

## Are You Disclosing Enough Information to Your Tax Return Preparer?

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The Small Business and Work Opportunity Tax Act of 2007 (the Act) became law on May 25, 2007. The Act affected over 60 Internal Revenue Code (the Code) sections, some provisions of which related to income tax preparers. You may be wondering why rules that apply to tax return preparers are relevant to you. The answer is simply that your tax return preparer will likely be much less receptive to aggressive tax deductions and tax positions under the new penalty scheme. As such, understanding the new rules may help you understand the concerns of your tax return preparer.

One provision increases the types of returns subject to preparer penalties. Another toughened the standards of conduct that tax preparers must meet when preparing returns coupled with an increase in the penalty for violating the redefined "unreasonable position" standard, or simply imposing harsher penalties for the "willful or reckless conduct" provision in the Code.

Before the Act, tax return preparer penalties only applied to understatements of tax on income tax returns. Now the enhanced standard and increased penalties also apply to estate and gift tax, employment tax, excise tax and exempt organization returns.

### Tax Return Preparer

A "tax return preparer" is a person who prepares a tax return for compensation or who employs one or more persons to prepare one for compensation. There are some exceptions to the definition of a tax return preparer. Two of the more common exceptions include: (i) a regular and continuous employee who prepares a return or claim for refund for their employer; or (ii) someone who merely types or photocopies a return. Unless an individual is a tax return preparer under the Code definition, the penalties will not apply.

### Standards of Conduct for Unreasonable Positions

First, an unreasonable position is when (i) the preparer knew or reasonably should have known of the position taken on the return; (ii) there was not a reasonable

belief that the position would more likely than not be sustained on its merits (likelihood of success); and, (iii) the position was appropriately disclosed as required or there was no reasonable basis for the position. Also, as with some other provisions regarding the imposition of penalties in the Code, there is a reasonable cause exception that may apply, but it should not be assumed that the preparer would qualify in most cases.

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**While the Act imposes the new standards and penalties immediately on returns prepared after May 25, 2007, the IRS has granted transitional relief to all returns, amended returns, and refund claims due on or before December 31, 2007, 2007 estimated tax returns due on or before January 15, 2008 and 2007 employment and excise tax returns due on or before January 31, 2008.**

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The standard of care required of a preparer is now far more stringent than the earlier standard. While the preparer's knowledge of the return position taken and disclosure requirements remain unchanged, the former "realistic possibility of success" standard has been toughened to "a reasonable belief" standard.

The former standard, the "realistic possibility of success" meant that a preparer had to believe there was at least a "one-in-three" (a one-third) chance that the tax return position would be sustained if audited. Many regulations are available to illustrate what the "one-third" test meant. The new standard, the "reasonable belief" standard is a tougher test and means "more probable than not." The new higher standard means there must be a one-in-two (a 50% chance) that the position will be sustained. With no regulations issued

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by the Internal Revenue Service (the IRS) the new standard is unclear. Now disclosure is required with the new reasonable belief standard instead of the realistic possibility of success standard to mitigate the imposition of a penalty.

Disclosure alone will not always avoid the imposition of penalties for the preparer taking an unreasonable position. Even before, disclosure would not eliminate a penalty if the position was frivolous. But now even that standard is toughened. The new standard is higher than frivolous but not as high as the new reasonable belief standard. That new standard, again without IRS guidance, is a new term, a “no reasonable basis” standard. The new reasonable belief standard is now more than 50% likely to succeed. The frivolous position standard only has a 5% chance of success. The new “reasonable basis” standard will fall between the two. The “willful or reckless conduct” standard remains unchanged, but the penalties are dramatically increased.

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### Penalties Imposed

The former preparer penalties imposed for unreasonable positions (\$250 per violation) and for willful or reckless conduct (\$1,000 per violation) are substantially increased. The unreasonable position penalties are imposed when (i) there is an understatement of tax related to an undisclosed position that should have been disclosed; or (ii) when there is no reasonable basis for the position taken. Now when an unreasonable position has been taken by the preparer, the penalty is the greater of \$1,000 or 50% of the preparer’s compensation. If the understatement is from willful or reckless conduct, the penalty is the greater of \$5,000 or 50% of the preparer’s compensation. If both are imposed, only the greater of the two penalties is paid.

If disclosure of that position would exempt the preparer from penalties, a U.S. Form 8275 Disclosure Statement or U.S. Form 8275-R Regulation Disclosure Statement is attached to the return. U.S. Form 8275 is used to disclose items or positions not otherwise adequately disclosed on the return. U.S. Form 8275-R is used by both taxpayers and preparers to disclose positions taken on a tax return that are contrary to Treasury Regulations.

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### Effective Date

While the Act imposes the new standards and penalties immediately on returns prepared after May 25, 2007, the IRS has granted transitional relief to all returns, amended returns, and refund claims due on or before December 31, 2007, 2007 estimated tax returns due on or before January 15, 2008 and 2007 employment and excise tax returns due on or before January 31, 2008. No transitional relief is given for advice regarding returns for tax year 2008 and to preparers who exhibit willful or reckless conduct.

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### Conclusion

Another factor comes into play under the new rules. The disclosure requirements for self-prepared returns are not as strict as the requirements for tax return preparers. A potential conflict exists between return preparers and their clients because of the different standards between the two. The prediction is that some taxpayers will shop around for a preparer willing to sign off on aggressive tax positions without required disclosures. For preparers, the new law will require more detailed research on all aspects of a return previously reserved for only non-routine tax transactions. For those of you using professional tax preparers, the level of scrutiny your return information receives in the coming year will increase. Taxpayers will certainly have much more communication with their preparers. Do not be surprised at the increased costs associated with return preparation as a result of the increased standards and penalties. As with most new rules, no guidance has been issued from the IRS so you should consult your tax preparer or advisor for more information concerning how these changes may affect your particular circumstances. ©

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