

MSCPA Federal Tax Forum Update

Procedure

By Christopher E. Pulick

1. Procedure—Sharing SSNs with Offshore Tax Preparers: Prior regulations forbade a U.S. tax return preparer from sharing taxpayers' social security numbers (SSNs) with offshore preparers. But since there are situations where a foreign tax preparer may need the SSN to properly file the return or get treaty benefits from a foreign government, new regulations (included in TD 9409) allow the sharing of SSNs if the taxpayer gives consent and proper security measures are in place. A related revenue procedure provides the procedures and format required for the taxpayer's consent—see Rev. Proc. 2008-35, 2008-29 IRB .

2. Procedure—Tax Return Preparer Oversight: California and Oregon have requirements that return preparers must meet to practice their trade. Oregon has a two-tiered system, with education, examination, and work experience requirements. According to a Government Accountability Office (GAO) report (GAO-08-781), Oregon returns are more likely to be accurate compared to the rest of the country. Should Congress determine that the Oregon paid preparer regulations account for even part of the higher accuracy of Oregon federal tax returns at a reasonable cost, the GAO recommends that it consider adopting a similar regime nationwide. To view the full GAO report, go to www.gao.gov/new.items/d08781.pdf .

3. Procedure— Temporary regs explain penalty for failing to report reportable transactions: IRS has issued temporary regs on the [Code Sec. 6707A](#) penalty for the failure to include on any return or statement any information required to be disclosed under [Code Sec. 6011](#) with respect to a reportable transaction. In particular, the temporary regs discuss IRS's authority to rescind all or part of the penalty and how to request rescission. The text of the temporary regs also serves as the text of proposed regs

4. Procedure—Auction Rate Securities Settlements: According to the IRS, auctions for auction rate securities began to fail on 2/12/08, so many taxpayers could not sell their securities for their par amount. This could lead to legal claims against other parties (referred to as *Corporation X*) and settlement offers giving the taxpayer the right during a specified period (the "window period") to cause Corporation X to buy taxpayer's securities for their par amount. For taxpayers within the scope of this revenue procedure, the IRS will not challenge the position that (1) the taxpayer continues to own the auction rate security upon accepting a settlement offer, (2) the taxpayer does not realize income from accepting a settlement offer, or (3) the amount realized from the sale of the auction rate security during the window period is the full amount of the cash proceeds received from Corporation X. Rev. Proc. 2008-58, 2008-41 IRB .

MSCPA Federal Tax Forum Update

Procedure

By Christopher E. Pulick

5. Procedure—Interest Rate on Wrongful Levy: Under IRC Sec. 6621(a)(1) , the overpayment rate for corporations equals the federal short-term rate plus two percentage points; however, the rate for the portion of a corporate overpayment of tax exceeding \$10,000 is lower—the federal short-term rate plus 0.5 of a percentage point. A Washington District Court previously held that a wrongful levy was not an *overpayment of tax* within the meaning of IRC Sec. 6621(a)(1) , so the lower rate did not apply. In reversing this decision, the 9th Circuit noted that the "plain meaning of IRC Sec. 7426 and IRC Sec. 6621 compel the conclusion that Congress intended to treat wrongful levy judgments like overpayments of tax for purposes of calculating the overpayment rate." *Cheung v. U.S.* , 102 AFTR 2d 2008-XXXX (9th Cir.).

6. Procedure—Court Refuses to Enforce IRS Summons: A Pennsylvania District Court denied the IRS's request to enforce a summons issued to Smith Barney for documents pertaining to taxpayer's transfer of "significant assets out of her personal accounts just days before her death." Although the IRS met the standard for enforcement of the summons (e.g., the summons was relevant to a legitimate purpose and the IRS didn't possess the information sought), lack of possession of the summoned documents is a valid defense to an enforcement order. Furthermore, the fact that the summons "may not have borne all the fruit the IRS was hoping for does not mean that Smith Barney has failed to comply with the summons." *U.S. v. Smith Barney* , 101 AFTR 2d 2008-2669 (DC W. Penn.).

7. Procedure—Filing Form 8027 Electronically: The IRS revised the specifications for electronically filing Form 8027 (Employer's Annual Information Return of Tip Income and Allocated Tips). This form is filed by large food or beverage establishments when the employer is required to make annual reports to the IRS on receipts from food or beverage operations and tips reported by employees. Since the IRS no longer accepts magnetic media, Form 8027 must be filed through the Filing Information Returns Electronically (FIRE) System. Rev. Proc. 2008-34, 2008-27 IRB .

