. §1.6694-1(e)).

A position must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, a position must not be based on a representation or assumption that the preparer knows, or has reason to know, is inaccurate (Proposed Reg. §1.6694-2(b)(2)).

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)). A return or claim for refund is deemed prepared on the date it is signed by the tax return preparer (Proposed Reg. §1.6694-1(a)(2)). If a "signing preparer" (as described in Proposed Reg. §301.7701-15(b)(1)) fails to sign the return, the return is deemed prepared on the date the return is filed (Proposed Reg. §§1.6694-1(a)(2) and 1.6695-1). In the case of a "non-signing preparer" (as described in Proposed Reg. §301.7701-15(b)(2)), the relevant date is the date the nonsigning preparer provides the tax advice with respect to the position giving rise to the understatement. This date is to be determined based on all the facts and circumstances (Proposed. Reg. §1.6694-1(a)(2)).

Reasonable Basis Exception and Reliance on Information Received.

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 proposed 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 nonsigning 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 (Proposed Reg. §1.6694-2(c)(1)). A preparer 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 1.6694-2(c)(2) allow a preparer to generally rely in good faith without verification upon whatever information is provided by the taxpayer. Proposed Reg. §1.6694-1(e) would allow similar reliance, but provides that a preparer may not rely on information provided by taxpayers with respect to legal conclusions on federal tax issues. 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).

The 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 preparer, or other party (Proposed Reg. §1.6694-1(e)(1)). However, the preparer may not ignore the implications of information furnished to the preparer or actually known by the preparer. 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 prepared by a taxpayer or another preparer and 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 received or actually known by the planner. 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 Code Sec. 6694(a) penalty will not apply if the return position has a reasonable basis and is "adequately disclosed" (Proposed Reg. §1.6694-2(c)(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. 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.

1. Signing Preparers. Under Proposed Reg. §1.6694-2(c)(3)(i), a "signing preparer" is deemed to satisfy the disclosure requirements of Code Sec. 6694 with respect to a position for which there is a reasonable basis but for which the preparer does not have a reasonable belief that the position would more likely than not be sustained on the merits, if the preparer satisfies any of the following standards:

a. *Position is Disclosed.* 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 in Reg. §1.6662-4(f)(2) (see Rev. Proc. 2008-14, IRB 2008-7, 435, identifying circumstances under which the disclosure on a taxpayer's return with respect to an item or a position is adequate for the purpose of avoiding the preparer penalty under Code Sec. 6694(a) (relating to understatements due to unreasonable positions) with respect to income tax returns). Under Rev. Proc. 2008-14, disclosure within the return itself for a return other than an income tax return will not be adequate with respect to a preparer penalty under Code Sec. §6694(a) (Proposed Reg. §1.6694-2(c)(3)(i)(A)).

b. *No Substantial Authority for the Return Position.* For income tax returns, if the position would not meet the standard for the taxpayer to avoid a penalty under Code Sec. 6662(d)(2)(B)(i) without disclosure (no substantial authority), the preparer must provide the taxpayer with the prepared return that includes the disclosure in accordance with Reg. §1.6662-4(f) (Proposed Reg. §1.6694-2(c)(3)(i)(B));

c. *Substantial Authority for the Return Position.* For income tax returns, if the position would otherwise meet the requirement for non-disclosure under Code Sec. 6662(d)(2)(B)(i)(substantial authority), the preparer must advise 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. The preparer must also contemporaneously document the advice in the preparer's files (Proposed Reg. §1.6694-2(c)(3)(i)(C));

d. *Reportable Transactions.* For income tax returns, if Code Sec. 6662(d)(2)(B) does not apply because the position may be described in Code Sec. 6662(d)(2)(C) (a tax shelter, reportable transaction with a significant purpose of tax evasion, or a listed transaction), the preparer must advise the taxpayer that there needs to be 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 Code Sec. 6662(d) or Code Sec. 6662A and that disclosure will not protect the taxpayer from assessment of the accuracy related penalty if either Code Sec. 6662(d) or Code Sec. 6662A applies to the position. The preparer must also contemporaneously document the advice in the preparer's files (Proposed Reg. §1.6694-2(c)(3)(i)(D));

e. *Transactions Subject to Other Transactions*. 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) (i.e., the accuracy related penalty for negligence or disregard of the rules or regulations, etc.), 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.). The preparer must also contemporaneously document the advice in the preparer's files (Proposed Reg. §1.6694-2(c)(3)(i)(E)).

