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PENALTIES FOR GEORGIA TAX RETURN PREPARERS

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On March 30, 2009, the Georgia General Assembly passed House Bill 444, which for the first time provides the Georgia Department of Revenue (the "Georgia DOR") with authority to impose penalties upon tax return preparers for understating the tax liability of their clients. H.B. 444 amends the Code of Georgia to include a new statute, Section 48-2-62 (the "Georgia Penalty Statute" or "Statute"), that (for the most part) adopts the tax return preparer penalty statutes of the Internal Revenue Code (the "IRC").[1] While the Internal Revenue Service (the "IRS") has for many years possessed the authority to impose penalties on tax return preparers, the Georgia Penalty Statute provides new authority to the Georgia DOR.

In comparison to the broad authority given to the IRS by the IRC's penalty statutes, the Georgia Penalty Statute appears to allow less discretion to the Georgia DOR to decide when to penalize tax return preparers. On the other hand, the Georgia DOR appears to have broader discretion than the IRS to decide when to bar a tax return preparer from being able to prepare tax returns in the future.

This article will (1) outline the Georgia Penalty Statute, (2) compare it to the corresponding IRC penalty statute, and (3) note how the IRS has interpreted key provisions that have not yet been interpreted by the Georgia DOR or a Georgia court.

I. WHO IS SUBJECT TO THE GEORGIA PENALTY STATUTE?

The Georgia Penalty Statute applies to a "tax return preparer," a term that is defined to mean:

> *any person who prepares for compensation*, or who employs one or more persons to prepare for compensation, *any return of tax* imposed under Chapter 7 [Georgia Income Tax], 7A [Georgia Tax Credits], or 8 [Georgia Sales and Use Tax] of this title *or any claim for refund of such tax*. The *preparation of a substantial portion* of a return or claim for

[1] *See* I.R.C. §§ 6694, 6695, and 6696.

> refund *shall be treated as if it were the preparation* of such return or claim for refund.[2]

While the full scope of this definition has not yet been clarified, the IRS broadly interprets the term "tax return preparer" in the IRC to include not only preparers of tax returns, but also those advising such preparers (*e.g.*, accountants, consultants, and attorneys).[3] If the Georgia DOR chooses to adopt this IRS interpretation, then a broad range of tax professionals will now become subject to the Georgia Penalty Statute.

The IRS has further ruled that "no more than one individual associated with a firm … is treated as a preparer with respect to the same return or claim for refund."[4] The one responsible individual will be either the signing preparer or the individual with overall supervisory responsibility for the advice given by the firm with respect to the return or refund claim.[5] The IRS designates the latter as the "nonsigning preparer," which is any preparer who is not a signing preparer. Examples of nonsigning preparers include those who provide advice (written or oral) either directly to a taxpayer or to preparers who are not associated with the same firm as the preparer who provides the advice.[6] If the Georgia DOR follows the IRS in interpreting "tax return preparer" to include a broad range of tax professionals, then a class of nonsigning preparers similar to the one in the Treasury Regulations will need to be defined.

The Treasury Regulations provide that:

> [o]nly a person … who prepares all or a substantial portion of a return or claim for refund shall be considered to be a preparer…. A person who renders advice which is directly relevant to the determination of the existence, characterization, or amount of an entry … will be regarded as having prepared that entry.[7]

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[2] H.B. 444, § 1, 150th Gen. Assem., Reg. Sess. (Ga. 2009) (emphasis added) (hereafter "H.B. 444") (to be codified as O.C.G.A. § 48-2-62(a)(1)).