8. Procedure—Filing Substitute Form 941: The IRS updated the rules and specifications for filing paper and computer-generated substitutes of the 1/08 revision of Form 941 (Employer's Quarterly Federal Tax Return) and Schedule B (Report of Tax Liability for Semiweekly Schedule Depositors). For additional information on who must complete the forms and how to complete them, see the instructions for Form 941 and IRS Pub. 15 , "(Circular E) Employer's Tax Guide." Rev. Proc. 2008-32, 2008-28 IRB .

MSCPA Federal Tax Forum Update
Procedure
By Christopher E. Pulick

9. Procedure—Economic Stimulus Payments: According to a 7/11/08 Treasury Dept. news release, the last of the "mass disbursements of stimulus payments" has been completed. [**Editor's Note:** In total, Treasury sent out 112.405 million economic stimulus payments totaling \$91.834 billion.] Payments will be sent in small batches through the end of the year as returns are filed by the 10/15/08 extended deadline. The news release adds that taxpayers who do not file by 10/15/08 but still qualify for a payment "can obtain their stimulus payment by filing a 2008 tax return next year."

10. Procedure—Filing Substitute Form W-2: The IRS updated the rules for using substitutes of Form W-2 (Wage and Tax Statement) and W-3 (Transmittal of Wage and Tax Statements) for wages paid during the 2008 calendar year. [**Editor's Note:** A new prohibition against including slogans, advertising, and other logos on information returns and employee statements for wages paid during the 2010 calendar year is included to provide advance notice of this change.] The IRS maintains a centralized call site at its Enterprise Computing Center—Martinsburg (ECC) to answer questions relating to Form W-2 , Form 1099, etc. The ECC can be contacted by calling 304-263-8700 (not a toll-free number) or 866-455-7438 (toll-free) Monday through Friday from 8:30 a.m. to 4:30 p.m. Eastern time. Rev. Proc. 2008-33, 2008-28 IRB .

11. Procedure—Reporting Statutory Stock Options: Prop. Regs. 1.6039-1 and 1.6039-2 (found in REG 103146-08) clarify the reporting of incentive stock options (ISOs) and employee stock purchase plans (ESPPs) following changes by the 2006 Tax Relief and Health Care Act. [**Editor's Note:** Now, IRC Sec. 6039 requires corporations to file an information return with the IRS along with an information statement to the employee following a stock transfer.] Corporations will use Form 3921 (Exercise of an Incentive Stock Option) to report ISO transactions and Form 3922 [Transfer of Stock Acquired Through an Employee Stock Purchase Plan Under Section 423(c)] to report ESPP transactions. While the regulations are effective as of 1/1/07, employers will not need to comply for stock transactions occurring in 2007 or 2008.

12. Procedure—Substitute Forms: The IRS issued the 2008 requirements for reproducing paper substitutes and for furnishing substitute recipient statements for Form 1096, Form 1098 , Form 1099, Form 5498, Form W-2G , and Form 1042-S. A substitute form or statement must conform to the official form or the specifications in this revenue procedure to be acceptable to the IRS. The "What's New" section notes in part that (1) there is a new email address and room number for the Substitute Forms Unit, (2) all paper information returns must be filed with the Austin or Kansas City Service Centers, and (3) magnetic media filing is no longer acceptable. Furthermore, there is new guidance on the use of logos, slogans, or advertising on substitute payee statements. Rev. Proc. 2008-36, 2008-33 IRB (superseding Rev. Proc. 2007-50, 2007-31 IRB 244).

MSCPA Federal Tax Forum Update
Procedure
By Christopher E. Pulick

13. Procedure—Tax Practitioner/Client Privilege: An Illinois District Court held that Valero Energy had to provide summoned documents to the IRS it had previously withheld under the Section 7525 privilege for confidential communications between a federal tax practitioner and client. After noting that the Section 7525 privilege does not apply to the practitioner's promotion of a client's participation in a tax shelter, foreign (Canadian) tax advice, or to business advice or accounting services, the District Court stated that: "just as communications from an attorney to a client are privileged only if they constitute legal advice, or tend directly or indirectly to reveal the substance of a client confidence [citation omitted], communications from a tax practitioner to a client are also privileged only in those circumstances." *Valero Energy Corp. v. U.S.* , 102 AFTR 2d 2008-XXXX (N.D. Ill.).

