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Code section 6694 has recently been amended. As a result of the amendment, preparers are held to higher duties and are potentially subject to greater penalties. In addition, some preparers who previously were not subject to the section are now within its reach. Notice 2008-13 has provided interim guidance. And, at the moment, section 10.34 of Circular 230 is similar but not identical to section 6694. This article details the requirements applicable to preparers under the code and the circular. Two decision-trees are provided for the reader, portraying in a visual format the various rules.

Table of Contents

Introduction

Circular 230 sets forth ethical rules that lawyers and CPAs who practice before the IRS must follow. Violations of Circular 230 may result in severe disciplinary action, including disbarment from practice before the IRS and monetary penalties. Although the section of Circular 230 regarding written advice that constitutes a so-called covered opinion (section 10.35) has received much publicity, section 10.34 has received little publicity, even though it has much wider application and therefore poses a greater concern to practitioners. Unlike section 10.35, which applies only to a limited category of written advice, section 10.34 applies whenever advice (whether written or oral) is given on a position to be taken on a tax return or claim for refund. It also applies to any affidavit or other document that is submitted to the IRS. Historically, section 10.34 has closely mirrored section 6694 of the Internal Revenue Code. Section 6694 imposes penalties on those who for compensation prepare a return or claim for refund or give advice about a position to be taken on the return or claim. Until recently, section 6694, like section 10.34, had received little attention.

In the last several months, however, as a result of changes and proposed changes, these provisions have assumed much greater significance to tax practitioners. In May 2007, section 6694 was significantly amended. Shortly after the amendment, the IRS issued Notice 2007-54, 2007-27 IRB 12, *Doc 2007-13936*, *2007 TNT 113-14*, in which it largely deferred the effective date of the amendment until the beginning of 2008. And, in September 2007, Treasury proposed an amendment to Circular 230 section 10.34 designed to make its provisions more or less parallel to section 6694 as amended in May. This flurry of activity makes it imperative for practitioners to carefully consider their obligations under the code and Circular 230.

One item deserves special note. Although the proposed amendments to section 10.34 are to be effective only when the regulation effecting those changes becomes final, the Treasury Department has included ''Reserved'' in both section 10.34(a) and (e) because Circular 230 was amended in September 2007 to expand its scope to cover written submissions other than returns and claims for refund. Nonetheless, based on unofficial conversations with government employees, we believe that section 10.34(a) and (e) (formerly (d)) apparently were intended to continue to apply before the regulation that would make the proposed changes effective becomes final. In other words, it is understood that section 10.34(a) and (e) should be viewed as having the same provisions and applications as they had before the September changes were made. This article and the attached charts have been prepared on that basis.

Fundamental Changes to Section 6694

The 2007 amendments to section 6694 changed the statute in three principal ways. First, the penalties were increased. Second, whereas the section had previously applied only in the case of income tax returns, the amendment removes that limitation. As a result, it is now

applicable to virtually all types of tax returns, including estate, gift, and generation-skipping transfer tax returns. Third, the standards with which practitioners must comply to avoid the penalties that the section imposes have been significantly toughened.

An understanding of the new standards under section 6694 is more easily reached by first considering the preamendment requirements. Before the amendment, a preparer could avoid penalty under section 6694 if the return position had a realistic possibility of success on the merits. Reg. section 1.6694-2(b) provides that this standard is satisfied if there is at least a one-in-three chance of being sustained on the merits. If there was no realistic possibility of success on the merits, the preparer could nonetheless avoid a penalty under the section if the position was not frivolous (that is, not patently improper) provided the position was adequately disclosed on the return. In general, disclosure is made by attaching Form 8275 to the return (or, if the position is contrary to a Treasury regulation, Form 8275R). In the case of a nonsigning preparer, the lower standard was applicable if particular advice about disclosure was given to the taxpayer.

Under the 2007 amendment, the realistic possibility of success standard is replaced with a requirement that the practitioner reasonably believe that the position is more likely than not correct. Requiring a reasonable belief that there is more than a 50 percent (or, in other words, more than a one-in-two) likelihood of success, this standard is obviously more difficult to satisfy than the preamendment one-in-three standard. The not frivolous standard is replaced with a reasonable basis standard. Again, as suggested, this standard is more stringent than the one it replaces. Like its predecessor, the reasonable basis standard is, according to the statute, available only if disclosure is made.