[3] I.R.C. § 7701(a)(36). *See generally* Treas. Reg. § 301.7701-15; *Id*. § 1.6694-1(b)(3) (providing an example of an attorney who was a tax return preparer); *id*. § 301.7701-15(a)(3) ("A person may be an income tax return preparer without regard to educational qualifications and professional status requirements."); *id*. § 301.7701-15(a)(1) ("A person who furnishes to a taxpayer or other preparer sufficient information and advice so that completion of the return or claim for refund is largely a mechanical or clerical matter is considered an income tax return preparer, even though that person does not actually place or review placement of information on the return or claim for refund."); *id*. § 301.7701-15(a)(5) ("A person who prepares a return or claim for refund outside the United States is an income tax return preparer, regardless of his nationality, residence, or the locations of his places of business.").

[4] *Id*. § 1.6694-1(b)(1). Also, Treasury Regulations provide that an individual or the firm with which the individual is associated may be subject to penalty. *See id*. § 1.6694-2(a)(2) and § 1.6694-3(a)(2).

[5] *Id*. § 1.6694-1(b)(1).

[6] *Id*. § 1.6694-1(b)(2).

[7] *Id*. § 301.7701-15(b)(1).

Similarly, the Georgia Penalty Statute provides that "preparation of a ***substantial portion*** of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund." This "substantial portion" language provides the statutory support needed to impose penalties upon advisors for understatements of liability on the tax returns or refund claims on which they have participated.

It is unclear, however, whether the Georgia DOR will adopt a safe-harbor exemption for attorneys or advisors who prepare "a substantial portion of a return or claim for refund." In interpreting the phrase "substantial portion of a return or claim for refund," the IRS has created a *de minimis* safe harbor:

> [I]f the schedule, entry, or other portion of the 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 of the gross income (or adjusted gross income if the taxpayer is an individual) … then the schedule … is not considered to be a substantial portion.[8]

While the Georgia DOR has not expressly embraced or adopted the IRS's bright-line safe harbor, its discretion should nevertheless be limited by the Statute's use of the words "***substantial portion***" of a return or refund claim.

II. WHAT ARE THE STANDARDS FOR IMPOSING PENALTIES FOR UNDERSTATING TAX LIABILITY?

The Georgia Penalty Statute imposes a penalty for understating a taxpayer's liability on a tax return or refund claim, if any part of the understatement is due to: (1) an undisclosed position that has *no reasonable basis* or (2) *willful and reckless misconduct*. The Statute defines an "understatement of liability" as any "understatement of the ***net*** amount payable for a tax imposed … or an overstatement of the ***net*** amount creditable or refundable from such tax."[9] The *cause* of the understatement is the only relevant factor in the Georgia Penalty Statute. There are no *de minimis* exceptions relating to the amounts of the understatement of liability.

A. "No Reasonable Basis" Penalty

A tax return preparer may be subject to a penalty of up to $500 for an understatement where:

- The tax return preparer ***knew or reasonably should have known*** of the position;

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[8] *Id*. § 301.7701-15(b)(2).

[9] H.B. 444, § 1 (emphasis added) (to be codified as O.C.G.A. § 48-2-62(a)(2)).

- There was ***not a reasonable basis*** for the position; ***and***

- The position was ***frivolous or not adequately disclosed*** in the return or claim for refund or in a statement attached to the return or claim for refund.[10]

This three-part test is different from the corresponding IRC penalty provision for asserting unreasonable positions.[11] Under the IRC penalty statute, a preparer is penalized for taking an unreasonable position if he knew or reasonably should have known of the position, and the position is either (1) *undisclosed and unsupported by* "*substantial authority*," or (2) *disclosed but unsupported by a* "*reasonable basis*."[12] The IRC penalty statute focuses on whether the preparer had sufficient legal support for taking the position (*e.g.*, substantial authority or reasonable basis).