14. Procedure—Third-party summons enforcement—attorney-client privilege—work product protection: Magistrate judge accepted in part and rejected in part law firm's privilege claims for not turning over to IRS documents responsive to summons seeking information relating to firm's former client. Magistrate found that certain documents didn't contain any privileged communications or involved communications for which firm had effectively waived attorney-client privilege via voluntary disclosures to 3d parties. Magistrate also found that work product protection wasn't available absent proof that firm prepared subject documents in anticipation of litigation. Magistrate noted that many documents went to real estate transactions and partnership and financing issues. Accordingly, firm was required to produce those non-privileged/non-protected documents to IRS. However, magistrate also found that 117 other documents did contain confidential legal advice and were privileged. (*Starn O'Toole Marcus Fisher, et al. v. U.S.*, DC HI, [102 AFTR 2d ¶2008-5038](#)).

15. Procedure—Federal Contract Information Returns: The IRS updated the rules for filing Form 8596 (Information Return for Federal Contracts, Electronically) and Form 8596-A (Quarterly Transmittal of Information Returns for Federal Contracts) through the Filing Information Returns Electronically (FIRE) System with the IRS Enterprise Computing Center-Martinsburg This revenue procedure applies to Federal Executive Agencies, the Postal Service, and the Postal Rate Commission for reporting contracts and amendments where the net value exceeds \$25,000, and is effective for forms filed for the quarter beginning on 1/1/09. Rev. Proc. 2008-49, 2008-34 IRB .

16. Procedure—Electronic Filing of Foreign Withholding Form: The IRS updated the rules for filing Form 1042-S (Foreign Person's U.S. Source Income Subject to Withholding) electronically. These rules must be used to prepare current and prior year information returns filed beginning on 1/1/09 and received by the IRS Enterprise Computing Center-Martinsburg or postmarked by 12/31/09. The IRS no longer accepts tape cartridges or other magnetic media. Instead, forms must be filed through the FIRE (Filing Information Returns Electronically) System. However, the system will be down during the last week of December and the first week of January for upgrading. Rev. Proc. 2008-44, 2008-30 IRB .

MSCPA Federal Tax Forum Update

Procedure

By Christopher E. Pulick

17. Procedure—Levy against Single-member LLC: Collection personnel requested advice from the IRS National Office because the "issue of whether the [IRS] can levy to collect the tax liabilities of an LLC's owner from a disregarded LLC comes up often." This chief counsel advice involves an Ohio single-member LLC that provides daycare services to a county pursuant to a written contract. The LLC's owner reports taxable income from the business on Schedule C. Under these facts, the IRS can serve a notice of levy on the LLC requiring it to turn over income in its possession to which the owner is entitled for daycare services rendered prior to the service of the levy. Conversely, whether the LLC is disregarded or elects to be taxed as a corporation, a levy served on the county will be ineffective to collect the tax liabilities of the single owner. However, the IRS can levy on the owner's membership interest in the LLC and sell it, or file suit to foreclose the federal tax lien against the ownership interest. CCA 200835030 .

18. Procedure—Electronic Filing of Excise Tax Form: Form 2290 (Heavy Highway Vehicle Use Tax Return) is filed to report and pay highway-use excise taxes. Individuals and organizations with 25 or more trucks, tractors, or other heavy vehicles used on highways are now required to make their excise tax filings electronically rather than by paper. According to the IRS, electronic filing streamlines the processing of Form 2290 , and reduces preparation and processing errors. Another advantage of electronically filing Form 2290 is that taxpayers don't have to wait for a stamped version of the Schedule 1 (Schedule of Heavy Highway Vehicles) to be returned by mail because they will almost instantly receive the equivalent of a stamped version electronically. This means that truckers won't have to wait to register their vehicles with the appropriate state authority when obtaining the proper license tags. News Release IR-2008-94 .

MSCPA Federal Tax Forum Update
Procedure
By Christopher E. Pulick

19. Procedure—IRS Again Revises Procedures for Automatic Consent to Change in Accounting Method

[Rev. Proc. 2008-52](#), 2008-36 IRB xxx, contains comprehensive procedures under which a taxpayer may obtain automatic consent for a change in an accounting method described in its Appendix. Automatic consent procedures for changes in several accounting methods are consolidated in the new 280-page guidance and additional changes in accounting methods for which a taxpayer may obtain automatic consent are added.