Also, as was true before the amendment, the penalty is not imposed if it is shown that there is reasonable cause for the understatement and that the error was made in good faith.

Interim Guidance Under Notice 2008-13

On December 31, 2007, as the suspension effected by Notice 2007-54 was about to expire, the IRS issued Notice 2008-13, 2008-3 IRB 282, *Doc 2007-28351*, *2008 TNT 1-6*, providing interim guidance under revised section 6694. It is anticipated that proposed regulations under the section will soon be released, although it is expected that guidance provided by the notice will continue to apply until the regulations become final.

The notice separates the standards for signing preparers from nonsigning preparers. For signing preparers, no penalty is imposed if there is a reasonable basis for the position, even if the preparer does not reasonably conclude that the position would more likely than not be sustained, if:

> (1) The required disclosure form disclosing the position is filed with the return;
>
> (2) the preparer provides the taxpayer with a return that includes the disclosure form (even if, apparently, the taxpayer removes it before filing the return);
>
> (3) there is substantial authority for the position and the preparer advises the taxpayer of the difference between the penalty standards applicable to the taxpayer under section 6662 (which imposes penalties on taxpayers for negligence, disregard of IRS rules and regulations, substantial underpayment of income tax, overstatement of pension liabilities, and some under- and overvaluation misstatements) and those applicable to the preparer under section 6694 and the preparer contemporaneously documents that this advice was given; or
>
> (4) the position relates to a tax shelter (as defined in section 6662(d)(2)(C)) and the preparer advises the taxpayer of the penalty standards applicable to the taxpayer under section 6662(d)(2)(C) (which provides that certain safe harbors do not apply to tax shelters) and the difference, if any, between those standards and the standards under section 6694, and contemporaneously documents that this advice was given.

Under the notice, no penalty is imposed on nonsigning preparers if there is a reasonable basis for the position, even if the more likely than not standard is not satisfied, provided the preparer informs the taxpayer about any opportunity to avoid penalties under section 6662 through disclosure and about the requirements for disclosure. If in these circumstances a practitioner gives the advice to a preparer, rather than to the taxpayer, the practitioner need tell the preparer only that disclosure may be necessary under section 6694. For the nonsigning preparer to establish that the necessary information was provided, there must be contemporaneous documentation to that effect.

Requirements Under Circular 230 Section 10.34

Before the 2007 amendment to section 6694, Circular 230 section 10.34 largely mirrored section 6694. And it almost certainly will continue to do so once a proposed amendment to section 10.34 is adopted. Until the proposal is finalized, however, the standard under Circular 230 is parallel to the preamendment standards in section 6694: for signing practitioners, realistic possibility of success in the absence of disclosure, and not frivolous if the requisite disclosure is made.

Under section 10.34, unlike section 6694, practitioners are required to inform the taxpayer about any penalty that is reasonably likely to apply; about any opportunities to avoid the penalty through disclosure; and about the requirements for disclosure. The section explicitly provides that these rules apply even if the practitioner is fully compliant with section 6694. Finally, unlike section 6694, which applied only to income tax returns before the 2007 amendment, section 10.34 has long applied to all returns.

Coping With Conflicting Standards and Duties

Section 6694 applies to all who prepare (or provide advice with respect to) returns whether or not they are subject to Circular 230. Hence, practitioners subject to Circular 230 must comply with section 10.34 as well as section 6694. On occasion, the standards under section 10.34 and section 6694 may not be identical, requiring

practitioners to determine which of the two standards is applicable. For example, the substantial authority provision in Notice 2008-13 — allowing a signing preparer to prepare the return without disclosure even though the more likely than not standard is not satisfied — has not been incorporated into section 10.34. Similarly, the tax shelter provision in the notice — creating a parallel exception to the more likely than not standard for tax shelters — is not yet contained in section 10.34. In any event, although preparers may avoid penalty under section 6694 simply by filing the return with the appropriate disclosure, section 10.34 will require in many cases that advice be given about penalties, even on positions for which there is substantial authority and on tax shelter positions. Pending further clarification, cautious practitioners will adhere to the more rigorous standard of section 10.34 in cases such as these, and advise taxpayers about penalties.

Understanding Section 6662 Penalties

As indicated above, the standards applicable to taxpayers under section 6662 are different from those applicable to practitioners under section 6694 and Circular 230 section 10.34. Yet, as also indicated above, compliance with section 6694 and Circular 230 is intertwined with the section 6662 penalties. Hence, practitioners must be fully conversant with section 6662. Here's a primer about section 6662.

