IRS Guidance on the Tax Preparer Penalty Statutory Revisions

By Kip Dellinger

Kip Dellinger discuss the IRS guidance on the new tax preparer penalty standards created by the Small Business and Work Opportunity Tax Act.

On December 31, the IRS issued Notice 2008-13¹ (“the Notice”), which establishes temporary rules for application of the revised Code Sec. 6694 preparer penalty provisions that were enacted pursuant to the Small Business and Work Opportunity Tax Act of 2007.


There were a few refreshing surprises in the temporary rules from a tax practitioner viewpoint. For a summary of the changes, see Chart 1.

Signing Preparers and Adequate Disclosure

A signing preparer may satisfy the preparer’s required “disclosure” of a tax position for which there is a reasonable basis but not a “more likely than not” (MLTN) level of confidence by advising the taxpayer of the differences between the taxpayers substantial authority requirements under Code Sec. 6662(d)(2)(B)(i) (for nondisclosed items) and the preparer’s requirements under Code Sec. 6694 and contemporaneously documenting, in the preparer’s files, that the advice was provided (see Chart 2). The practical effect of this approach is that when the taxpayer has substantial authority for the tax treatment of an item, actual disclosure in the return to satisfy the preparer’s more likely than not confidence threshold will not be required.

The same process may also be used with regard to “tax shelter” issues for the taxpayer and preparer under Code Sec. 6662(d)(2)(C).⁵

These are very liberal temporary provisions. Essentially, the provisions say that, if the taxpayer and the preparer are “in conflict,” the taxpayer may make the disclosure decision for the preparer as long as the preparer has advised the taxpayer of the conflict between the preparer and taxpayer disclosure standards.⁶

Nonsigning Preparers and Adequate Disclosure

Nonsigning preparers advising a taxpayer are only required to advise a taxpayer of any possibility of avoiding penalties under Code Sec. 6662 by disclosure for lack of substantial authority—provided that there is reasonable basis for the advice. In other words, the nonsigning preparer has no duty to require or even request disclosure for her own protection under Code Sec. 6694.⁷

When providing advice to a signing preparer, a nonsigning preparer must, however, advise the signing preparer of the opportunity to avoid penalties under Code Sec. 6694 by disclosure. The signing preparer may—until further notice—discharge her responsibility with regard to a position that meets substantial authority but not more likely than not

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the advice is characterized as "reliance" advice under Covered Opinion rules. A reliance opinion reaches a more likely than not confidence threshold with regard to advice on the tax treatment of an item where a significant purpose of any partnership or other entity, any investment plan or arrangement or any other plan or arrangement is the avoidance or evasion of any tax imposed by the Internal Revenue Code ("the Code"). The preceding italicized language is imported into the Covered Opinion provisions of Circular 230 virtually verbatim from Code Sec. 6662(d)(2) dealing with tax shelters. Some commentators believed—when the Covered Opinion provisions were promulgated—that the Circular 230 application was intended to be much broader in scope than the Code definition. The author has long contended that the definition in Circular 230 has no broader meaning than in the Code and that a reliance opinion is only intended to include tax shelter type transactions.8 See Chart 3.

Comment. The guidance does not change the basic definition of either a signing and nonsigning tax return preparer contained in Reg. §1.6694-1, Reg. §1.6694-3 and Reg. §301.7701-15. The signing preparer for a firm is the preparer of the return or claim and no other individual with the firm is a (nonsigning) preparer. In situations involving firms where one or more individuals may be considered nonsigning preparers, only one of the individuals will be designated a (nonsigning) preparer; that is the individual with overall supervisory responsibility for the advice given by the firm with respect to the (particular) advice given by the firm concerning the return or claim.10

by informing the taxpayer and contemporaneously documenting the file.8

**Observation.** Nonetheless, nonsigning preparers generally provide advice in writing and, despite the guidance, may not be able to provide "penalty protection" if they cannot reach a more-likely-than-not confidence threshold due to restrictions imposed by the Covered Opinion provisions of Circular 230 (§10.35)—for example, where

