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BEWARE OF BEING A PREPARER

By Neal Nusholtz

The Internal Revenue Service estimates that between $11 billion and almost $14 billion in erroneous Earned Income Tax Credit (EITC – a refundable credit for low income taxpayers) clams are paid annually.[1] Two-thirds of all EITC claims are prepared by paid tax return preparers. For 2011, the government decided to increase the penalty from $100 to $500 for each preparer's failure to comply with due diligence requirements in preparing a tax return.[2]

Taxpayers cannot possibly cope with the complexity of our tax system. The solution under the EITC is to shift the burden to professionals to implement the rules and police taxpayers who might try to get around the rules, or a professional will face penalties. There are many different examples of this type of burden being placed on tax return preparers. But while the government has made it harder to be a tax return preparer, they have also made it easier to be tax preparer, by accident, as in the following example:

> Prior to the sale of a $5 million business, an attorney writes an opinion where the tax savings could be $1 million. The attorney charges for 3 hours of work. The following tax season, the client returns to the attorney's office with a draft of his tax return. It shows the sale and the client wants review and final approval. The attorney looks at it for 10 minutes, sees the sale property reported, and gives the draft his approval.
>
> **Question:** Is the attorney required to sign the tax return?
>
> **Answer:** The attorney may be a signing tax return preparer of a tax return if he or she is primarily responsible "for the overall substantive accuracy of the preparation of such return"[3]. The attorney will be a non-signing tax return preparer if: (1) someone else has final say on the return;[4] (2) the advice given[5] relates to items on the return that are "substantial;"[6] and (3) at least 5% of the advice occurs after the pertinent facts have occurred.[7] A substantial portion of the return is an item which is: (1) a "substantial portion of the tax" and (2) an item of gross income or a deduction of at least: (1) $10,000.00 or (2) $400,000 and at least 20% of the gross income on the return[8].

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Professionals could inadvertently run afoul of the preparer rules and the rules are numerous (they are listed at length below). A good place to start would be a discussion about the differences between a signing return preparer and a non signing return preparer.

TABLE OF DIFFERENCES BETWEEN *SIGNING AND NON SIGNING PREPARERS*

Topic	Signing Preparer	Non Signing Preparer
Definition	"A signing tax return preparer is the individual tax return preparer who has the primary responsibility for the overall substantive accuracy of the preparation of such return or claim for refund."[9]	"A non signing tax return preparer is any tax return preparer who is not a signing tax return preparer but who prepares all or a substantial portion of a return or claim for refund within the meaning of paragraph (b)(3) of this section with respect to events that have occurred at the time the advice is rendered. In determining whether an individual is a non signing tax return preparer, time spent on advice that is given after events have occurred that represents less than 5 percent of the aggregate time incurred by such individual with respect to the position(s) giving rise to the understatement shall not be taken into account. Notwithstanding the preceding sentence, time spent on advice before the events have occurred will be taken into account if all facts and circumstances show that the position(s) giving rise to the understatement is primarily attributable to the advice, the advice was substantially given before events occurred primarily to avoid treating the person giving the advice as a tax return preparer, and the advice given before events occurred was confirmed after events had occurred for purposes of preparing a tax return. Examples of non signing tax return preparers are tax return preparers who provide advice (written or oral) to a taxpayer (or to another tax return preparer) when that advice leads to a position or entry that constitutes a substantial portion of the return within the meaning of paragraph (b)(3) of this section. "[10]
Definition of "Substantial Portion"		"A person who renders tax advice on a position that 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. Whether a schedule, entry, or other portion of a return or claim for refund is a substantial portion is determined based upon whether the person knows or reasonably should know that the tax attributable to the schedule, entry, or other portion of a return or claim for refund is a substantial portion of the tax required to be shown on the return or claim for refund. A single tax entry may constitute a substantial portion of the tax required to be shown on a return."[11]
Exceptions from Substantial Portion Rules		(1) Less than $10,000; or (2) Less than $400,000 and also less than 20 percent of the gross income as shown on the return or claim for refund (or, for an individual, the individual's adjusted gross income). [12]