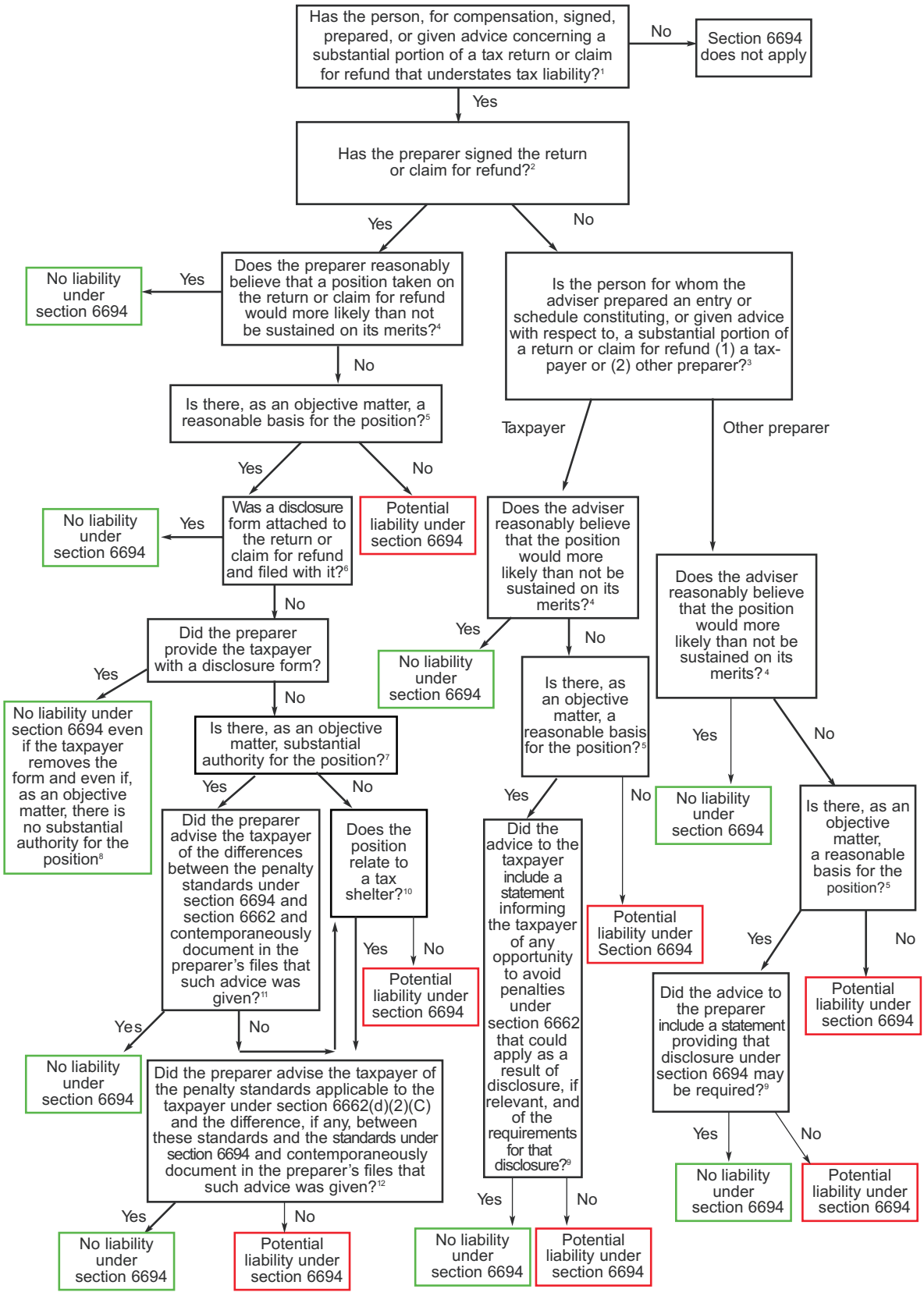
The penalties under section 6662 are imposed on any portion of an underpayment of tax required to be shown on a return if the underpayment is attributable to one or more of the following: (1) negligence or disregard of rules or regulations; (2) a substantial underpayment of income tax; (3) a substantial valuation misstatement for income tax purposes; (4) a substantial overstatement of pension liabilities; or (5) a substantial estate or gift tax valuation understatement. The penalty for negligence does not apply if the taxpayer's position has a reasonable basis. The penalty for disregard of rules or regulations does not apply if the position is disclosed on the return and there is a reasonable basis for the position. Similarly, the penalty for substantial understatement of income tax will not be imposed if the position is disclosed and it is determined that the position has a reasonable basis. The substantial understatement penalty can also be avoided if there is substantial authority for the position. However, neither the substantial authority exception nor the disclosure exception will apply if the transaction constitutes a tax shelter within the meaning of section 6662(d)(2)(C). It is important to note, however, that under section 6664(c), no penalty is imposed under section 6662 if there was a reasonable cause and the taxpayer acted in good faith.