In section 15(30), IRS lists additional changes in accounting methods that have been added. They include changes:

- For lessor improvements abandoned at termination of lease.
- For accounting for, or identifying disposed of, repairable and reusable spare parts.
- From depreciating land (or nondepreciable land improvement) to not depreciating land (or nondepreciable land improvement).
- To capitalize and depreciate repairable and reusable spare parts.
- From the cash method to an accrual method for specific items.
- To the overall cash method for specified transportation industry taxpayers.
- To an overall cash/hybrid method for certain banks.
- To an overall cash method for farmers.
- For nonshareholder contributions to capital under [Section 118](#).
- For retainages under [Section 451](#).
- To the timing of incurring liabilities for employee bonuses and vacation pay under [Section 461](#).
- For rebates and allowances under [Section 461](#).
- From a ratable inclusion of rental income or expense to inclusion in accordance with the rent allocation.
- From permissible methods of identifying and valuing inventories.
- In the official used vehicle guide used in valuing used vehicles.
- To invoiced advertising association costs for new vehicle retail dealerships.
- To dollar-value pools of manufacturers.
- To comply with [Regs. 1.1012-1\(c\)\(1\) through \(4\)](#) (dealing with the basis of stock in a sale).

[Rev. Proc. 2008-52](#) is generally effective for applications filed after 8/17/08 for a year of change ending on or after 12/31/07. The Service will return any application within [Rev. Proc. 2008-52](#)'s scope that is filed with the National Office after this date if it is filed under guidance other than [Rev. Proc. 2008-52](#). Transition rules apply to previously filed applications.

MSCPA Federal Tax Forum Update

Procedure

By Christopher E. Pulick

20. Procedure—Taxpayer Could Amend Timely Refund Claim After Expiration of Three-year Statute of Limitations:

Tax advisors live in fear of time-barred claims for refund. Also, advisors may want to amend a taxpayer's original claim for refund after the limitations period has expired to clarify, supplement, or possibly add new claims to the original claim. In [CCA 200819016](#), the IRS considered whether a Form 1040X was a timely amendment to an original claim for refund or instead was a new claim for refund and therefore barred by the statute of limitations.

Facts. Taxpayer X timely filed a Form 1040 for tax year 1999 in April 2000 (date 1). X claimed a refund of \$A on her Form 1040. That refund was computed based on (1) exemptions totaling \$11,000 for herself and three dependents (a son and two grandchildren), (2) a standard deduction of \$6,350 based on head of household filing status, and (3) an earned income credit of \$B, based on her son and one grandchild as qualifying children.

On date 2, the IRS sent X an examination report that proposed to change her 1999 income tax return by disallowing the exemptions for the three dependents and changing her filing status from head of household to single. The IRS also proposed to disallow the entire earned income credit, based on the Service's position that X had no "qualifying children." The IRS proposed to issue X a refund of only \$C. After the taxpayer failed to respond to the notice of proposed changes to her 1999 tax return, the Service issued X a refund check in an amount that equaled \$C plus interest.

Later, X filed a Form 1040X for her 1999 tax year. The Form 1040X was received by the IRS on date 3 and claimed a refund of \$G. X computed the refund based on (1) exemptions totaling \$5,500 for herself and one dependent (her son), (2) a standard deduction of \$6,350, based on head of household filing status, and (3) an earned income credit of \$F, based on her classification of her son as a qualifying child. Taxpayer X realized that she had claimed her grandchildren as dependents in error, and had incorrectly computed the earned income credit.

By filing Form 1040X, X reiterated the same grounds for refund stated in her Form 1040 filed in April 2000 and merely corrected the errors caused by inappropriately claiming dependency exemptions and the earned income credit for her grandchildren. Taxpayer X attached to her Form 1040X the documentation to validate her entitlement to a refund of \$G.

The IRS originally concluded that taxpayer X's Form 1040X was untimely because it was filed more than three years after the original Form 1040. The IRS issued a notice of claim disallowance on date 4. X protested the Service's findings to the IRS Appeals Office. Appeals concluded that X would have been entitled to a refund but for the fact that her Form 1040X was untimely. Thus, Chief Counsel's Office reviewed whether the Form 1040X was an amendment to the claim for refund on the original Form 1040 or a time-barred new claim.

IRS analysis. Under [Section 6402\(a\)](#), the Service has the authority to make refunds within the applicable period of limitations when a taxpayer overpays taxes. [Reg. 301.6402-2\(a\)\(1\)](#) provides that "refunds of overpayments may not be allowed or made after the expiration of the statutory period of limitation properly applicable, unless, before the expiration of such period, a claim therefore has been filed by the taxpayer."

