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**Presented**

**by**

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**IRS THIRD-PARTY TAX PENALTIES**  
**AND CIRCULAR 230 SANCTIONS**

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I. Third-Party Penalties

- A. Preparer Penalty. Tax return preparer defined under Treasury Regulations on Procedure and Administration §301.7701-15(b)(3) ("Proc. Reg.") [26 C.F.R.] (1986 Code), i.e., person who prepares (signing or nonsigning) for compensation all or substantial portion of a tax return or claim for refund (See Rev. Rul. 81-171, 1981-1 Cum. Bull. 589, Rev. Rul. 81-246, 1981-2 Cum. Bull. 249, Rev. Rul. 81-270, 1981-2 Cum. Bull. 250).
1. Penalties imposed against tax professionals whose advice results in incorrect reporting.
  2. One "individual" per firm.
    - a. Both the individual and firm (participant rule) can be subject to penalty (Treas. Reg. §1.6694-3[a][2]).
    - b. Nonsigning preparer - oral or written advice to taxpayer or another preparer (Treas. Reg. §1.6694-1[b][3]).

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- c. Substantial portion of return if -
    - (1) More than \$2,000 of income; or
    - (2) More than \$100,000 of income and also more than 20% of reported gross income (A.G.I.) Treas. Reg. §1.7701.15(b)(2).
  - d. "Returns" were original or amended under subtitle A of the Code (i.e., income tax).
    - (1) Returns did not include those for estate tax, gift tax, excise tax, withholding tax, extension applications, information returns (PLR 7846077).
      - (a) New rules for some of these returns (see below).
  - e. Understatement of tax liability. Return is viewed as a whole without any threshold amounts. Rev. Rul. 82-25, 1982-1 Cum. Bull. 214.
  - f. Verification of information from taxpayer not required but cannot ignore implication of information requiring reasonable inquiry.
    - (1) Maintenance of documents required for certain items, e.g., entertainment expenses.
3. Penalty amounts and standards.
- a. First tier penalty. For returns due after May 25, 2007, (see transitional relief below) penalty equal to greater of \$1,000 or 50% of income derived (or to be derived) for each return, amended return or claim,

- (1) Now includes income, plus estate, gift, generation-skipping, employment and excise tax returns.
    - (a) Wider range of preparers now affected by standard.
  - (2) Standard - A position for which there is a reasonable belief that tax treatment more likely than not will be sustained on merits.
    - (a) Gauged by position which has at least 51% chance of being sustained.
    - (b) Tension between reporting standards for taxpayer (substantial authority) and new standard for preparer.
    - (c) RPOS eliminated (see below).
  - (3) Disclosure with reasonable basis for reporting position.
    - (a) Frivolous standard eliminated.
  - (4) Transitional relief - Old standard applies to returns due in 2007. IRS Notice 2007-54
  - (5) Signing preparer (Forms 8275 or 8275-R) vs. nonsigning preparer (oral or written statement to disclosed party).
    - (a) Heightened awareness.
- b. Prior Law, Penalty equal to \$250 for each income tax return or refund claim where any part of tax liability understatement based upon -

- (1) Standard - A position for which there is a realistic possibility of success ("RPOS") (Treas. Reg. §1.6694-2[a][1]).
  - (a) Broader than old "negligent or intentional disregard" (due diligence) standard.
  - (b) RPOS borrowed from ABA and AICPA ethical standards.
  - (c) Gauged by position which has at least one-third chance of being substantiated (Treas. Reg. §1.6694-2[b][1]).
  - (d) Same analysis as substantial authority standard under substantial understatement of tax penalty [Cf. IRC §6662(b)(1)].
    - (i) Written determination, e.g., PLR, TAM, RAR.
- (2) Preparer knew or reasonably should have known of such position (Treas. Reg. §1.6694-2[d]).
  - (a) Position adequately disclosed and not frivolous (IRC §6694[a]); Treas. Reg. §1.6694-3[e][1]).

c. Second tier penalty. For tax returns due after May 25, 2007, (no transitional relief) penalty equal to or greater of \$5,000 or 50% of income derived (or to be derived) for each return or amended return, including income, estate, gift, generation-skipping, employment and excise tax returns, or claim for refund where any part of income tax liability understatement was based upon -

- (1) Preparer's willful attempt to understate tax.

- (2) Preparer's reckless or intentional disregard of rules and regulations (IRC §6694[b]).
  - (3) Prior law - \$1,000 for each income tax return or claim for refund.
- d. Waiver - reasonable cause for understatement and preparer acted in good faith (Treas. Reg. §1.6664-2[d]).
- (1) Factors to consider -
    - (a) Nature of error.
    - (b) Frequency of error.
    - (c) Materiality of error.
    - (d) Preparer's normal office practice.
    - (e) Reliance on advice of another preparer.
- e. General Defenses.
- (1) Ultimate determination that there is no understatement of liability.
  - (2) Preparer exercised due diligence in applying the tax law to information furnished by taxpayer. See, Brockhouse v. United States, 749 F.2d 1248 (7th Cir. 1984).
  - (3) Good faith belief Treasury Regulation or ruling does not accurately reflect the Code or case does not accurately reflect the rule.
  - (4) Good faith belief of advice received from attorney of accountant defeats intentional disregard of

rules. Swayze v. United States, 785 F.2d 715 (9th Cir. 1986).

f. Recent Modifications

- (1) Rev. Proc. 2005-60 - additional guidance for return preparers using the e-filing systems.
- (2) Rev. Proc. 2005-75 - identifies and updates circumstances under which disclosure on a return is adequate for purposes of avoiding the preparer penalty.
- (3) Notice 2004-7 - promoters and appraisers of intellectual property may be subject to penalties under IRC §§6662, 6694, 6700 or 6701 with respect to deductions of charitable contributions in excess of the amounts allowed under IRC §170.

B. Promoter Penalty

1. Definition

- a. IRC §6700 imposes a penalty on any person who engages in the organization of, or sale of any interest in, a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement, if the person makes or furnishes, or causes another to make or furnish -
  - (1) a false or fraudulent tax benefit statement as to a material matter; or
  - (2) a gross valuation overstatement as to a material matter.
- b. A matter is material if it would have a substantial impact