

# Taxation Law



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## President's Message

by Ada Ko

Happy New Year to our Members! The Tax Section has had a great start to its 2007/2008 fiscal year. The committee chairs have provided brief reports in this newsletter so our members can understand the activities of the different tax committees and realize the benefits of participating in the Tax Section. If you aren't already participating on a committee, I strongly encourage you to do so. Your participation is welcomed. Feel free to contact any of the committee chairs to get involved!

My focus will be on the CLE Committee for this newsletter: The CLE Committee has been very active in bringing our members educational opportunities to keep

us informed on current tax issues. On November 9, 2007, the Tax Section held its first Brown Bag CLE at the offices of Lane Powell PC. The second Brown Bag CLE was on international mergers and acquisitions and was held on February 8. We are also planning a third Brown Bag CLE on June 2, 2008, at the offices of Deloitte Tax LLP.

In December 2007, the Tax Section held its first Toolbox CLE, which was held at the WSBA offices. The Toolbox was titled "Tax Issues for Business Transactions" and was sold out! We are planning another Toolbox CLE on Section 409A, which will be held both in Seattle and in a location to be identified in Eastern Wash-

ington sometime early summer. Lastly, the Tax Section is co-sponsoring the first annual Oregon-Washington Tax Institute, which will be a one-and-a-half-day tax program with recognized speakers from the United States and Canada. The Tax Institute will be May 1st and 2nd and will coincide with the Tax Section's Annual Luncheon on May 1st, so save the date!!!

All of our committee chairs are working hard to provide benefits to our members, and I encourage all members to get involved with the section and attend our regular committee events. Please feel free to contact me if you have any questions or suggestions. I can be reached at [koa@lanepowell.com](mailto:koa@lanepowell.com).

## In This Issue

President's Message .....	1
Congress Adopts Amendments to Tax Return Preparer Penalties .....	1
CLE Committee Report .....	4
Estate & Gift Tax Committee Report	5
IRS Liaison Committee Report .....	5
International Tax Committee .....	5
Scholarship Committee Report .....	5
Please Donate to the Tax Section Scholarship Fund .....	6

## Congress Adopts Amendments to Tax Return Preparer Penalties

by G. Martin Bingisser<sup>1</sup>

In late May 2007, Congress passed the Small Business and Work Opportunity Tax Act of 2007.<sup>2</sup> In addition to providing incentives to employers and employees of small businesses, the Act also provided an unexpected and abrupt change to the tax return preparer penalty provisions under section 6694 of the Internal Revenue Code. Because of the sudden change, the Service granted transition relief for returns due on or before December 31, 2007 and excise tax returns due on or before January 31, 2008.<sup>3</sup> However, with the temporary relief no longer applicable, it is necessary for tax preparers to be aware of penalties that may be imposed under section 6694.

The recent amendments to section 6694 make three important changes to tax return preparer liability. First, the scope of the statute is extended to cover more activities. While the old penalties applied only to income tax return preparers and income tax returns, the new penalties are imposed on nearly all preparers for all types of returns. Second, the standard for liability was increased such that penalties are now imposed on any undisclosed position that is not "more likely than not" to be sustained on the merits. Finally, the amount of the penalty has been substantially increased. This article discusses each change  
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## Congress Adopts Amendments to Tax Return Preparer Penalties... continued from previous page

individually before analyzing what effects the law may have on tax attorneys and their clients.

### I. Eligible Returns and Eligible Preparers

As enacted in 1976, section 6694 imposed penalties for tax positions that an "income tax return preparer" knew, or should have known, did not have "a realistic possibility of being sustained on its merits" independent of the chance of audit.<sup>4</sup> Penalties were only imposed for positions taken in an income tax return or claim for refund under subtitle A.<sup>5</sup> Accordingly, no penalty was imposed for understatements on estate or gift tax returns, excise tax returns, withholding tax returns, or other tax returns.

As mentioned above, only "income tax return preparers" were subject to section 6694 penalties. The definition of an income tax return preparer was found in section 7701(a)(36). The term encompasses any person who prepares, or employs another to prepare, all or a substantial portion of a return or claim for refund.<sup>6</sup> The term is very broad in its reach, encompassing both signing and nonsigning preparers. Furthermore, an income tax return preparer could be an individual, trust, estate, partnership, association, company or corporation.<sup>7</sup> Importantly, since the tax return preparer does not need to be the signing preparer, "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."<sup>8</sup>