Topic	Signing Preparer	Non Signing Preparer
Examples under Treas. Reg. §301.7701-15(b)(2) :		Example 2. Attorney B, an attorney in a law firm, provides legal advice to a large corporate taxpayer regarding the tax consequences of a proposed corporate transaction. Based upon this advice, the corporate taxpayer enters into the transaction. Once the transaction is completed, the corporate taxpayer does not receive any additional advice from B with respect to the transaction. B did not provide advice with respect to events that have occurred and is not considered a tax return preparer. Example 3. The facts are the same as Example 2, except that Attorney B provides supplemental advice to the corporate taxpayer on a phone call after the transaction is completed. Attorney B did not provide advice before the corporate transaction occurred with the primary intent to avoid being treated as a tax return preparer. The time incurred on this supplemental advice by B represented less than 5 percent of the aggregate amount of time spent by B providing tax advice on the position. B is not considered a tax return preparer. [13]
Date Return is Deemed Prepared	Date signed, if unsigned, date filed.[14]	Date non signing Preparer provides advice"[15]
Obligation for Accuracy on the Return	"Primary Responsibility for the overall substantive Accuracy" [16]; unless it is determined that the signing preparer is not responsible for the position and there is a non signing tax preparer within the firm with overall supervisory responsibility for the position(s) giving rise to the understatement. [17] A penalty may be assessed against a signing or non signing preparer in the same firm but not both.[18] Note that this rule does not apply to people in different firms. [19]	If "based upon credible information from any source, it is concluded that the signing tax return preparer is not primarily responsible for the position(s) on the return "[20]A penalty may be assessed against a signing or non signing preparer in the same firm but not both. [21] Note that this rule does not apply to people in different firms.[22]
§6694 Penalty	the amount of penalties assessed against the individual and the firm shall not exceed 50 percent of the income derived (or to be derived) by the firm from the engagement of preparing the return or claim for refund or providing tax advice ...The portion of the total amount of the penalty assessed against the individual tax return preparer shall not exceed 50 percent of the individual's compensation as determined under paragraphs (f)(1) and (2) of this section. [23]	
§6694 Adequate Disclosure	From 8275 or 8275-R, disclosure under 1.6662-4(f), or if other than accuracy related penalties, contemporaneously documented advice to the taxpayer [24]	Disclosure on the Tax return the same as for a signing tax preparer[25] or if the advice is provided to a taxpayer "if the tax return preparer advises the taxpayer of any opportunity to avoid penalties under section 6662 that could apply to the position, if relevant, and of the standards for disclosure to the extent applicable. The tax return preparer must also contemporaneously document the advice in the tax return preparer's files."[26] If advice is provided to another tax preparer disclosure is adequate if the other tax return preparer [is advised] that disclosure under section 6694(a) may be required. The tax return preparer must also contemporaneously document the advice in the tax return preparer's files.[27]

Topic	Signing Preparer	Non Signing Preparer
Duties under 1.6695-1	• Furnish copy • Sign Return • Furnish identifying number on return • Retain Copy • Cannot Negotiate Client's Refund Checks	
§6695 Earned income Tax Credit	Prepare 8867.[28] Retain Form 8867, a completed Earned Income Credit Worksheet, a record how and when the information used to prepared the 8867 was obtained[29] for 3 years from the latest of: (1) due date of the return; (2)date of filing; (3)if not filed, date presented.[30]	Provide Signing Return Preparer with a Completed form 8867. Records are retained three years from the date "the date the nonsigning tax return preparer submitted to the signing tax return preparer that portion of the tax return or claim for refund for which the nonsigning tax return preparer was responsible."[31]

TABLE OF ILLUSTRATIVE *PREPARER ISSUES*[32]

Question	Holding	Cite
Can a general partner who prepares the partnership return be considered a preparer of the Limited Partners tax return subject to penalties for negligent or intentional disregard of rules and regulations from the understatement of tax on a limited partner's return?	Yes, if the General Partners has been compensated and the K-1 entries are a substantial Portion of the Limited Partner's tax return. Preparation "of a Schedule K-1, which provides information relating to specific amounts of income, deductions, and credits for each partner [is] advice [that] is directly relevant to the existence, characterization, and amount of entries on each partner's return." (GCM 38747)	Rev. rul. 81-2701981-2 CB 250; GCM 38746 (6/5/81)
An attorney receives a signed return prepared by his client for review with instructions to send it in if no changes are needed. The attorney reviews the return for correctness, asks a few questions and sends the return in for filing. Is the attorney required to sign the tax return or, if not, be subject to a penalty under §6695?	Yes.	Situation 4 Rev. Rul. 84-3 1984-1 C.B. 264
An attorney receives a draft of a tax return, and advises the client to make substantial changes, which the client does before mailing it in. Is the attorney subject to a §6695 penalty for not signing the return.	Yes, unless the attorney can prove he made a request to receive the revised return for signature and the request was not honored. In the alternative, a preparer may draft a return based on available information and sign and send it to the taxpayer. (GCM 29322 (1/10/85))	Situation 3 Rev. Rul. 84-3 1984-1 C.B. 264

