



Delay of Game—IRS Postpones Effective Date for Some Penalty Provisions of New Law

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Notice 2007-54 and the Penalty Provisions

The IRS this week, in response to requests from professional organizations, granted temporary relief from the full impact of the newly revised provisions of §6694 that we discussed in a previous podcast. Note that this stay is only temporary, and portions of the new provision will be enforced immediately—the notice does not put us back to the old version of §6694 through the end of the year. Rather, it allows some time for practitioners to grapple with the difference between the “more likely than not” and “reasonable basis” standards before the penalties will be imposed based on the higher standard.

Time Period of Application

The scope paragraph at the beginning of the notice outlines the returns to which this notice will apply, and breaks them down into three categories.

1. Returns, amended returns and refund claims due on or before December 31, 2007 (determined with regard to any extension of time for filing);
2. 2007 estimated tax payments due or before January 15, 2008 and
3. 2007 employment and excise tax returns due on or before January 31, 2008 [Notice 2007-54]

There are a few issues that arise from this date—note that for the first category, you determine the filing date with regard to any extension. The sentence does not appear to be clear on whether that would include *potential but not requested* extensions or just those actually granted. I believe the latter is what is intended, but if the former is what the IRS intends then, for most returns, an April 30 year end corporate return with a regular due date of July 15, 2007 but a potential extended due date of January 15, 2008 would fall under the new rules. And, in either event, it appears that if an extension is actually requested for that return, the new rules would apply even if the return is actually filed a day later.

Since claims for refund and amended returns don't actually have due dates (unless we are considering the date the statute runs out), it appears the test there is meant to be for such claims or amendments actually filed on or before December 31.

The inclusion of estimated tax payments and employment tax returns serves as a reminder of the increased breadth of these rules—they no longer are limited to income tax issues, but apply to any federal return filing with a return position contained on it.

Justification for Delay

The IRS goes on to explain why they have decided to grant this relief at this time. The IRS notes a number of factors that argue against strict application of these rules as of the provision's stated effective date of May 25, 2007.

The IRS notes that a number of items may need to be modified and clarified in additional guidance (whether via regulations or other guidance) to deal with:

- Activities that would represent preparing a tax return;
- Who is a tax return preparer under §7701(a)(36) and
- How these rules would apply to both signing and non-signing preparers

The IRS specifically indicates they are considering potential changes to Regulations §301.7701-15 (which has a detailed definition of who is an income tax return preparer)

and Regulations §§ 1.6694-0 through 1.6694-4 (the regulations specifically addressing the §6694 penalties).

The definition of a preparer under §301.7701-15 is especially interesting and expansive—and, as is clear, more than one person quite often will be a preparer for a return in question—and perhaps even individuals working at more than one firm under the substantial preparation standard found at §301.7701-15(b). A nonsigning preparer may not have any direct control over whether disclosure is made with the return, or even whether the taxpayer is given that option.

Note that the issue really existed under the prior law, since old §6694 still required disclosure by the preparer in certain situations and the practical reality has always been that, in virtually all cases, the signing preparer controls what is presented to the client to be filed. As well, such nonsigning preparers still can avail themselves of “good faith” defenses (that is, if they attempted to get the item disclosed but, unknown to them, the disclosure was removed from the return they would clearly have acted properly).

Law Changes

The notice goes on to quickly review the law changes. The IRS notes that the amount of the penalty under both §§6694(a) and §§6694(b) was increased by the new law, both were expanded to include more types of returns, but that the standard of conduct was changed only with regard to §6694(a). The IRS does not grant any relief for §6694(b) conduct in the Notice—the IRS notes, in its conclusion, that it does not feel that transitional relief should be granted to preparers who exhibit willful or reckless conduct, regardless of the type of return prepared.

However, the IRS does grant certain relief with regard to §6694(a) issues. For income tax returns, amended returns and claims for refund, the standards applicable under the prior version of §6694(a) and the current regulations under §6694 will be applied for filings covered by this relief. That means that the “realistic possibility” rather than “more likely than not” standard will be used in determining whether disclosure is required and that the “not-frivolous” standard rather than the “realistic possibility” standard will be used to measure disclosed positions.

Disclosures required will continue to need to comply with Revenue Procedure 2006-48, requiring the use of Form 8275 or 8275-R except for those items granted other disclosure standards under that procedure.