MSCPA Federal Tax Forum Update

Procedure

By Christopher E. Pulick

[Section 6511\(a\)](#) provides that a claim for credit or refund of an overpayment of any tax in respect of which the taxpayer is required to file a return has to be filed within three years from the time the return was filed or two years from the time the tax was paid, whichever of such periods expires later. If no return is filed by the taxpayer, a claim for credit or refund must be filed within two years from the time the tax was paid. Under [Section 6511\(b\)\(1\)](#), no credit or refund will be allowed or made after the expiration of the period of limitations prescribed in [Section 6511\(a\)](#), unless a claim for credit or refund is filed by the taxpayer within such period.

In [CCA 200819016](#), the IRS found that taxpayer X's Form 1040 filed in April 2000 was a timely claim for refund for tax year 1999. The Service cited [Reg. 301.6402-3\(a\)\(5\)](#), which provides that an individual's original income tax return may constitute a claim for refund within the meaning of [Section 6402](#) and that "such claim shall be considered as filed on the date on which such return ... is considered as filed." The Form 1040 would be considered a timely claim for refund as X's refund claim made on the Form 1040 was considered filed at the same time as the return was filed. Thus, the Service concluded the claim was considered filed within three years of the return (simultaneously in this case) and was timely under the three-year rule of [Section 6511\(a\)](#). See [Rev. Rul. 76-511, 1976-2 CB 428](#).

The Service next focused on whether the Form 1040X was a supplement to the original Form 1040 (and therefore a refund was due), or a new claim for refund (and therefore time-barred as the Form 1040X was apparently filed after the three-year filing period). The IRS said two considerations were relevant in determining whether a supplemental claim for refund is considered an amendment to the original timely claim, rather than an untimely new claim. If these two requirements are satisfied, there is no specific time period within which a supplemental claim must be filed as the original claim was timely.

First, the supplemental claim will not be considered an amendment to the original claim if it would require the investigation of new matters that would not have been disclosed by the investigation of the original claim. See *Andrews*, [19 AFTR 1243](#), 302 US 517, 82 L Ed 398, 1938-1 CB 322 (1938), and *Pink*, [23 AFTR 148](#), 105 F2d 183 (CA-2, 1939). In that event, the IRS will treat the filing as a new claim for refund rather than an amendment to the existing timely claim. The Service pointed out that the policy ground for not allowing time-barred claims that vary from timely claims is that "[t]he Commissioner does not possess the time or resources to perform extensive investigations into the precise reasons and facts supporting every taxpayer's claim for refund," citing *Stoller*, [27 AFTR 2d 71-1396](#), 444 F2d 1391 (CA-5, 1971).

Second, a supplemental claim generally will not be considered an amendment if the IRS took final action on the original claim by either rejecting or allowing the claim in whole or in part. In either event, the supplemental claim is untimely because once the IRS has taken final action on the original claim, there is no longer any claim left to amend. See *Mondschein*, [28 AFTR 2d 71-5806](#), 338 F Supp 786 (DC N.Y., 1971), *aff'd* [31 AFTR 2d 73-533](#), 469 F2d 1394 (CA-2, 1973); *Edwards v. Malley*, [24 AFTR 253](#), 109 F2d 640 (CA-1, 1940); *New York Trust Co.*, [18 AFTR 836](#), 87 F2d 889 (CA-2, 1937).

The IRS found there were certain narrow exceptions to the rule concerning whether the Service took final action on the original claim. For example, the Service's disallowance of a claim would not constitute final action by the IRS if the IRS did not fully consider all grounds for the refund. See *Bemis Bros. Bag Co.*, [12 AFTR 28](#), 289 US 28, 77 L Ed 1011, 1933-1 CB 338 (1933). In *Bemis Bros.*, the IRS denied a claim for refund by rejecting one of the three grounds stated in the claim, while overlooking two independent grounds

MSCPA Federal Tax Forum Update

Procedure

By Christopher E. Pulick

for the claim. The taxpayer then submitted an amended claim, reiterating the grounds stated in the original claim. The Supreme Court held that the amended claim could be considered even though it was filed after the statute of limitations had expired, as such claim was an amendment to the timely filed original claim and the two independent grounds had not been considered.

In [CCA 200819016](#), the IRS first considered whether the Form 1040X would have required the Service to investigate new matters. On both the Form 1040 and the Form 1040X, taxpayer X claimed a refund based on an exemption for her son, a filing status of head of household, and an earned income credit computed with her son as a qualifying child. The IRS pointed out that the Form 1040X did not contain new information, and instead repeated the same details claimed on the Form 1040. Thus, the Service did not have any new information to investigate.