Question	Holding	Cite
An attorney writes a tax opinion for a substantial item on a tax return for a company that has its own tax department and the tax department makes final decisions on tax matters. Is the attorney required to sign the tax return?	No. A person who is a preparer solely because they have given advice on a specific issue of law under §301.7701-15(a)(2) and (b) is not required to sign the return where "the extent of review" does not include the final decision as to an item on the Return.	1.6695(b)(95). PLR 792033

SUMMARY OF APPLICABLE CODE SECTIONS AND *OTHER PROVISIONS THAT APPLY TO PREPARERS*:

IRC § 6694 – Understatement of taxpayer's liability by tax return preparer.

IRC § 6694(a) – Understatement due to unreasonable positions. The 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.

IRC § 6694(b) – Understatement due to willful or reckless conduct. The penalty is the greater of $5,000 or 50% of the income derived by the tax return preparer with respect to the return or claim for refund.

IRC § 6695 – Other assessable penalties with respect to the preparation of tax returns for other persons.

IRC § 6695(a) – Failure to furnish copy to taxpayer. The penalty is $50 for each failure to comply with IRC § 6107 regarding furnishing a copy of a return or claim to a taxpayer. The maximum penalty imposed on any tax return preparer shall not exceed $25,000 in a calendar year. And ERO (Electronic Return Originator) must provide a form 8453 an a printout of the electronic portion of the return.

IRC § 6695(b) – Failure to sign return. The penalty is $50 for each failure to sign a return or claim for refund as required by regulations. The maximum penalty imposed on any tax return preparer shall not exceed $25,000 in a calendar year. See Notice 2004-54 (Alternative methods of signing include signature from computer software program.

IRC § 6695(c) – Failure to furnish identifying number. The penalty is $50 for each failure to comply with IRC § 6109(a)(4) regarding furnishing an identifying number on a return or claim. The maximum penalty imposed on any tax return preparer shall not exceed $25,000 in a calendar year.

IRC § 6695(d) – Failure to retain copy or list. The penalty is $50 for each failure to comply with IRC § 6107(b) regarding retaining a copy or list of a return or claim. The maximum penalty imposed on any tax return preparer shall not exceed $25,000 in a return period.

IRC § 6695(e) – Failure to file correct information returns and keep employee records. The penalty is $50 for each failure to comply with IRC § 6060. The maximum penalty imposed on any tax return preparer shall not exceed $25,000 in a return period. A person who employs someone to prepare tax returns other than their own is require to keep a record of the name,s taxpayer identification numbers, and places of work of each employee for a 12 month period starting on July 1 of each year ("the return period") and make that record available to the Internal Revenue Service upon request or the 3-year period following the close of the return period to which that record relates.

IRC § 6695(f) – Negotiation of check. The penalty is $500 for a tax return preparer who endorses or negotiates any check made in respect of taxes imposed by Title 26 which is issued to a taxpayer.

IRC § 6695(g) – Failure to be diligent in determining eligibility for earned income credit. The penalty is $500 for each failure to comply with the EIC due diligence requirements imposed in regulations.

IRC § 6700 – Promoting abusive tax shelters

The penalty is for a promoter of an abusive tax shelter and is generally equal to $1,000 for each organization or sale of an abusive plan or arrangement (or, if lesser, 100 percent of the income derived from the activity).

IRC § 6701 – Penalties for aiding and abetting understatement of tax liability.

The penalty is $1000 ($10,000 if the conduct relates to a corporation's tax return) for aiding and abetting in an understatement of a tax liability. Any person subject to the penalty shall be penalized only once for documents relating to the same taxpayer for a single tax period or event.

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

The penalty is $250 for each unauthorized disclosure or use of information furnished for, or in connection with, the preparation of a return. The maximum penalty on any person shall not exceed $10,000 in a calendar year. Under Treas. Reg. 301.7216-2(h) tax return information amon authorized IRS e-file providers is permitted. Treas. Reg. 301.7216 requires consents from a taxpayer in order to use taxpayer information for any purpose other than the preparation of a tax return.

IRC § 7206 – Fraud and false statements.

Guilty of a felony and, upon conviction, a fine of not more than $100,000 ($500,000 in the case of a corporation), imprisonment of not more than three years, or both (together with the costs of prosecution).

IRC § 7207 – Fraudulent returns, statements, or other documents.

