

Titus Tax Alert

Tax Penalty Provisions: *A Summary regarding Interest and Penalties*

May 2010

Federal tax law imposes penalties to enhance voluntary compliance with the Internal Revenue Code. There are over 140 separate penalty provisions in the Internal Revenue Code, and the Internal Revenue Manual is the primary source of authority for the administration of penalties by the Internal Revenue Service (IRS).¹ In addition to the assessment of penalties, the IRS is using an increasing number of reporting requirements and enforcement tactics to help increase taxpayer compliance with federal income tax laws.

Highlights of Recent Changes to Tax Penalty Provisions

Forms 5471, 8865, 8858, 5472 - Automatic Assessment of Penalties under Section 6038(b)(1).

The IRS has begun automatically assessing late filing penalties related to US international tax returns, including Forms 5471, 8865, 8858 and 5472. A monetary penalty of \$10,000 may be assessed for each such form that is filed after the due date of the corporation's income tax return (including extensions) or does not include the complete and accurate information. If the failure-to-file continues for more than 90 days after notice of such failure is provided to the US person, such person also is liable for a penalty of \$10,000 for each 30-day period (or fraction thereof) during which such failure continues, with such additional penalties not to exceed \$50,000. Further, a 10 percent reduction of the foreign taxes available for credit under sections 901, 902 and 960 may be assessed in addition to the late-filing penalty.

Therefore, in addition to the failure-to-file and failure-to-pay penalties applicable to corporate income tax returns, a separate penalty may apply to each US international tax return that is filed after the due date of the income tax return, and such penalty will apply whether or not any tax is due on Form 1120.

Potential for Indefinite Statute of Limitations. The HIRE Act changes the statute of limitations for the assessment of tax if a taxpayer fails to file, or files substantially incomplete, certain IRS international-related information returns, including Form 5471, Form 8865, Form 8858, Form

¹ Internal Revenue Manual 20.1.1.1.

5472, Form 926, Form 8621 and Form 3520-A (collectively “US international tax returns”). Thus, any failure to fully comply with the filing requirements for any one of these forms keeps the statute of limitations open indefinitely for assessments on the entire tax return and not just with respect to those items required to have been reported on the information return.

Partnerships/S Corporations. Starting in 2010 the late filing fee for Partnership returns (Form 1065, U.S. Return of Partnership Income) and for S-corporation returns (Form 1120S) is increasing. The previous monthly penalty was \$89 per month (or part of a month) per shareholder or partner; it is now more than doubled to \$195 per month per partner or shareholder. The penalty can be charged for up to 12 months and it is multiplied by the total number of persons who were partners/shareholders in the partnership/corporation, respectively, during any part of the entity’s tax year. The penalty may be assessed on a timely filed return if the IRS determines that the return fails to show the information required under section 6031 (related to gross income, deductions, and credits). The penalty *may* be abated if the partnership or S-corporation can show the failure to file was due to a reasonable cause.

Interest. Interest is charged on taxes paid late even if an extension of time to file is granted. Interest is also charged on penalties imposed for failure to file, negligence, fraud, substantial valuation misstatements, substantial understatements of tax and reportable transaction understatements from the due date (including extensions) until the date of payment. The interest charge is computed at a rate determined under section 6621.

Failure-to-File Penalty. A corporation that does not file its tax return by the due date, including extensions, may be penalized 5 percent of the unpaid tax for each month or part of a month the return is late. This penalty cannot be more than 25 percent of the tax liability, but it is reduced by the failure-to-pay penalty (discussed below) for any month that both penalties apply² and also by any amount of the tax which is paid on or before the date prescribed for payment of the tax as well as by any credit against the tax which may be claimed by the taxpayer on the tax return. The minimum penalty for a return that is over 60 days late is the smaller of 100 percent of the tax due or \$135 unless it is shown that such failure is due to reasonable cause and not due to willful neglect. Corporations that file late should attach a statement explaining the reasonable cause.³

The failure-to-file penalty is imposed on the "net amount due," which is computed by reducing the taxpayer's correct tax liability for the tax period at issue by the amount of tax paid on or before the date for payment of the tax (and reduced by the amount of any credit against the tax that may be claimed on the return). Generally the payment due date is the

² See Section 6151(c)(1).

³ See Section 6151(a)(1).

same as the due date for filing the return, which is determined without regard to any extension of time for filing the return.⁴

Returns that are filed late, but which show no tax due in excess of the taxpayer's withholding and/or estimated tax payments (net of applicable credits), should not be subject to the late-filing penalty since there is no net amount due on which such penalty can be imposed. However, the IRS will still assess the penalty if the correction of a mathematical error on a delinquent return results in net tax due or, more importantly, if on examination the Service proposes adjustments that create a deficiency in tax exceeding the overpayment shown on the return.