For all the other returns now brought under this standard, the IRS will use the “*reasonable basis*” standard as defined in the current regulations under §6662 for filings covered by this Notice. Those other returns will specifically include, but not be limited to:

- Estate tax returns

- Gift tax returns
- Generation-Skipping Transfer Tax Returns
- Employment Tax Returns
- Excise Tax Returns

The IRS notes it will apply the reasonable basis standard in those regulations, determined without regard to the disclosure standards in the regulations under §6662 (which required disclosure to be able to use the “reasonable basis” standard for a taxpayer to escape the penalty for a position that did have “substantial authority”).

Note that this is not the same standard used for income tax positions—rather most have interpreted this in the past to be a higher standard than the 1/3 position. As well, the IRS’s silence would imply that the “reasonable basis” rather than “not-frivolous” standard would apply for disclosed positions—which would mean that disclosure doesn’t really affect the §6694(a) penalty in these cases directly, though it clearly could impact a decision on “good faith” on the part of the preparer.

Issues With Penalties

The one thing these changes have generated is a lot of heat in online discussion forums on this matter—and some items of interest should be noted.

Kip Dellinger has noted multiple times on the California Society of CPAs discussion forum that the “more likely than not” standard is not that much higher than the “reasonable basis” standard for which CPAs should have already been advising clients on the advisability of disclosure to reduce exposure to penalties on the client. He asserts, and I would agree, that as a practical matter there are few positions where a position will fall into that narrow crack between “more likely than not” and “reasonable basis” for the purposes of disclosure. And, presumably, preparers have been weighing positions based on the “reasonable basis” standard when serving taxpayers and complying with their duties under Circular 230 and other professional standards.

Kip also pointed out that California has been operating under the “more likely than not” standard for the past three years.

My own experience in online discussions is that it appears that a number of preparers may have previously dismissed the entire area of these penalties, presuming that they didn’t apply to their practice. Now that Congress has shined a new light in this area, preparers are looking at these rules in more detail, and treating the entire area as if it were just adopted rather than understanding that relatively strict standards had previously applied in this area.

One thing I think is clear is that Congress did mean to send a message that they wanted the IRS to concentrate on “cleaning up” what they felt was the existence of a culture of

disregard for the tax law among too large a group of preparers. Some items that are clear from developments in this provision in the law, IRS actions in modifying Circular 230 and enforcement actions announced include these:

- There is a perception that, despite ethical prohibitions, many preparers are using a modified version of playing the audit lottery in the advice they are giving and the returns they are preparing.
- Some preparers are playing a “I can beat that” game in terms of pushing positions that are aimed at reducing taxes, even when the position has questionable or no support under the law

Recent issues that arose on the low end of the market in phone credit frauds, along with the well known marketed shelters aimed at the upper end of the market a few years ago likely helped convince Congress that there is a widespread problem that is not limited to one segment of the tax advice market—it cuts across all levels.

Whether we agree with this perception or not, it is the one we are going to have to deal with. It seems unlikely that Congress will act to lower this standard, nor that the IRS would extend relief beyond the end of this year (at least so long as they get revised guidance issued).

Practitioners need to be sure they individually understand the issues under these rules, and need to also keep themselves informed about future guidance issued by the IRS in this area.

Part III – Administrative, Procedural, and Miscellaneous

PREPARER PENALTY PROVISIONS UNDER THE SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007

NOTICE 2007-54

This notice provides guidance and transitional relief for the return preparer penalty provisions under section 6694 of the Internal Revenue Code, as amended by the Small Business and Work Opportunity Act of 2007.

SCOPE

The transitional relief provided by this notice will apply to all returns, amended returns, and refund claims due on or before December 31, 2007 (determined with regard to any extension of time for filing); to 2007 estimated tax returns due on or before January 15, 2008; and to 2007 employment and excise tax returns due on or before January 31, 2008.

BACKGROUND

The Small Business and Work Opportunity Act of 2007, Pub. L. No. 110-28, 121 Stat. ____, (the Act) was enacted into law on May 25, 2007. Section 8246 of the Act amends several provisions of the Code to extend the application of the income tax return preparer penalties to all tax return preparers, alter the standards of conduct that must be met to avoid imposition of the penalties for preparing a return which reflects an understatement of liability, and increase applicable penalties. The amendments are effective for tax returns prepared after the date of the enactment, May 25, 2007.

