



TAX ADVISOR

MAY 2008

ADVISOR CIVIL TAX PENALTY UPDATE: THE END TO “I DIDN’T KNOW!”

In the 1870s, British statesman Lord Palmerston observed that only three individuals correctly understood what was then known as the “Schleswig-Holstein Problem.” One has forgotten, one was dead and the third was insane.¹ Trying to explain the new civil tax penalties, which are applicable to Advisors, is almost as problematic.

Advising a client on a business transaction can have unintended tax consequences. Advisors to businesses are slowly becoming more aware that if a business transaction is not reported correctly, then they can be liable for civil tax penalties to the IRS. This is true even if the advisor never saw or signed the business’ tax return. The era of “I didn’t know” has come to an end.

New IRS Directive to IRS Auditors: On April 13, 2008, the IRS issued a directive to its auditors to review the possible application of tax return preparer penalties in *each and every* field exam (e.g. IRS audit). That means the auditor cannot pass on the issue of Preparer Penalties. This directive is in addition to the existing IRS Manual requirement which states that every instance of failing to adhere to Circular 230 must be referred to the National Director of Professional Practice for potential discipline.

The definition of a tax preparer has been expanded. Effective May 25, 2007, the expanded definition now includes preparers of income, estate, gift, employment, excise tax, and exempt organization returns, as well as advice that will be incorporated into a tax return. This expanded group of “preparers” is now required to disclose any tax position that they believe is ‘More Likely Than Not’² incorrect. If incorrect tax positions are not disclosed, then the advisor will be subject to a penalty as described below.

Case #1: In *Goulding*, an attorney for three Research & Development limited partnerships was deemed the preparer of the tax returns for the partnership and the limited partners. Since the taxpayers’ liability was understated on the tax returns, the IRS imposed a penalty on this attorney.

Case #2: In **Reg. 1.6694-1(b)(3)**, this is an example which illustrates the scope of the inclusion of non-signing preparers. In this example, Atty. A provides advice to Client C concerning the proper treatment of a significant item on C’s income tax return. Atty. A’s advice constitutes preparation of a substantial portion of the return. In preparation, Atty. A discusses the matter with Atty. B. Atty. B is associated with the same firm as Atty. A, but Atty. A is the attorney with the overall supervisory responsibility for the advice. Neither Atty. A, nor anyone in Atty. A’s firm, signs the return. The example in this Regulation concludes that **Atty. A is an income tax preparer who could be subject to the penalty under Section 6694**, while Atty. B is NOT a preparer with respect to Client C’s tax return.

Increased \$ amount for tax preparer penalties. The penalty was increased to be equal to the greater of: \$1000 or 50% of the fees received by the preparer. For “willful or reckless conduct,” the penalty has been raised to \$5000 or 50% of the fees received by the preparer.

How can Accounting Firms and Law Firms protect themselves and their clients from the impact of Section 6694 penalties?

Option 1: Advise your clients to disclose, across the board, all tax return positions that do not meet the ‘More Likely Than Not’ standard.

Option 2: Obtain an outside tax opinion from an unrelated independent tax expert. Stephen L. Robison is a full-time practicing tax attorney, as well as a Board Certified Federal Tax Specialist since 2002. Mr. Robison and his team of professionals will work with you and your clients to minimize your risk of tax malpractice.

¹“Only three people understood the Schleswig-Holstein Question. The first was Albert, the Prince consort and he is dead; the second is a German professor, and he is in an asylum; and the third was myself - and I have forgotten it.” - Lord Palmerston.

²Tax Code, Section 6694



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