Some taxpayers have attempted to minimize or avert the failure-to-file penalty by making one or more payments of tax rather than filing the delinquent return in order to reduce or eliminate the amount upon which the failure-to-file penalty would be imposed. However, while such payments reduce the amount of unpaid tax upon which the failure-to-pay penalty is computed, it has no effect on the failure-to-file penalty as such payments occurred after the date prescribed for payment of the tax and do not reduce the "net amount due" on which the failure-to-pay penalty is imposed.⁵ In summary, a failure to file a tax return may be cured only by filing the tax return.

The situation described above may occur when an application for an automatic extension of time to file the return (for corporations, Form 7004, Application for Automatic Extension of Time to File Corporation Income Tax Return) is not timely filed. Note that a timely filed extension request generally provides the taxpayer with complete protection from the failure-to-file penalty, assuming that the tax return is filed on or before the extended due date. On the application for extension, the corporate taxpayer must properly estimate its tax liability for the tax year and remit any unpaid amount on or before the date prescribed for payment. When the IRS processes an extended tax return, it will not automatically invalidate the extension if the return reports a tax liability greater than the estimated liability shown on the request for extension even if the discrepancy between the two amounts is substantial. However, on examination the IRS could invalidate the extension if it determines that the taxpayer failed to make a bona fide attempt to estimate its annual tax liability.

Increase in Penalty for Fraudulent Failure to File. If any failure to file any return is due to fraud, a corporation may be penalized 15 percent of the unpaid tax for each month or part of a month the return is late, and such penalty cannot be more than 75 percent of the tax

⁴ See Section 6151(b)(1).

⁵ See Crocker, 92 TC 899 (1989).

liability.⁶

Failure-to-Pay Penalty. A corporation that does not pay the tax when due generally may be penalized ½ of 1 percent of the unpaid tax for each month or part of a month the tax is not paid, up to a maximum of 25 percent of the unpaid tax. The penalty is reduced by any amount of the tax which is paid on or before the date prescribed for payment of the tax as well as by any credit against the tax which may be claimed by the taxpayer on the tax return.⁷ The penalty will not be imposed if the corporation can show that the failure to pay on time was due to reasonable cause.⁸ For purposes of the failure-to-pay filing penalty, reasonable cause is presumed if the amount of tax shown on Form 7004 is at least 90 percent of the amount of tax shown on the taxpayer's Form 1120, U.S. Corporation Income Tax Return.⁹

Increase in Penalty When Notice is Received. If the IRS issues a notice of intent to levy and demand for immediate payment, the failure-to-pay penalty rate will increase to 1 percent at the start of the first month beginning at least 10 days after the day that the notice is issued. This penalty cannot be more than 25 percent of your unpaid tax and the penalty may be abated if the taxpayer can show reasonable cause for not timely paying the tax. This failure-to-pay penalty is added to interest charges on late payments.¹⁰

Accuracy-Related Penalty. An accuracy-related penalty of 20 percent applies to any underpayment due to:

- Negligence or disregard of rules or regulations;
- Any substantial understatement of income tax;
- Any substantial valuation misstatement;
- Any substantial overstatement of pension liabilities; or
- Any substantial valuation understatement in connection with estate or gift tax.

The penalty is based on the part of the underpayment due to negligence or disregard of rules or regulations, not on the entire underpayment on the return. Even though an underpayment was due to both negligence and substantial underpayment, the total accuracy-related penalty cannot exceed 20 percent of the underpayment. The penalty is not imposed if there is reasonable cause accompanied by good faith.¹¹

Negligence for this purpose includes the lack of any reasonable attempt to comply with provisions of the Internal Revenue Code. *Disregard* includes the careless, reckless, or

⁶ See Section 6151(f).

⁷ See Section 6151(b)(2).

⁸ See Section 6151(a)(2).

⁹ Reg. Sec. 301.6651-1(c)(4)(i).

¹⁰ See Sections 6151(d) and 6331(a), (d).

¹¹ See Section 6662.

intentional disregard of rules or regulations.¹²

Substantial understatement of income tax. In the case of a corporation other than an S corporation or a personal holding company, income tax is substantially understated if the understatement of tax exceeds the lesser of:

- 10 percent of the correct tax (or if greater, \$10,000), or
- \$10,000,000

Adequate disclosure. The amount of the understatement will be reduced by that portion of the understatement which is attributable to the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment or any item if the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.¹³ The reduction, however, shall not apply to any item attributable to a tax shelter. For this purpose, "tax shelter" means a partnership or other entity, any investment plan or arrangement or any other plan or arrangement if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax.¹⁴

Substantial authority. Whether there is or was substantial authority for the tax treatment of an item depends on the facts and circumstances. Consideration will be given to court opinions, Treasury regulations, revenue rulings, revenue procedures, and notices and announcements issued by the IRS and published in the Internal Revenue Bulletin that involve the same or similar circumstances as yours.

