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Ten Things You Need to Know About Return Preparer Penalties

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Tax return preparers (and other tax advisers) have to worry about giving accurate tax advice to please their clients—tax advisers want to make sure their clients return year after year.

They also want to ensure that their clients do not suffer mishaps that cause them to seek legal recourse against them.

But apart from the web of liability concerns shared by any provider of professional services, a tax adviser is in a unique role. The tax adviser helps clients to comply with their tax obligations. The tax adviser (and perhaps especially the return preparer) is thus part of the tax system.

You might even view the tax adviser's role as quasi-governmental. The IRS and Treasury Department have detailed rules about what tax advisers and tax preparers can and cannot do. Not only are there ''dos and don'ts'' IRS and Treasury have set down, but there can be penalties imposed on the tax adviser himself or herself.

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This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

Tax return preparers have long been subject to discipline as well as financial penalties for mistakes they may make in preparing and filing tax returns for their clients. The concept of ''preparer penalties'' is therefore nothing radical or new. Yet in the last few years, the stakes have changed. Although preparer penalties have applied for many years, they generally were restricted to situations in which there was no realistic possibility of the tax position being sustained on the merits, the preparer knew it (or reasonably should have known it), and the tax position was not disclosed. That was a pretty high three-rail hurdle for IRS to prove.

All that changed in 2007, when §6694 was amended to make it easier for IRS to impose preparer penalties. Now, IRS needs to show that the preparer knew or reasonably should have known of the position and:

- the position was with respect to a tax shelter or a reportable transaction (as described below), and it was not reasonable to believe that the position would more likely than not be sustained on its merits;
- the position was not disclosed, and there was not substantial authority for the position; or
- the position was disclosed, but there was no reasonable basis for the position.

Exactly who is and is not a preparer, and what will or will not subject you to a penalty, is often not obvious. The stakes are high. Here are 10 things you need to know about return preparer penalties.

1. Consider Yourself a Preparer

If you give tax advice, you may or may not actually fill out tax returns. As a tax lawyer, I give tax advice daily, but I do not actually prepare tax returns. I give advice about tax return items, and I routinely review tax returns, but I do not fill them out for clients. However,

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it is clear that I am usually regarded as a ''return preparer'' by IRS.

If you prepare a return, prepare a substantial portion of a return, or provide advice on a position that is directly relevant to the determination of the existence, characterization, or amount of an entry on a return, you are a preparer.

Among other things, I give advice to clients about specific line items on their returns (for example, about the deductibility of attorneys' fees, or the tax treatment of a settlement payment). IRS actually includes within the ''return preparer'' moniker both ''signing'' and ''non-signing'' preparers. There can be nuances about the liability of signing return preparers and non-signing return preparers (I am usually the latter).

However, to simplify these rules, get used to thinking of yourself as having preparer liability and abiding by the standards IRS enunciates. In other words, when in doubt, consider yourself to be a return preparer.

2. When in Doubt, Disclose

It may sound trite, but one of the best ways to avoid the imposition of penalties as a preparer is to ensure that your client discloses any and all questionable tax positions. In fact, you might take a very strict view about what you consider to be questionable. In some ways, what is questionable is the $64,000 question.

Everything in the tax world is not black and white, and there are gradations of positions. At one end of the tax spectrum are tax positions that are frivolous, or perhaps a little better than that (which you might describe with the faint praise of ''not frivolous''). At the other end of the spectrum would be a tax position that will prevail. Between these poles lies ample middle ground.

If challenged, some deductions or other items will be more in your favor, and some will be more in the government's. The tough part is deciding when to disclose, how much to disclose, and on what form to do it. We will come back to these disclosure issues later.

In general, though, get used to the mantra that when in doubt, opt in favor of disclosure. Disclosure is not a cure-all, but it is close.

3. Skip Tax Shelters

The best policy is probably to steer clear of tax shelters entirely. That means do not invest in them yourself, do not advise clients to do so, and do not prepare returns for clients who do.

Yet not everyone can do that. In fact, especially forgoing the preparation of returns for clients who do invest in tax shelters may be overcautious, and may keep you from earning a living. Plus, it may keep clients who may have done shelter transactions from having good representation.