Federal law provides that "substantial authority" is a higher standard to meet than a mere "reasonable basis." The Treasury Regulations provide that "[t]here is substantial authority for the tax treatment of an item only if ***the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment***."[13]

Under the Georgia Penalty Statute, if an undisclosed position (known or should have been known) results in an understatement of liability, then to avoid the imposition of penalty, the tax return preparer must be able to show that the position had a reasonable basis. While the Statute does not expressly define what is or is not a "reasonable basis," the IRS provides the following guidance:

> The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on ***one*** or more of the ***authorities*** set forth … (taking into account the ***relevance*** and ***persuasiveness*** of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard.[14]

In the same session in which H.B. 444 was passed, the Georgia General Assembly passed House Bill 441, which provides for the penalizing of ***taxpayers*** for

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[10] *Id*. § 1 (emphasis added) (to be codified as O.C.G.A. § 48-2-62(b)(1) - (2)).

[11] *See* I.R.C. § 6694(a).

[12] *Id*.

[13] Treas. Reg. § 1.6662-3(d)(3) (emphasis added).

[14] *Id*. § 1.6662-3(b)(3) (emphasis added).

certain refund claims for which there is no reasonable basis.[15] In H.B. 441, the term "reasonable basis" is defined to mean:

> a position that is reasonably based on ***one*** or more of the following authorities: applicable provisions of this title and other statutory provisions; proposed and adopted regulations construing such statutes; court cases; official opinions of the Attorney General; and letter rulings, policy statements, informational bulletins, and other administrative pronouncements published by the commissioner.[16]

Thus, in contrast to the IRS's "substantial authority" standard, it seems Georgia's "reasonable basis" standard can be satisfied with only one relevant authority.[17] Accordingly, a preparer can be penalized under the IRC for taking undisclosed positions that are not supported by "substantial authority," while at the same time avoiding penalties under the Georgia Penalty Statute for asserting the same positions because there was at least one supporting authority.

Under the Georgia Penalty Statute, disclosing the tax position should generally insulate a preparer from a penalty, even when there is no reasonable basis for the position. A position is adequately disclosed if it is stated in the return or in a disclosure statement filed with the return. If a preparer is only advising on a tax position (*e.g.*, an attorney providing advice that is a substantial portion of the return), then Treasury Regulations will be the best source for understanding when a position has been adequately disclosed.[18] Until the Georgia DOR provides its own guidance on this issue, tax advisors (nonsigning preparers) need to be aware of their potential exposure to penalties for advising on any positions taken on a return or refund claim that are arguably not supported by a reasonable basis and not adequately disclosed. Also, for now, it is advisable that a tax advisor/preparer maintain proper documentation reflecting

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[15] H.B. 441, § 1, 150th Gen. Assem., Reg. Sess. (Ga. 2009) (hereafter "H.B. 441").

[16] *Id*. § 1 (emphasis added) (to be codified as O.C.G.A. § 48-2-35.1(c)(1)(E)).

[17] Treasury Regulations provide that the following are types of "authority": applicable provisions of the Internal Revenue Code and other statutory provisions; proposed, temporary, and final regulations construing such statutes; revenue rulings and revenue procedures; court cases; congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers. *See id*. § 1.6662-4(d)(3)(iii).

[18] *Id*. § 1.6694-2(d)(3)(i) ("In the case of a signing tax return preparer … disclosure of a position … for which there is a reasonable basis … is adequate if the tax return preparer meets any of the following standards: (A) … [D]isclosure on a properly completed and filed Form 8275, 'Disclosure Statement,' or Form 8275-R, 'Regulation Disclosure Statement,' as appropriate, or on the tax return …; or (B) … The tax return preparer provides the taxpayer with the prepared tax return that includes the disclosure."); *id*. § 1.6694-2(d)(3)(ii) ("In the case of a nonsigning tax return preparer … disclosure of a position … that satisfies the reasonable basis standard … is adequate if the position is disclosed in accordance with … disclosure on a properly completed and filed Form 8275 or Form 8275-R, as applicable, or on the return.").

what the taxpayer or other preparer was advised of regarding potential penalties and the standards for disclosing the tax position.[19]