Guilty of a misdemeanor and, upon conviction, a fine of not more than $10,000 ($50,000 in the case of a corporation), imprisonment of not more than one year, or both.

IRC § 7216 – Disclosure or use of information by preparers of returns.

Guilty of a misdemeanor for knowingly or recklessly disclosing information furnished in connection with a tax return or using such information for any purpose other than preparing or assisting in the preparation of such return. Upon conviction, a fine of not more than $1,000, imprisonment for not more than 1 year, or both (together with the costs of prosecution).

IRC § 7407 – Action to enjoin tax return preparers.

A federal district court may enjoin a tax return preparer from engaging in certain proscribed conduct, or in extreme cases, from continuing to act as a tax return preparer altogether.

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

A federal district court may enjoin a person from engaging in certain proscribed conduct (including any action, or failure to take action, which is in violation of Circular 230).

Note: Please see the Internal Revenue Code, corresponding Treasury Regulations, and other related published guidance for additional information on each penalty section.

Circular 230 Section 10.21 Obligation to Advise of Consequences of Noncompliance, Error or Omission

§ 10.21 Knowledge of client's omission A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.

Circular 230 Section 10.21 Dilgence as to Accuracy

§ 10.22 Diligence as to accuracy. (a) *In general.* A practitioner must exercise due diligence — (1) In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;

SPECIFIC RULES APPLYING TO *EARNED INCOME TAX CREDIT*

Generally, four requirements must be met by Return Preparers to avoid a penalty under §IRC 6695(g), which requires due diligence in the course of preparing tax returns with an earned income tax credit.

First, the tax preparer must complete either Form 8867 or its equivalent, and complete an eligibility checklist based on information provided by the taxpayer for the tax preparer.

Second, the preparer must keep the EIC worksheet or equivalent that demonstrates how the EITC was computed. The preparer must keep either: (1) the Earned Income Credit Worksheet in the Form 1040 Instructions or (2) a record in the electronic files of the calculation, including the method and information used. The worksheet may be prepared based on information provided by the taxpayer, or otherwise reasonably obtained by the preparer.

Third, the preparer must not know or have reason to know, at the time of the preparation of the return, that any information used in determining the taxpayer's eligibility for, or the amount of, the EITC is incorrect, incomplete or inconsistent. In satisfying this knowledge requirement, the taxpayer must also (1) not ignore the implications of information furnished or known, (2) make reasonable inquiries if a reasonable and well-informed tax return preparer, knowledgeable in the law, would conclude the information furnished appears to be incorrect, inconsistent or incomplete, and (3) document in

his/her records any additional inquiries and responses made. Whenever a preparer knows or has reason to know that more than one taxpayer is seeking to claim the EIC for the same child, a penalty will be asserted if the preparer does not apply the tie breaker rules, which are: (1) between a parent and a non parent, the parent; (2) if neither claimants are parents, the one with the higher Adjusted Gross Income; (3) if both claimants are parents who do not file jointly, the parent with whom the child lived longest during the year; and (4) if both parents are claimants and their time with the child is equal, the one with the higher adjusted gross income.

> **IRS Publication 4687** defines Due Diligence:
>
> IRS assesses most due diligence penalties for failure to comply with the knowledge requirement. To meet the knowledge requirement, you should:
>
> - Apply a common sense standard to the information provided by your client
> - Evaluate whether the information is complete and gather any missing facts
> - Determine if the information is consistent; recognize contradictory statements and statements you know not to be true
> - Conduct a thorough, in-depth interview with every client, every year
> - Ask enough questions to reasonably know the return is correct and complete
> - Document in the file any questions you asked and your client's responses, as it happens.
>
> If a Return Preparer receives conflicting information from two different taxpayers, the return preparer has an affirmative duty to request verification from both taxpayers to determine which information is correct and to only file a return with information the preparer does not know or have reason to know is incorrect (CCA 200029008)

Lastly, the due diligence requirements relating to record retention require that the preparer retain the Form 8867 (or its equivalent) and the EITC worksheet, maintain a record of how and when the information used to complete these forms was obtained, verify the identity of the person furnishing the information, and retain the records on paper or electronically for three years after the latest of:
(A) The due date of the tax return (determined without regard to any extension of time for filing);

(B) In the case of a signing tax return preparer electronically filing the tax return or claim for refund, the date the tax return or claim for refund was filed;

(C) In the case of a signing tax return preparer not electronically filing the tax return or claim for refund, the date the tax return or claim for refund was presented to the taxpayer for signature; or

(D) In the case of a nonsigning tax return preparer, the date the nonsigning tax return preparer submitted to the signing tax return preparer that portion of the tax return or claim for refund for which the nonsigning tax return preparer was responsible.

