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# Impact of Tax Return Preparer Penalties on the Insurance Industry

by John Keenan

Over the past several months, the Treasury Department (Treasury) and the Internal Revenue Service (IRS) were busy developing guidance to implement the changes made by the Small Business and Work Opportunity Tax Act of 2007<sup>1</sup> (the Act) to the Internal Revenue Code (Code) provisions dealing with tax return preparer penalties. On Dec. 31, 2007, the Treasury and the IRS issued a series of Notices (Notice 2008-11, Notice 2008-12 and Notice 2008-13) to provide interim guidance on the application of the tax return preparer penalties as amended by the Act, and to solicit public comments regarding the revision of the regulatory scheme governing tax return preparer penalties.

Tax professionals have been busy contemplating how the recent statutory amendments to the tax return preparer rules and the guidance found in the Notices might affect how they do business. While many tax professionals have been actively considering how the amendments might affect their practice—not to mention, the significantly increased penalty amounts—the perception is that other professionals, who would not consider themselves to be tax return preparers but who may assist tax professionals, have not been as active in the process of determining if they are subject to the section 6694 return preparer rules. This article highlights the section 6694 tax return preparer penalty regime and examines how it might potentially apply to other professionals, such as actuaries, who assist those traditionally considered to be tax professionals.

## Section 6694

### Background

Prior to amendment, sections 6694(a) and 6694(b) imposed penalties on income tax return preparers for certain understatements of liability on a tax return or claim for refund. In May 2007, Congress amended section



6694 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 a return preparer penalty and increase the penalty amounts.<sup>2</sup>

Under amended section 6694, a paid tax return preparer could be subject to a penalty if the preparer does not have a reasonable belief that the return position for an item would more likely than not be sustained on its merits. A paid tax return preparer who does not reasonably believe a position taken on a tax return is more likely than not correct can avoid a penalty if the position is adequately disclosed.<sup>3</sup> Prior to the amendment of section 6694, a paid tax return preparer was not subject to a penalty if the return position satisfied the realistic possibility of success standard.<sup>4</sup>

The Act also significantly increased the section 6694(a) penalty. Prior to amendment, the penalty was \$250. After amendment, the penalty is equal to the greater of \$1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer from the preparation

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<sup>1</sup> P.L. 110-28.

<sup>2</sup> Small Business and Work Opportunity Act of 2007, Pub. L. No. 110-28, 121 Stat., was enacted into law on May 25, 2007. The amendments are effective for tax returns prepared after the date of the enactment, May 25, 2007. On June 11, 2007, the IRS released Notice 2007-54, 2007-27 IRB 1 (*see* § 601.601(d)(2)(ii)(b)), providing guidance and transitional relief for the return preparer provisions under amended section 6694. Notice 2007-54 provides that for income tax returns, amended returns, and refund claims, the standards set forth under section 6694 prior to amendments and current regulations under this section will be applied 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).

<sup>3</sup> The minimum standard for disclosed positions was also modified. For disclosed positions (*i.e.*, on a Form 8275 or 8275-R), amended IRC § 6694 replaces the non-frivolous standard with the requirement that there be at least a reasonable basis for the position.

<sup>4</sup> A return position is considered to have a realistic possibility of success on the merits if a reasonable and well-informed analysis by a knowledgeable tax adviser would conclude that the position has at least a one-in-three likelihood of being sustained on its merits if challenged by the IRS. Treas. Reg. § 1.6694-2(b).

of the return or claim with respect to which the penalty is imposed.

On Dec. 31, 2007, the Treasury and the IRS issued three Notices to provide guidance on the implementation of the amendments to the tax return preparer provisions. Of particular interest for purposes of this article is Notice 2008-13, which provides guidance on (1) the relevant categories of tax returns or refund claims subject to section 6694, (2) the definition of a tax return preparer, (3) the standards of conduct applicable to tax return preparers and (4) interim penalty compliance obligations applicable to tax return preparers. This article focuses on who is considered a return preparer under this recent guidance and what activities constitute return preparation.