While disclosures seem to create a safe harbor under the Georgia Penalty Statute, it should be noted that even a disclosed position can still result in a penalty if the position is deemed to be frivolous. While the Statute does not define the term "frivolous," the Treasury Regulations define "frivolous" as being "patently improper."[20] It will be interesting to see how the Georgia DOR distinguishes between a "frivolous" position and "willful and reckless" misconduct (which, as discussed below, provides a more severe penalty). The overlapping of these two standards may be one reason why the IRC no longer uses the "frivolous" standard for its penalty statute.[21]

A tax return preparer may not be subject to the Georgia Penalty Statute for understating liability if he can show that there was a reasonable cause for the understatement and that he acted in good faith.[22] Factors considered by the IRS when determining whether reasonable cause and good faith exist include:

(1) The nature of the error causing the understatement;

(2) The preparer's frequency of errors;

(3) The materiality of his errors;

(4) The preparer's normal office practice;

(5) His reliance on advice of others; and

(6) His reliance on generally accepted administrative or industry practice.[23]

The Treasury Regulations also provide that "the preparer generally may rely in good faith without verification upon information furnished by the taxpayer. Thus, the preparer is not required to audit, examine or review books and records, business operations, or documents or other evidence in order to verify independently the taxpayer's information."[24] Accordingly, a preparer's errors resulting from good-faith reliance on the taxpayer's work papers should not result in a penalty.

B. Willful and Reckless Misconduct Penalty

The Georgia Penalty Statute imposes harsher sanctions when an understatement is deemed to be willful and reckless. Thus, a tax return preparer will be

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[19] *Id*. § 1.6694-2(d)(3)(ii)(A) and (B).

[20] *Id*. § 1.6694-2(c)(2) (in effect during 2007); *see also id*. § 1.6662-3(b)(3).

[21] While I.R.C. Section 6694 previously used a "frivolous" standard under the unreasonable position penalty, the amended statute removed the "frivolous" test.

[22] H.B. 444, § 1 (to be codified as O.C.G.A. § 48-2-62(b)(3)).

[23] Treas. Reg. § 1.6694-2(e).

[24] *Id*. § 1.6694-1(e).

subject to a penalty of the greater of $5,000 or 50 percent of the income derived from an understatement of liability that is caused by a "(1) willful attempt in any manner to understate the liability for tax on the return or claim for refund; ***and*** (2) reckless or intentional disregard of the law."[25] The use of the conjunction "and" as opposed to the disjunction "or" distinguishes the Georgia Penalty Statute from the willful or reckless conduct penalty provisions of the IRC.[26] The Treasury Regulations describe "willful" behavior as "an attempt wrongfully to reduce the tax liability of the taxpayer."[27] The IRS bears the burden of proof on this issue and needs to show clear evidence to properly impose a penalty for a willful attempt to understate liability.[28]

Treasury Regulations further provide that a "preparer is considered to have recklessly or intentionally disregarded a rule or regulation if the preparer takes a position on the return or claim for refund that is contrary to a rule or regulation … and the preparer knows of, or is reckless in not knowing of, the rule or regulation."[29] Unlike the IRS's burden to prove "willful" behavior when assessing an enhanced penalty, the Treasury Regulations provide that the preparer bears the burden of proving that he did *not* recklessly or intentionally disregard a rule or regulation.[30] Thus, there is no presumption of innocence, and the IRS can avoid its burden of proving "willful" behavior simply by assessing an enhanced penalty for reckless or intentional disregard of a rule or regulation. In contrast, the use of the word "and" in the Georgia Penalty Statute appears to impose a two-part test on the Georgia DOR, which will always bear some burden of proof when assessing a penalty for willful and reckless misconduct.

III. WHAT OTHER PENALTIES CAN BE IMPOSED?

A tax return preparer will be subject to a $50 penalty for failing to sign a return or refund claim that requires the preparer's signature.[31] However, if it is shown that (1) such failure is due to reasonable cause and not due to willful neglect, or (2) the practice of not signing is an accepted industry standard, then no penalty will be assessed.[32] Conformity with accepted industry standards is an exception unique to the Georgia Penalty Statute—not found in the IRC or Treasury Regulations.