2. Nonsigning Preparers. Under Proposed Reg. §1.6694-2(c)(3)(ii), a "nonsigning preparer" is deemed to satisfy the disclosure requirements of Code Sec. 6694 with respect to a position for which there is a reasonable basis but for which the preparer does not have a reasonable belief that the position would more likely than not be sustained on the merits if the position is disclosed in accordance with Reg. §1.6662-4(f) (which permits disclosure on a properly completed and filed Form 8275 or Form 8275-R, as appro-

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priate, or on the return in accordance with an annual revenue procedure described in Reg.§1.6662-4(f)(2)). In addition, disclosure of a position is adequate in the case of a nonsigning preparer if, with respect to that position, the preparer complies with any of the following provisions:

a. *Advice to Taxpayers.* If a nonsigning preparer provides advice to the taxpayer with respect to a position for which there is a reasonable basis but for which the nonsigning 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 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 (Proposed Reg. §1.6694-2(c)(3)(ii)(A)).

b. *Advice to Another Preparer.* If a non-signing preparer provides advice to another preparer with respect to a position for which there is a reasonable basis but for which the non-signing 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 preparer advises the other preparer that disclosure under Code Sec. 6694(a) may be required. The preparer must also contemporaneously document the advice in the tax return preparer's files (Proposed Reg. §1.6694-2(c)(3)(ii)(B)).

c. *Requirements for Advice.* For purposes of satisfying the foregoing disclosure standards, each return position for which there is a reasonable basis but for which the 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 preparer. The advice to the taxpayer with respect to each position, therefore, must be specific to the taxpayer and tailored to the taxpayer's specific facts and circumstances. The preparer is required to contemporaneously document the fact that such advice was provided.

There is no general pro forma language or special format required for a preparer to comply with these rules. However, boilerplate language will not constitute a sufficient disclaimer. A preparer may choose to comply with the documentation standard in a single document covering each position, or in multiple documents covering all of the positions (Proposed Reg. §1.6694-2(c)(3)(iii)). If the advice regarding the position was in writing, the statement must be in writing. Generally, all such advice should be in writing.

d. *Pass-Through Entities.* Disclosure in the case of items attributable to a pass-through entity is adequate if made at the entity level in accordance with the foregoing rules (Proposed Reg. §1.6694-2(c)(3)(iv)). Thus, disclosure in the case of pass-through items must be made on a Form 8275 or 8275-R, as appropriate, attached to the entity return (or qualified amended return), or on the entity's return in accordance with the revenue procedure described in Reg.§1.6662-4(f)(2), if applicable. A taxpayer (i.e., partner, shareholder, beneficiary, or holder of a residual interest in a REMIC) also may make adequate disclosure with respect to a pass-through item, however, if the taxpayer files a properly completed Form 8275 or 8275-R, as appropriate, in duplicate, one copy attached to the taxpayer's return (or qualified amended return) and the other copy filed with the IRS Center with which the return of the entity is required to be filed. Each Form 8275 or 8275-R, as appropriate, filed by the taxpayer should relate to the pass-through items of only one entity (Reg. §1.6662-4(f)(5)).

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

When the planner recommends disclosure of an uncertain return position, is the planner recommending disclosure to protect the planner at the expense of exposing a questionable position on the return to the possible detriment of the taxpayer-client? The planner might consider recommending that the taxpayer seek independent advice before following the planner's disclosure recommendation.

Reasonable Cause and Good Faith Exception.

For the planner, the most relevant penalty issue may 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 or 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 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 (Proposed Reg. §1.6694-2(d)(5)).

