RETURN PREPARER PENALTIES UNDER TITLE 26

Bio - Garrett Gregory

- Received JD from South Texas College of Law in 1999
- Member of the Texas State Bar as of 1999
- Received Master of Laws (Taxation) from Boston University in 2000
- Worked for PriceWaterhouse Coopers (International Planning Services)
- Worked for Office of Chief Counsel (IRS) in the National Office (International Branch 5-Financial Institutions and Products) and Dallas Field Office (LMSB/LB&I)
- Co-Founder of Gregory Law Group, PLLC

Disclaimer

- The information contained in this presentation is for educational purposes only and does not constitute legal advice nor does it create an attorney-client relationship between the presenter and any audience member. Please consult an attorney or other tax professional to obtain proper representation.

Summary of penalties

- IRC §6694 – Understatement of taxpayer's liability by tax return preparer.
- IRC §6695 – Other assessable penalties with respect to the preparation of tax returns for other persons.
- IRC §6700 – Promoting abusive tax shelters.
- IRC §6701 – Penalties for aiding and abetting understatement of tax liability.
- IRC §6713 – Disclosure or use of information by preparers of returns.
- IRC §7206 – Fraud and false statements.
- IRC §7207 – Fraudulent returns, statements, or other documents
- IRC §7216 – Disclosure or use of information by preparers of returns.
- IRC §7407 – Action to enjoin tax return preparers.
- IRC §7408 – Action to enjoin specified conduct related to tax shelters and reportable transactions.
- Note that this list doesn't include Circular 230 which relates to professional standards of conduct and associates penalties with breaches of those standards.

Who is a “Tax Return Preparer?”

- §7701(a)(36) – Defines “return preparer”
- “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.”
- This includes both signing and non-signing preparers.
- Non-signing preparers are liable if they prepare all or a substantial portion of a return or claim for refund with respect to events that occurred at the time the advice is rendered.

IRC §6694 Penalties

- IRC §6694(a) – Understatement due to unreasonable positions.
- This penalty is the greater of $1,000 or 50% of the income derived by the tax return preparer with respect to the return or claim for refund.
- To be liable, return preparer must know or reasonably should have known of the position.
- “Understatement” can be either an understatement of the net amount payable on a tax return or an overstatement of the net amount creditable or refundable on a claim for refund.
- Penalty is automatically abated if it is later determined that there was no understatement of tax.
- Penalty cannot be imposed on a preparer if the ‘aid and abet’ penalty of §6701 is imposed.

IRC §6694 Penalties (Cont.)

- Definition of "unreasonable position"
- There are 3 categories of unreasonable positions:
  1. General undisclosed positions;
  2. Disclosed positions; and
  3. Tax shelter and reportable transactions.

IRC §6694 Penalties (Cont.)

- General Undisclosed Positions
  - Penalty applies to undisclosed positions that are unreasonable.
  - Exception to the application of the penalty where there is (or was) "substantial authority" for the position.
  - "Substantial authority" is defined in Treasury Regulation §1.6662-4(d)(2).
  - "Substantial authority" falls somewhere between the "more likely than not" (greater than 50% likelihood of success) standard and the lower requirement of "reasonable basis."
  - You need to have the weight of the authorities on your side with respect to the position

IRC §6694 Penalties (Cont.)

- Disclosed Positions
  - If a position is disclosed, then preparer is fine as long as there is “reasonable basis” for the position.
  - Reasonable basis allows for the preparer’s reliance in good faith on information provided by the taxpayer and information and advice provided by another advisor, tax return preparer, or third party.
  - Preparer does not have to independently verify information provided by the taxpayer or third party.
  - The processes for properly disclosing a return position are found in Treas. Reg. §1.6694-2(d)(3).

IRC §6694 Penalties (Cont.)

- Tax Shelters and Reportable Transactions
  - These transactions are deemed unreasonable “unless it is reasonable to believe that the position would more likely than not be sustained on its merits.” IRC §6694(a)(2)(C).
  - A tax shelter will not be deemed to be an unreasonable position if there is “substantial authority for the position and the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer in the event that the transaction is deemed to have a significant purpose of Federal tax avoidance or evasion. See IRS Notice 2009-5, 2009-3 IRB 309.

IRC §6694 Penalties (Cont.)