Only persons who prepare all or a "substantial portion" of the return may be an income tax return preparer within the meaning of the statute. The Service plans to publish regulations in 2008 that further define a "substantial portion." Current regulations state a substantial portion is determined by comparing the length and complexity of the entry, and the tax liability or refund involved therein, to the length and complexity of, and tax liability or refund involved in, the return or claim for refund as a whole.<sup>9</sup> Regulations also set forth a safe harbor with respect to this element. A portion of a return or claim for

refund is not considered substantial if it involves amounts of gross income: (1) less than \$2,000; or (2) less than \$100,000 and also less than 20% of the gross income as shown on the return.<sup>10</sup>

The regulations also precisely define the type of legal work that is subject to section 6694 penalties. A person who gives legal advice is not considered to be an income tax return preparer unless the advice is given with respect to events which have already occurred 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. Therefore, when an attorney gives an opinion on the tax characterization of a transaction, the attorney may fall within the definition of income tax return preparer unless the return has already been filed. Furthermore, any individual that reviews the substantive correctness of a return is considered a preparer, even if the review results in no changes to the return.<sup>11</sup>

The Small Business and Work Opportunity Tax Act altered both the definition of an income tax return preparer and the scope of the tax return preparer penalties. First, rather than being applicable to an income tax return preparer, the penalties may be imposed on "tax return preparers."<sup>12</sup> The amendments to section 7701 merely removed the word "income" and left the remaining statutory definition of tax return preparer unchanged.<sup>13</sup> In Notice 2008-13, the Service has indicated that the regulations should be similarly interpreted until revised. Individuals who prepare gift tax and other tax returns can now be subject to penalties under section 6694. Furthermore, section 6694 is applicable to positions taken on any return or claim for refund. This change extends the law to cover the preparation of estate tax returns, gift tax returns, generation-skipping transfer tax returns, employment tax returns, and excise tax returns. The broad standard under the old section 6694 is now even broader.

The Service also provided more guidance on the definition of the term "substantial portion." Notice 2008-13 provides further guidance by illustrating what information returns and documents are now

subject to section 6694 penalties.<sup>14</sup> For instance, the preparer of a depreciation schedule that does not calculate tax liability could still be considered a "tax return preparer" under section 6694 if the affected entries on the return constitute a substantial portion of that tax return. It also indicated that the "substantial portion" should 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 that the preparer knows or reasonably should know is a significant portion of the tax liability reported on the tax return.

### II. The Penalty Standard

Under old section 6694, penalties were only imposed on preparers for an undisclosed position that did not have a "realistic possibility" of being sustained on the merits. If the position was disclosed to the Service, it only needed to be "not frivolous" to avoid penalties. Under treasury regulations, a position is considered to have a realistic possibility of being sustained on the 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 its merits."<sup>15</sup> The one-third likelihood was calculated independent of the likelihood of being audited.<sup>16</sup> For instance, if there is a 10 percent chance the Service will audit the return, but a 100 percent chance the Service would disallow the deduction if the return is audited, the position would not have a realistic possibility of being sustained on the merits. The fact that from a practical perspective the return would not likely be audited and no adjustment is anticipated would be disregarded.

The return preparer was also exempted from any penalty when acting in good faith and with reasonable cause.<sup>17</sup> No exemption was allowed and an increased penalty was imposed for an understatement due to willful or reckless conduct.<sup>18</sup>

Under the Small Business and Work Opportunity Tax Act, the standard for imposing a penalty has increased. Rather

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## Congress Adopts Amendments to Tax Return Preparer Penalties... continued from previous page

than using the "realistic possibility" standard, the new law uses an "unreasonable position" standard. An unreasonable position is defined as a position for which there is no "reasonable belief" that the position would "more likely than not be sustained on its merits."<sup>19</sup> The standard is also met if the position has a "reasonable basis" and is disclosed to the service.<sup>20</sup> According to regulations, the reasonable basis standard is "significantly higher than not frivolous."<sup>21</sup> The new law also maintains the exception for preparers acting in good faith and with reasonable cause.<sup>22</sup> For instance, a preparer may rely in good faith on information furnished by the taxpayer.

Compared with the old rules, undisclosed positions now must have a greater than 50 percent chance of success rather than a mere one-in-three chance of the position being sustained. Similarly, disclosed positions must have a reasonable basis rather than being merely not frivolous. Both changes impose a higher standard on tax return preparers.

### III. The Penalty Amount

Finally, the amount of the penalty has also been increased. Under the old section 6694, the penalty for violation of the statute was \$250.<sup>23</sup> The penalty has been substantially increased to the greater of \$1,000 or 50 percent of the income derived by the tax return preparer with respect to the return or claim.<sup>24</sup> While the old penalty constituted an insignificant amount for most tax return preparers, the new penalty could be exponentially larger. Considering legal fees can reach into the millions for some tax advice, penalties are no longer insignificant. Such changes could subject unsuspecting preparers to an unforgiving penalty.

