Can You/Should You Skirt Return Preparer Definition?

By Robert W. Wood[1]

I. INTRODUCTION

Semantics play a particularly important role in the tax law. Whether by cause or effect, it is perhaps no coincidence, therefore, that more than a few English majors become tax lawyers. Word choice, structure, and definitions in the tax law are highly important. I believe this is more true today than it was 30 years ago when I embarked upon my career.

Today, the need for clear definitions in tax law has never been more acute. This is probably true across a wide spectrum of tax issues, including a variety of substantive areas of specialization in what is clearly the most complex and convoluted tax system that has ever existed in any country. Nonetheless, my concern today is with a rather simple rule (at least it *ought* to be simple): who is a return preparer?

II. A ROSE BY ANY OTHER NAME

Axiomatically, a tax return preparer is someone who fills out a tax return for someone else. It is easy enough to say that a tax lawyer who does not complete tax returns is simply not a return preparer. Yet, we know such a literalist approach to the definition of return preparer is both inappropriate and inaccurate.

A new federal law, the U.S. Troop Readiness, Veterans' Care, Katrina Recovery and Iraq Accountability Appropriations Act of 2007,[2] was enacted on May 25, 2007. Prior to that new statute, the definition of "income tax return preparer" did not include preparers of non-income tax returns, such as gift, estate, excise, or employment tax returns. However, this recent omnibus of federal law redefined "return preparer" to refer to both income tax and non-income tax returns. The Treasury Regulations have not yet been amended to reflect this change.

Code Sec. 7701(a)(36) generally defines the term "Tax Return Preparer" as any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any tax return or claim for refund (unless it is for the person himself). Thus, we can reasonably assume that an enrolled agent, an accountant (certified or otherwise) or a lawyer who fills out tax returns for clients is a tax return preparer.

But, what if the preparer does not get paid? Willing or not, many a tax professional has probably filled out a few tax forms for relatives, and paused to reflect on the "paid preparer" signature line at the bottom of each return. Fortunately, the Treasury Regulations make it clear that a person who prepares a return (or claim for refund) for a taxpayer with no explicit or implicit agreement for compensation is not a preparer. In fact, that is so even if the person receives a gift or return service or favor.[3] Thus, I'll leave aside the category of return preparers that are not "paid" preparers.

III. LINE ITEM ADVISORS

Almost thirty years ago, I remember being taught as a young tax lawyer that any time I gave advice about a tax return line item, I was in effect, a return preparer. That was a useful bit of grounding, essentially requiring thought about tax return preparation standards. This is still true today.[4] You can be a preparer without filling out forms.

Sensibly, the Treasury regulations attempt to deal with the notion of non-signing return preparers, covering someone who gives advice about line items, but who doesn't actually prepare or sign returns. Treasury Reg. §301.7701–15 states that a person is a tax return preparer if he 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.

The classification of non-signing preparers is not limited to those who simply furnish information or advice so that a return may be completed. Persons who provide legal advice on specific issues of law may also be classified as a non-signing preparer. The Treasury Regulations state that a person who only gives advice on specific issues of law is generally not considered an income tax preparer,[5] unless the advice is given after the transaction which the person is giving advice upon has already occurred, and the advice is "directly relevant to the determination of the existence, characterization, or amount of an entry" on the tax return or claim for refund.[6]

Accordingly, an advisor who gives legal advice on an item that will go on a return after the transaction was done, and before the return is filed, could be considered a non-signing preparer. I should be clear that I have never before studied these provisions, nor thought about whether my advice to a client was specific enough to bring me within the return preparer ambit. Rather, I have always assumed it was, and that never caused me one whit of concern.

IV. MAGINOT LINE

Today, however, writings in the tax press cause me to wonder if I am better off, and if my client is better off, if I can legitimately conduct myself so that my advice does not make me a return preparer. Why? If I give line-item advice (and thus am a preparer), it appears that the client's tax position must be more likely than not to be correct. If it is not, the return preparer faces penalties.

On the other hand, if I give advice that is short of the preparer standard, the client's tax position must only have substantial authority to avoid penalties. In that case, of course, as I am not a preparer, I would avoid penalties too. Without being Machiavellian, steering clear of the return preparer moniker seems sensible for both advisor and client, something that had never occurred to me before.

Although the Treasury Regulations appear to clarify the definition of "tax return preparer," it is important to remember that these Regulations were promulgated prior to the amendments made by the U.S. Troop Readiness, Veterans' Care, Katrina Recovery and Iraq Accountability Appropriations Act of 2007. The Act's amendments raise questions regarding what activities represent the preparation of a tax return, who is a return preparer within the meaning of §7701(a)(36) as amended, and how the statute applies to both signing and non-signing preparers.

