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Requested Date:	11/07/2005
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Subject: Preparer Penalty

QUESTIONS PRESENTED AND RESPONSES

1. Is the tax preparer subject to the post amnesty penalty when assessing the tax preparer penalty?

Response: No.

2. Must the client be notified when proposing a tax preparer penalty to the Practitioner?

Response: We should not reveal to the taxpayer that we are imposing a preparer penalty against the preparer. However, we may contact the taxpayer in our examination of the preparer, providing we comply with the third party contact rules provided under section 19504.7 of the Revenue and Taxation Code.

Section 19542 of the Revenue and Taxation Code states the following general rule regarding disclosure of information:

> Except as otherwise provided in this article and as required to administer subdivision (b) of Section 19005, it is a misdemeanor for the Franchise Tax Board or any member thereof, or any deputy, agent, clerk, or other officer or employee or other individual, who in the course of his or her employment or duty has or had access to returns, reports, or documents required to be filed under this part, to disclose or make known in any manner information as to the amount of income or any particulars (including the business affairs of a corporation) set forth or disclosed therein.

Section 19549(b) further provides:

> "Return information" means a taxpayer's identity, the nature, source, or amount of his, her, or its income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments, whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing, or any other data, received by, recorded by, prepared by, furnished to, or collected by the Franchise Tax Board with respect to a return or with respect to the determination of the existence, or possible existence, of liability, or the amount thereof, of any person under Part 10 (commencing with Section 17001), Part 11 (commencing with Section 23001), or this part for any tax, addition to tax, penalty, interest, fine, forfeiture, or other imposition, or offense.

Although this last section could be read to address the liability of the taxpayer as it relates to his or her return, it could also be read to include the return prepared by the preparer and the preparer's liability, when it states that "return information" also includes the "possible existence, of liability, or the amount thereof, of any person under Part 10 . . . for any . . . penalty . . ." This section, coupled with the general provisions of section 19542, could be read to preclude disclosure of the preparer penalty to the taxpayer.

The Internal Revenue Service has considered disclosure issues relating to preparer penalties under section 6694 in the Internal Revenue Service Manual. The manual provides that in certain situations the notice and recordkeeping requirements of IRC section 7602(c) may apply to contacts made to determine the applicability of return preparer penalties because these penalties are treated as a tax under IRC section 6671.

For section 6694 penalties, the manual states that the preparer penalty under IRC section 6694 is usually not subject to third party notification and recordkeeping requirements. This is because information on the applicability of the preparer penalties is often a by-product of the taxpayer examination and does not always require examiners to directly address the taxpayer as a third party for information on the preparer's conduct. However, the manual further provides that the notice and recordkeeping requirements come into effect whenever the examiner addresses the taxpayer as a third party – i.e., whenever the examiner directly asks the taxpayer for information needed for making a determination on the preparer's liability for a penalty. Before an inquiry of that character is initiated, the examiner must follow the federal third party contact requirements under section 7602(c) and issue notice to the preparer and then re-contact the taxpayer.

If the preparer penalty matter is not part of an examination of the specific return and is instead part of what the IRS terms a program action, then examination contacts with these taxpayers are considered third party contacts for the purpose of making a penalty determination against the preparer.

The IRS manual also includes the following information:

> On Forms 4813 and 4700-A examination workpapers, the examiner should only document the fact that the required inquiries on the return preparer issues were completed. The taxpayer's answers to these inquiries should not be written on Forms 4318 and 4700-A, nor should they be included in any other workpapers in the taxpayer's case file. All information on the return preparer's activities and the applicability of any penalties relating to the return preparer should be separated from the taxpayer's case file. If the information were included in the case file, it would be disclosed to the taxpayer if the taxpayer requested a copy of the case file. This would constitute an IRS disclosure violation, since information regarding the return preparer's liability for taxes is confidential.

Thus, the IRS considers it a disclosure violation to actually advise taxpayers that it is imposing preparer penalties against their return preparer. This seems logical also under California law, in light of sections 19542 and 19549(b), cited above.

3. Do we have authority to provide the client's SSN (within SB 25) on the Practitioner's notice when proposing a tax preparer penalty to the Practitioner?

Response: SB 25 does not apply in this situation. SB 25 does not preclude us from disclosing the taxpayer's SSN on a notice to the preparer.

The broader question is whether it is even necessary to provide the SSN on the notice and what disclosure rules apply when providing the preparer with taxpayer information.