The Treasury regulations promulgated under section 6662 flesh out important details about its provisions, including the meaning of substantial authority, reasonable basis, and other important matters.

Summary and Conclusions

Practitioners who must comply with the rigors of Circular 230 and who for compensation prepare or give advice on a tax return face two hurdles: Circular 230 and section 6694. The sections are currently disparate, but a pending amendment to section 10.34 would create greater parity. In the interim, practitioners need to ensure that they fully comply with the requirements of each section. Because both sections are intertwined with section 6662, practitioners must fully understand that section as well. Study of the regulations under that section is essential to compliance. To aid practitioners with the challenge of complying with both section 6694 and Circular 230 section 10.34, two flowcharts are attached to this article, providing guidance on each provision.

Figure 1. Preparer Penalties Under Section 6694



Note: This chart reflects IRS Notice 2008-13, which provides merely interim guidance.

Figure 1 Notes

Footnotes for 6694 Flowchart:

[1]Section 6694 defines ''understatement of liability'' as ''any understatement of the net amount payable with respect to any tax imposed by this title or any overstatement of the net amount creditable or refundable with respect to any such tax.''

[2]Section 7701(36)(a) provides that ''[t]he term 'tax return preparer' means 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. For purposes of the preceding sentence, the preparation of a substantial portion of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund.'' Note that the Small Business and Work Opportunity Tax Act of 2007 (the act) amended this definition such that it now is not limited to preparers of income tax returns, and Notice 2008-13 provides that, for purposes of section 6694, the applicable regulations be interpreted similarly. Current regulations do not limit preparer penalties to those who sign a tax return or claim for refund; for example, reg. section 301.7701-15(b)(1) provides that ''[a] person 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.'' Notice 2008-13 interprets the term ''substantial portion'' in reg. section 301.7701-15(b)(1) to mean ''a schedule, entry, or other portion of a tax return or claim for refund that, if adjusted or disallowed, could result in a deficiency determination (or disallowance of refund claim) that the preparer knows or reasonably should know is a significant portion of the tax liability reported on the tax return (or, in the case of a claim for refund, a significant portion of the tax originally reported or previously adjusted).'' In other words, a person will be deemed to be a preparer if he prepares part of a return or claim for refund and knows or should know that a deficiency attributable to that preparation would be significant (see reg. section 301.7701-15(b)(2) safe harbor provision), compared with the tax liability that the taxpayer originally reported (and, apparently, as is determined by an objective standard). The distinction between signing and nonsigning preparers, however, is not entirely clear.

[3]For purposes of this chart, a nonsigning preparer is referred to as an adviser.

[4]To meet the ''more likely than not'' standard, according to Notice 2008-13, the preparer or adviser must analyze ''the pertinent facts and authorities'' and, as a result, in good faith, reasonably hold the belief that the likelihood of the taxpayer succeeding is greater than 50 percent. The appropriate manner in which a preparer or adviser should analyze the pertinent facts and authorities is set forth in reg. section 1.6662-4(d)(3)(ii). It is interesting to note that, if a preparer or adviser researches an issue and, although that person concludes that a position has a reasonable basis, it is impossible to precisely quantify whether the position is more likely than not correct, Example 10 in Notice 2008-13 suggests that no penalty would be imposed even if no disclosure is made. However, the safer course may be to disclose when in doubt, although this may not be what the client desires, such as in a case where disclosure will not prevent the imposition of a penalty, such as negligence on an estate tax return.

[5]Reg. section 1.6662-3(b)(3) provides that ''[i]f a return position is reasonably based on one or more of the authorities set forth in [reg.] section 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 even though it may not satisfy the substantial authority standard as defined in 1.6662-4(d)(2).'' The authorities listed in reg. section 1.6662-4(d)(3)(iii) include, among others, applicable code provisions, proposed, temporary, and final regulations interpreting applicable code provisions, court cases, revenue rulings and procedures, and some private letter rulings and technical advice memorandums. On the other hand, ''[c]onclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals'' are not appropriate authority to consider for this purpose. This is an objective legal determination, not one based on the subjective belief of the preparer or adviser, no matter how reasonably held that belief may be.