The IRS next focused on the question of whether it had taken final action on the taxpayer's Form 1040 such that it could not be amended after the statute of limitations had expired. [CCA 200819016](#) states the Service did not issue a notice of claim disallowance when initially determining that taxpayer X was only entitled to a refund of \$C. Thus, the failure to issue a notice of claim disallowance for the remaining portion of the refund claimed on the Form 1040 certainly could be interpreted as the Service's not taking final action with respect to a portion of the refund claim.

In addition, although the IRS issued taxpayer X a refund for tax year 1999 based on the Form 1040 she filed in April 2000, that refund was not based on an exemption for her son, a filing status of head of household, or an earned income credit computed with her son as a qualifying child. Thus, the IRS did not consider all of the grounds stated in X's original claim for refund. Therefore, even though the IRS issued her a refund, there was still a claim pending that could be amended after the statute of limitations had expired.

Accordingly, the IRS concluded the Form 1040X it received on date 3 was a timely amendment to the taxpayer's Form 1040 for tax year 1999 as (1) the IRS did not have any new information from the Form 1040X to investigate, (2) the IRS failed to issue a notice of claim disallowance, and (3) the IRS did not consider all the grounds stated in taxpayer X's original claim. As the Form 1040X was a supplement to the claim for refund reported on the original Form 1040, the IRS found the Form 1040X was an amendment to the original claim, and therefore X was entitled to a refund based on the positions stated in the Form 1040X.

Implications. Advisors often file claims for refund shortly before the expiration of the statute of limitations. [CCA 200819016](#) provides a valuable discussion of when advisors can file a supplement to the original claim after the statute expires and still have the IRS consider the supplemental information. Tax advisors would be well served by stating the supplemental information is an amendment to the original claim and tying the new assertions to the prior positions stated in the original claim.

Under any scenario, taxpayers must set forth in detail each ground on which a refund is claimed and facts sufficient to apprise the IRS of the basis for the claim; see [Reg. 301.6402-2\(b\)\(1\)](#). Otherwise, the Service will argue under the doctrine of variance that the taxpayer is precluded from raising factual or legal grounds in litigation that were not raised during the IRS administrative proceedings. See *Angelus Milling Co.*, [33 AFTR 837](#), 325 US 293, 89 L Ed 1619, 1945 CB 463 (1945).

MSCPA Federal Tax Forum Update
Procedure
By Christopher E. Pulick

21. Procedure—New guidance on Stimulus Act's increased expensing and bonus depreciation, [Rev Proc 2008-54, 2008-38 IRB](#)


A new revenue procedure provides guidance on the 2008 Stimulus Act's enhanced expensing under [Code Sec. 179](#), and 50% bonus first year depreciation for most types of depreciable personal property as well as qualifying software. The guidance explains how the new rules interact with GO Zone and Kansas disaster area incentives. It also provides rules for making expensing elections on amended returns.

Enhanced expensing. Under the Stimulus Act, a qualifying business can expense up to 50% bonus depreciation. Under the Stimulus Act, businesses may claim a bonus depreciation allowance equal to 50% of the adjusted basis of qualifying property during the year the property is placed in service. In general, the property must be new, bought after Dec. 31, 2007 and before Jan. 1, 2009, and must be placed in service after Dec. 31, 2007, but generally before Jan. 1, 2009.


22. Procedure—New law retroactively eases preparer standard: Effective for returns prepared after May 25, 2007, the Small Business and Work Opportunity Tax Act of 2007 (Small Business Act) toughened the standard for avoiding the preparer penalty under [Code Sec. 6694](#). Section 506 of Division C of the Emergency Economic Stabilization Act of 2008 (Act), which was signed into law on Oct. 3, 2008, for the most part, retroactively eliminates the Small Business Act toughened standard and replaces it with an eased standard for returns prepared after May 25, 2007.

Background. Under pre-Act law, the Code provided that a tax return preparer was liable for a penalty if he prepared any return or claim for refund for which any part of an understatement of liability was due to an "unreasonable position." The penalty was in an amount equal to the greater of \$1,000, or 50% of the income derived (or to be derived) by the tax return preparer for the return or refund claim. A position was "unreasonable" if all of the following applied:

- ... the tax return preparer knew (or reasonably should have known) of the position,
- ... there was not a reasonable belief that the position would more likely than not be sustained on its merits, and
- ... the position wasn't disclosed as provided in [Code Sec. 6662\(d\)\(2\)\(B\)\(ii\)](#), or there was no reasonable basis for the position.

 **RIA observation:** [Code Sec. 6662\(d\)\(2\)\(B\)\(ii\)](#) is the disclosure rule under the [Code Sec. 6662](#) penalty for substantial understatement of income tax, which is imposed on the taxpayers themselves.