However, if you are going to venture into any part of the shelter arena, you need to know the ropes. Tax shelters are defined in §6662(d)(2)(C)(ii) to include any plan or arrangement having a significant purpose of avoiding or evading federal income tax. In addition, there are reportable transactions (to which §6662(a) applies) that are also subject to special disclosure rules. These include listed and reportable transactions that have a significant purpose of tax avoidance or tax evasion.

In both cases, you incur a penalty under §6694(a) when you put these items on a tax return, unless you meet a high ''more likely than not'' standard about the particular tax issues involved, or unless you disclose. More specifically, the penalty applies unless you disclose or had a reasonable belief that the position set forth in the return would more likely than not be sustained on the merits. This applies for returns prepared for tax years ending after Oct. 3, 2008.*

4. Make a Careful Assessment Of How Much Authority You Have

How do you assess tenuous tax positions? To put it in the language of Circular 230, how do you make a determination about the substantial authority or more likely than not standards? Well, let us start with what you cannot do.

You cannot consider audit rates. In other words, you must assume the taxpayer and the specific tax position in question will be audited, and that it will be tested on the merits. You evaluate the case law and administrative authority, and you use your best legal judgment.

That means some advisers might come out differently than others. The standards are meant to be objective but they are necessarily somewhat subjective.

There is ''substantial authority'' for the tax treatment of an item if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities—pro and con—should be considered. The weight of authorities is determined in light of the pertinent facts and circumstances.

In determining whether there is substantial authority for a position, you are not supposed to take the applicability of court cases to a taxpayer's situation into account due to the taxpayer's residence in a particular jurisdiction. However, there is substantial authority for a position if there is controlling precedent from a U.S. court of appeals to which the taxpayer has a right of appeal regarding the position. So, if there is a controlling tax case favorable to the return position in the Ninth Circuit where the taxpayer lives, but unfavorable cases in all the other circuits, there is substantial authority for the position.

Regarding timing, there is substantial authority for a position only if there is substantial authority on the date the return or claim for refund is prepared, or if there was substantial authority on the last day of the tax year to which the return relates.

What if you are not sure if you have enough favorable authority (and enough favorable factually similar authority) to tip the balance in favor of your reported treatment? Remember, ''more likely than not'' means a more than 50% chance your position will prevail. If you are not sure, then disclose.

5. Disclose to IRS

If you do not have the requisite level of authority to avoid preparer penalties without disclosure (generally, that means if you do not have a more likely than not position in a tax shelter or listed transaction, or if you do

* *See* Notice 2009-5.

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not have substantial authority in most other areas), you may avoid penalties by disclosure. But just what is disclosure and how do you do it?

What constitutes adequate disclosure varies. The disclosure should include all relevant facts and authorities. It must be sufficient to reasonably apprise IRS of the reason for the disclosure.

Some disclosures in the return itself (and in footnotes to the return, which can be on white paper) will be enough. Usually, though, disclosures should be on IRS Form 8275, which is specifically designed for this purpose. Sometimes, disclosure must be on Form 8275R, where you are taking a position that conflicts with a regulation or other authority.

As this tip of the iceberg discussion suggests, the waters here can be treacherous. If this area affects your practice and you find yourself in unfamiliar waters, do not just go full steam ahead. Read the regulations yourself, even though they can be daunting. Plus, you may actually need to get some professional advice from a tax lawyer or tax accountant who is on familiar terms with these rules.

6. Disclose to Your Client

When you talk about disclosure, most tax professionals assume you are talking solely about disclosure to IRS. But there is also disclosure to your client.

Under IRS's current interim guidance, you can avoid the §6694 preparer penalty with respect to tax shelters and reportable transactions if there is ''substantial authority'' for the position (a lower standard than ''more likely than not''), and if the preparer advises the taxpayer of the penalty standards applicable to the taxpayer if the transaction is deemed to have a significant purpose of federal tax avoidance or evasion. This ''tell-your-client'' standard is detailed and unforgiving.

