

"Substantial Authority" The "New" Section 6694 Return Preparer Standard

BY MARK S. LANGE AND CRISSY WOLFE

Since May 25, 2007, the standard of conduct that tax return preparers must meet in order to avoid the imposition of penalties under Section 6694 of the Internal Revenue Code of 1986, as amended (the "Code"), which governs the penalty provisions applicable to tax return preparers where a preparer's advice results in a substantial understatement of tax on a client's return, has been in flux. However, the standard is now firmly set at "substantial authority", pursuant to the passage of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343 (the "2008 Act"), which is best known for its financial crisis "bailout" provisions, and was signed into law by President Bush on October 3, 2008.

Prior to May 25, 2007, the "realistic possibility of success" standard governed the instances in which a tax return preparer would be subject to penalties under Section 6694 of the Code. On May 25, 2007, Congress passed the Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28 (the "2007 Act"), amending Section 6694 and raising the tax return preparer's standard, requiring the tax return preparer to "reasonably believe that the tax treatment of the position will more likely than not" succeed on the merits. The 2007 Act also made a number of other changes, such as expanding the definition of who qualifies as a tax return preparer, and broadening the scope

of returns that the penalties would apply to from "income tax returns" to "tax returns". Similar changes were proposed to Circular 230, although those changes to Circular 230 have not yet been finalized.

The "more likely than not" standard was amongst the more controversial of those changes in the 2007 Act, not only because it raised the standards for tax return preparers, but also because it created a discrepancy between the penalty standards for tax return preparers and their taxpayer clients. The tax return preparers, which with its broader definition now included non-signing tax return preparers who had no control over the return preparation or what the taxpayer filed, were held to a higher standard – that of "more likely than not" – than their clients who, under Section 6662, only needed substantial authority in order to not be subject to accuracy-related penalties. As a reference, "more likely than not" is a more than fifty percent (50%) chance of success on the merits if the matter were litigated, whereas "substantial authority", although not statutorily set at a percentage, has been perceived by commentators and the Internal Revenue Service (the "IRS") to be an approximately forty percent (40%) chance of success on the merits if the matter were litigated.

The discrepancy, and lack of guidance on how a tax return preparer, especially a non-signing tax return preparer, could effectively avoid the penalty when the decision to file the return was in the hands of the taxpayer, who had a lower standard, resulted in a flurry of transitional provisions and interim guidance from the IRS, as well as the dissemination of proposed regulations and helpful examples explaining specific issues (on the “more likely than not” standard), which were supposed to go into effect January 1, 2009, or when finalized by IRS, whichever date was later. Notably, the IRS in Notice 2007-54¹ provided for transitional relief for all returns, amended returns and refund claims due on or before December 31, 2007, which applied the “standards set forth under the previous law and current regulations under Section 6694 in determining whether the Service will impose a penalty under Section 6694(a)”. The standard referred to in Notice 2007-54 is one of a “realistic possibility of success” (which existing IRS regulations had defined as a “one in three” chance of success on the merits if the matter were litigated), which is a lower standard than both “more likely than not” and “substantial authority”.

However, on October 3, 2008, when President Bush signed into law the 2008 Act, the tax return preparer penalty standard for undisclosed tax return positions was changed, reducing the applicable tax return preparer standard from “more likely than not” to one of “substantial authority”, retroactive to May 25, 2007. There are a number of interesting things to note with this newest change in the tax return preparer standard.

First, although the standard has been reduced from “more likely than not” to “substantial authority”, it is still higher than the pre-May

2007 standard of a “realistic possibility of success”. This has the effect of accomplishing at least two (2) very different results: (1) the tax return preparer standard under Section 6694 and the taxpayer accuracy-related penalty standard under Section 6662 are now aligned, which is a positive result; and (2) because the “substantial authority” standard is retroactive to May 25, 2007, tax return preparers are theoretically liable and could be subject to penalties for returns filed prior to January 1, 2008 containing return positions for which a tax return preparer had only “realistic possibility of success”, even though such returns were filed in reliance upon the transitional relief found in Notice 2007-54. It is unclear whether any special transitional relief will be provided by the IRS to deal with this new retroactive impact of the 2008 Act.

Second, the IRS is close to promulgating the proposed regulations for Section 6694 (as well as other provisions of the Code relating to penalties or which otherwise had an effect on the broadening of the return preparer penalties) that were written when the tax return preparer standard under Section 6694 was “more likely than not”. This includes rules for how a tax return preparer can avoid being subject to penalties due to the then discrepant standards for taxpayer and tax return preparer, as well as the revised definition of a tax return preparer, the one preparer per firm rule, and the extent to which a tax return preparer can rely on third-party information. It is anticipated that many of these provisions will be retained, as they continue to have relevance.² The question remains, however, what provisions will be retained and what revisions will be made to align the proposed regulations with the new “substantial authority” standard.

◇ ◇ ◇

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Atlanta lawyers:

Mark S. Lange
404-815-2207
marklange@paulhastings.com

Crissy Wolfe
404-815-2322
criswolfe@paulhastings.com

¹ Notice 2007-54, 2007-27 I.R.B. 12 (June 11, 2007).

² See Jeremiah Coder, "Changes to Preparer Penalty Standard Won't Require Scrapping Regs, Practitioners Say" 2008 TNT 195-1 (Oct. 7, 2008).