Section 19545 of the Revenue and Taxation Code identifies an exception to the prohibition against disclosing taxpayer return or return information as follows:

> A return or return information may be disclosed in a judicial or administrative proceeding pertaining to tax administration, if any of the following apply:
>
> (b) The treatment of an item reflected on the return is directly related to the resolution of an issue in the proceeding.
> (c) The return or return information directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer which directly affects the resolution of an issue in the proceeding.

Section 19545 of the Revenue and Taxation Code is similar to section 6103(h)(4) of the Internal Revenue Code. Thus, the interpretation of section 6103(h)(4) is relevant to determining proper disclosure under section 19545. Like section 19545, IRC section 6103(h)(4) includes an "item" test and a "transaction" test.

The IRS recently issued Chief Counsel Notice CC 2006-003 on October 25, 2005. This Notice addresses disclosure issues under 6103(h)(4) and explains the standards for

disclosure under the item and transaction tests as they relate to providing information gathered in examinations or investigations of tax shelter promoters or investors. Although we are not considering disclosure relating to examinations of tax shelter promoters, the analysis of the item and transaction tests seems relevant to the interpretation of section 19545 as it relates to disclosing taxpayer information to a preparer in contemplation of imposing a preparer penalty.

The Notice provides that under the item test, "the disclosure of tax information of taxpayers who participated in substantially similar transactions promoted by the same promoter is permitted, so long as the tax information directly relates to the resolution of an issue in the proceeding." In defining what it means to be "directly related" to the issue in the proceeding, the Notice cites to *United States v. Northern Trust Co.* (N.D. Ill 2001) 210 F.Supp.2d 955, 957, and provides that "while section 6103(h)(4)(B) [item test] does not require any transactional nexus between the third party and the taxpayer, the '[third party's] tax return's contents must be germane to an element of the claim, not simply be used to impeach a witness' credibility, and must apply to the specific taxpayer's liability, not analogous third parties.'" The notice further indicates that whether the third party information directly relates to an issue depends "first, upon the nature of the particular proceeding, and second, on the particular issues in dispute in that proceeding."

In deciding whether we should disclose taxpayer information to the preparer as a basis for imposing the penalty, the disclosure could very well be allowed pursuant to the item test exception under section 19545(b). As provided under Revenue and Taxation Code section 19166, the liability of the preparer for the penalty is based on the taxpayer's return and the understatement of liability. Thus, return information would be directly related to the issue of the preparer's liability for the penalty and disclosure of that information should be allowed pursuant to the item test under section 19545(b).

Disclosure should also be allowed pursuant to the transaction test under section 19545(c). The corresponding federal authority is found at 6103(h)(4)(C). According to the IRS CC 2006-003 Notice, "a third party's tax information may be disclosed in judicial or administrative proceedings pertaining to tax administration if the third party's tax information directly relates to a transactional relationship between a person who is a party to the proceeding and the third party and directly affects the resolution of an issue in the proceeding."

In a proceeding addressing a preparer's liability for the penalty under section 19166, the taxpayer's return and return information could very well meet the transaction test as defined by the IRS in CC 2006-003. As a result of preparing the taxpayer's return, there is a transactional relationship between the preparer and taxpayer, and because the preparer is obviously a party to the proceeding determining his or her liability for the preparer penalty, disclosure of return information would appear warranted under this test.

The Notice further instructs that the IRS "should offer in evidence only those returns or portions of returns, and only those items of return information, that specifically meet the item or transaction tests."

Section 19545 allows for disclosure in a judicial or administrative proceeding. Several courts have considered what is an administrative proceeding for purposes of disclosing return or return information under section 6103(h)(4). Although there is contrary authority, a majority of courts that have considered this issue have concluded that an audit is an administrative proceeding for purposes of disclosure under the item and transaction test under section 6103(h). This conclusion is based upon the premise that the term "tax administration" should be read broadly when determining whether a proceeding pertains to tax administration. (See, *Duquette, Inc. v. Commissioner* (2000) 110 F.Supp.2d 16, where the court observed that although section 6103(h) did not define tax administration, "when determining whether an administrative proceeding pertains to tax administration, the term 'tax administration' should be read broadly.")

Similarly, we could argue that an audit of the preparer is an administrative proceeding and that disclosure of return and return information should be allowed because the information directly relates to the resolution of the issue in the proceeding (item test) or directly relates to the transactional relationship between the preparer and taxpayer.

Tax Counsel