[6]The disclosure forms that must be filed are either Form 8275 or, when the position is contrary to a regulation, Form 8275R. In some cases, other forms of disclosure may be adequate. According to reg. section 1.6662-4(f)(2), ''[t]he Commissioner may by annual revenue procedure (or otherwise) prescribe the circumstances under which disclosure of information on a return (or qualified amended return) in accordance with applicable forms and instructions is adequate.'' *See, e.g.*, Rev. Proc. 2008-14.

[7]The substantial authority standard is described in reg. section 1.6662-4(d) as ''less stringent than the more likely than not standard but more stringent than the reasonable basis standard. . . .'' Generally, there is substantial authority for the tax treatment of an item only if the weight of authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. For authorities listed in reg. section 1.6662-4(d)(3)(iii), see note 5 *supra*. Again, this is an objective legal determination, not one based on the subjective belief of the preparer or advisor, no matter how reasonably held that belief may be.

[8]Note that if the position does have substantial authority then, under certain circumstances, penalties under code section 6694 may not be imposed. *See* Notice 2008-13.

[9]If the advice with respect to the position is in writing, the statement must be in writing, but if the advice is oral then the statement must also be oral. Notice 2008-13 provides that ''[c]ontemporaneously prepared documentation in the [adviser's] files is sufficient to establish that the statement was given to the taxpayer or other tax return preparer.'' Thus, it appears that a written record should be prepared documenting that either written or oral advice was given. *But see* note 11 below.

(Notes continued on next page.)

Figure 1 Notes (Continued)

[10]As defined in section 6662(d)(2)(C), a tax shelter is a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax.

[11]This advice should include a discussion of the penalty to the taxpayer under section 6662 and the opportunity to defeat it by disclosure. If the preparer is a practitioner subject to Circular 230, the better practice may be for the documentation to be in the form of a memorandum (not circulated outside of the practitioner's firm) and not included in the professional's records of time spent on a matter (sometimes called time sheets or day notes), which, if given to the client or anyone else outside the practitioner's firm, may have to comply with section 10.37 of the Circular and, possibly, section 10.35.

[12]The taxpayer should be made aware that disclosure of the position to the IRS will not help the taxpayer to avoid substantial understatement penalties under section 6662 (though disclosure will enable the preparer to avoid penalties under section 6694). If the preparer is a practitioner subject to Circular 230, the better practice may be for the documentation to be in the form of a memorandum (not circulated outside of the practitioner's firm) and not included in the professional's records of time spent on a matter (sometimes called time sheets or day notes), which, if given to the client or anyone else outside the practitioner's firm, may have to comply with section 10.37 of the Circular and, possibly, section 10.35.

Special Notes for Section 6694 Flowchart

Pretransaction Advice — It is important to keep in mind that section 6694 contains an exception for pretransaction advice. Reg. section 301.7701-15 provides: ''A person who only gives advice on specific issues of law shall not be considered [a tax return preparer] unless the advice is given with respect to events which have occurred at the time the advice is rendered and is not given with respect to the consequences of the contemplated actions; and the advice is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund.'' It seems uncertain whether there is a pretransaction advice exception under Circular 230 section 10.34, which historically has largely mirrored section 6694.

Reliance on Third Parties — Under section 6694, for the purposes of complying with the more likely than not standard, IRS Notice 2008-13 provides that a tax return preparer

> may rely in good faith without verification upon information furnished by the taxpayer, as provided in [reg. section] 1.6694-1(e). In addition, a tax return preparer may rely in good faith and without verification upon information furnished by another advisor, tax return preparer or other third party. Thus, a tax return preparer is not required to independently verify or review the items reported on tax returns, schedules or other third party documents to determine if the items meet the standard requiring a reasonable belief that the position would more likely than not be sustained on the merits. The tax return preparer, however, may not ignore the implications of information furnished to the tax return preparer or actually known to the tax return preparer. The tax return preparer also must make reasonable inquiries if the information furnished by another tax return preparer or a third party appears to be incorrect or incomplete.

