National Association of Tax Professionals

Comments on Tax Return Preparer Penalties Under §6694 and §6695

August 15, 2008

Background

The National Association of Tax Professionals (NATP) is a nonprofit professional association that is committed to the accurate administration and application of tax laws and regulations by providing education, research, and information to all tax professionals. For 29 years, NATP has existed to serve professionals who work in all areas of tax practice.

NATP's 18,683 members and 35 Chapters include individual practitioners, enrolled agents, certified public accountants, accountants, attorneys, and certified financial planners. These members own or work in firms that prepare more than 11 million tax returns annually on behalf of individuals and other entities. NATP serves these members by providing over 200 education offerings in more than 95 cities throughout the United States, a service unmatched by any other national tax association.

Purpose

NATP is providing comments specifically regarding the implication of the proposed regulations under §6694 and §6695 as they relate to the manner in which the regulations may affect tax preparers in their day-to-day business operations, the burden of compliance, and the possible difficulty in conveying the rules to their clients. The specific areas NATP is addressing include:

- Disclosure
- Signing and nonsigning tax preparers
- The determination of the amount of the penalty
- Due Process
- Longer Transition Period

Disclosure

NATP understands that it is the tax preparers' responsibility to remain current with the tax laws and continue to improve their understanding and application of the Internal Revenue Code and the regulations thereunder. NATP has a commitment to its membership and the tax preparation community to provide quality continuing education to further this effort. The increasing complexity of the tax laws, however, has proven this to be a daunting task. There will continue to be instances where the tax preparer makes every effort to be compliant, apply the tax law to their client's specific situation, and ensure that their position is reasonable and will more likely than not be sustained on its merits, yet still make mistakes.

A tax return preparer is afforded some relief from the penalties under Code Sec. 6694, but further clarification is needed. For example, the regulations outline multiple ways to satisfy the disclosure standards depending on whether one is a signing or a nonsigning preparer. That relief is available. No relief, however, is formally offered to preparers who commit errors in the preparation of a return. That is not in keeping with the intent of the law as expressed in the preamble to these regulations.

NATP believes there should be verbiage incorporated into the final regulations that specifically address a pattern of behavior. The concern here is that a rogue agent, in the course of an examination, will discover an error on a return that may constitute a substantial portion of the return and create understatement of tax liability. For all practical purposes, this may be a one-time error and not an egregious, intentional disregard of the rules. Further, it may be the result of an error that a preparer's client made in the course of carrying out business and recording transactions in its books and records. The preparer of the return is not necessarily the auditor of the client's financial statements.

The preamble to the proposed regulations states, "In matters involving non-willful conduct, the IRS will generally look for a pattern of failing to meet the required penalty standards under §6694(a) before making a referral to OPR….." This language should be included in the final regulations so that the intent of the law is not "lost." IRS auditors should be disabused from raising a penalty as the result of a material error unless it is willful and there is a repeated pattern of it happening with the preparer. A one-time error cannot be the basis for the application of a penalty. It must be a recurring error on more than one return. It is egregious to pick out an error on a return that was made in the normal course of business.

Tax return professionals should be accorded due process in any proposal to penalize. A preparer should not discover, as the result of a CP-2000 letter, that a return he has prepared is subject to an assertion of greater liability due to an error or a position taken by his client in error. An example of this might be the erroneous inclusion of an asset in a class having a much shorter life than appropriate: a misclassification error. How can a preparer be subject to a disclosure penalty before he knows it's erroneous? There's a large difference between preparing a return and taking a position on it. The return can be prepared from the books and records supplied by a client without audit. A preparer cannot be expected to check every transaction and every classification of this nature unless so engaged and paid to do so by his client. One can readily see that a return could

"rise to the level" of penalty. There is a difference between that and a circumstance where the preparer would rise to this level. That needs clarification in these regulations.