Returns and Claims for Refund Subject to the Code 6694 Penalty

IRS Notice 2008-13, IRB 2008-3, 282, describes categories of returns and other documents to which Code Sec. 6694 could

apply. Notice 2008-46, IRB 2008-18, 868, added certain returns and documents supplementing Exhibits 1, 2, and 3 of Notice 2008-13. Notice 2008-13 provides that, solely for purposes of Code Sec. 6694, a return or claim for refund includes the tax returns listed in Exhibit 1 to the Notice or a claim for refund with respect to any such return. Returns listed on Exhibit 1 include variations of Form 706 together with Form 709, Form 843, Form 990-PF, Form 1041, Form 1041-N and others. Notice 2008-13 also provides that solely for purposes of Code Sec. 6694, an information return or document listed on Exhibit 2 that includes information that is or may be reported on a taxpayer's tax return or claim for refund is a return to which Code Sec. 6694 could apply if the information reported constitutes a substantial portion of that taxpayer's tax return or claim for refund. Information returns listed on Exhibit 2 include Form 1065, Form 1120S, Form 3520, Form 3520-A, Form 5500 and others.

Finally, Notice 2008-13 provides that solely for purposes of Code Sec. 6694, a document listed on Exhibit 3 that includes information that is or may be reported on a taxpayer's tax return or claim for refund (and that constitutes a substantial portion of such tax return or claim for refund) will not subject the preparer to a penalty under Code Sec. 6694(a). Documents listed on Exhibit 3 include Form 1099, Form 990, Form 4768, Form 8868, Form 8892, A document listed on Exhibit 3, however, may subject the preparer to a willful or reckless conduct penalty under Code Sec. 6694(b) if the information reported on the document constitutes a substantial portion of the tax return or claim for refund and is prepared willfully in any manner to understate the liability of tax on a tax return or claim for refund, or in reckless or intentional disregard of rules or regulations.

Income Derived (Or to Be Derived) with Respect to the Return or Claim for Refund

For purposes of computing the amount of the potential Code Sec. 6694 penalties, income derived (or to be derived) means all compensation received or expected to be received with respect to the engagement of preparing the return or providing tax advice (including research and consultation) regarding the position(s) taken on the return or claim for refund that gave rise to the understatement (Proposed Reg. §6694-1(f)). Only compensation for 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 Code Sec. 6694(a) or (b) penalties. As such, this computation looks to each person involved in the process for a completed transaction leading to the positions set forth on a return in determining the applicable amount of the penalty for that person.

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 the position(s) taken on the return or claim for refund that gave rise to the understatement (Proposed Reg. §6694-1(f)).

A firm that employs the individual planner (or the firm of which the planner is a partner, member, shareholder, or other equity holder) is subject to a penalty under Code Sec. 6694(a) or (b) pursuant to the provisions in Proposed Reg. §§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 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 (Proposed Reg. §6694-1(f)).

If the firm has multiple engagements related to the same return or claim for refund, only those engagements relating to the position(s) taken on the return or claim for refund that gave rise to the understatement are considered for purposes of calculating the income derived (or to be derived) with respect to the return or claim for refund (Proposed Reg. §6694-1(f)(2)(i)). If a lump sum fee is received that includes amounts not taken into account under the preceding sentence, the amount of income derived will be based on a reasonable allocation of the lump sum fee between the tax advice giving rise to the penalty and the advice that does not give rise to the penalty (Proposed Reg. §6694-1(f)(2)(ii)).

It may be possible to demonstrate, based upon information provided by the planner or the planner'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 so, the amount of 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 under Code Sec. 6694 (Proposed Reg. §6694-1(f)(2)(iv)).

If both an individual within a firm and a firm that employs the individual (or the firm of which the individual is a partner, member, shareholder, or other equity holder) are subject to a penalty under Code Sec. 6694 pursuant to the provisions in Proposed Reg. §§1.6694-2(a)(2) or 1.6694-3(a)(2), the amount of penalties assessed against the individual and the firm shall not exceed 50 percent of the income derived (or to be derived) by the firm from 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 portion of the total amount of the penalty assessed against the individual tax return preparer shall not exceed 50 percent of the individual's compensation as determined under Proposed Reg. §§6694-1(f)(1) and (2) (Proposed Reg. §6694-1(f)(3)).

Miscellaneous Provisions re Amended Section 6694

The proposed regulations are generally applicable to returns and claims for refund filed after the date that final regulations are published in the Federal Register. In the meantime, the

proposed regulations represent significant guidance for practitioners and the government in determining the potential applicability of Code Sec. 6694 to a specific situation.