### IV. Compliance With the New Standards

As discussed in the next section, the taxpayer and the tax return preparer have differing disclosure requirements. As a result, circumstances may arise where the taxpayer is not required to disclose a tax position, but section 6694 requires disclosure to avoid tax return preparer penalties. In such a situation, Notice 2008-13 states that a tax return preparer meets the re-

quirements of section 6694 when the preparer includes with his or her advice a statement about the requirements for disclosure and the opportunity to avoid penalties under section 6662.

As outlined in Notice 2008-13, a signing tax return preparer has several means of complying with the requirements of section 6694. For example, if the position does not meet the standard for the taxpayer to avoid penalty without disclosure, the preparer may avoid a penalty by including a disclosure in the tax return provided to the taxpayer. If the position meets the requirements for nondisclosure, the tax return preparer may inform the taxpayer concerning the difference between the section 6662 and section 6694 penalty standards to avoid penalties. The preparer should also document that advice was provided.

### V. Analysis and Issues

The recent changes to the tax return preparer penalty provisions create several issues for preparers. Congress chose only to alter the tax return preparer penalty, while leaving the taxpayer penalty unchanged. Taxpayers continue to face an accuracy penalty only for an undisclosed position for which there is not substantial authority, or a disclosed position that has a reasonable basis.<sup>25</sup> Furthermore, the language of Circular 230 also remains unchanged. The new tax preparer penalty now drastically departs from the language of the taxpayer penalty and Circular 230, thereby creating a potential conflict of interest and further uncertainty for tax return preparers.

A considerable conflict of interest may arise now that the taxpayers and preparers face different penalty standards. Specifically, the potential penalties a preparer can face may impact whether the preparer advises the client to disclose his or her tax position to the Service. For instance, if there is a 40 percent chance that a tax position will be sustained on its merits, the preparer has an interest in disclosing the position to the Service, since disclosure will allow the preparer to avoid any potential penalties under section 6694. However, the taxpayer would not be subject to an accuracy related penalty under section

6662, and it would be against his or her interest to disclose the position to the Service since disclosure would raise a red flag concerning the questionable tax position. Under the old law, this potential conflict of interest was not raised since the "substantial authority" and "realistic possibility" standards were relatively close. Now, a potential conflict is more likely because the "substantial authority" and "more likely than not" standards are quite different.<sup>26</sup> While Congress may eventually amend the taxpayer standard under section 6662, preparers should be careful not create a conflict of interest. To do so, preparers should add a notice to all correspondence outlining the elements touched on in the previous section. The notice should make clear that the reason for the disclosure is to allow the tax return preparer to avoid penalties. Such a notice would be similar to the current Circular 230 notices used by tax practitioners.

The amendments to section 6694 also cause the language of the statute to depart from the language of Circular 230. Previously, the language of section 6694 was nearly identical to the Circular 230. Under Circular 230:

A practitioner may not sign a tax return as a preparer if the practitioner determines that the tax return contains a position that does not have a realistic possibility of being sustained on its merits (the realistic possibility standard) unless the position is not frivolous and is adequately disclosed to the Internal Revenue Service. A practitioner may not advise a client to take a position on a tax return, or prepare the portion of a tax return on which a position is taken, unless—

1. The practitioner determines that the position satisfies the realistic possibility standard; or
2. The position is not frivolous and the practitioner advises the client of any opportunity to avoid the accuracy-related penalty in section 6662 of the Internal Rev-

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enue Code by adequately disclosing the position and of the requirements for adequate disclosure.<sup>27</sup>

Because the language of Circular 230 mirrored the old law, it now provides a lower standard than the current section 6694. Under current law, a preparer can sign a return or provide advice under Circular 230, but may still be penalized by section 6694. It is likely that Circular 230 might be amended to be consistent with the higher standard of the new section 6694.

#### VI. Conclusion

Under the new section 6694, the scope of tax return preparer liability has been expanded to cover all return preparers and all types of returns. Furthermore, the amendments increase the penalty amount and impose a higher standard to avoid penalties. The language of the amendment also departs from language in the old statute, the language in the section 6662 taxpayer penalty provisions, and in Circular 230, thus creating a potential conflict of interest. Overall, the changes to the law are drastic and preparers should be aware of potential liability.