These regulations, without benefit of the inclusion of the preamble denoting the intent of the law, would substantially alter the manner in which tax return preparers carry out their service in the normal course of business. We would remind the Treasury of comments recently made by Richard S. Goldstein, special counsel to the IRS Associate Chief Counsel in a webcast before the American Law Institute-American Bar Association (ALI-ABA) on July 11, 2008. Mr. Goldstein specifically stated that "Code Section 6694 should not require you to alter the way you do business…. If you have any information that suggests there is a problem with a document, you need to check into that," he stated. Then he asked: "Does the document give you any thought that you need to do more inquiry?" This statement would not contemplate the thought that the books and records of a taxpayer may need examination and verification for clerical or other such errors made by the taxpayer in the normal course of generating his books and records.

Signing/Nonsigning Return Preparer

The regulations go into some detail regarding the application of the penalties to signing and nonsigning tax return preparers. It appears the potential application of the penalties might be skewed in favor of nonsigning preparers. That cannot be determined without further clarification by way of examples for these rules.

When a tax return preparer operates a small tax preparation firm, in most, if not all cases, that business owner is the signing preparer and as such, has the overall authority over the accuracy of that client's tax return. In these cases, it is quite clear who is subject to the penalty in the event of a violation under §6694.

Less clear is how the regulations intend to treat a nonsigning preparer as opposed to a signing preparer in a firm where, for purposes of these regulations, there is more than one preparer of a return. The regulations provide the "10,000/$400,000" de minimis exception to penalty for nonsigning tax return preparers. Such de minimis exceptions do not exist for signing preparers. The connection between relief for signing and nonsigning preparers needs clarifying examples, particularly when there are signers, position researchers, reviewers and those with supervisory responsibility all involved with the same return. The rules for the treatment of these preparers and examples illustrating their treatment should be connected by way of illustration.

For example, take the case of an office where a firm employs a less experienced tax return preparer to interview the client, gather information, and prepare and sign the tax return. In the course of the service, the preparer implements a position passed down by another person doing research in the firm and making a recommendation on how to handle a transaction. The preparer would then present the completed return to a reviewer and a senior member of the firm who has overall supervisory responsibility over the accuracy of the return. In this case, the senior firm member, the reviewer and the person who took the position on the return are subject to potential penalties under §6694 as nonsigning return preparers. If the return is subsequently audited and a liability is found, but the amounts involved do not constitute a substantial portion of the return

under the $10,000/$400,000 rule, the nonsigning preparers are not subject to penalty. The signing preparer should not be subject to penalty either for his reliance on the nonsigning preparers. In such cases it could be inferred that none of the preparers would be subject to penalty. That is not clear from these regulations, however, and more clarifying examples are needed to illustrate this.

Amount of Penalty

The penalties for taking an unreasonable position under §6694(a) are the greater of $1,000 or 50 percent of the income earned (whether or not collected) by the tax return preparer for preparing the return or claim. The penalty is increased to $5,000 under §6694(b).

The regulations are unclear as to the meaning of "income derived" for purposes of applying the penalty. The preamble appears to indicate that all compensation the tax return preparer receives or expects to receive with respect to the engagement is reachable by the Treasury Department. This provision is too broad in scope and can be interpreted to mean different things by different revenue agents or revenue officers.

For example, a tax return preparer is paid an hourly wage by a firm for the preparation of tax returns and is not compensated directly by the taxpayer. The return preparer is deemed the signing preparer and thus, would be subject to potential penalties. Assuming the taxpayer is charged a flat fee by the firm for tax preparation services, on what compensation is the penalty based? To illustrate, assume a tax preparer is compensated at a rate of $20/hour for tax preparation services. It takes the preparer ten hours to complete the return. The return is reviewed for overall accuracy by a senior member of the firm and returned to the preparer for signature. The firm charges the client $2,500 for the completed return. In the event a position taken on the return was not disclosed and subsequently disallowed resulting in a penalty, what is the penalty? Is it $1,000 or $1,250? If the income derived by the preparer (in the way of compensation) is used, the penalty would be $1,000 – the greater of $1,000 or 50 percent of the income derived. If the fee the firm charged the client is used, the penalty is $1,250 (50 percent of the $2,500 fee). Using these facts, if the position does not constitute a substantial portion of the return, the senior firm member could be construed as to be the nonsigning preparer if he has overall supervisory responsibility over the accuracy of the return. In this case the penalty is avoided altogether.