#### *Definition of Tax Return Preparer*

While section 6694 sets forth the penalties that can be imposed upon tax return preparers who do not meet the required return position standards, the definition of who is a tax return preparer requires one to look at section 7701(a)(36) of the Code, as well as Treas. Reg. §§ 1.6694-1, 1.6694-3, and 301.7701-15.<sup>5</sup>

Prior to the amendment in May 2007, section 7701(a)(36) defined *income tax return preparer* as any person who prepared for compensation an income tax return or claim for refund, or a substantial portion of an income tax return or claim for refund. The Act expanded the application of the income tax return preparer penalties to apply to all tax return preparers and is no longer lim-

ited solely to persons who prepare income tax returns. As amended, section 7701(a)(36) now defines *tax return preparer* as any person that prepares for compensation a tax return or claim for refund, or a substantial portion of a tax return or claim for refund.<sup>6</sup>

Notice 2008-13 advises that, until further guidance is provided, the term “tax return preparer” will be defined by utilizing current Treas. Reg. §§ 1.6694-1, 1.6694-3, and 301.7701-15 with the following modifications:

- The word “income” is eliminated as a modifier to *tax return preparer* throughout Treas. Reg. §§ 1.6694-1, 1.6694-3, and 301.7701-15.
- The definitions of returns and claims for refund from *returns of tax under subtitle A, claims for refund under subtitle A*, or similar language, is expanded to include returns of tax and claims for refund under subtitles A through E of the Code throughout Treas. Reg. §§ 1.6694-1, 1.6694-3, and 301.7701-15.

The current regulation under section 7701 defines the term *income tax return preparer* to include any person who prepares for compensation all or a substantial portion of a tax return or claim for refund.<sup>7</sup> By including persons who prepare a substantial portion of a tax return in the definition of tax return preparer, the regulation brings into the preparer penalty regime a wide range of activities performed by persons who do not sign the tax return or claim for refund.

<sup>5</sup> See Notice 2008-13.

<sup>6</sup> Section 7701(a)(36), as amended in May 2007, provides, in pertinent part:

In general. —The 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.

<sup>7</sup> Treas. Reg. § 301.7701-15 Income tax return preparer.

(a) In general. An income tax return preparer is any person who prepares for compensation, or who employs (or engages) one or more persons to prepare for compensation, other than for the person, all or a substantial portion of any return of tax under Subtitle A of the Internal Revenue Code of 1954 or of any claim for refund of tax under Subtitle A of the Internal Revenue Code of 1954.

(1) A person who furnishes to a taxpayer or other preparer sufficient information and advice so that completion of the return or claim for refund is largely a mechanical or clerical matter is considered an income tax return preparer, even though that person does not actually place or review placement of information on the return or claim for refund. See also paragraph (b) of this section.

(2) A person who only gives advice on specific issues of law shall not be considered an income tax return preparer, unless:

(i) 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 contemplated actions; and

(ii) The advice is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund. For example, if a lawyer gives an opinion on a transaction which a corporation has consummated, solely to satisfy an accountant (not at the time a preparer of the corporation’s return) who is attempting to determine whether the reserve for taxes set forth in the corporation’s financial statement is reasonable, the lawyer shall not be considered a tax return preparer solely by reason of rendering such opinion.

The current regulations broadly define the term *substantial portion* using a facts-and-circumstances test that compares the relative length, complexity and tax liability of a particular schedule, entry or other portion of a tax return or claim for refund to the length, complexity and tax liability of the tax return or claim for refund as a whole. However, those who do not sign the tax return or claim for refund may not have the ability to determine if the size or complexity of their work—relative to the entire tax return or claim for refund—is such that it constitutes a substantial portion of the tax return. In fact, they may have no knowledge of how their work is ultimately reported on the tax return or claim for refund.

Under Notice 2008-13—solely for purposes of section 6694—the term *substantial portion* in § 301.7701-15(b) (1) will be interpreted 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, whether a person is considered to be a return preparer will depend on the relative size of the deficiency attributable to the schedule, entry or other portion of the return prepared by that person compared to the taxpayer's correct tax liability.

#### *“Signing Preparer” and “Nonsigning Preparer”*

The regulation under section 7701(a)(36) identifies all the “income tax return preparers” of a return. The current regulations under section 6694 separate preparers into two types: “signing preparers” and “nonsigning preparers.”

