New Standards for Tax Return Preparer Penalties Are “More Likely Than Not” Part of a Larger Trend

By Todd Simmens, John DiIorio and James Hartford

Todd Simmens, John DiIorio and James Hartford examine the new standards for tax return preparer penalties.

The Small Business and Work Opportunity Tax Act of 2007 (“the Act”) was enacted on May 25, 2007, as part of legislation concerning supplemental appropriations for the Iraq war. Section 8246 of the Act contains provisions that expand the federal return preparer penalty provisions under Section 6694 of the Internal Revenue Code of 1986, as amended (“Code”) to apply to any position below one that the preparer reasonably believes will “more likely than not” be sustained which is not disclosed, and any position that is below “reasonable basis.” The newly revised Code Sec. 6694 also provides for a substantial increase in penalties for violations. Moreover, the Act revises Code Sec. 6694 to apply to all federal tax returns—not just income tax returns. This legislation shifts the onus of compliance and transparency from taxpayers to tax return preparers through enhanced disclosure obligations and harsher penalties. These changes also present another opportunity for policymakers to create transparency for both taxpayers and practitioners when taking a position below the “more likely than not” standard.

Prior Law

Prior to the amendment of Code Sec. 6694, tax return preparer penalties applied to a person who prepared, for compensation, a federal income tax return or claim for refund. The penalties did not apply to any other types of returns such as employment or estate tax returns. Former Code Sec. 6694 included a $250 penalty for an income tax return preparer who knew, or reasonably should have known, of the position that caused the understatement due to a frivolous position or an undisclosed position for which there was not at least a realistic possibility of being sustained on its merits. An income tax return preparer engaging in willful or reckless conduct with respect to preparing an income tax return, under the former rules, was subject to a penalty of $1,000.

Changes to Code Sec. 6694

The Act expands the reach of Code Sec. 6694 to tax preparers of all types of federal tax returns, including estate and gift tax returns, employment tax returns, excise tax returns and returns of exempt organizations. Perhaps the most notable changes are to the standards for avoiding the imposition of Code Sec. 6694 penalties for preparing a return for which there is an understatement of tax, as well as the increase in the amount of any potential penalty. The Act replaces the realistic possibility standard for undisclosed positions with a requirement that the preparer have a reasonable belief that the tax treatment of the position is “more likely than not” the proper treatment. The Act also increases the standard at which a preparer is subject to penalty for a disclosed position from better than frivolous to reasonable basis. These changes represent a significant departure from the
standards to which practitioners have traditionally been subject. By adopting the “more likely than not” standard for undisclosed positions, new Code Sec. 6694 is now on par with the standards required for many other taxpayer, practitioner and financial accounting provisions.¹

In addition to heightening the disclosure standards for return preparers, the Act raises the penalty under Code Sec. 6694 to the greater of $1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer. For willful or reckless conduct, the penalty is the greater of $5,000 or 50 percent of the income derived (or to be derived) by the tax return preparer. Both of these penalties are a marked increase from the $250 or $1,000 penalties under prior law.

What is unclear is the affect that this new standard will have on the relationship between taxpayers and their return preparers. For instance, what if a taxpayer has a non-“tax-shelter” transaction, and that position is at “substantial authority”? The taxpayer is not required to disclose that position on its return to avoid the Code Sec. 6662 accuracy-related penalty; however, the tax return preparer must attach a Form 8275 to the return to disclose that position to avoid sanctions under Code Sec. 6694. What affect will this have on the relationship between tax return preparers and their clients? What if the taxpayer removes the Form 8275 from the return prior to filing the return?

Tax return preparers must be alert to the current climate of stronger enforcement including the new standards under Code Sec. 6694.

Transitional Relief

While the changes to Code Sec. 6694 were effective for tax returns prepared after May 25, 2007, the Treasury provided transitional relief for all federal returns, amended returns and refund claims due on or before December 31, 2007, in Notice 2007-54.² Notice 2007-54 states: “Because the amendments to Code Sec. 6694 are effective immediately for returns prepared after May 25, 2007, the IRS and the Treasury Department believe that effective tax administration requires transitional relief with respect to the new standards of conduct under Code Sec. 6694(a).” The notice further provides that the standards of the former Code Sec. 6694(a) will apply to all returns due on or before December 31, 2007 (determined with regard to any extension of time for filing). Under Notice 2007-54, the IRS will apply the pre-Act standards (i.e., realistic possibility of success for an undisclosed position and better than frivolous for a disclosed position) for returns due during the remainder of 2007. If, however, a practitioner falls short of the standards, the new penalties apply.³

The IRS will not offer any transitional relief for penalties under Code Sec. 6694(b), as well it should not, as those preparers who willfully disregard the rules deserve whatever penalties the law imposes.

“More Likely Than Not” a Trend

The changes to Code Sec. 6694 mirror the trend to look to the a more-likely-than-not level of comfort as reflected in changes to the regulations and penalties associated with Circular 230, Final Interpretation Number 48 (FIN 48), and the provisions of Code Secs. 6662 and 6662A.