Disclosure statement. The understatement may also be reduced if the taxpayer has adequately disclosed the relevant facts about your tax treatment of an item. To make this disclosure, use Form 8275, Disclosure Statement. You must also have a reasonable basis for treating the item the way you did.

Revenue Procedure 98-62 identifies circumstances under which the disclosure on a taxpayer's return of a position with respect to an item is adequate for the purpose of reducing the understatement of income tax under section 6662(d) (relating to the substantial understatement aspect of the accuracy-related penalty), and for the purpose of avoiding the preparer penalty under section 6694(a) (relating to understatements due to unrealistic positions). If these requirements are met, the item is adequately disclosed on your return without filing Form 8275, Disclosure Statement. Otherwise, Form 8275 or

¹² See Section 6662(c).

¹³ See Section 6662(d)(2)(B).

¹⁴ See Section 6662(d)(2)(C).

Form 8275-R, Regulation Disclosure Statement, should be filed to disclose items or positions that are not otherwise adequately disclosed on a tax return or are contrary to Treasury regulations, respectively.

Reasonable cause. Taxpayers will not have to pay a penalty if they show reasonable cause and good faith for the tax treatment of an item.

Substantial Valuation Misstatement. A substantial valuation misstatement occurs if:

1. The value of any property (or the adjusted basis of any property) claimed on any income tax return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be), or
2. The either of the following:
 - The price of any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of such price, or
 - The net section 482 transfer price adjustment for the taxable year exceeds the lesser of \$5,000,000 or 10 percent of the taxpayer's gross receipts.¹⁵

No penalty shall be imposed by reason of the substantial valuation misstatement rules unless the portion of the underpayment for the taxable year attributable to substantial valuation misstatement exceeds \$10,000 in the case of a corporation other than an S corporation or a personal holding company as defined in Section 542.¹⁶

The term "net section 482 adjustment" means, with respect to any taxable year, the net increase in taxable income for the taxable year (determined without regard to any amount carried to such taxable year from another taxable year) resulting from adjustments under section 482 in the price for any property or services (or for the use of property).¹⁷

For purposes of determining whether the above threshold requirements are met, the following shall be excluded:

1. Any portion of the net increase in taxable income which is attributable to any redetermination of a price if:
 - a. It is established that the taxpayer determined such price in accordance with a specific pricing method set forth in the section 482 regulations and that the taxpayer's use of such method was reasonable.
 - b. The taxpayer has documentation (which was in existence as of the time of filing the return) which sets forth the determination of such price in

¹⁵ See Section 6662(e)(1).

¹⁶ See Section 6662(e)(2).

¹⁷ See Section 6662(e)(3)(A).

- accordance with such a method and which establishes that the use of such method was reasonable, and
- c. The taxpayer provides such documentation to the Secretary within 30 days of a request for such documentation.¹⁸
2. Any portion of the net increase in taxable income resulting from section 482 adjustments which is attributable to a redetermination of price where such price was not determined in accordance with a specific pricing method if:
 - a. The taxpayer establishes that one of such pricing methods was likely to result in a price that would clearly reflect income, the taxpayer used another pricing method to determine such price, and such other pricing method was likely to result in a price that would clearly reflect income,
 - b. The taxpayer has documentation (which was in existence as of the time of filing the return) which sets for the determination of such price in accordance with such other method and which establishes that the clear reflection of income requirements above were met, and
 - c. The taxpayer provides such documentation to the Secretary within 30 days of request for such documentation.¹⁹
 3. Any portion of such net increase which is attributable to any transaction solely between foreign corporations unless, in the case of any such corporation, the treatment of such transaction affects the determination of income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States.²⁰

For purposes of section 6664(c), which addresses reasonable cause exceptions for underpayments of tax, the taxpayer shall not be treated as having reasonable cause for any portion of an underpayment attributable to a net section 482 transfer price adjustment unless such taxpayer meets the above requirements with respect to such portion.²¹

Increase in Penalty for Gross Valuation Misstatements. To the extent that a portion of the underpayment is attributable to one or more gross valuation misstatements, the understatement penalty percentage increases from 20 percent to 40 percent. The term “gross valuation misstatement” means:

1. The value of any property (or the adjusted basis of any property) claimed on any income tax return is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be), or
2. Either of the following:
 - o The price of any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 is 400 percent or more (or 25 percent or less) of

¹⁸ See Section 6662(e)(3)(B)(i)

¹⁹ See Section 6662(e)(3)(B)(ii).