A “signing preparer” is any preparer who signs a return of tax or claim for refund as a preparer. A “nonsigning preparer” is any preparer who is not a signing preparer. Examples of nonsigning preparers are preparers who provide advice (written or oral) either to a taxpayer or to a preparer who is not associated with the same firm as the preparer who provides the advice.

#### *Could an Actuary Be a Return Preparer?*

Interestingly, Notice 2008-13 contains an example that is meant to demonstrate the reasonable cause and good faith exception to the imposition of a section 6694(a)

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... whether a person is considered to be a return preparer will depend on the relative size of the deficiency attributable to the schedule. ...

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penalty, but the example also sheds some light on the concept of who might be considered a nonsigning return preparer.

By way of background, a tax return preparer is not subject to a penalty under section 6694 if the preparer satisfies the reasonable cause and good faith exception. 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 whom the tax return preparer had reason to believe was competent to render the advice. Notice 2008-13 contains the following example of this reasonable cause and good faith exception:

**Example 7.** In preparing a tax return, Accountant G relies on the advice of an actuary concerning the limit on deductibility under section 404(a)(1)(A) of a contribution by an employer to a qualified pension trust. The actuary providing the advice was not associated with Accountant G's firm. On the basis of this advice, Accountant G completed the tax return. It is later determined that there is an understatement of liability for tax that resulted from incorrect advice provided by the actuary. Accountant G had no reason to believe that the advice was incorrect or incomplete, and the advice appeared reasonable on its face. Accountant G was also not aware of any reason why the actuary did not know all of the relevant facts or that the advice was no longer reliable due to developments in the law since the time the advice was given. Accountant G is not subject to a penalty under section 6694.

While the example is meant to demonstrate that the accountant satisfies the reasonable cause and good faith exception to the imposition of a section 6694 penalty, it does not address whether there are any consequences to the actuary under this scenario. As discussed below, one reading of the example could be that the actuary who provided advice on the deductibility limits under section 404(a)(1)(A) is a nonsigning return preparer of the tax return prepared by Accountant G.

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Remember, to be a tax return preparer under amended section 6694, the individual must have prepared, for compensation, all or a substantial portion of a tax return or claim for refund under subtitles A through E of the Code. Assuming the actuary in Example 7 was compensated by the employer claiming the deduction for its contribution to the qualified pension trust, the question that remains is whether the actuary's work constitutes a substantial portion of the tax return.

There is little in the way of guidance as to how one determines if the work performed constitutes a substantial portion of the tax return. As discussed above, the only guidance provided simply says that whether one is considered to be a return preparer will depend on the relative size of the deficiency attributable to the portion of the return prepared by that person compared to the taxpayer's correct tax liability. One could envision an argument that, under Notice 2008-13, the actuary's work would constitute a "substantial portion" of the employer's tax return if the actuary knew that the disallowance of the deduction for the contribution to the qualified pension plan could result in a deficiency that was significant in comparison to the tax liability reported on the employer's tax return. While the example does not give sufficient information to make such a determination, the example raises the possibility that under certain circumstances the actuary could be considered to be a nonsigning return preparer of the employer's return and, thus, subject to penalties under section 6694.

#### **Standards of Conduct Applicable to Tax Return Preparers**

Tax and other professionals who work with tax professionals in preparing a tax return must be cognizant of the section 6694 tax return preparer regime and the standards of conduct that must be met to avoid imposition of the penalties for preparing a return that reflects an understatement of liability.

Under amended section 6694, a tax return preparer may be subject to a penalty if the preparer does not have a reasonable belief that a position will more likely than not be sustained on its merits and the position is not adequately disclosed. Notice 2008-13 provides that a tax return preparer is considered to reasonably believe that a position is more likely than not to be sustained on its merits if the tax return preparer analyzes the pertinent facts and authorities in the manner described in §1.6662-4(d)(3)(ii) and, relying on that analysis, reasonably concludes in good faith

that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged by the IRS. In performing its analysis, the tax return preparer may rely in good faith and without verification on information provided by the taxpayer, another advisor or another third party. 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 appears to be incorrect or incomplete.