In any proceeding with respect to the penalty imposed by Code Sec. 6694(a), the planner will bear the burden of proof on whether: (i) the planner knew or reasonably should have known that the questioned position was taken on the return; (ii) there is reasonable cause and good faith with respect to such position; and (iii) the position was adequately disclosed in accordance with Proposed Reg. §1.6694-2(c) (Proposed Reg. §1.6694-2(e)).

The penalty under Code Sec. 6694(a) must be assessed within three years of the filing date of the return or claim for refund to which the penalty is being assessed (Code Sec. 6696(d)(1)). The statute of limitations on a return preparer penalty case under Code Sec. 6694(a) can be extended pursuant to Code Sec. 6501(c)(4) using Form 872-D, Consent to Extend the Time on Assessment of a Tax Return Preparer Penalty (Rev. Rul. 78-245, 1978-1 CB 435). The willful disregard penalty under Code Sec. §6694(b) may be assessed at any time (Code Sec. 6696(d)(1)).

If the statutory period for assessment of the Code Sec. 6694(a) penalty is about to expire and the planner will not agree to an extension, the IRS will likely assess the penalty. The planner, upon request, should be provided post-assessment appeal rights in the same way pre-assessment appeal rights would have been provided. The IRS will not normally submit preparer penalty cases to Appeals if less than 180 days remain on the statute of limitations. Instead, they will usually first request an extension of the statutory period for assessment.

Code Sec. 6696(c) and Proposed Reg. § 1.6696-1(b) authorize the filing of claims for credit or refund on any penalties paid under Code Sec. 6694. To avoid enforced collection, within 30 days after the date of notice and demand for payment, the planner must pay at least 15 percent of the penalty and timely file a claim for refund on Form 6118, Claim for Refund of Tax Return Preparer Penalties. Using the procedure described in Code Sec. 6694(c)(1), collection of the remaining portion of the penalty will be suspended until the earlier of: (i) 30 days after the refund claim is denied, or (ii) 30 days from the period ending six months after the preparer files the claim. If the planner begins a proceeding in a United States District Court for the determination of the penalty during either of these 30 day periods, collection of the penalty will continue to be suspended until the final resolution of the proceeding (Reg. §1.6694-4).

Form 6118 is prescribed for making a claim as provided in Proposed Reg. §1.6696-1 (Proposed Reg. §1.6696-1(e)). The claim must be filed with the IRS campus or office that issued to the statement (or statements) of notice and demand for payment of the penalty (or penalties) included in the claim (Proposed Reg. §1.6696-1(f)). A claim for a penalty paid by a planner under Code Sec. 6694 and Proposed Reg. §1.6694-1 shall generally be filed within three years from the date of full payment. Payment is considered made on the date payment is received by the IRS or, if applicable, on the date an amount is credited in satisfaction of the penalty. For purposes of determining whether a claim is timely filed, the rules under Code Secs. 7502 and 7503 and the provisions of Reg. §§1.7502-1, 1.7502-2, and 1.7503-1 apply (Proposed Reg. §1.6696-1(g)).

Summary and Recommendations for Return Preparers

1. *Think "More Likely than Not."* Code Sec. 6694 and the Proposed Amendments to Circular 230 generally require a "more-likely-than-not" standard, or "reasonable basis" plus disclosure.

2. *Preparer Judgment.* The judgment of the preparer and other tax advisors, not the client, should be the determining factor regarding positions set forth on the return. If the client refuses to comply with your recommendations, the significance of each recommendation in relation to the return may be the deciding factor re whether to withdraw from representation.

3. *Think Disclosure.* Code Sec. 6694 and the Proposed Amendments to Circular 230, §10.34 each contain a disclosure defense for the preparer. 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.

4. *Tax Advice is Sufficient for Code Sec. 6694 to Apply.* 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.

5. *Mandatory OPR Referrals.* IRS employees are required to make a referral to the IRS Office of Professional Responsibility (OPR) if a preparer penalty is sustained. Even if the IRM is changed to make referrals discretionary, anticipate an increase in the incidences of referrals to OPR. Anticipate the government will contact the preparers current and former clients and that they may require the preparer to also disclose the violations to their clients with a full explanation.

6. *Penalties Could be 150 percent of Fees Received.* Referrals of Code Sec. 6694(a) penalties to OPR potentially could expose preparers to a combined penalty well in excess of fees or income actually received from providing services with respect to a tax return or refund claim: a maximum 50 percent Code Sec. 6694(a) penalty plus a possible 100 percent monetary penalty under Circular 230.