²⁰ See Section 6662(e)(3)(B)(iii).

²¹ See Section 6662(e)(3)(D).

the amount determined under section 482 to be the correct amount of such price, or

2. The net section 482 transfer price adjustment for the taxable year exceeds the lesser of \$20,000,000 or 20 percent of the taxpayer's gross receipts.²²

Imposition of Accuracy-Related Penalty on Understatements with Respect to Reportable Transactions. An accuracy-related penalty of 20 percent applies to any reportable transaction underpayment.²³ The terms “reportable transaction” and “listed transaction” have the respective meanings given to such terms under Section 6707A.

Fraudulent Return Penalty. If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributed to fraud.²⁴ If the Secretary establishes that any portion of an underpayment is attributable to fraud, the entire underpayment shall be treated as attributable to fraud, except with respect to any portion of the underpayment which the taxpayer establishes by a preponderance of the evidence is not attributable to fraud.²⁵

Failure to File Certain Information Return Penalties. Any person who does not file an information return or a complete and correct information return with the IRS by the due date (determined with regard to any extension of time for filing) is subject to a penalty for each failure.²⁶ Maximum limits apply to all such penalties. IRS enforcement with respect to international tax information returns is taking on increased significance for corporations due to federal tax compliance and reporting obligations. The following discussion summarizes such penalties in the context of Forms 5471, Information Return of US Persons With Respect To Certain Foreign Corporations, and certain other international tax returns.

Forms 5471, 8865, 8858, 5472 - Automatic Assessment of Penalties under Section 6038(b)(1). Section 6038 requires information returns to be filed by U.S. persons who have a controlling interest in foreign corporations and partnerships. U.S. persons affected by this requirement include those who own stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of a corporation, or who are controlling 50 percent partners or controlling 10 percent partners.²⁷

²² See Section 6662(h).

²³ See Section 6662A.

²⁴ See Section 6663(a).

²⁵ See Section 6663(b).

²⁶ See Section 6652.

²⁷ See Section 6038(e)(2), (3).

Section 6038(a) describes the information required to be reported on the US international tax returns form. Section 6038(b)(1) provides for a monetary penalty of \$10,000 for each Form 5471 that is filed after the due date of the income tax return (including extensions) or does not include the complete and accurate information described in section 6038(a). If the failure-to-file continues for more than 90 days after notice of such failure is provided to the US person, such person also is liable for a penalty of \$10,000 for each 30-day period (or fraction thereof) during which such failure continues, with such additional penalties not to exceed \$50,000.²⁸ Further, a 10 percent reduction of the foreign taxes available for credit under sections 901, 902 and 960 may be assessed in addition to the late-filing penalty.²⁹

Therefore, in addition to the failure-to-file and failure-to-pay penalties applicable to corporate income tax returns, Form 1120, (discussed above), a separate penalty may apply to each US international tax return that is filed after the due date of the income tax return. This penalty will apply whether or not any tax is due on Form 1120.

Potential for Indefinite Statute of Limitations. Moreover, the HIRE Act changes the statute of limitations for the assessment of tax if a taxpayer fails to file, or files substantially incomplete, certain IRS international-related information returns, including Form 5471, Form 8865, Form 8858, Form 5472, Form 926, Form 8621 and Form 3520-A (collectively “US international tax returns”). Thus, any failure to fully comply with the filing requirements for any one of these forms keeps the statute of limitations open indefinitely for assessments on the entire tax return and not just with respect to those items required to have been reported on the information return.

Partnerships/S Corps. Starting in 2010 the late filing fee for Partnership returns (Form 1065, U.S. Return of Partnership Income) and for S-corporation returns (Form 1120S) is increasing. The previous monthly penalty was \$89 per month (or part of a month) per shareholder or partner; it is now more than doubled to \$195 per month per partner or shareholder.³⁰ The penalty can be charged for up to 12 months and it is multiplied by the total number of persons who were partners/shareholders in the partnership/corporation, respectively, during any part of the entity’s tax year. The penalty may be assessed on a

²⁸ See Section 6038(b)(2).

²⁹ See section 6038(c).