- Reasonable Cause Waiver
  - No penalty for an unreasonable position if there is “reasonable cause for the understatement and the tax return preparer acted in good faith.” IRC §6694(a)(3).
  - Treasury Regulations §1.6694-2 describe the factors that will be considered in determining whether or not preparer had reasonable cause for the understatement:
    - Nature of the error causing the understatement. Think complexity.
    - Frequency of errors. Infrequent errors may establish reasonable cause.
    - Materiality of errors. Is the error immaterial to the determination of the correct tax liability?
    - Preparer’s normal office practice. Are systems in place to ensure accuracy and consistency?
    - Reliance on advice of others. Preparer may rely, in good faith, on information furnished by the taxpayer or other party.
    - Reliance on generally accepted administrative or industry practice.

IRC §6694 Penalties (Cont.)

- IRC §6694(b) – Understatements owing to willful and reckless conduct.
  - Preparer acts willfully or recklessly if any part of the understatement was due to the preparer's "willful attempt in any manner to understate the tax liability on the return or claim," or to any "reckless or intentional disregards of rules or regulations."
  - Penalty is $5,000 or 50% of the income derived (or to be derived) by the tax return preparer.
  - This penalty is coordinated with the penalties under sections 6694(a) and 6701 so that the maximum total penalty under all of these provisions is $5,000 or 50%. No stacking of these penalties.
  - Government bears the burden.

IRC §6695 Penalties

- §6695(a) – Failure to provide the taxpayer with a copy of the prepared return. Carries a $50 fine per failure. Maximum of $25,000 for each calendar year.
- §6695(b) – Failure to sign the prepared return. Carries a $50 fine per failure. Maximum of $25,000 for each calendar year.
- §6695(c) – Failure to provide an identifying number. Carries a $50 fine per failure. Maximum of $25,000 for each calendar year.
- §6695(d) – Failure to retain a copy of the return or a list of returns prepared. Carries a $50 fine per failure. Maximum of $25,000 for each calendar year. References §6107(b) which requires maintenance for 3 years.
- §6695(e) – Failure to file a tax return preparer information return or set forth an item in the return as required under IRC §6060. Carries a $50 fine per failure. Maximum of $25,000 for each calendar year.
- §6695(f) – Negotiate a refund check or misappropriate a refund via electronic means. Carries a $500 fine per failure.
- §6695(g) – Discussed in greater detail next.

IRC §6695 Penalties (Cont.)

- §6695(g) – Failure to be diligent in determining eligibility for the EIC
  - IRS is very aggressive with this penalty. Penalty applies to firms where preparer works.
  - Penalty of $500 for each return in which preparer failed to comply. Proposed legislation to increase to $1,000/return.
  - Due Dilligence Requirements:
    - Form 8867 must be completed
    - EITC worksheet in Form 1040 instruction (or an equivalent) must be completed to document the computation of the EIC. This must be maintained in preparer's files.
  - Cont.

IRC §6695(g)

- Knowledge requirement
  - Preparer cannot know or have reason to know that the information used to determine EIC eligibility is incorrect.
  - This is really an “ignorance requirement.”
  - Preparer must make further inquiries if the taxpayer’s information appears to be incorrect, incomplete, or inconsistent.
  - Preparer must document these additional inquiries and the answers provided by the taxpayer.
  - Additional inquiries are judged on a reasonableness standard.
    - E.g., a client tells you that they have 4 children and household income is $15,000.

IRC §6695(g)

- IRC §6695(g) record retention
  - Preparer is required to retain:
    - Form 8867;
    - Computation of the EIC;
    - Record of how and when the info used was obtained. This includes the identity of the person providing the info and the additional inquiries made by the preparer and the answers to those inquiries.
  - Retention is required for 3 years from the later of the return due date, electronically filed date, date return was presented to taxpayer, or date a non-signing preparer submits his/her portion of the return.

IRC §6695(g)

- Office Procedures Exception
  - No §6695(g) penalty applies if the "tax return preparer can demonstrate to the satisfaction of the Commissioner that, considering all the facts and circumstances, the tax return preparer's normal office procedures are reasonably designed and routinely followed to ensure compliance with the due diligence requirements…and the failure to meet the due diligence requirements…with respect to the particular tax return or claim for refund was isolated and inadvertent." Treas. Reg. §1.6695-2(d).