The advice to the taxpayer must explain that, if the position has a significant purpose of tax avoidance or evasion, there needs to be, at a minimum, ''substantial authority'' for the position. Plus, you must advise the client that he or she must possess a reasonable belief that the tax treatment was more likely than not the proper treatment in order to avoid a penalty. Finally, you must inform the client that disclosure in accordance with Regs. §1.6662-4(f) will not protect the taxpayer from assessment of an accuracy-related penalty if §6662(d)(2)(C) applies to the position.

7. Keep Good and Contemporaneous Records

Not only do you need to make a detailed disclosure to your client, but you need to be able to prove that you did! That does not mean relying on your memory or the memory of your clients. It means making a timely written record that you gave all the required disclosures to your client. The preparer should contemporaneously document this advice in his or her files.

It is best to give a summary of the advice in writing, and to require the client to sign acknowledging that the client received the disclosure. Admittedly, a requirement that the client sign something may rub some clients the wrong way. However, hopefully you can explain that IRS standards are high, and that you need to maintain a good record.

8. If You Advise Another Preparer, Document That Too

The rules acknowledge that there may be more than one preparer, and that one preparer may be advising another.

If a non-signing preparer provides advice to another preparer regarding a position for a tax shelter, the position will not be considered an unreasonable position if there is substantial authority for the position, and if the non-signing preparer provides a statement to the other preparer about the penalty standards applicable to the preparer under §6694.

Again, you should keep contemporaneous documentation in your file showing that you gave the statement to the other preparer.

9. Be Reasonable

This may sound vacuous but it is not. There has been a great deal of panic about these professional standards. Some of it is justified. The tax system got out of whack during the tax shelter era, and it is understandable that IRS expects tax advisers to take a bigger role in policing the system.

Still, dialogues with clients can be tough. Some taxpayers may be reluctant to attach Form 8275 to a return. They may feel that their tax position on the particular issue is strong and that a disclosure on Form 8275 will flag their return for audit.

Usually this fear is unjustified, or at least overblown. The fact is that the basic form of disclosure now is the Form 8275. There is every reason to believe that many stacks of these disclosure forms are being filed with returns. Thus, if it is a red flag, red may be the prevailing color of many tax returns these days.

Just as taxpayers may shy away from the disclosure for perhaps the wrong reasons, preparers, on the other hand, may have an incentive to over-disclose. Some preparers may insist on disclosure for virtually every significant tax position that they feel may conceivably be questioned by the government. Better safe than sorry, as the adage goes.

Be reasonable in your tax positions, be reasonable in disclosures, and be reasonable in working through these issues with your clients. Note that there is at least a potential for a conflict of interest, although it is one that seems manageable.

The preparer may be recommending disclosure of an uncertain tax return position to avoid the accuracy-related penalty (on the taxpayer), to avoid the preparer penalty (on the preparer), or to avoid both. Preparers and their clients have to work through these issues, which usually is not too hard. Nevertheless, there will occasionally be hurt feelings or even terminations of engagements when client and preparer disagree.

10. Act in Good Faith

It is probably obvious that if you find yourself saying ''I acted in good faith,'' it may mean that you have done something wrong, or at least that you have made a mistake. Still, for many preparers, the most relevant penalty question can be just how reasonable it was for you to believe in the reported tax position, as opposed to actually how likely it was that the tax position would prevail. In other words, be reasonable, and act in good faith.

Whatever happens, being reasonable and acting in good faith goes a long way.

In fact, a preparer will not face a §6694(a) penalty 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. You can show good faith in a variety of ways.

For example, a preparer will be deemed to have acted in good faith if he or she relies on the advice of a third party who the preparer had reason to believe was competent to render the advice. Plus, the regulations list a variety of pertinent factors in making the good faith assessment. Interestingly, many of these factors go not to the specific error that is being examined, but rather to the preparer's course of conduct.

Thus, it is relevant to consider the frequency of errors, the materiality of the errors, and even the preparer's normal office practice. On the latter point, it can be relevant to ask whether such an error would occur rarely, and whether the preparer's normal office practice was followed in preparing the return.

Conclusion

This is only a summary, and summaries can be dangerous. Be careful out there.

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