³⁰ The Mortgage Forgiveness Debt Relief Act of 2007, P.L. 110-142 (MRA), increased the per-partner penalty amount from \$50 to \$85. The coverage period was also increased from 5 months to a maximum of 12 months. Thus, ignoring the provisions of the Virginia Tech Victim’s Relief Act discussed below, the new maximum penalty for a late filed Form 1065 using the same number of months and partners as in the above example would be \$1,785 ($\$85 \times 3 \times 7$). This is an increase of 238% over the above example resulting from both the increased penalty amount and two additional months of consideration. Expanding on this, if the return was filed beyond the new 12-month consideration period, the maximum penalty would be \$3,060 ($\$85 \times 3 \times 12$). This is a significant increase over the previous maximum penalty (for a three-partner partnership) of \$750. The legislation also adds a penalty for late filed S corporation returns that is essentially equivalent to the increased partnership penalty. Prior to the MRA, no statutory penalty existed for late filed S corporation returns.

timely filed return if the IRS determines that the return fails to show the information required under section 6031 (related to gross income, deductions, and credits).³¹

Reasonable Cause Relief. The penalty *may* be abated if the partnership or S-corporation can show the failure to file was due to a reasonable cause. There are procedures to address these penalties assuming the entity is domestic, has a small number of partners or shareholders, the individuals in question are natural persons who have reported all their income from the business with timely filed tax returns and this failure to file timely is not a recurring problem.³²

Filing Deadlines. For many S-corporations and Partnerships no tax is due; these forms are *information returns* that tell the individual partners and shareholders their distributive share of income and expenses. Therefore, to avoid failure to file penalties, taxpayers must heed the following filings deadlines:

- **Partnership tax returns are due April 15** for calendar-year partnerships, or the 15th of the fourth month after the close of the fiscal year for fiscal-year partnerships.
- S-corporation tax returns for calendar-year S-corporations are due March 15, or the 15th of the third month after the close of the fiscal year for fiscal-year S-corporations.
- If the 15th falls on a weekend or bank holiday the due date is the next business day.

Filing Extension is Available. Like other tax returns a taxpayer can file a form to extend the time to file, but all taxes are due on the day the tax return is initially due, which means the partners or shareholders will have to estimate their tax liability including income from the Partnership or S Corporation without underestimating the tax due in order to avoid the failure to pay penalty along with interest. Form 7004 can be filed for the extension to file Form 1065 or Form 1120S. The Form 7004 must be filed on or before the original due date of the Form 1065 or Form 1120S. Form 7004 will give an automatic 6-month extension to file Form 1120S (S-corporation) returns, but will only grant a 5-month extension to file Form 1065 (Partnership) returns. **In 2010 all Forms 1065 and Forms 1120S for which an extension (Form 7004) was filed will be due September 15, 2010.**

³¹ See Sections 6698 and 6699.

³² Rev. Proc. 84-35 provides a reasonable-cause safe harbor for certain small partnerships. Under this procedure, a domestic partnership composed of 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) and each of whom has fully reported his or her share of the income, deductions, and credits of the partnership on timely filed income tax returns, is considered to have met the reasonable cause test and is not subject to the penalty under Sec. 6698. If a partnership of 10 or fewer partners fails to qualify for relief under Rev. Proc. 84-35, the partnership may still show reasonable cause for failure to file a timely and complete return (Rev. Proc. 84-35, section 3.03).

Failure by Corporation to Pay Estimated Income Tax. A corporation that does not make estimated tax payments when due may be subject to an underpayment penalty for the period of underpayments. Generally, a corporation is subject to the penalty if its tax liability is \$500 or more and it did not timely pay the smaller of its tax liability for the subject tax year, or its prior year's tax.³³

The underpayment rate is established under section 6621, and is applied to the amount of the underpayment for the period of the underpayment.³⁴

Penalty for Pursuing Frivolous Tax Arguments. Taxpayers filing returns with frivolous positions may be subject to the accuracy-related penalty under section 6662 (twenty percent of the underpayment attributable to negligence or disregard of rules or regulations) or the civil fraud penalty under section 6663 (seventy-five percent of the underpayment attributable to fraud) or the erroneous claim for refund penalty under section 6676 (twenty percent of the excessive amount). Additionally, late filed returns setting forth frivolous positions may be subject to an addition to tax under section 6651(f) for fraudulent failure to timely file an income tax return (triple the amount of the standard failure to file addition to tax under section 6651(a)(1)).³⁵ This penalty is in addition to any other penalty provided by law.

