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Am I a Return Preparer?

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Semantics play a particularly important role in 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 tax law are highly important. I believe that is truer today than it was 30 years ago when I embarked on 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 anywhere. Nonetheless, my concern today is with a rather simple rule (at least it *ought* to be simple): Who is a return preparer?

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 that such a literalist approach to the definition of return preparer is both inappropriate and inaccurate.

The U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007[1] was enacted on May 25, 2007. Before that date, the definition of the term ''income tax return preparer'' did not include preparers of non-income-tax returns such as gift, estate, excise, or employment tax returns. The new law redefined return preparer to refer to both income tax and other tax returns. The Treasury regulations have not yet been amended to reflect the change.

Section 7701(a)(36) generally defines a tax return preparer as any person who is compensated for preparing, or who employs one or more persons who are compensated for preparing, 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 tax professionals have 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 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 the case even if the person receives a gift or return service or favor.[2] Thus, I'll leave aside the category of return preparers that are not ''paid'' preparers.

Line-Item Advisers

I remember being taught as a young tax lawyer almost 30 years ago 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. That is still true today.[3] You can be a preparer without filling out forms.

Sensibly, the regulations attempt to deal with the notion of nonsigning return preparers, covering someone who gives advice about line items but doesn't prepare or sign returns. Reg. section 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 nonsigning 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 nonsigning preparers. The regulations state that a person who gives advice only on specific issues of law is generally not considered an income tax return preparer,[4] unless the advice is given after the transaction that the person is giving advice on 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.[5]

Accordingly, an adviser who gives legal advice on an item that will go on a return after the transaction was

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[1]Also known, somewhat more pithily, as the Small Business and Work Opportunity Act of 2007.

[2]Reg. section 301.7701-15(a)(4).
[3]*See* reg. section 301.7701-15(a)(ii).
[4]Reg. section 301.7701-15(a)(2).
[5]Reg. section 301.7701-15(a)(2)(i), (ii).

done, and before the return is filed, could be considered a nonsigning preparer. I should be clear that I have never before studied those provisions or 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.

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.

However, if I give advice that is short of the preparer standard, the client's tax position must have only 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 adviser and client, something that had never occurred to me before.

Although the regulations appear to clarify the definition of tax return preparer, it is important to remember that the regulations were promulgated before the amendments made by the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007. Those amendments raise questions regarding what activities represent the preparation of a tax return, who is a return preparer under section 7701(a)(36) as amended, and how the statute applies to both signing and nonsigning preparers.

Cognizant of the need for greater clarity in this area, the IRS has provided transitional relief in Notice 2007-54.[6] In the notice, the IRS states that it is considering whether other published guidance or new regulations are needed.[7] This might include amendments to various regulations (sections 301.7701-15 and 1.6694-0 through 1.6694-4).[8] 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.

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 to comply with the rules for return preparers, and what penalties apply to failures to meet those standards? The standards for tax return positions and their related penalties have changed significantly. Ostensibly, that 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 recent commentary recently suggests, it now appears that returns prepared by professionals are subject to higher standards than those completed by the taxpayer himself.[9] I want to focus primarily (if not exclusively) on the 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 clumsily 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 33⅓ percent likely to succeed.[10] "More likely than not" means more than 50 percent (but not necessarily as high as 51 percent).[11]

It might not sound like a whopping difference to go from 33⅓ percent to more than 50 percent, 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 be 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.[12] However, the regulations do not quantify the meaning of substantial authority. Instead, the regulations explicitly state that the substantial authority standard is less stringent than the more likely than not standard.[13] The following table may help lay out the menu.

[6] 2007-27 IRB 12, *Doc 2007-13936, 2007 TNT 113-114.*
[7] *Id.*
[8] *Id.*

[9] *See*, *e.g.*, Jonathan Brenner, "New Standard for Tax Return Positions Is Inappropriate," *Tax Notes*, Aug. 13, 2007, p. 559, *Doc 2007-16822, 2007 TNT 157-31*. *See also* Edward G. Langer and Robert E. Meldman, "Penalties of the Small Business and Work Opportunity Tax Act of 2007," 85 *TAXES — The Tax Magazine* 9 (Sept. 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 (Aug. 26, 2007).
[10] *See* reg. section 1.6694-2(b). *See also* Circular 230 section 10.34(d)(1).
[11] *See* reg. section 1.6662-4(d)(2).
[12] *See* section 6662.
[13] *See* reg. section 1.6662-4(d)(2).

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"More Likely Than Not"	>50% chance of success
"Realistic Possibility of Success"	>33⅓% 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"[a]

[a]*See* reg. section 1.6694-2(c)(2).

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 (they hope) avoid the 6662 penalty. Assuming the taxpayer has a reasonable basis[14] 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 percent 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 the treatment of paid return preparers and that of taxpayers? 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 are 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 for nondisclosure.

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

More Penalties

Adding insult to injury, the new rules include a higher penalty imposed under section 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 on the preparer.

The new law increases the first-tier penalty from $250 to the greater of $1,000 or 50 percent 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 percent 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 return 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 percent of the preparer's income) could be imposed. The penalty would swallow the preparer's fees whole.

Stay of Execution?

The new law is effective for tax returns prepared after May 25, 2007. However, in Notice 2007-54,[15] the IRS relaxes that 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.[16]

Notably, no transitional relief is available for return preparers who exhibit willful or reckless conduct.[17]

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.[18] 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 professionally prepared returns than for do-it-yourself returns; and
- a more sweeping definition of 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. That may be done to minimize both their own and their client's penalty exposure. Not only that, but it may also be

[14]*See* reg. section 1.6662-3(b)(3).

[15]Notice 2007-54, note 6 *supra*.

[16]*Id.*

[17]*Id.*

[18]*See* "Grassley Says More Oversight Is Needed of Tax Return Preparers," *Doc 2007-9510, 2007 TNT 72-28* (Apr. 12, 2007). *See also* Karla L. Miller, "Jackson Hewitt Under Investigation," *Doc 2007-13481, 2007 TNT 109-3* (June 5, 2007).

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designed to allow their clients to take positions on tax returns that 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.''

Respectfully disagreeable since 1970.

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