For opinions that are considered “covered opinions” under Section 10.35 of Circular 230, if a practitioner is unable to reach a more-likely-than-not level of comfort on the underlying issue(s), the preparer generally must disclose that fact in the opinion and advise the client that, to the extent a level of comfort less than more likely than not has been reached, the opinion may not be used for penalty protection. Similarly, under FIN 48, a financial accounting principle (as opposed to a rule of tax law), enterprises may not recognize the benefit of tax positions for which they have not reached a comfort level of more-likely-than-not or better when calculating their current and deferred income tax expense. Only after reaching a more-likely-than-not level of comfort may the benefit of such tax positions be recognized in their income tax expense.⁶

The more-likely-than-not standard has also been adopted for avoidance of certain federal taxpayer penalties. Under Code Sec. 6662A (enacted in October 2004), the penalty for understatements attributable to reportable transaction understatements, no penalty is imposed on any portion of an understatement due to reasonable cause. For a taxpayer to show such reasonable cause, he must (1) have adequately disclosed the position under Code Sec. 6011; (2) have substantial authority for the
position; and (3) have reasonably believed that the treatment was more likely than not the proper treatment.7

The substantial understatement penalty also, in some instances, requires taxpayers to have reasonably believed that the treatment of the position was more likely than not proper. For non–tax-shelter positions, taxpayers generally may reduce the amount of a potential understatement to the extent they have substantial authority for the position if undisclosed, or, if adequately disclosed, when there is a reasonable basis for the position. For tax shelter positions, however, Code Sec. 6662(d)(2)(C) provides that the understatement cannot be reduced.8 Relief from understatements due to tax shelter positions is available only if there is reasonable cause for the position. Similar to Code Sec. 6662A, to establish reasonable cause, taxpayers generally must have substantial authority and a reasonable belief that the treatment is more likely than not proper.9

Tax return preparers must be alert to the current climate of stronger enforcement for noncompliance including the new standards under Code Sec. 6694. In addition, the current regulations under Code Sec. 6694 state that the employers of tax return preparers can face separate preparer penalties for situations where management participates in taking a position that fails to meet the standards under Code Sec. 6694, where employers fail to put in place proper review processes, or where those review processes are not followed. As the standards for tax positions continue to elevate, it will become increasingly important for practitioner and taxpayers, alike, to be satisfied that their tax positions have been properly vetted and reported. The recent changes to Code Sec. 6694 send this message to practitioners. For non–tax-shelter positions of taxpayers, it would seem that conforming changes to Code Sec. 6662 might be on deck.

ENDNOTES

1 This article reflects the views of the authors only. It does not necessarily reflect the views, opinions or positions of Ernst & Young, LLP or Thompson Hine LLP. The authors wish to thank Mark Siegel of Ernst & Young LLP for his invaluable comments.

2 Code Sec. 6694. An “income tax preparer” for purposes of Code Sec. 6694 is defined under the current regulations (in effect prior to the May 2007 change to Code Sec. 6694) generally to include any person who is an income tax return preparer within the meaning of Code Sec. 7701(a)(35) (i.e., any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by this title or any claim for refund of tax imposed by this title). Reg. §1.6694-1(b).

3 Examples of provisions which have adopted the “more likely than not” standard include Code Sec. 6662 accuracy-related penalty for tax shelter transactions; Code Sec. 6662A reportable avoidance transaction penalty; Code Sec. 6695A substantial and gross valuation misstatements attributable to incorrect appraisals; Circular 230 covered opinion rules; and FIN 48 accounting for uncertain tax positions.\footnote{Notice 2007-54, IRB 2007-27, 12.}

4 What is not clear is the case where a return has an original due date of prior to December 31, 2007, and an extended due date of after December 31, 2007, and it is filed prior to December 31, 2007—what standard applies? One could very well say that by filing the extension request, the return preparer has invited the new standard upon itself, where if an extension request were not filed, the transitional standard would apply.\footnote{Under FIN 48, the benefit of such tax positions also may be recognized when either the period of limitations on assessment of the tax position has expired or the tax position has been effectively settled with the taxing authority through negotiation or settlement.}


6 Under FIN 48, the benefit of such tax positions also may be recognized when either the period of limitations on assessment of the tax position has expired or the tax position has been effectively settled with the taxing authority through negotiation or settlement.\footnote{Reg. §1.6664-4(d).}

7 Code Sec. 6664(d).

8 A “tax shelter” under Code Sec. 6662 is defined as any partnership, investment, plan or arrangement if a significant purpose is the avoidance or evasion of federal income tax. Code Sec. 6662(d)(2)(C).

9 Regulations have not, however, been amended to reflect the changes to Code Sec. 6662 from Act Sec. 812(d) of the American Jobs Creation Act of 2004 (P.L. 108-357), which do not allow for a reduction in understatements attributable to tax shelter items of any taxpayer; the only recourse for such taxpayers is to establish reasonable cause. See also Code Sec. 6695A substantial and gross valuation misstatements attributable to incorrect appraisals.