The Tax Relief Health Care Act of 2006³⁶ amended section 6702 to allow imposition of a \$5,000 penalty for frivolous tax returns and for specified frivolous submissions other than returns, if the purported returns or specified submissions are either based upon a position identified as frivolous by the IRS in a published list or reflect a desire to delay or impede tax administration. The term specified submission means:

- i. a request for a hearing under section 6320 (relating to notice and opportunity for hearing on filing of a notice of lien),
- ii. a request for hearing under section 6330 (relating to notice and opportunity for hearing before levy),
- iii. an application under section 6159 (relating to agreements for payment of tax liability in installments),
- iv. an application under section 7122 (relating to compromises), or
- v. an application under section 7811 (relating to taxpayer assistance orders).

³³ See Section 6655.

³⁴ See Section 6655(a).

³⁵ See Mason v. Commissioner, T.C. Memo. 2004-247, 88 T.C.M. (CCH) 398 (2004) (frivolous arguments may be indicative of fraud if made in conjunction with affirmative acts designed to evade paying federal income tax).

³⁶ Pub. L. No. 109-432, § 407(a), 120 Stat. 2922 (2006).

This amendment is effective for frivolous returns or specified frivolous submissions made after March 15, 2007, the release date of Notice 2007-30, 2007-1 C.B. 883, identifying the list of frivolous positions. Notice 2008-14, 2008-4, I.R.B. 310, updates the prior list with four additional frivolous positions:

- (1) the Ninth Amendment to the U.S. Constitution allows a taxpayer to not pay taxes because of objections to military spending;
- (2) only fiduciaries are taxpayers, or only persons with a fiduciary relationship to the government must pay taxes;
- (3) a supposed “Mariner’s Tax Deduction” (or the like) allows a taxpayer employed on a ship to deduct the cost of meals provided by the employer at no cost to the taxpayer; and
- (4) the section 6421 fuels credit may be claimed in patently unallowable amounts without meeting the requirements for the credit.

Other frivolous tax return arguments delineated in Notice 2007-30 include:

- (1) Compliance with the internal revenue laws is voluntary or optional and not required by law;
- (2) Because filing a tax return is not required by law, the Service must prepare a return for a taxpayer who does not file one in order to assess and collect tax; and
- (3) A taxpayer’s income is excluded from taxation when the taxpayer rejects or renounces United States citizenship because the taxpayer is a citizen exclusively of a State (sometimes characterized as a “natural-born citizen” of a “sovereign state”), that is claimed to be a separate country or otherwise not subject to the laws of the United States. This position includes the argument that the United States does not include all or a part of the physical territory of the 50 States and instead consists of only places such as the District of Columbia, Commonwealths and Territories (e.g., Puerto Rico), and Federal enclaves (e.g., Native American reservations and military installations).

In the 1980s, Congress showed its concern about taxpayers misusing the courts and obstructing the appeal rights of others when it enacted tougher sanctions for bringing frivolous cases before the courts. Section 6673 allows the courts to impose a penalty of up to \$25,000 when they come to any of three conclusions:

- a taxpayer instituted a proceeding primarily for delay,
- a position is frivolous or groundless, or
- a taxpayer unreasonably failed to pursue administrative remedies.

An appeals court explained the rationale for the sanctions in *Coleman v. Commissioner*, 791 F.2d 68, 72 (7th Cir. 1986): “The purpose of § 6673 . . . is to induce litigants to conform their behavior to the governing rules regardless of their subjective beliefs. Groundless litigation diverts the time and energies of judges from more serious claims; it

imposes needless costs on other litigants. Once the legal system has resolved a claim, judges and lawyers must move on to other things. They cannot endlessly rehear stale arguments [T]here is no constitutional right to bring frivolous suits People who wish to express displeasure with taxes must choose other forums, and there are many available.”

Taxpayers who rely on frivolous arguments may also face criminal prosecution for:

- (1) attempting to evade or defeat tax under section 7201, a felony, for which the penalty is a fine of up to \$250,000 and imprisonment for up to 5 years; or
- (2) making false statements on a return under section 7206(1), a felony, for which the penalty is a fine of up to \$250,000 and imprisonment for up to 3 years.

Persons who promote frivolous arguments and those who assist taxpayers in claiming tax benefits based on such arguments may also face various penalties such as:

- (1) a \$250 penalty under section 6694 for each return prepared by an income tax return preparer who knew or should have known that the taxpayer’s argument was frivolous (or \$1,000 for each return where the return preparer’s actions were willful, intentional or reckless);
- (2) a \$1,000 penalty under section 6701 for aiding and abetting an understatement of tax; and
- (3) criminal felony prosecution under section 7206(2) for which the penalty is up to \$250,000 and imprisonment for up to 3 years for assisting or advising about the preparation of a false return or other document under the internal revenue laws.