Exception to penalty. The section 6695(g) penalty will not be applied with respect to a particular tax return or claim for refund if the tax return preparer can demonstrate to the satisfaction of the IRS 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 of paragraph (b) of this section, and the failure to meet the due diligence requirements of paragraph (b) of this section with respect to the particular tax return or claim for refund was isolated and inadvertent. The preceding sentence does not apply to a firm that is subject to the penalty as a result of paragraph (c) of this section.[33]

MANNER OF ASSESSMENT

Preparer penalties will be assessed in the same manner as taxes. Preparers subject to proposed penalties will be sent a 30 day Letter 1125 (Transmittal of Examination Report) and if a response to the 30 day letter is not made, the penalty will be assessed.[34] Preparer penalties will not be submitted to Appeals if less than 180 days remain on the statute of limitation. A request for extension of the statute will be made and if not granted, the penalty will be assessed.[35] Once assessed, the penalty must be paid and a claim for refund filed to obtain a hearing. Except in §6694, §6695 and §6713 cases, if a hearing in appeals has not been previously granted, one will be granted on filing a claim for refund.[36] In §6694, §6695 and §6713 cases, an appeals hearing will be granted even if the preparer was previously granted an appeals hearing pre-assessment.[37]

CONCLUSION

Well, that covers the complete landscape of rules that apply to preparers, including people who might not think they are preparers. Once facts have occurred upon which tax advice is given, no simple rule of thumb exists which, if followed, will exempt anyone from the application of all of these rules. So, be prepared to be a preparer and keep the following in mind. In a parting statement before he left IRS, David Williams, the former director of the IRS Return Preparer Office (RPO), acknowledged there were doubts among the tax pro-

fessional community about the agency's ability "to halt preparer fraud and root out non-signing preparers." IRS considers this a high priority, Williams said in a statement posted on Facebook on Sept. 4.

About the Author

Neal Nusholtz is a tax attorney in Troy, Michigan.

Endnotes

1 IRS EITC Fact Sheet. Data for TY 2008 through June 30, 2009. Available at: http://www.eitc.irs.gov/rptoolkit/compliance.

2 112th Congress, Committee Report for JCS-3-11: "Increase penalty imposed on paid preparers who fail to comply with Earned Income Tax Credit ("EITC") due diligence requirements "

3 Treas. Reg. 301.7701-15 (a)

4 PLR 7902033

5 §301.7701-15(b)(3)

6 Treas. Reg. 301.7701-15(b)(2)

7 Treas. Reg. 301.7701-15(b)(2)

8 §301.7701-15(b)(3)(ii)

9 §301.7701-15(b)(1)

10 §301.7701-15(b)(2)

11 301.7701-15(b)(3)

12 §301.7701-15((b)(3)(ii)

13 301.7701-15(b)(2) Examples 2 and 3:

14 1.6694-1(a)(2)

15 1.6694-1(a)(2)

16 §301.7701-15(b)(1)

17 §1.6694-1(b)(3) and 1.6694-1(b)(6) Example 1.

18 §1.6694-1(b)(4)

19 (See §1.6694-1(b)(6) Example 4.)

20 §1.6694-1(b)(2)

21 §1.6694-1(b)(4)

22 (See example 4 §1.6694-1(b)(6) Example 4."Same as Example 1, except Attorney D, who works for a different firm than A [signing preparer], also provides advice on the same position upon which A relies. It may be concluded that D is [in addition to B] also primarily responsible for the position on the return and may be subject to penalty under section 6694."

23 §1.6694-1(f)(3)

24 §1.6694-2(d)(3)i(A)-(C)

25 §1.6694-2(d)(3)(ii)

26 §1.6694-2(d)(3)(ii)(A)

27 §1.6694-2(d)(3)(ii)(B)

28 §1.6695-2(b)(1)(C)

29 §1.6695-2(b)(4)(i)

30 §1.6695-2(b)(4)(i)

31 §1.6695-2(b)(4)(ii)

32 This list can be found on the IRS website under Summary of Preparer Penalties under Title 26

33 1.6695-2(d)

34 Internal Revenue Manual 20.1.6.19.1(2)

35 Internal Revenue Manual 20.1.6.19.1(3)

36 Internal Revenue Manual 20.1.6.19.3

37 Internal Revenue Manual 20.1.6.19.4