The amendments made by the Act raise questions regarding activities representing preparation of a tax return, who is a return preparer within the meaning of section 7701(a)(36) (as amended), and how the statute applies to signing and non-

signing preparers. In order to address these questions, the Internal Revenue Service and the Treasury Department are considering whether regulations or other published guidance are needed, including but not limited to, amendments to Treas. Reg. sections 301.7701-15 and 1.6694-0 through 1.6694-4. Because the Act extends the types of returns subject to the new provisions, changes are also required to the relevant forms and publications. The Service must also alter existing procedures in order to process disclosures with certain forms and in electronic formats. Because the amendments to section 6694 are effective immediately for returns prepared after May 25, 2007, the Service and the Treasury Department believe that effective tax administration requires transitional relief with respect to the new standards of conduct under section 6694(a).

PENALTY UNDER SECTION 6694

Prior to amendment by the Act, the penalty under section 6694(a) applied if:

(1) any part of an understatement of liability with respect to any return or claim for refund is due to a position for which there was not a realistic possibility of being sustained on its merits,

(2) any person who is an the income tax return preparer with respect to such return or claim knew (or reasonably should have known) of such position, and,

(3) such position was not disclosed as provided in section 6662(d)(2)(B)(ii) or was frivolous.

Prior to amendment by the Act, the penalty under section 6694(b) applied if any part of an understatement was due to:

- (1) a willful attempt in any manner by an income tax return preparer to understate the liability for tax; or
- (2) to any reckless or intentional disregard of rules or regulations by an income tax return preparer.

Section 8246 of the Act amended several provisions of the Code to extend the scope of the income tax return preparer penalties to preparers of all tax returns, amended returns and claims for refund, including estate and gift tax returns, generation-skipping transfer tax returns, employment tax returns, and excise tax returns. The Act amended section 6694(a) to provide that the penalty would apply if:

(A) the tax return preparer knew (or reasonably should have known) of the position,

(B) there was not a reasonable belief that the position would more likely than not be sustained on its merits, and

(C)(i) the position was not disclosed as provided in section 6662(d)(2)(B)(ii), or

(ii) there was no reasonable basis for the position.

Although the Act did not alter the standard of conduct under section 6694(b), it increased the amount of the penalty and made the penalty applicable to all tax return preparers.

Section 8246 of the Act amends the standards of conduct under section 6694(a) in two ways. First, for undisclosed positions, the Act replaces the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment of the position would more likely than not be sustained on its merits. Second, for disclosed

positions, the Act replaces the not-frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position.

The Act also increased the first-tier section 6694(a) penalty for understatements from \$250 to the greater of \$1000 or 50% of the income derived (or to be derived) by the tax return preparer from the preparation of a return or claim with respect to which the penalty was imposed. The Act increased the second-tier section 6694(b) penalty for willful or reckless conduct from \$1000 to the greater of \$5,000 or 50% of the income derived (or to be derived) by the tax return preparer.

Under both the prior and current law, disclosure under section 6694(a) is adequate if made on a Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, attached to the return, amended return, or refund claim, or pursuant to the annual revenue procedure authorized in Treasury Regulation sections 1.6694-2(c)(3) and 1.6662-4(f)(2). In addition, under both the prior and current law, the penalty under section 6694(a) would not be imposed if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith.

TRANSITIONAL RELIEF

In order to provide sufficient time to address issues pertaining to the implementation of the Act, the Service is providing the following transitional relief: For income tax returns, amended returns, and refund claims, the standards set forth under the previous law and current regulations under section 6694 will be applied in determining whether the Service will impose a penalty under section 6694(a). Generally, in applying transitional relief for income tax returns, amended returns or refund claims, disclosure would be adequate if made on a Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, attached to the return, amended return, or

refund claim, or pursuant to the annual revenue procedure authorized in Treasury Regulation sections 1.6694-2(c)(3) and 1.6662-4(f)(2).

For all other returns, amended returns, and claims for refund, including estate, gift, and generation-skipping transfer tax returns, employment tax returns, and excise tax returns, the reasonable basis standard set forth in the regulations issued under section 6662, without regard to the disclosure requirements contained therein, will be applied in determining whether the Service will impose a penalty under section 6694(a).

This transitional relief will apply to all returns, amended returns, and refund claims due on or before December 31, 2007 (determined with regard to any extension of time for filing); to 2007 estimated tax returns due on or before January 15, 2008; and to 2007 employment and excise tax returns due on or before January 31, 2008.

No transitional relief is available under section 6694(b) as transitional relief is not appropriate for return preparers who exhibit willful or reckless conduct, regardless of the type of return prepared.

EFFECTIVE DATE

This Notice is effective as of May 25, 2007.

CONTACT INFORMATION

The principal author of this notice is Michael E. Hara of the Office of Associate Chief Counsel (Procedure and Administration). For further information regarding this notice, contact Mr. Hara at (202) 622-4910 (not a toll-free call).