7. *Requirements to Notify State Licensing Authorities.* Many states have requirements for a licensee to notify the state licensing authority in the event of a preparer penalty. Failure to provide timely notification could be a separate violation. If the preparer penalty is assessed, notify your licensing authority. It may be awkward but it is appropriate.

8. *Establish a System of Checklists for Preparation and Advice and Follow the System.* Best practices in the office must provide a system for promoting accuracy and consistency in the preparation of returns or claims and generally should include, in the case of a signing preparer, checklists, meth-

ods for obtaining necessary information from the taxpayer, a review of the prior year's return, and review procedures.

9. *Standards for Malpractice Determinations.* Anticipate that potential malpractice claims will routinely include allegations of a failure to comply with the federal tax standard of care and Circular 230.

10. *Maintain the Appearance of Cooperation and Reasonableness When Representing Clients in a Tax Dispute.* The examining agent may make a referral for penalties under Code Sec. 6694 and refer the matter to OPR based on information developed during the examination. Be professional and courteous at all times.

11. *Document Your Advice to Clients and Others in Writing.* Protect yourself and your firm. 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. "Best practices" suggest documentation of any tax related research (including authorities both for and against the reported tax position), the reasoning behind the advice, and relevant authorities supporting the advice.

12. *Maintain Accurate Time and Billing Records.* This is important for obvious reasons. Additionally such records may be necessary to determine the "income derived" from the services rendered or the exception to liability if such services are relatively insignificant. Consider separate engagements for separate projects.

13. *Anticipate Increased Assertions of Preparer Penalties.* The amendments to Code Sec. 6694(a) may result in an increase in incidences of assertion of the Code Sec. 6694(a) penalty. Many of these referrals could be based on confusion about the new standard, inadvertent oversight, or relatively minor infractions. Be careful, especially with respect to valuation and discount issues in returns.

14. *Disclose, Disclose, Disclose.* Your client should not make the determination as to whether a disclosure is required. The preparer penalty and possible Circular 230 violations apply to you, not your client! When appropriate (or in doubt), disclose, disclose, disclose . . . .

15. Your Client is Not Your Friend. If you need a friend, get a dog!

OPR Referrals of Assessed Preparer Penalties

OPR, formerly known as the Director of Practice, enforces the regulations governing the practice of attorneys, certified public accountants (CPAs), enrolled agents, enrolled actuaries and appraisers before the IRS as set forth in Treasury Department Circular No. 230. Circular 230 provides the regulations governing the practice of attorneys, CPAs, enrolled agents, enrolled actuaries, and appraisers before the IRS. A copy of Circular 230 is available at *www.irs.gov.* OPR also reviews applications from individuals who wish to become an enrolled agent or enrolled actuary.

OPR has the authority to impose suspension, disbarment and/or significant monetary fines on federally authorized tax practitioners, firms and other entities. In addition, as part of any OPR investigation they may and likely will contact current and former clients. Presently, the Internal Revenue Manual requires a referral to OPR in all cases in which a return preparer penalty is assessed (IRM 7 20.1.6.2.1. (07-08-1999)). However, the IRS has stated an intention to modify the IRM such that referrals by agents will not be per se mandatory when a penalty is assessed under Code Sec. 6694(a). Instead, in matters involving non-wilful conduct, the IRS will generally look for a pattern of failing to satisfy the appropriate penalty standards before making the referral to OPR, although egregious conduct subjecting the preparer to the Code Sec. 6694(a) penalty may also form a basis for the OPR referral.

Notification of State Licensing Authorities

Many states have statutes and regulations requiring the notification of the state licensing authority in the event a practitioner receives notification of a practitioner penalty or an inquiry investigation from an agency such as the IRS Office of Professional Responsibility. A failure to timely notify the licensing authority within the required time period (typically 30 days from receipt of knowledge of the notification or inquiry) could result in a separate, additional violation.

Looking to the Future

Preparer penalty issues will most often arise during or at the conclusion of an IRS examination of the taxpayers 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? 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).

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 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 isn't. Be a prepared preparer. When in doubt . . . disclose, disclose, disclose!

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