Cognizant of the need for better clarity in this area, the IRS has provided transitional relief in Notice 2007–54[7]. In the Notice, the Service stated that it is considering whether new regulations or other published guidance are needed.[8] This might include amendments to various regulations (§§301.7701–15 and §§1.6694–0 through 1.6694–4).[9] For the time being, the definition of tax return preparer remains substantially unchanged (except for the inclusion of non-income tax return preparers). Tax practitioners can only speculate what the new standards might be.

V. NEW RETURN FILING STANDARDS

My myopic focus on whether one is or is not a return preparer as defined has a point: what conduct is required, and what penalties apply to failures to satisfy its standards? The standards for tax return positions and their related penalties have changed significantly. Ostensibly, this should have nothing to do with whether a paid return preparer or the taxpayer completes the return himself. Right is right, and wrong is wrong.

Yet, as a litany of commentary recently suggests, it now appears that returns prepared by professionals are subject to higher standards than those completed by the taxpayer himself.[10] I want to focus primarily (if not exclusively) on real honest-to-goodness impact at the practitioner level, skipping over the esoterica. However, we need a baseline, and it emanates from the U.S. Troop Readiness, Veterans' Care, Katrina Recovery and Iraq Accountability Appropriations Act of 2007.

This Orwellian named new federal law increases tax return reporting standards applicable to tax return preparers for undisclosed non-tax avoidance items from the "realistic possibility of success" standard to the "more likely than not" standard. In tax *lingua franca*, a realistic possibility of success generally means 33 1/3% likely to succeed.[11] In contrast, "more likely than not" means more than 50% (but not necessarily as high as 51%).[12]

It might not sound like a whopping difference to go from 33 1/3% to over 50%, but those approximately 17 percentage points can mean a world of difference. In the arcane world of the tax laws, sometimes one can easily conclude (based on the facts and the law) that a tax return position has a realistic possibility of success. Yet, one might not feel comfortable saying that the position is more likely than not to succeed.

Despite the new rigor given to preparers, taxpayers themselves are subject to a different standard. Taxpayers are not subject to penalties with respect to a substantial understatement of income tax if they have "substantial authority" for a position.[13] However, the Treasury Regulations do not quantify the meaning of "substantial authority." Instead, the Treasury Regulations explicitly state that the "substantial authority" standard is less stringent than the "more likely than not" standard.[14] The following table may help lay out the compliance menu.

"More Likely Than Not"	>50% chance of success
"Realistic Possibility of Success"	>33 1/3% chance of success
"Substantial Authority"	Something Less than "Realistic Possibility of Success," but Greater than "Reasonable Basis"
"Reasonable Basis"	Something significantly higher than "Not Frivolous," but less than "Substantial Authority"
"Not Frivolous"	Something that is not "patently improper"[15]

VI. DO ASK, DO TELL

Disclosure is nearly a cure-all today. Disclosure is generally made on Form 8275, a form designed for taxpayers to disclose positions to (hopefully) avoid the 6662 penalty. Assuming the taxpayer has "reasonable basis"[16] for a position, disclosure by the taxpayer would protect the taxpayer and his tax return preparer from penalties. If a taxpayer decides not to disclose an item, but has "substantial authority" for his tax position, penalties will not be assessed against him. In contrast, the taxpayer's return preparer may be penalized even if the undisclosed tax position meets the "substantial authority" standard.

If a tax item is not disclosed, and a tax return preparer does not meet the "more likely than not" standard, he's in trouble. Such a return preparer may incur penalties equal to the greater of $1,000 or 50% of the income derived (or to be derived) by the tax return preparer from the preparation of the return or claim with respect to which the penalty was imposed. How can the preparer avoid this liability? Disclose the item.

What accounts for the difference between paid return preparers on the one hand and taxpayers on the other? There does not appear to be a good explanation for the discrepancy, and there is at least one major drawback.

The difference in standards presents a potential conflict of interest between the taxpayer and his preparer. If a tax item's chances of success fall below the "more likely than not" standard but above the "substantial authority" standard, the tax return preparer is put in the precarious position of advising the taxpayer that he does not need to disclose the item, while risking the imposition of a penalty from non-disclosure. The tax return preparer could advise his client to disclose the item, but that seems to elevate the preparer's interests above those of the client, which may violate the advisor's fiduciary duty to his client.

There is nothing wrong with disclosure, of course, but does it increase audit risk? A client may ask, "Why disclose if I don't have to?"