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[25] H.B. 444, § 1 (emphasis added) (to be codified as O.C.G.A. § 48-2-62(c)).

[26] I.R.C. § 6694(b)(2).

[27] Treas. Reg. § 1.6694-3(b).

[28] *Id*. § 1.6694-3(h).

[29] *Id*. § 1.6694-3(c)(1).

[30] *Id*. § 1.6694-3(h).

[31] H.B. 444, § 1 (to be codified as O.C.G.A. § 48-2-62(e)(1)).

[32] *Id*. § 1 (to be codified as O.C.G.A. § 48-2-62(e)(1)). The Treasury Regulations provide the following regarding reasonable cause: "If the tax return preparer asserts reasonable cause for failure to sign, the IRS will require a written statement to substantiate the tax return preparer's claim of reasonable cause. For purposes of this paragraph (b), reasonable cause is a cause that arises despite ordinary care and prudence exercised by the individual tax return preparer." Treas. Reg. § 1.6695-1(b)(3).

A tax return preparer will also be subject to a $50 penalty if he fails to furnish the preparer's identifying number on the return or refund claim.[33] However, if it is shown that (1) such failure is due to reasonable cause and not due to willful neglect, or (2) the practice of not providing an identifying number is an accepted industry standard, then no penalty will be assessed.[34]

Lastly, a tax return preparer will be subject to a $500 penalty for any fraudulent endorsement of a check made for the taxes imposed under Chapter 7 (Georgia Income Tax), 7A (Tax Credits), or 8 (Sales and Use Tax) of title 48 of the Georgia Code.[35]

IV. INJUNCTIONS OF TAX PREPARERS

The Georgia Penalty Statute also authorizes the Georgia DOR to seek an injunction decree against a tax return preparer who has violated any section of the Georgia Penalty Statute:

> A civil action in the name of the State of Georgia may be commenced at the request of the commissioner to ***enjoin any tax return preparer or an employer*** having knowledge of an employee tax return preparer who is doing business in this state and engaging in conduct described in this subsection ***from further engaging in preparing tax returns***.[36]

Presumably this injunction would bar the offender from preparing only ***Georgia*** tax returns and claims for refunds, since "tax return preparer" is defined as preparing certain Georgia returns and refund claims. Unlike the Georgia Penalty Statute, the IRC provides first for an enjoinment of specific misconduct, instead of the complete prohibition of tax return preparation.[37]

The Georgia Penalty Statute also allows the enjoining of the employer of a tax return preparer when the employer has knowledge of the preparer's misconduct. It is

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[33] H.B. 444, § 1 (to be codified as O.C.G.A. § 48-2-62(e)(2)(A)).

[34] *Id*. § 1 (to be codified as O.C.G.A. § 48-2-62 (e)(2)(A)). The exception actually provides the following: "***unless it is shown that such failure***: (i) Is due to reasonable cause and not due to willful neglect; or (ii) ***Failed to conform to accepted industry standards***." *Id.* (emphasis added). The latter part seems to have a typo and presumably should be the same "industry standards" exception as the one contained in the failure-to-sign provision.

[35] *Id*. § 1 (to be codified as O.C.G.A. § 48-2-62 (e)(3)). The exception to the fraudulent endorsement penalty is a "deposit by a bank … of the full amount of the check in the taxpayer's account in such bank for the benefit of the taxpayer." *Id.*

[36] *Id*. § 1 (to be codified as O.C.G.A. § 48-2-62 (f)(1)). An action can be brought in Superior Court of the county of (1) the tax preparer's residence or (2) the tax preparer's principal place of business or (3) in which the taxpayer for whose tax return the action is brought resides. *Id.*

[37] I.R.C. § 7407(b).

unclear from the Statute's language whether an employer's injunction is limited to the one tax return preparer responsible for the understatement of liability or whether the entire firm (no matter the size) could be barred from preparing Georgia tax returns and refund claims. The IRC penalty statute does not authorize the IRS to enjoin employers of tax return preparers.