Even if all of the above conditions applied, the preparer penalty for unreasonable positions wasn't imposed where the preparer showed both that there was a reasonable cause for the understatement and that the preparer acted in good faith.

 **RIA observation:** The "more likely than not" standard (i.e., a standard requiring a greater than 50% likelihood) was particularly controversial. It is much stricter than the substantial authority standard that applies to a client for purposes of avoiding a [Code](#)

MSCPA Federal Tax Forum Update
Procedure
By Christopher E. Pulick

[Sec. 6662](#) substantial understatement penalty. Thus, tax return preparers were held to a higher standard than taxpayers for reporting questionable positions on a return. Thus, a taxpayer could prepare his own return taking aggressive positions without making full disclosure, while a tax return preparer would be subject to stiff penalties if he did the same thing.

The above rules were the result of changes that were enacted by the Small Business Act effective for returns prepared after May 25, 2007. Before the changes, the penalty was imposed where there wasn't a realistic possibility of a position being sustained on its merits, the preparer knew or should have known of the position, and the position was undisclosed or frivolous.

The penalty also was limited to income tax return preparers and did not apply to preparers of estate, gift, employment and other tax returns.

A position was considered to have a realistic possibility of being sustained on its merits if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead him to conclude that the position had approximately a one in three, or greater, chance of being sustained.

To provide guidance for preparers trying to adapt to the changes, IRS provided interim rules effective as of: (1) Jan. 1, 2008, for all tax returns, amended tax returns, and claims for refund (other than 2007 employment and excise tax returns) filed after Dec. 31, 2007 for advice provided after Dec. 31, 2007; and (2) Feb. 1, 2008, for all 2007 employment and excise tax returns filed after Jan. 31, 2008 for advice provided after Jan. 31, 2008 (see [Notice 2008-13, 2008-3 IRB](#) discussed at [Weekly Alert ¶ 13 1/10/2008](#)). IRS said tax return preparers may rely on the interim guidance until further guidance is issued, but noted also that the regs expected to be finalized in 2008 might be substantially different from the interim rules, and in some cases more stringent.

Among the more significant rules in the interim guidance is a provision stating that, for purposes of determining whether the tax return preparer has a reasonable belief that the position would more likely than not be sustained on the merits, and for purposes of determining whether the tax return preparer has a reasonable basis for a position, a tax return preparer may rely in good faith without verification on information furnished by the taxpayer. He can also rely in good faith and without verification on information furnished by another advisor, tax return preparer or other third party. Thus, he isn't required to independently verify or review the items reported on tax returns, schedules or other third party documents to determine if the items meet the reasonable belief standard. But, he can't ignore the implications of information furnished to him or that is actually known by him. He also must make reasonable inquiries if the information furnished by another tax return preparer or a third party appears to be incorrect or incomplete.

Proposed regs would provide a similar rule (see [Weekly Alert ¶ 30 6/19/2008](#)).

Transitional rules applied to all returns, amended returns and refund claims due before Jan. 1, 2008 (determined with regard to any extension of time for filing); 2007 estimated tax returns due before Jan. 16, 2008; and 2007 employment and excise tax returns due before Feb. 1, 2008 (see [Notice 2007-54, 2007-27 IRB](#), as modified by [Notice 2008-11, 2008-3 IRB](#), as discussed at [Weekly Alert ¶ 13 6/14/2007](#) and [Weekly Alert ¶ 13 1/10/2008](#)).


MSCPA Federal Tax Forum Update
Procedure
By Christopher E. Pulick


New law. Effective for returns prepared after May 25, 2007, the Act has changed the preparer penalty for understatements due to unreasonable positions, described above, so that a tax return preparer must pay the penalty if the preparer:


... prepares any return or claim for refund for which any part of an understatement of liability is due to an "unreasonable" position (described below) and
... knew (or reasonably should have known) of the position. ([Code Sec. 6694\(a\)\(1\)](#))

Except as otherwise provided below, a position is "unreasonable" unless there is or was substantial authority for it. ([Code Sec. 6694\(a\)\(2\)\(A\)](#))

If the position was disclosed under [Code Sec. 6662\(d\)\(2\)\(B\)\(ii\)\(I\)](#) and isn't a position described in the rules for tax shelters and reportable transactions below, the position is unreasonable unless there is a reasonable basis for it. ([Code Sec. 6694\(a\)\(2\)\(B\)](#))


 **RIA observation:** Thus, the general rules under the new law replace the "more likely than not" standard with the substantial authority standard for cases where disclosure is not made. However, the new law is similar to the pre-Act provision in that, where disclosure is made, the reasonable basis standard determines whether the penalty applies.