VII. MORE PENALTIES

Adding insult to injury, the new rules include a higher penalty imposed under Code §6694. Under the old law, if a tax return preparer knew (or reasonably should have known) of an undisclosed tax position that did not have a realistic possibility of being sustained (or if the position was disclosed, but was frivolous), the first-tier penalty was $250 per return. If the tax return preparer engaged in willful or reckless conduct in preparing the return, a second-tier penalty of $1,000 per return was levied upon the preparer.

The new law increases the first-tier penalty from $250 to the greater of $1,000 or 50% of the preparer's income from the preparation of the underlying return or claim. The new law also increases the second-tier penalty from $1,000 to the greater of $5,000 or 50% of the preparer's income from the preparation of the underlying return or claim.

The new penalties can be onerous. For example, suppose the tax preparer collects $800 in fees from the preparation of a tax return. If the return preparer knew or reasonably should have known of an undisclosed tax position that fails to meet the "more likely than not" standard, a penalty of $1,000 (the greater of $1,000 or 50% of the preparer's income) could be imposed. The penalty would swallow the preparer's fees whole.

VIII. STAY OF EXECUTION?

The new law is effective for tax returns prepared after May 25, 2007. However, in Notice 2007–54[17], the IRS relaxes this effective date for:

- all returns, amended returns, and refund claims due (with extensions) before 2008;
- 2007 estimated tax returns due by January 15, 2008; and
- 2007 employment and excise tax returns due by January 31, 2008.[18]

Notably, no transitional relief is available for return preparers who exhibit willful or reckless conduct.19

IX. UNCERTAIN FUTURE

There may be good reasons for tightening tax return preparer standards. Some tax return mills have engaged in conduct that is bound to generate an administrative and even Congressional response.[20] Yet, it is not clear that this is a sufficient explanation. Like the tax shelter era that also produced a Pavlovian response, here we have:

- heightened punishment for preparers;
- a higher standard for professional vs. do-it-yourself returns; and
- a more sweeping definition for who is a preparer.

This may produce an odd mix of incentives. I do not know if it will produce (or can be reasonably expected to

affect) taxpayer and tax professional behavior in positive ways. I do know it will prompt at least some tax professionals to look anew at their practices. Indeed, perhaps for the first time, some practitioners may attempt to consciously avoid the preparer label. Such preparer anathema may be to minimize both their own and their client's penalty exposure. Not only that, but it may also be designed to allow their clients to take positions on tax returns which the government has implicitly acknowledged taxpayers themselves may take, but on which preparers may not assist them.

That seems odd. Reversing a popular aphorism, the government now seems to say: "Try this at home."

ENDNOTES

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2. Also known by the somewhat less kitchen sink name, the Small Business and Work Opportunity Act of 2007.

3. Treas. Reg. §301.7701-15(a)(4).

4. See Treas. Reg. §301.7701-15(a)(ii).

5. Treas. Reg. §301.7701-15(a)(2).

6. Treas. Reg. §301.7701-15(a)(2)(i), (ii).

7. 2007-27 IRB 1, Doc 2007-13936, 2007 TNT 113-114 (June 11, 2007).

8. *Id*.

9. *Id*.

10. See, for example Jonathan Brenner, "New Standard for Tax Return Positions is Inappropriate," Volume 116, #7 T*ax Notes*, August 13, 2007, page 559. *See also* Edward G. Langer and Robert E. Meldman, "Penalties of the Small Business and Work Opportunity Tax Act of 2007," Taxes - The Tax Magazine, 85 Taxes 9 (September 2007). *See also* American Institute of Certified Public Accountants, Statement Submitted to Subcommittee on Oversight, Committee on Ways and Means. Public Hearing: IRS Operations, 2007 Filing Season, and Tax Gap (Mar. 20, 2007). *See also* CCH Tax Day Report: Federal, "New Return Reporting Standard Will Harm Practitioner-Client Relationship, National Association of Tax Professionals Tells CCH," Taxday, Item #M.2 (August 26, 2007).

11. *See* Treas. Reg. §1.6694-2(b). *See also* Circular 230 §10.34(d)(1).

12. *See* Treas. Reg. §1.6662-4(d)(2).

13. *See* IRC §6662.

14. *See* Treas. Reg. §1.662-4(d)(2).

15. *See* Treas. Reg. §1.6694-2(c)(2).

16. *See* Treas. Reg. §1.662-3(b)(3).

17. 2007-27 IRB 1, Doc. 2007-13936, 2007 TNT 113-114 (June 11, 2007).

18. *Id*.

19. *Id*.

20. *See* Tax Notes Today, "Grassley Says More Oversight Is Needed Of Tax Return Preparers", 2007 TNT 72-28 (April 12, 2007). *See also* Karla L. Miller, "Jackson Hewitt Under Investigation", 2007 TNT 109-3 (June 5, 2007).