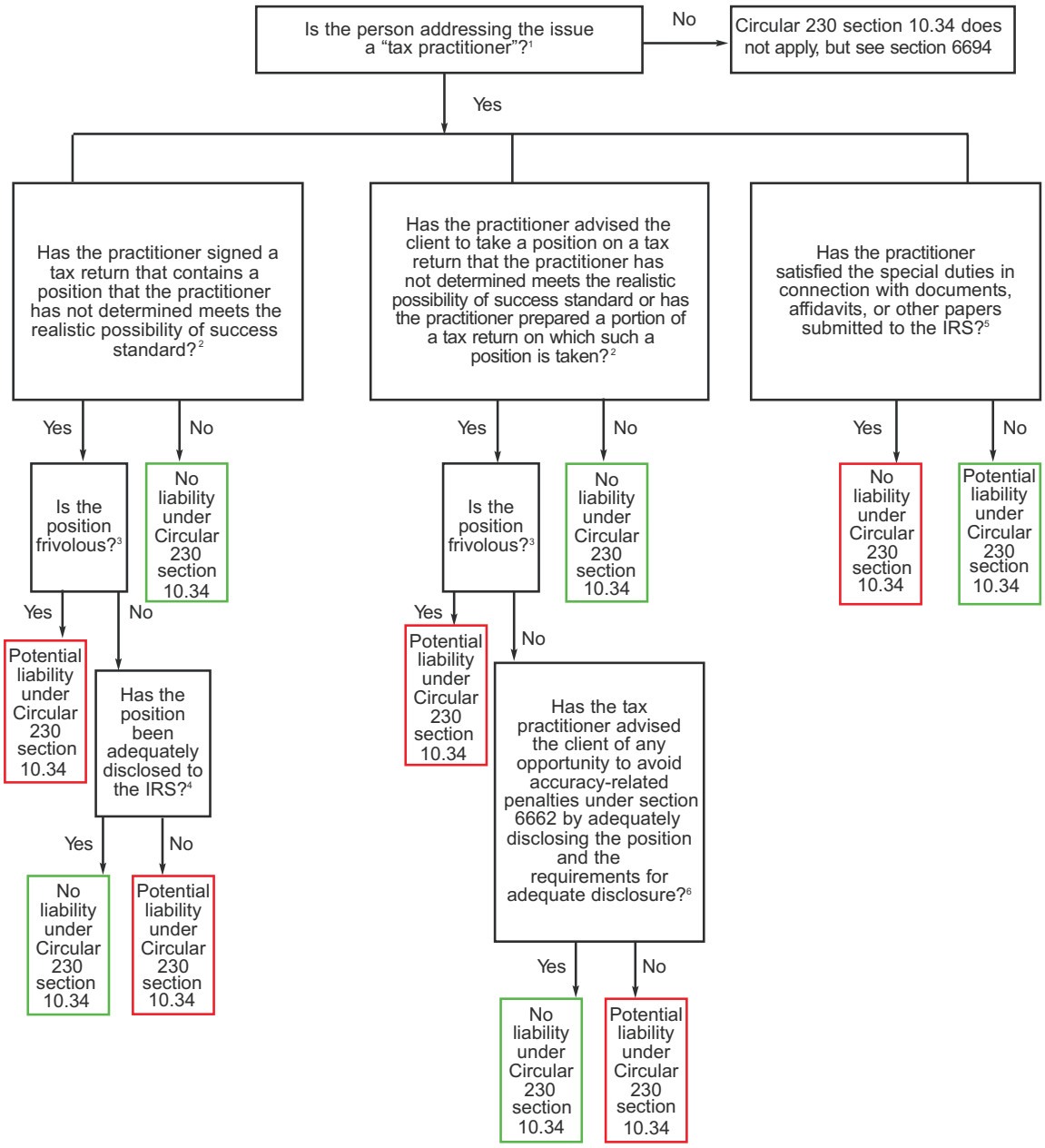
This provision also applies to the reasonable basis standard, except that the notice does not provide that, for the purposes of complying with the reasonable basis standard, a preparer may rely on information furnished by another adviser.

Reasonable Cause and Good Faith Exception — Section 6694 will not apply if there was a reasonable cause for the understatement and the tax return preparer acted in good faith. Notice 2008-13 provides that good faith will continue to be determined based on the factors in reg. section 1.6694-2(d), but that,

> [f]or the purposes of this interim guidance, a tax return preparer will be found to have acted in good faith when the tax return preparer relied on the advice of a third party who is not in the same firm as the tax return preparer and who the tax return preparer had reason to believe was competent to render the advice. The advice may be written or oral, but in either case the burden of establishing that the advice was received is on the tax return preparer. A tax return preparer is not considered to have relied in good faith if the advice is unreasonable on its face; the tax return preparer knew or should have known that the third party advisor was not aware of all relevant facts; or the tax return preparer 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.