 **RIA observation:** Thus, the new law seems to largely eliminate the disparity between the standard for preparers and taxpayers. As indicated above, the more-likely-than-not standard was much stricter than the substantial authority standard that applies to a client for purposes of avoiding a [Code Sec. 6662](#) substantial understatement penalty. The substantial authority standard under [Code Sec. 6694](#) should be similar to the substantial authority standard under [Code Sec. 6662](#).

 **RIA observation:** Regs relating to the [Code Sec. 6662](#) substantial understatement penalty say that the substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the "more likely than not" standard, but more stringent than the reasonable basis standard. Substantial authority exists if the weight of authorities supporting the taxpayer's treatment is substantial in relation to the weight of those that take a contrary position.


Substantial authority includes the Code and other statutes, regs (final, temporary, and proposed), court cases, tax treaties, statements of Congressional intent, and administrative pronouncements (revenue rulings, revenue procedures, private letter rulings, technical advice memoranda, actions on decisions, general counsel memoranda, press releases, notices, and similar documents).


Under an exception to the above rules, if the position is with respect to a tax shelter as defined in [Code Sec. 6662\(d\)\(2\)\(C\)\(ii\)](#) or a reportable transaction to which [Code Sec. 6662A](#) applies, the position is unreasonable unless it is reasonable to believe that the position would more likely than not be sustained on its merits. ([Code Sec. 6694\(a\)\(2\)\(C\)](#))

 **RIA observation:** Thus, the new law retains the "more likely than not standard," but only for tax shelters and reportable transactions. The retained "more likely than not" standard for such entities is even more onerous than the pre-Act "more likely than not"


MSCPA Federal Tax Forum Update
Procedure
By Christopher E. Pulick

standard because it doesn't have the exception for disclosure, although the reasonable cause and good faith exception is still available.


 **RIA observation:** [Code Sec. 6662\(d\)\(2\)\(C\)\(ii\)](#), which defines tax shelter for purposes of the substantial understatement penalty, defines a tax shelter as: (a) a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement (b) which has as a significant purpose the avoidance or evasion of federal income tax.


 **RIA observation:** A reportable transaction to which [Code Sec. 6662A](#) applies is any transaction for which information must be included with a return or statement because, as determined under regs issued under [Code Sec. 6011](#), the transaction has a potential for tax avoidance or evasion. Thus, it is one of the categories of reportable transactions under [Reg. § 1.6011-4\(b\)\(1\)](#).

As under the pre-Act provision, the penalty is in an amount equal to the greater of \$1,000, or 50% of the income derived (or to be derived) by the tax return preparer for the return or claim. ([Code Sec. 6694\(a\)\(1\)](#).) Also unchanged by the Act is the rule that the penalty isn't imposed where the preparer shows both that there is a reasonable cause for the understatement and that the preparer acted in good faith. ([Code Sec. 6694\(a\)\(3\)](#))

 **RIA caution:** The changes above, and consequently the above discussion, relate only to the [Code Sec. 6694\(a\)](#) preparer penalty for understatements due to unreasonable positions. The heavier [Code Sec. 6694\(b\)](#) preparer understatement penalty for willful, reckless or intentional conduct is unaffected.

Effective date. The Act's changes apply for returns prepared after May 25, 2007, except as described below. In the case of a position described in [Code Sec. 6694\(a\)\(2\)\(C\)](#), the above rules apply to returns prepared for tax years ending after Oct. 3, 2008.

 **RIA observation:** A position described in [Code Sec. 6694\(a\)\(2\)\(C\)](#) is a position with respect to a tax shelter or a reportable transaction, unless it is reasonable to believe that the position would more likely than not be sustained on its merits. The delayed effective date of the change with respect to tax shelters and reportable transactions may reflect the fact that, as explained above, the new law is actually tougher than the pre-Act provision for such entities because the new law lacks a disclosure exception to the "more likely than not" rule for positions for such entities.

 **RIA observation:** **Thus, essentially the above rules retroactively repeal the "more likely than not" standard as of the date it was enacted, except in the case of tax shelters and reportable transactions. Note, however, that these changes are not a restoration of the law before the Small Business Act. As described above, the pre-May 25, 2007 law contained a "realistic possibility" standard, not a substantial authority standard.**

Note: All of above were extracted from RIA Checkpoint through October 10, 2008.