![Chart 1. Preparer-Taxpayer Standards and Notice 2008-13 Signing Preparers](chart1.png)
Chart 2. The Accuracy-Related and Preparer Penalties (FIN 48 Penalty Analysis)

<table>
<thead>
<tr>
<th>Threshold Level of Tax Item or Position</th>
<th>Prior Law</th>
<th>New Law</th>
</tr>
</thead>
<tbody>
<tr>
<td>More Likely Than Not (51% or greater)</td>
<td>Preparer w/o disclosure</td>
<td>Preparer must disclose while TAXPAYER has no similar requirement</td>
</tr>
<tr>
<td>Substantial Authority (40% to 45% or greater)</td>
<td>Taxpayer w/o disclosure</td>
<td>FIN 48 Recognition Level</td>
</tr>
<tr>
<td>Realistic Possibility of Success (33% or greater)</td>
<td>Preparer w/o disclosure</td>
<td>FIN 48 Penalty Protection Level</td>
</tr>
<tr>
<td>Reasonable Basis (20% to 25% or greater)</td>
<td>Taxpayer with disclosure</td>
<td>FIN 48 Penalty Protection Level</td>
</tr>
<tr>
<td>Not Frivolous (5% or greater)</td>
<td>Preparer with disclosure</td>
<td></td>
</tr>
</tbody>
</table>

Comment. Interestingly, in an example in the Notice (Example 6, discussed later) reliance may extend to information received from another member of the same firm.

Preparers May Rely on Taxpayer Representations
In addition to these rather liberal interpretations of preparer disclosure, the Notice also makes adamantly clear that a “signing preparer may rely on representations of the taxpayer or from third parties and is specifically not required to independently verify information. The preparer should make inquiries with regard to information that appears incorrect and cannot ignore the implications of information that is obviously is or may not be correct if actually known to the preparer.

Reliance on Another (Nonsigning) Preparer
A preparer may rely on another advisor. The current regulations are superseded by the following reliance requirements:
- The advice is not unreasonable on its face.
- The preparer does not know or should not have known that the third party did not have all relevant facts.
- The preparer knows or should know that no changes in the law have occurred since the advice was given.

Passthrough Entity Returns
The rules retain the concept that preparation of a K-1 constitutes preparation of the recipient’s tax return if the K-1 preparer should reasonably know that the amounts on that form will be significant with regard to the recipient’s return.

Nonsigning Preparer Advice: When Is It Preparer Advice?
Essentially, the temporary guidance retains the long-standing position in the regulations that only post-transaction type advice qualifies as “nonsigning preparer” advice. That is, planning advice or pre-transaction advice does not make the advisor a “tax preparer” for purposes of the imposition of the penalty. If the advisor provides both pre- and post-transaction
advice, then the advisor will be considered a nonsigning preparer. Similarly, if the advisor is asked to and confirms the pre-transaction advice, it will become post-transaction advice and rise to nonsigning preparer advice subject to the penalty provisions.

Additional Nonsigning Preparer Issues and Advice

The Notice makes clear that a person that prepares for compensation documents such as depreciation schedules or cost, expense or allocation studies that constitute a substantial portion of a return is a tax return preparer subject to the preparer penalties. In this arena, think cost segregation studies, valuations, Code Sec. 382 net operating loss studies and transfer pricing studies. Nonsigning preparers perform these types of studies; their obligation is to inform a signing preparer of the duty of disclosure. In turn, for now, the signing preparer may discharge her responsibility with regard to a position that meets substantial authority but not more likely than not by informing the taxpayer and documenting the file, contemporaneously (and the author believes the IRS is very serious about the “contemporaneous” requirement).

Advice on Insubstantial or Insignificant Amounts

The Notice provides that a substantial portion of a return or claim (the preparation of which is a requirement for imposing the preparer penalty) including the preparation of a schedule or entry or other portion of a return that the preparer knows or should know is substantial if, adjusted or disallowed, it would result in a significant tax deficiency determination. This provision is intended to clarify that whether or not a person is a tax return preparer is dependent on the relative magnitude of the deficiency attributable to the schedule, entry or other portion.