IRC §6695(g)

- Personal Experience
  - Our firm has handled many of these audits
  - In every case we have protested IRS-Appeals. IRS-Exam takes a very hardline approach in these audits.
  - Have been awarded significant concession in every case heard by Appeals.
  - Significant reason for this is that IRS-Appeals bases its decisions on “hazards of litigation.”
    - Currently no §6695(g) cases have been litigated in Tax Court.

IRC §6700 Penalty

- Imposes a penalty on promoters and others involved in the organization and sale of tax shelters and other investments and arrangements if they make false statements or exaggerated valuation claims.
- Penalty is the lesser of $1,000 or 100% of the gross income derived (or to be derived) by the offender.
- Covered activities:
  - Organizing a partnership or other entity, and investment plan, or any other arrangement,
  - Assisting in the organization of such an entity, plan, or arrangement, or
  - Participating, directly or indirectly, in the sale of an interest in any such entity, plan, or arrangement.
- Anyone who engages in a covered activity is subject to the penalty if they knowingly make a false statement or propagates a gross valuation overstatement.
- Very broad statute. Can apply to anyone who promotes.

IRC §6701 Penalty for Aiding and Abetting Understatements of Tax

- Imposes a penalty on any person who assists or gives advice in the preparation of any portion of a return or other document in connection with internal revenue laws if:
    1. Person knows or has reason to believe that this portion will be used for tax purposes; and
    2. Knows that the document, if used, will result in an understatement of tax liability.
- Penalty is $1,000, but is raised to $10,000 if the understatement involves a corporation.

IRC §6713 – Disclosure or use of information by preparers of returns

- §6713 – Applies to any person who discloses or uses any information furnished to them in connection with the preparation of a return for any purpose other than to prepare or assist in preparing the return.
- Penalty is $250 for each improper disclosure or use, up to $10,000 per calendar year.
- Exceptions:
  1. Disclosure pursuant to code section or court order;
  2. Info used to prepare state and local tax returns;
  3. Disclosure or use is permitted under treasury regulations.
- This is similar to §6103 prohibiting IRS employees from unauthorized disclosures.

IRC §7206 – Fraud and false statements (Crim)

- This is the tax code's own perjury and false statement statute.
- This is a felony punishable by imprisonment of not more than 3 years, a fine of up to $100,000 ($500,000 for a corporation), or both, together with the costs of prosecution.
- Applies to the following activities:
    1. Making a false declaration under penalties of perjury;
    2. Aid or assist in the preparation or presentation of any return or other document that is false as to a material matter (known as the preparer statute);
    3. Simulate or fraudulently execute or sign any bond, permit any entry or other document required by the internal revenue laws, or procure these acts to be done;
    4. Remove or conceal property with intent to evade or defeat assessment or collection of any tax; or
    5. In connection with an offer in compromise and closing agreement, either conceal property or withhold, falsify, or destroy records or make any false statement relating to the financial condition of the taxpayer or other person liable for the tax.
- ***Have your clients sign all of their own representations!!!

IRC §7207 – Fraudulent returns, statements, or other documents (Crim)

- Very rarely used criminal sanction.
- DOJ has a policy of only applying this where there are altered documents other than tax returns.

IRC §7216 – Disclosure or use of information by preparers of returns (Crim)

- Imposed on preparers who knowingly or recklessly:
  1. Discloses information furnished to him for, or in connection with, preparing a return for a purpose other than preparing a return, or
  2. Uses any such information for a purpose other than preparing, or assisting in preparing, a return.
- Imposes a penalty of $1,000 and/or imprisonment for up to 1 year, plus costs of prosecution.
- This is the criminal version of the earlier discussed IRC §6713.

IRC §7407 – Action to enjoin tax return preparers

- Consequence is loss of livelihood
- Practices that may result in injunctive action include:
  1. Conduct subject to §6694 and §6695 penalties;
  2. Conduct subject to criminal penalties;
  3. Misrepresentation of the return preparer's eligibility to practice before the Service, or his or her experience and education as an income tax return preparer;
  4. Guarantee of payment of a tax refund or of allowance of a tax credit; or
  5. Other fraudulent or deceptive conduct that substantially interferes with proper administration of the Internal Revenue laws.

IRC §7408 – Action to enjoin specified conduct related to tax shelters and reportable transactions

- This is very similar to §7407 except that it applies to preparers who engage in conduct subject to penalties under §§6700 or 6701.

Questions?

- Contact information:
  - Garrett Gregory
  - garrettgregory@gregorytaxlaw.com