In order for a tax return preparer to be subject to an injunction under the Georgia Penalty Statute, a court must find that the preparer: "(A) ***Engaged in any pattern of conduct subject to civil penalty*** under subsection (b) [no reasonable-basis position], (c) [willful and reckless misconduct], or (e) [other penalties] of this Code section; ***or*** (B) ***Guaranteed the payment of any tax refund or the allowance of any tax credit***."[38] In contrast, the IRC requires a court also to find that an injunction is necessary to prevent the recurrence of such conduct. The phrase "pattern of conduct subject to civil penalty" set out in the Georgia Penalty Statute appears to require multiple transgressions by a tax return preparer before the Georgia DOR can seek an injunction. However, there is no express language in the Georgia Penalty Statute that requires a court, as a precondition to granting injunctive relief, to find that an injunction is necessary to stop future misconduct.

V. ADMINISTRATION

The Georgia Penalty Statute provides that "[a]ny claim for refund of any penalty paid under this Code section shall be filed in accordance with rules and regulations promulgated by the commissioner."[39] The Statute also provides that "[e]xcept as otherwise provided by this Code section, proceedings to assess, collect, or seek a refund of any penalty imposed under this Code section shall be conducted in the same manner and subject to the same rights of appeal as assessments, collections, and claims for refund of the related taxes."[40] Since the Georgia DOR has not yet promulgated rules and regulations for the Georgia Penalty Statute, the same procedures that apply to an appeal of a tax assessment should apply to any appeal of a penalty assessment.[41]

Payment or posting of a bond may not be required to have an independent appeal. There are several alternatives to contesting a matter without paying the tax. Payment of tax can be avoided in an appeal directly to a superior court under the Georgia Code, Section 48-2-59, if a taxpayer (1) owns real estate within the state equal

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[38] H.B. 444, § 1 (emphasis added) (to be codified as O.C.G.A. § 48-2-62(f)(2)).

[39] H.B. 444, § 1 (to be codified as O.C.G.A. § 48-2-62(g)). Any penalty under subsection (b) [no reasonable basis position] or (e) [other penalties] must be assessed within three years of the filing of the return or claim for refund. *Id*. There is no statute of limitation for the assessment of penalties under subsection (c) [willful and reckless misconduct]. *Id*. A claim for refund of any penalty must be filed within three years of the time the penalty was paid. *Id*.

[40] *Id*. § 1 (to be codified as O.C.G.A. § 48-2-62(h)).

[41] *Id*.

to the tax, or (2) posts a bond.[42] Before the superior court will have jurisdiction to entertain an appeal filed by any aggrieved taxpayer, the taxpayer must file with the clerk of the superior court a written statement whereby the taxpayer agrees to pay all taxes for which the taxpayer has admitted liability on the date or dates the taxes become due.[43] Tax is not required to be paid if the taxpayer selects the appeal route through the Office of State Administrative Hearings as noted in the Georgia Code, Section 50-13-12. The taxpayer can also provide an "affidavit of illegality" to a levying officer of the Georgia DOR. Upon payment of the tax, if required as a condition precedent by the law levying the tax, or upon posting a bond in such an amount to cover the total of any adverse judgment plus costs if the law does not require the payment of the tax as a condition precedent, the levying officer is required to return the affidavit of illegality to the superior court, and the matter will be adjudicated.[44]

VI. CONCLUSION

When, how, and against whom the Georgia DOR will interpret and enforce the ambiguous areas of the Georgia Penalty Statute is not completely clear. In the meantime, tax return preparers—including tax advisors, consultants, and attorneys—should all be aware of the potential implications this new statute may have in the tax return preparer's dealings with the Georgia DOR.

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[42] O.C.G.A. § 48-2-59(c).

[43] *Id.*

[44] *Id.* § 48-3-1.