The preamble states –

> *In the situation of a tax return preparer who is not compensated directly by the taxpayer, but rather by a firm that employs the tax return preparer or with whom the tax return preparer is associated, income derived (or to be derived) means all compensation the tax return preparer receives from the firm that can be reasonably allocated to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position(s) taken on the return or claim for refund that gave rise to the understatement.*

> *In the situation where a firm that employs the individual tax return preparer (or the firm with which the individual tax return preparer is associated) is subject to a penalty under section 6694(a) or (b), income derived (or to be derived) means all compensation the firm receives or expects to receive with respect to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position(s) taken on the return or claim for refund that gave rise to the understatement.*

It would appear there may be undue burden placed on the firm in making proper determinations of the income derived for purposes of the penalty. Often an hourly employee will spend some time actually preparing the return, assembling the return, or conducting research and consultation services, all for the same taxpayer. Tracking and allocating hours in such a scenario to accurately determine the "income derived" based on compensation paid to the preparer would require additional recordkeeping or the possible economic outlay for time and billing software.

Due Process

The dramatic changes in the penalties of Code Sections 6694 and 6695 have caused a great concern within the tax professional community. Of particular concern is the lack of a coherent administrative appeal process for paid tax return preparers. While it is true that Reg. §1.6694-4(b) has been utilized since 1989, the much more stringent penalties and the attention focused upon them gives pause to preparers, justifiably so. Currently, if an agent in the field decides to impose a §6694 penalty at any point and for any reason, he may do so. Although the Internal Revenue Manual calls for the agent to notice the preparer of the imposed penalty, the preparer has no other recourse administratively other than to pay it or pay 15% of it in order to temporarily alleviate a collection process. Then he may file a refund claim. There is no ability to appeal to the agent's supervisor/manager. The only recourse a preparer has, after filing the refund claim and having it denied, is to start a proceeding in district court.

The inequity and abuse possibilities of the lack of an administrative remedy for preparers should be apparent. Conflicts could easily arise between a preparer and an agent whom the preparer has had disagreements with before in representing his clients. The time and cost of sending tax professionals to court as the only course of remedy is unfair, prohibitive and detrimental to the tax administration and district court systems. Under the circumstances, an appropriate and fair administrative appeal process should be available to tax professionals just as there is such a process for taxpayers.

Longer Transition Period

Given the complex nature of these regulations, the "case by case" approach being taken by Treasury in their application, the clear intent of the law as set out in the preamble and the need to incorporate it into the regulations themselves, NATP recommends that a longer transition period be

provided to implement these regulations. They are already being implemented in their proposed state at the IRS Center in Ogden, Utah. The positions being taken by auditors and their managers at that Center are clearly out of harmony with the preamble and with statements made by IRS Associate Chief Counsel Goldstein. It is already apparent that the IRS will need a transition period in which to work out the difficulties and equities of implementing these regulations every bit as much as tax professionals.

By way of final comment, we urge Treasury to consider the chilling effect these regulations may have on the entire tax professional community. While we understand that the law was changed under these penalty sections in order to discourage unscrupulous and unethical behavior, these regulations have the serious potential to overstep the spirit and intent of Congress. We do not want these regulations to become a barrier to entry into the tax administration system nor do we want them to cause a mass exit from the system.

NATP appreciates the opportunity to comment on these regulations. We trust that the remarks made herein will be helpful and used in the further revision and clarification of how Code Section 6694 and 6695 will be equitably administered.