

Understating Federal Tax Liabilities Could Lead to Bigger Penalties

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Do you prepare federal tax returns or claims of refunds? If so, be aware that last year Congress amended Internal Revenue Code § 6694, which allows the Internal Revenue Service to impose monetary penalties on a tax preparer who prepares a tax return or claim of refund that understates tax liabilities.

On December 31, 2007, the IRS issued Notice 2008-13 to clarify how it would enforce these new penalty provisions. This article summarizes the guidance on three major changes to § 6694: (1) the broadened application of the penalty provisions; (2) the altered standards of conduct that tax preparers must meet to avoid the penalties; and (3) the increased penalty caps. This article also discusses issues that may arise now that taxpayers and tax preparers will be scrutinized under differing penalty standards.

More returns and claims of refund covered

The new regulations significantly broaden when the understatement penalties apply. Previously, only an “income tax preparer” — a person who for compensation prepared a complete or substantial portion of a federal income tax return or claim for refund — could be subjected to penalties.

Under the 2007 amendments, however, liability extends to those who prepare or advise regarding federal income, estate and gift, employment and excise taxes. Moreover, these new standards apply to all such federal tax returns and claims of refund prepared after January 31, 2008. Some provisions took effect even earlier.

Penalties may be imposed on persons who do not fully prepare and sign a return. For example, Notice 2008-13 explains that a tax preparer who prepares an informational return or a substantial portion of a return may be subject to § 6694 penalties if unreasonable tax positions are taken.

Standards for tax positions raised

To avoid these penalties, a tax preparer must have greater confidence in the tax positions than previously required. Previously, a tax preparer had to believe there was a “realistic possibility” a tax position would be upheld if litigated. This meant the tax preparer had to believe that the taxpayer would win an adjudication of the position against the IRS at least one out of every three times (33% of the time). If the tax preparer lacked such faith in the position, the tax preparer could “disclose” or flag the position for the IRS and include the disclosed position, but only if the disclosed position was “non-frivolous.”

Under the new standard, the tax preparer must believe it is “more likely than not” that an undisclosed position will be upheld in adjudication. In other words, the tax preparer must believe the taxpayer would win an adjudication of the issue against the IRS more than one of every two times (50% of the time). If not, the position must be disclosed. And the tax preparer must have at least a “reasonable basis” even for disclosed positions. If a position is not frivolous, but the tax preparer does not have a “reasonable basis” for the position, it must be omitted from the return.

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Neither amended § 6694 nor Notice 2008-13 quantify the difference between a “reasonable” and a “non-frivolous” position. But Notice 2008-11 does explain that, for purposes of disclosure to avoid § 6694 penalties, IRS Form 8275 or 8275-R must be used, or the position must be disclosed in a manner that satisfies Treasury Regulations §1.6694-2(c)(3) and §1.6662-4(f).

Increased penalties

Finally, the penalties for understating tax liabilities have been increased. A tax preparer who advises an unreasonable tax position may face penalties up to the greater of \$1,000 or 50% of income derived for preparing the return or claim of refund. The potential penalties are increased to \$5,000 or 50% of the income derived for preparing a return or claim of refund if the understatement is due to willful or reckless conduct. These are substantial increases over the old penalties, which were capped at \$250 for unreasonable and at \$1,000 for willful or reckless understatements.

Potential conflicts with taxpayer clients

The new standards for disclosed and undisclosed tax positions apply only to tax preparers, not taxpayers. A taxpayer may still avoid penalties under Internal Revenue Code § 6662 if the taxpayer discloses a non-frivolous position, or if the taxpayer takes an undisclosed position when there is a realistic possibility the undisclosed position is valid. The variation in standards for taxpayers and tax preparers means that a tax preparer may be required to advise a taxpayer to avoid or disclose a position when, if the taxpayer ignores the advice, the taxpayer would not be subject to penalty.

Congress, not the IRS, bears responsibility for these inconsistent standards. Nevertheless, the IRS has tried to provide guidance for tax preparers facing such conflicts. In Notice 2008-13, the IRS advises a non-signing tax preparer who has a *reasonable* belief, but not a *more likely than not* belief, that a tax position will be sustained on its merits, to inform the taxpayer of any opportunity to avoid penalties under Internal Revenue Code § 6662 that could apply as a result of disclosure, and of the requirements for disclosure. This warning, which should be in the same format (oral or written) as the tax advice itself, satisfies the non-signing preparer’s obligations and should allow the tax preparer to avoid penalties under § 6694, even if the tax payer then chooses to ignore that advice.

Conclusion

The IRS has stated that a complete overhaul of the tax preparer penalty system is a top IRS priority for 2008. *See* IR-2007-213 (Dec. 31, 2007 — comments of IRS Chief Counsel Don Korb). In the meantime, you may want to consider the following safeguards to protect yourself under the new standards:

- At the outset of a tax representation, explain to a potential client that different standards apply to tax preparers and taxpayers,
- Obtain written confirmation from a client that you have explained the potential conflict that results from these differing standards, and the client authorizes you to prepare the return in accordance with the tax preparer standards,
- Carefully document the facts that the client described to you, the advice you gave regarding those facts, and authority upon which you relied when giving such advice.

Sources for Additional Reading

Internal Revenue Code § 6694 as amended, *available at* http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00006694----000-.html

Treasury, IRS Implement Enhanced Standards of Conduct for Tax Return Preparers; Plan Overhaul of Tax Return Preparer Regulatory Regime, IR-2007-213 (Dec. 31, 2007), *available at* <http://www.irs.gov/newsroom/article/0,,id=177036,00.html>

IRS Notice 2008-11, *available at* <http://www.irs.gov/pub/irs-drop/n-08-11.pdf>

IRS Notice 2008-13, *available at* <http://www.irs.gov/pub/irs-drop/n-08-13.pdf>