- 1 G. Martin Bingisser, University of Washington School of Law, Class of 2008.
- 2 U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007, Title VIII, Subtitle B (the Small Business and Work Opportunity Act of 2007), section 8246, Pub. L. No. 110-28, 121 Stat. 112.
- 3 Notice 2007-54, 2007-27 I.R.B. 12 (June 11, 2007). Effectively, this meant that the "realistic possibility" rather than "more likely than not" standard was used in determining whether disclosure was required during the transitional period. Furthermore, the "not frivolous" standard rather than the "realistic possibility" standard was used to measure disclosed positions. The temporary rule only applied to income tax returns. Other returns were temporarily judged by the "reasonable basis" standard. The relief also did not apply to understatements due to willful or reckless conduct, as defined in § 6694(b).
- 4 I.R.C. § 6694(a)(2) (2006).
- 5 I.R.C. § 6696(e)(1) (2006).
- 6 I.R.C. § 7701(a)(36)(A) (2006).
- 7 I.R.C. § 7701(a)(1).
- 8 Treas. Reg. § 301.7701-15(b)(1) (emphasis added).
- 9 Treas. Reg. § 301.7701-15(b)(1).
- 10 Treas. Reg. § 301.7701-15(b)(2).
- 11 Rev. Rul. 84-3.
- 12 I.R.C. § 6694(a)(1).
- 13 I.R.C. § 7701(a)(36).
- 14 Notice 2008-13 (January 2, 2008).
- 15 Treas. Reg. § 1.6694-2(b)(1) (emphasis added).
- 16 Treas. Reg. § 1.6694-2(b)(1).
- 17 Treas. Reg. § 1.6694-2(d).
- 18 I.R.C. § 6694(b) (2006).
- 19 I.R.C. § 6694(a)(2).
- 20 I.R.C. § 6694(a)(2)(C)(i)-(ii).
- 21 Treas. Reg. § 1.6662-3(b)(3).
- 22 Treas. Reg. § 1.6694-2(d).
- 23 I.R.C. § 6694(a) (2006).
- 24 I.R.C. § 6694(a)(1).
- 25 I.R.C. § 6662(d)(2)(B).
- 26 However, when the return concerns a public company, fewer conflicts of interest may arise since FIN 48 now applies the "more likely than not" standard to determine whether tax benefits are recognized in a financial statement.
- 27 Circular 230 § 10.34(a).

## CLE Committee Report

by Paige Davis

It has been a busy time for the Tax Section CLE Committee. The CLE Committee kicked off its Brown Bag lunchtime CLE series, which offers quarterly one-hour programs on various tax topics. On November 9, 2007, the first Brown Bag CLE was held at the offices of Lane Powell PC and featured John O'Donnell of Ogden Murphy Wallace PLLC speaking about admission of partners and members to ongoing partnerships and LLCs. The second Brown Bag lunch was February 8, 2008, at Lane Powell PC in Seattle, featuring Gary Tober of Lane Powell PC speaking on "Taxable International Mergers and Acquisitions or How Can a Non-Taxable Transaction Have So Many Issues." The next Brown

Bag will be held June 2, 2008, at the Seattle offices of Deloitte Tax LLP. Wendy Goffe of Graham & Dunn PC will be discussing estate planning for unmarried couples. The Brown Bag CLEs are free to Tax Section Members, \$25 for non-section members, \$8 for students and may be attended in person or by teleconference, so we hope to see you there.

In December, the CLE Committee also sponsored its first Lawyer's Toolbox titled "Tax Issues for Business Transactions." This Toolbox CLE was sold out and participant feedback has been overwhelmingly positive. The CLE Committee is planning to sponsor another Lawyer's Toolbox in the spring focusing on revised

Internal Revenue Code Section 409A, and we hope you will join us.

Save the date! The Washington Tax Section has joined with the Oregon Tax Section to present the first annual Oregon-Washington Tax Institute in Seattle on May 1st and 2nd, 2008. The Oregon-Washington Tax Institute will be a one-and-a-half day program with nationally recognized speakers from across the United States and Canada covering a broad range of tax topics, so mark your calendars. The Tax Institute will coincide with the Annual WSBA Tax Section luncheon. We hope that Tax Section members from throughout Washington will be available to attend.

## Estate & Gift Tax Committee Report

by Luke Thomas

The Estate and Gift Tax Committee continues to focus its efforts during the 2007/2008 year on a host of issues relating to Washington state's estate tax. Specifically, the Committee has been providing guidance to the Washington State Department of Revenue (DOR) on certain constitutional and procedural issues relating to the DOR's attempt to tax inter vivos and testamentary QTIP trusts established before the effective date of Washington's current estate tax law, as well as the taxation of out-of-state QTIP trusts and certain inter vivos gifts. A formal response from the DOR on these issues is expected to be presented at the Committee's next meeting which is scheduled to be held on Friday, February 1st, from 12:00-1:30 at the offices of K&L Gates. The Committee is also working on proposed changes to RCW 6.15.050 to increase statutory asset protection of Section 529 plans.