Further, promoters who fail to comply with court orders run the risk of incarceration for contempt of court.³⁷

Return Preparer Penalties. Section 6694 imposes penalties on tax return preparers who prepare returns and take positions that may not be fully supported by current law. Congress amended this section last year by extending the application of the income tax return preparer penalties to all tax return preparers and by raising the standard that preparers must meet to avoid the section 6694(a) preparer penalty. The Department of Treasury and IRS recently issued Notice 2008-13 in order to provide interim guidance

³⁷ A tax scam promoter named James A. Mattatall was arrested for failing to provide list of the names, addresses, phone numbers, and Social Security numbers of his customers to the Justice Department per the court’s order. See <http://www.usdoj.gov/tax/txdv04699.htm>. Also, a taxpayer named Charles D. Saunders was held in civil contempt, incarcerated and fined \$250 a day until he complied with the court’s order directing him to fully comply with a summons from the IRS. See 2006 TNT 164-16 (August 18, 2006).

regarding implementation of the tax return preparer penalty provisions until final regulations are published. To view a copy of Notice 2008-13 (“the Notice”), click [here](#).

In addition to Notice 2008-13, additional guidance has been provided in Notice 2008-12 with respect to the implementation of the tax return preparer signature requirement under Section 6695(b), and in Notice 2008-11, which clarifies the transition relief provided in Notice 2007-54, issued earlier this year.

This notice provides guidance regarding implementation of the tax return preparer penalty provisions under section 6694 and the related definitional provisions under section 7701(a)(36), as amended by the Small Business and Work Opportunity Tax Act of 2007 (“the Act”).³⁸

Calculation of Penalty. The Act also increased the first-tier section 6694(a) penalty for understatements from \$250 to the greater of \$1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer from the preparation of a return or claim with respect to which the penalty was imposed. The Act increased the second-tier section 6694(b) penalty for willful or reckless conduct from \$1,000 to the greater of \$5,000 or 50 percent of the income derived (or to be derived) by the tax return preparer.

Adequate Disclosure. Under both the prior and current law, disclosure under section 6694(a) is adequate if made on a Form 8275, *Disclosure Statement*, or Form 8275-R, *Regulation Disclosure Statement*, attached to the return, amended return, or refund claim, or pursuant to the annual revenue procedure authorized in Treasury Regulation sections 1.6694-2(c)(3) and 1.6662-4(f)(2). In addition, under both the prior and current law, the penalty under section 6694(a) would not be imposed if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith.

Effective Date of Rules. The revised standards for return preparers were effective for returns prepared after May 25, 2007. Transitional relief for the rest of the 2007 year was provided in Notice 2007-54 and clarified in Notice 2008-11. The regulations will be significantly revised in the upcoming year to update the regulatory scheme governing tax return preparer penalties that has remained substantially unchanged since the late 1970’s. Until then, this notice provides interim guidance on the application of the tax return preparer penalties as amended by the Act for this filing season.

Effective Date of Notice. Notice 2008-13 is effective as of: (1) January 1, 2008, for all tax returns, amended tax returns, and claims for refund (other than 2007

³⁸ Pub. L. No. 110-28, 121 Stat. 190.

employment and excise tax returns) filed on or after that date and with respect to advice provided on or after that date; and (2) February 1, 2008, for all 2007 employment and excise tax returns filed on or after that date and with respect to advice provided on or after that date.

Tax Return Preparers Subject to these Rules. A tax return preparer is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of a tax return or claim for refund of tax imposed by the Internal Revenue Code. Only one individual associated with a firm is a preparer with respect to the same tax return or refund claim. A person who prepares a return or claim for refund for a taxpayer with no explicit or implicit agreement for compensation is not a preparer, even though the person receives a gift or return service or favor. A person who prepares a return or claim for refund of an employer by whom the person is regularly and continuously employed is also not a preparer. If an attorney or CPA hires someone else to prepare one's own personal return, the attorney or CPA is the taxpayer and not a preparer for purposes of that return.

Forms Subject to the Section 6694 Penalty. Exhibit 1 in the Notice provides a list of tax returns and claims for refund that report tax liability that will subject a tax return preparer to a section 6694 penalty. Exhibit 2 in the notice provides a list of information returns that report information that is or may be reported on another tax return that may subject a tax return preparer to the section 6694(a) penalty if the information reported constitutes a substantial portion of the other tax return. Exhibit 3 lists forms that would not subject a tax return preparer to the section 6694(a) penalty unless prepared willfully in any manner to understate the liability of tax on a return or claim for refund or in a reckless or intentional disregard of rules or regulations.

The IRS may choose to add or remove documents from any of the categories or exhibits to the Notice in future guidance as they gain experience in implementing the provisions of the Act and receive public comments.