Observation. Clearly, the Treasury was intent on assisting the practitioner community in controlling costs with regard to (particularly for nonsigning...
preparers) providing advice on routine and minor matters with regard to tax reporting issues, as well as not making every depreciation schedule or similar item (for example, Code Sec. 199 allocations) subject to extensive review under the preparer penalty rules.

Signing Preparers and Engagement Understandings

Under the law as enacted prior to this guidance, the “signing preparer” community had to consider obtaining a “waiver” from clients in which the client acknowledged that the tax preparer might require disclosure in a return of an item (because the preparer did not believe the tax position did not meet a more likely than not confidence threshold) that the taxpayer may not otherwise be required to disclose (because the taxpayer had “substantial authority” for a non-tax shelter item).

One can conclude that the way the rules now operate—documenting the file with regard to the MLTN/substantial authority issue—may render engagement letter references to MLTN unnecessary. As long as the tax practitioner is diligent about the documentation that is probably a correct statement because while disclosure might be a preferred avenue, it really isn’t required under these temporary operating rules.

Similarly, nonsigning preparers must only provide advice to the client based on the client’s filing requirements. However, many preparers may choose to include language in their engagements that the client will advise the signing preparer of any tax positions of which the client is aware that do not meet the substantial authority threshold.

Exhibits and Examples

Conveniently, the Notice contains three exhibits. Exhibit 1 is a list of returns the preparation of which may lead to a preparer penalty. Exhibit 2 is a list of passthrough entity tax forms that—although there is no tax calculated on the particular forms—may result in imposition of a preparer penalty with regard to the entity or person on which the passthrough amounts are reported for purposes of determining a federal tax liability (e.g., partnership and S corporation returns). Exhibit 3 provides a list of information returns for which the preparer penalty will only be imposed if the preparer “willfully” understated a liability of tax on a return (or claim for refund) in any manner or demonstrated reckless or intentional disregard for the rules and regulations.

The Notice contains 12 examples of the application of the guidance set forth in Notice 2008-13. In summary, the Examples describe these various situations and conclusions:

1. Filing out a Form 8886 for a Reportable Transaction as not subject to the preparer penalty. The conclusion is that it is not a substantial portion of a tax return but is only prepared to disclose a transaction; it is not relevant to the actual determination or calculation of any federal tax.
2. Preparation of a partnership return by an accountant constitutes preparation of the individual partner’s returns.
3. When an attorney gives only pre-transaction, “tax planning” advice for a corporate transaction, he is not a “tax return preparer.”
4. When an attorney gives advice on a single entry on a large, complex corporate return, the “insignificant” exception is met, and he is not a “tax return preparer.”
5. An attorney who provides “tax planning” advice and then follows that advice with post-transaction advice to a group of affected parties (with knowledge that the items to be reported by those parties is “significant”), he is a tax return preparer for the tax returns of each affected taxpayer.
6. The concept of an exception to the preparer penalty for a “signing preparer” accountant that relies on a schedule prepared by someone else in the accountant’s office (where the schedule is not obviously erroneous on its face) is illustrated. It states that the signing preparer is not required to audit, examine or review the schedule in order to reach a more likely than not reasonable belief standard. This is noteworthy because it appears to be far more liberal than the preparer rules that existed prior to the guidance. It seems to imply that no one gets penalized and the regulations under Code Sec. 6694 for many years seemed to imply that—with regard to a single firm—“someone’s gotta get penalized” (with apologies to Harvey Keitel in National Treasury).
7. An accountant has the ability to rely on an actuary with regard to the deduction of qualified plan contribution in order to avoid the preparer penalty.
8. When an accountant fails to make obvious inquiries with regard to a $50,000 charitable
contribution of property—i.e., inquiring about the existence of a qualified appraisal and Form 8283—the accountant cannot rely on client representations and the accountant is therefore subject to a preparer penalty.

9. A situation involving missing Forms 1099 is illustrated, in which the accountant obtains after inquiry based on a comparison with prior years. However, despite a general inquiry about any other 1099s, the client does not disclose yet another 1099 and income is significantly underreported. Not surprisingly, the accountant is not subject to a preparer penalty because the accountant may rely upon the taxpayer’s representation and the accountant did make inquiry with respect to an item that was obvious.