## IRS Liaison Committee Report

Bob Boeshaar of IRS Counsel and Darek Jarski of LeSourd & Patten, P.S. are currently serving as co-chairs of the IRS Liaison Committee. The committee continues to conduct regular meetings to discuss various topics pertinent to practice before the Internal Revenue Service. The meetings generally take place in the Eagle Room of the Jackson Federal Building in Seattle. Past meeting topics include: collection of tax from LLC's, fraud issues during IRS audits, trust fund recovery penalty investigations, dealing with federal tax liens, and domestic and cross-border issues related to gambling income.

In addition, on February 6, 2008, the Tax Section sponsored a reception with U.S. Tax Court Judge Mark V. Holmes. The reception took place at the offices of Lane Powell PC from 5:30 p.m. to 7:00 p.m., and it was well attended.

On March 20, 2008, the IRS Liaison Committee is planning a presentation regarding the reporting requirements of the Bank Secrecy Act (BSA). The speaker will be Terri Malone, IRS BSA specialist. Among topics to be discussed will be the Report of Foreign Bank and Financial Accounts (FBAR), which has increasingly become an issue during IRS audits.

If you have any questions regarding past or future topics, please feel free to contact Bob or Darek.

### IRS Liaison Committee

Darek M. Jarski  
LeSourd & Patten, P.S.  
600 University Street, Suite 2401  
Seattle, Washington 98101  
206.624.1040 (phone)  
206.223.1099 (fax)  
djarski@lesourd.com

Bob Boeshaar  
IRS Office of Chief Counsel  
915 Second Avenue, Room 2710  
Seattle, Washington 98174  
(206) 220-5589 (phone)  
(206) 220-5959 (fax)  
robert.v.boeshaar@irs.counsel.treas.gov

## International Tax Committee

by Chris Brown

The International Tax Committee has planned several events for 2008. As in previous years, we are working with the International Committee of the Washington Society of CPAs to organize ongoing "International Tax Roundtable" lunches. The next event will be a lunch discussion on Passive Foreign Investment Companies, tentatively scheduled for the end of February or early March.

In May, we will be holding our annual International Conference. This all-day event will be held on Friday, May 9th, at the Red Lion Hotel in downtown Seattle. The scheduled speakers and topics will include Monica Gianni, of Davis Wright Tremaine LLP, speaking on inbound real estate investments and FIRPTA issues; Bill Zaleski, of PwC, speaking on cross-border Social Security planning and totalization agreements; Paige Davis, of Lane

Powell PC, covering the 5th Protocol to the U.S.-Canada Tax Treaty; Scott Rice, of Ernst & Young, speaking on inbound tax planning issues; and Suzanne Kane, of RSM McGladrey, addressing transfer pricing. Michael Ferguson, of Moss Adams, LLP, will provide a report on international tax developments over the last year. Our industry speaker this year will be Brian Ugai, a vice president of international tax at Starbucks Coffee Company, who will provide insights on the challenge of tax planning for a multinational enterprise.

If you have an idea for a Roundtable lunch topic, or would like to serve as a speaker, please contact Chris Brown at Summit Law Group, at [chrisb@summitlaw.com](mailto:chrisb@summitlaw.com).

## Scholarship Committee Report

By Cori Flanders-Palmer

The WSBA Tax Section is pleased to announce its seventh annual tax scholarship. The Tax Section is hoping to raise at least \$5,000 for the scholarship this year. Donations go directly to the recipient, so the greater the donations, the larger the prize to the winner. Anyone who contributes to the scholarship fund will be acknowledged at the Tax Section's annual luncheon and on the Tax Section website.

Most prior recipients of the award have become practicing members of the Washington State Bar Association and contributing members of our local tax community. Last year's recipient, Kara Kalenius, is currently attending the University of Washington's LLM program in Taxation and plans to practice law in the Seattle area.

The application deadline of March 28, 2008, is approaching quickly. Any graduating student from a Washington law school who has been accepted by and plans to attend a tax LLM program at an accredited United States law school is eligible to apply. The award recipient will be announced at the May 1, 2008, Tax Section annual luncheon.

For more information, please visit the scholarship link under our Tax Section website (<http://wsbatax.org>).