Penalties Under Section 6694 — In addition to changes to the applicable standards and to the persons to whom section 6694 applies, the act also increases the amount of the penalty under section 6694 from $250 to the greater of $1,000 or one-half of the tax return preparer's fee with respect to the return or claim. If there is willful or reckless conduct involved with respect to the understatement on the part of the tax return preparer, the penalty is the greater of $5,000 or one-half of the tax return preparer's fee.

Figure 2. Practitioner Penalties Under Circular 230 Section 10.34



Note: A practitioner who gives advice about a position taken on a return or who prepares or signs a return must inform the client of any penalties that are reasonably likely to apply to the client. The practitioner must also inform the client of any opportunity to avoid these penalties through disclosure and the requirements for adequate disclosure. These duties also apply in the case of any document, affidavit, or other paper (including a claim for refund) submitted to the IRS.

Note: There is a pending amendment to section 10.34 that would more closely conform the standards a practitioner must meet to the elevated standards a preparer must meet under section 6694.

Figure 2 Notes

Footnotes for Circular 230 Section 10.34 Flowchart:

[1]Tax practitioners are certain lawyers, CPAs, registered agents, actuaries, and appraisers.

[2]According to reg. section 1.6694-2(b), "[a] position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on the merits." In determining whether there is at least a one in three likelihood of the position being sustained on the merits, the tax practitioner should consider, at least, applicable code provisions, proposed, temporary, and final regulations interpreting applicable code provisions, court cases, revenue rulings and procedures, and certain private letter rulings and technical advice memorandums. On the other hand, "[c]onclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals" are not appropriate authority to consider for this purpose.

[3]Under Circular 230 section 10.34, a position is frivolous if it is "patently improper."

[4]Although section 10.34 of the circular does not mandate any particular form of disclosure, it would seem advisable to comply with the requirements for disclosure under section 6694.

[5]It is unclear, but it does not appear that this includes a tax return. A practitioner may not advise the client to take a position on a document, affidavit, or other paper submitted to the IRS unless the position is not frivolous. Moreover, a practitioner may not advise the client to submit a document, affidavit, or other paper to the IRS the purpose of which is to delay or impede the administration of the federal tax laws, that is frivolous, or that contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.

[6]With respect to Circular 230, although the advice to the taxpayer about penalties may be given either orally or in writing, it may be prudent to include the advice in any writing containing substantive advice. Where advice is given orally, it may be prudent to provide the advice concerning disclosure in writing to avoid any question about whether the advice about disclosure was in fact given. If the disclosure advice is given orally, at the very least, an internal memorandum should be prepared confirming the fact that it was provided to the client. It should be noted, however, that if the memorandum is given to anyone outside the tax practitioner's firm, it may have to comply with section 10.37 of the circular and, possibly, section 10.35.

Special Notes for Circular 230 Section 10.34 Flowchart

Pretransaction Advice — Note that section 10.34 of Circular 230 does not have an explicit exception for pretransaction advice. It applies when a tax practitioner assists a client in preparing a document submitted to the IRS at any time. In the case of pretransaction advice, it is not entirely clear whether section 10.34 applies. Nonetheless, if the pretransaction advice is in writing, section 10.37 would apply since its scope is generally broader than section 10.34. Section 10.37 applies to any written tax advice whether pre- or post-transaction. Also, section 10.35 may apply to such written advice.

Reliance on Third Parties — Under section 10.34 of the circular, a tax practitioner may rely in good faith on information supplied by a taxpayer, and the practitioner does not have a duty to verify the accuracy of the information. However, the tax practitioner cannot accept a taxpayer's supplied information at face value if it appears incorrect. It would appear, nonetheless, that the practitioner's obligations in terms of information gathering may be broader under section 6694 than under section 10.34 of the circular.

Penalties Under Circular 230 — Under section 10.50 of Circular 230, after notice of an opportunity for a proceeding, a tax practitioner may be censured, suspended, or disbarred from practice before the IRS or subject to monetary penalties for failure to comply with the requirements of the circular and certain other actions.