Application of Penalties. If the form or document in Exhibit 3 was prepared willfully in any manner to understate the liability of tax on a tax return or claim for refund or in reckless or intentional disregard of rules or regulations, the preparer may be subject to a penalty under either section 6694(a) or 6694(b).

De Minimus Rule. A tax return preparer will not be considered to have prepared a "substantial portion" of a return or claim for refund if the schedule, entry, or other portion of a return or claim for refund involves amounts of gross income, amounts of deductions, or amounts on the basis of which credits are determined which are (i) less than \$2,000; or (ii) less than \$100,000, and also less than 20 percent on the gross income (or adjusted gross income if the taxpayer is an individual) as shown on the return or claim for refund. The IRS is considering whether revisions to these current

de minimus rules are necessary in any future regulations.

Verification Requirements. A preparer may rely in good faith without verification upon information furnished by the taxpayer if it does not appear to be incorrect or incomplete, but may not ignore the implications of information furnished to the tax return preparer or actually known to the tax return preparer. The preparer, however, needs to inquire about the existence of documentation in accordance with the appropriate reporting and substantiation requirements.³⁹

Cases of No Substantial Authority, but Reasonable Basis. In cases where there is no substantial authority, but for which a reasonable basis exists to take a tax position, the preparer must provide the taxpayer a prepared tax return with a complete Form 8275 or Form 8275-R disclosure statement, or disclose the position on the return in accordance with the annual revenue procedure.

Rules Regarding Tax Shelters as Described in Section 6662(d)(2)(C). The preparer must advise clients that, for tax shelter positions, there needs to be at a minimum substantial authority and a reasonable belief that the tax treatment was more likely than not the proper treatment in order for the taxpayer to avoid a penalty, that disclosure will not protect the taxpayer from penalty and any differences with the preparer's own standards under section 6694.

How Preparers May Comply with the Interim Guidance. There is no general pro forma language that a preparer may use to comply with the interim transitional rules. There is also no special format required under the Notice to satisfy the interim guidance and documentation requirements of the notice. The important point is that each item subject to the notice must be specifically addressed by the preparer with the taxpayer in a meaningful fashion and the contemporaneous documentation must in turn memorialize the discussion regarding each item. The language of the interim compliance rules also clearly contemplates that the advice and documentation are two separate events. A preparer runs a serious risk of not complying with the interim guidance standards if the only thing the preparer does is include a memo with the return. A preparer may choose to comply with the documentation requirement in one document covering all items, or in multiple documents each covering one item. Note that taxpayers are already permitted to disclose multiple items on a single Form 8275 for purposes of satisfying the penalty disclosure provisions of the Code.

Definition of "The Gross Income Derived" in Calculating the Section 6694 Penalty. Notice 2008-13 addresses the interim standards applicable to tax return preparers

³⁹ See Example 8 in Notice 2008-13.

under section 6694(a), and was not intended to address other aspects of the return preparer penalty. Final guidance under Section 6694, when issued, will address the standards applicable to tax return preparers under section 6694, as well as all of the other elements of the return preparer penalty under Section 6694, including the penalty amounts and related calculations. Nevertheless, tax return preparers and their clients should understand that the IRS has significant experience in looking through the form of transactions in determining their true substance, and should expect that all billing arrangements between tax return preparers and their clients will be scrutinized to ascertain the actual substance of those arrangements.

Application of Rules to Other Returns or Claims Prepared in Other Countries. Under existing regulations, there are no geographical limitations regarding who may be considered a tax return preparer.

Disclosure of Position in the case of Items Attributable to a Pass-Through Entity. Disclosure in the case of items attributable to a pass-through entity (“pass-through items”) is generally made with respect to the return of the entity. Thus, disclosure in the case of pass-through items must be made on the entity’s prepared tax return with a complete Form 8275 or 8275-R disclosure statement, or on the entity's return in accordance with the annual revenue procedure, if applicable.

IRS Assessment of a Section 6694 penalty if a Non-disclosed, Incorrect Position is Taken on a Return.

The IRS will not automatically assess a penalty in such cases. Rather, this determination will be made on a case-by-case basis and the penalty will be determined in appropriate cases. Similarly, the IRS will not choose what tax returns to examine based upon the existence or absence of a disclosure.

Rules Regarding Paid Preparers Signing Returns. Notice 2004-54 provides that paid preparers will be permitted to sign original returns, amended returns, or requests for filing extensions by rubber stamp, mechanical device (such as signature pen), or computer software program. The interim rules provided in Notice 2008-12 do not affect the ability of preparers to continue to sign returns as previously authorized.

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