

Family Tax Planning Forum

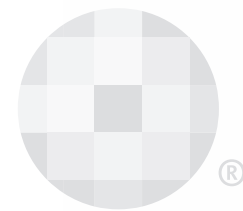
By Robert S. Keebler

New Preparer Penalty Rules— A Silver Lining?

On May 25, 2007, President Bush signed the Small Business and Work Opportunity Tax Act of 2007 (P.L. 118-28) (“2007 Small Business Tax Act”). While the focus of the 2007 Small Business Tax Act was to increase the minimum wage and to help small businesses and hurricane victims, there was a provision that significantly changed the preparer penalty provisions of the Code. In short, if a return preparer receives too many preparer penalties or the penalty is for a serious offense, the IRS Director of Practice has the authority to disbar the preparer from practice before the IRS.

The following summarizes the salient provisions relating to the preparer penalty section of the 2007 Small Business Tax Act:

- The new preparer penalties are now extended to the preparation of estate, gift, excise, exempt organizations and employment tax returns.
- Under prior law, a preparer penalty could only be imposed when the position did not have a “realistic possibility of success” (*i.e.*, one-third or greater chance of being sustained on its merits). However, under the new tax act, this standard now requires a “more-likely-than-not” chance of success (*i.e.*, greater than 50-percent chance of being sustained on its merits).
- Notwithstanding the above, the new tax act states that the preparer penalty will not be imposed if the position is disclosed on the return (using either IRS Form 8275 or IRS Form 8275-R) and there is a “reasonable basis” for the position taken (*i.e.*, one-third or greater chance of winning).



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- The “first-tier” penalty (relating to an understatement of tax from taking a “unrealistic” position) is increased from \$250 to the greater of (1) \$1,000 or (2) 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 is imposed.
- The “second-tier” penalty (relating to an understatement of tax due to a willful attempt to understate tax or a reckless or intentional disregard of the rules or regulations) is increased from \$1,000 to the greater of (1) \$5,000 or (2) 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 is imposed.
- A new 20-percent additional penalty is imposed on the excess of the amount of a claim for refund or credit over the amount allowable, except if the claim had a reasonable basis.

So what, then, does all of this mean?

First of all, the standard of care has been extended to basically all returns that are filed with the IRS. The extension of this to gift and estate tax returns is troubling, especially in lieu of valuation issues.

Secondly, and more importantly, the 2007 Small Business Tax Act changes the standard to avoid the preparer penalty from a 33 1/3-percent standard to a greater-than-50-percent standard, unless the position is adequately disclosed on the tax return. Because millions of tax returns are prepared each year, the practical problem of the new changes is that there are going to be many returns that will fail to meet the new standards. In the past, with a 33 1/3-percent standard, preparers had very limited risk when preparing tax returns. However, with the greater-than-50-percent standard, this will require considerably more due diligence. Furthermore, there will be an increase in the number of qualified opinion letters that are given in order to reach a more-likely-than-not position, thereby increasing demand for opinion letter work.

In order to better understand the new preparer rules, Table 1 provides a summary of the standards for various positions.¹

Table 1.

Standard	% Standard	Code Sec. 6694 (Prior Rule)	Code Sec. 6694 (New RULE)
More Likely Than Not	> 50%	No Disclosure Required	No Disclosure Required
Realistic Possibility (Old Standard)	33 1/3-50%	No Disclosure Required	Disclosure Required
Reasonable Basis (New Standard)	20-33 1/3%	Disclosure Required	Disclosure Required
Frivolous Return	< 20%	Cannot Sign	Cannot Sign

Increased Opportunity— The Silver Lining

History proves that with most dark clouds, there is a silver lining, and the statutory changes in the preparer penalty rules appear to be no exception. As a result of the new statutes, tax professionals will have an increased opportunity to develop client referral relationships which will enhance the profitability and work quality for both professions.

Over the next five years we will see the following:

- Lawyers outsourcing individual, fiduciary and gift tax returns to CPA firms while simultaneously filling this time void with additional tax planning work. The additional tax planning work will likely be derived through referrals from the very CPAs the attorneys send their fiduciary and gift tax work to. Increased referrals, coupled with the impending clarification over the next 36 months as to the future of the estate tax, will lead to a tremendous demand for planning services. The effect of this “dam breaking” will be increased time pressure on lawyers forcing the overall model of the highest and best use of one’s time.
- Tax professionals will also have a tremendous opportunity to draft Circular 230 opinion letters for other tax preparers. If the IRS does begin to impose preparer penalties, paranoia will sweep across the tax profession and CPAs and lawyers alike will be running for cover trying to hide behind more-likely-than-not opinion letters. Accordingly, tax professionals will benefit greatly from the opportunity to help other practitioners with Circular 230 opinion letters and perhaps in reviewing specific return issues.

Conclusion

When looking at the new statutory changes with foresight and a “glass is half full” mentality, the somewhat harsh provisions of the new preparer penalty rules do not seem as bad. In this case, opportunity will come in the form of a new tax planning model, which will increase referrals between CPAs

and attorneys, thus improving quality, profitability and professional fulfillment.

ENDNOTE

- ¹ The author would like to thank Michael G. Goller, Reinhart, Boerner, Van Deuren, SC, Milwaukee, Wisconsin, for his insight and contributions to the preparation of the position standard matrix. Mr. Goller is an Adjunct Professor at the University of Wisconsin—Milwaukee, where he teaches tax practice and procedure.

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