Observe that the standard that applies to accuracy-related penalties for taxpayers continues to be substantial authority, as set forth in IRC section 6662. The new more-likely-than-not standard imposed on paid tax return preparers is stricter than the substantial authority standard. Thus, the modified standards place paid tax return preparers and their taxpayer clients in differing positions with respect to the imposition of accuracy-related penalties.

#### **Interim Penalty Compliance Rules**

Notice 2008-13 provides interim compliance rules on which tax return preparers can rely to avoid a penalty under section 6694(a). Tax return preparers can rely on these until further guidance is issued.

Under the interim compliance rules of Notice 2008-13, a signing tax return preparer is deemed to have met the requirements of section 6694 for positions the tax return preparer does not have a reasonable belief will more likely than not be sustained on the merits, but for which there is a reasonable basis, if the tax return preparer meets any of the following requirements:

- (1) The position is disclosed in accordance with Treas. Reg. §1.6662-4(f) (*i.e.*, on a properly completed Form 8275 or Form 8275-R, or in accordance with the annual revenue procedure described in Treas. Reg. §1.6662-4(f)(2)).
- (2) If the position would not meet the standard for the taxpayer to avoid penalties under section 6662(d)(2)(B) without disclosure—*i.e.*, a non-shelter position that lacks substantial authority—the signing preparer could avoid a penalty by providing the taxpayer with the prepared tax return that includes the disclosure in accordance with Treas. Reg. § 1.6662-4(f).



(3) If the position would otherwise meet the taxpayer's requirement for nondisclosure under section 6662(d)(2)(B)(i)—*i.e.*, a non-shelter position supported by substantial authority—the signing preparer could avoid a penalty by (a) advising the taxpayer of the difference between the penalty standards applicable to the taxpayer under section 6662 and those applicable to the tax return preparer under section 6694, and (b) contemporaneously documenting in the signing preparer's files that this advice was provided.

(4) If section 6662(d)(2)(B) does not apply because the position may be described in section 6662(d)(2)(C)—*i.e.*, a tax shelter position—the signing preparer could avoid a penalty by (a) advising the taxpayer of the penalty standards applicable to the taxpayer under section 6662(d)(2)(C) and the difference, if any, between those standards and the standards under section 6694, and (b) contemporaneously documenting in the signing preparer's files that this advice was provided.

A nonsigning tax return preparer is deemed to have met the requirements of section 6694 for positions for which the tax return preparer does not have a reasonable belief that the position will more likely than not be sustained on the merits, but for which there is a reasonable basis if the nonsigning tax return preparer meets the following requirements:

(1) *Advice to taxpayers.* The nonsigning tax return preparer can avoid a penalty by (a) including with the advice a statement informing the taxpayer of any opportunity to avoid penalties under section 6662 that could apply to the position as a result of disclosure, if relevant, and the requirements for disclosure, and (b) contemporaneously documenting in the preparer's file that the statements were given.

(2) *Advice to other preparers.* The nonsigning tax return preparer can avoid a penalty by (a) including with the advice a statement that disclosure under section 6694(a) may be required, and (b) contemporaneously documenting in the preparer's file that the statements were given.

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## Determining whether a person qualifies as a "return preparer" is not necessarily a simple undertaking. ...

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(3) *Format of required statements.* The statements referred to above must be in writing if the advice was in writing, but may be oral if the advice was oral.

### Conclusion

Determining whether a person qualifies as a "return preparer" is not necessarily a simple undertaking for those individuals who have only provided advice to a taxpayer and have not physically completed the taxpayer's tax return. As the exposure to penalties for tax return preparers has increased as a result of the Act's changes to the standards required to avoid a penalty—as well as the amount of the penalty that could potentially be imposed—professionals who would not consider themselves to be tax return preparers, but who may assist tax professionals, must be aware of the section 6694 tax return preparer regime. These professionals should take steps to ensure they are complying with the standards of conduct that must be met to avoid imposition of penalties. ◀

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*Editor's Note:* Recently, there has been a movement to pass additional legislation dealing with the standards applicable to return penalties for taxpayers and preparers. Any further developments on this issue will be discussed in an upcoming edition of *Taxing Times*.