10. This example involves a situation where an accountant encounters an issue involving various small asset expenditures and the accountant is unable reach a more likely than not conclusion concerning the tax treatment of these items. The return is filed without disclosure. The example concludes that no tax preparer penalty is assessable—apparently because the amounts in question are not a substantial portion of the return.

11. This example describes how an accountant informs the client that the accountant cannot reach a more likely than not confidence threshold but that the client has substantial authority for the tax treatment of an item and explains to the client of the differences between the preparer and taxpayer penalty standards and contemporaneously the accountant creates documentation for her files. The taxpayer files the return without disclosure and no penalty is assessed against the preparer.

12. This example describes a situation where an attorney gives advice to a client that there is not “substantial authority” for the tax treatment of an item and advises the client that without disclosure the client will be subject to an accuracy-related penalty. The attorney contemporaneous documents the advice in the attorney’s files. The example concludes, again not surprisingly, that the attorney is not subject to a preparer penalty.

This treatment is entirely consistent with Section 10.34 of Circular 230 “best practices” prior to the revised preparer penalty provisions.

Concluding Thoughts

On the whole, the guidance is both welcome to and should be well received by the practitioner community. The Treasury clearly made an extra effort to find a workable solution—if only temporary—for the unreasonable conflict in the taxpayer and tax preparer disclosure statutes (i.e., not forcing taxpayer disclosure merely to protect the preparer from her penalties). In addition, the guidance provides that incidental or insignificant advice within an entire return will not render the advisor a “tax preparer” and the guidance also recognizes that a nonsigning preparer has no real control over whether or not the recipient of the advice makes a disclosure.

The news release that accompanied the Notice indicates the revised preparer regulations will be top priority for the IRS in 2008 and seeks practitioner community input into the regulation setting process. In this regard, the news release indicates that the goal is to complete the regulations process—described as a major overhaul—by the end of 2008.

Not surprisingly, considering the pressure that the Treasury was under extreme pressure to provide guidance before the 2008 filing season, there remain a multitude of unanswered questions. For example, the guidance is focused entirely on income tax preparation and does not address the other very common area of concern for attorneys and some CPAs—estate and gift tax returns. And the guidance does not address potential areas of overlap between those returns and income tax returns, e.g., family limited partnerships that have both income and estate and gift tax implications where the advice given may involve nonsigning preparers (and that may involve pre- and post-transaction advice). This is just one area of concern and there will be many others identified. Identifying and addressing these issues will be an important element for tax professionals and their professional organizations to address in the process of developing a new regulatory structure for the expanded preparer penalty regime.

ENDNOTES

5 Notice 2008-13, G, with regard to tax shelters described in Code Sec. 6662(d)(2), the taxpayer will advise the preparer that no confidence
threshold will absolve the taxpayer of liability for the accuracy-related penalty, but will also inform the taxpayer of the fact that the penalty may not be imposed if the taxpayer can successfully assert a reasonable cause defense under Code Sec. 6664(d).

The Notice does not change the requirement of disclosure by both taxpayers and CPAs with respect to tax positions taken on state income tax returns (notably California and New York) that do not meet a state required standard of “more likely than not” confidence threshold, and the requirement of reasonable basis for disclosed tax positions.

6 Supra note 5.
7 Supra note 5.
8 Supra note 5.
10 Notice 2008-13, B.
11 Notice 2008-13, D, which is consistent with current regulations and Circular 230 and AICPA Statement on Standards for Tax Services No. 3.
12 Notice 2008-13, F.
14 Notice 2008-13 does not modify the long standing provision in the regulations defining a tax preparer that does not include pre-transaction advice as tax preparer advice. See Reg. §301.7701-15(a)(2)(i).
15 Notice 2008-13, A. 2(b).
16 Notice 2008-13, B.
17 The conclusion in the example likely derives from the fact that the signing preparer may not actually be aware that the schedule was prepared by someone else at the firm.

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