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TAX SECTION E-ALERT

June 11, 2007

New Preparer Penalty Legislation Affects Taxpayers and Practitioners

The "Small Business and Work Opportunity Tax Act of 2007" signed into law on May 25 contains return preparer penalty changes that will affect taxpayers and practitioners. See page 34 of the Joint Committee on Taxation [report](#) for an explanation of the penalty changes.

Preparer Penalty Standard Higher -- The act modifies the standards for avoiding preparer penalties for an understatement of tax. The current law *realistic possibility* standard for undisclosed positions is replaced with a requirement that the preparer have a reasonable belief that a position to be taken on a return would *more likely than not* be sustained on its merits. For disclosed positions, the provision replaces the *non-frivolous* standard with the requirement that there be a *reasonable basis* for the tax treatment of the position. The tax return preparer's reporting standard now exceeds the taxpayer's reporting standard (*substantial authority*) for most transactions. As a result, without disclosure, a tax return preparer could be subject to a section 6694 penalty for taking a position that the taxpayer could properly take without a penalty. The AICPA has opposed these changes and will continue to seek a remedy for this inconsistency in the penalty standards.

Penalty Applies to More Returns -- The act broadens the penalties to cover the preparation of estate and gift tax, employment tax, excise tax, and exempt organization returns.

Penalty Level Increased -- The act dramatically raises penalty amounts - the bill increases the section 6694(a) penalty (understatements due to unreasonable positions) from \$250 to the greater of \$1,000 or 50 percent of the income derived (or to be derived) from preparing the return or claim for refund. The legislation also increases the section 6694(b) penalty (willful or reckless conduct) from \$1,000 to the greater of \$5,000 or 50 percent of the income derived (or to be derived) from preparing the return or claim.

Analysis Required to Reach MLTN Standard -- In determining if a tax position satisfies the MLTN standard, all relevant authorities are taken into account, and the authorities supporting the position are weighed against the authorities contrary to the position. Because of the more clearly defined percentage test of the MLTN standard (more than 50% likely to succeed), practitioners may find the need for more analysis in order to reach an appropriate level of comfort for the MLTN standard. This may increase return preparation expenses and client fees.

Effective Date Issues -- The higher standards and penalties apply to returns prepared on or after May 25. Some 2006 returns will be subject to the old standard and some for the same type of taxpayer will be subject to the new standard, depending on when the return is prepared. Extended returns prepared on or after May 25 are affected, and amended returns will also be subject to the new rules, possibly for the

entire return. Practitioners should record when the return is prepared to know which standard applies—this may be uncertain for returns that were under preparation on the effective date of the change. The AICPA has had extensive discussions and has sent a [letter to Treasury](#) regarding the effective date issues. We expect clarification of effective date and transition issues shortly, possibly by the time you receive this, and we will cover the clarification in a subsequent E-Alert. Practitioners should discuss with clients any change in disclosures that may be required under the new standard that were not expected to have to be disclosed before the change.

Different Standards for Taxpayers and Practitioners -- In the past, the standard for undisclosed positions for return preparers (realistic possibility of success) was lower than the standard for taxpayers (substantial authority). Now, the preparer standard is higher. This may cause tension in the client relationship where a position lies between the two standards and the preparer wants the taxpayer to disclose a position that the taxpayer could properly take without disclosure if the preparer were not involved. These situations should be discussed with clients to avoid any misunderstandings. If the client won't disclose a position that does not satisfy the MLTN standard, to avoid the penalty, the a preparer would have to withdraw from the engagement before preparing a substantial portion of the return or forgo compensation so as not to be a preparer as defined in Section 7701(a)(36). Going forward, engagement letters may need to be modified to reflect understandings related to penalties and disclosures.

"Adequate Disclosure" -- The IRS has indicated that it will provide guidance shortly as to what constitutes adequate disclosure. Certain issues, for example, might be adequately disclosed on Schedule M-3.

E-Filing and Disclosures -- E-filed returns allow only limited disclosure. Until e-file programs are changed, hard-copy returns may have to be filed.

Forms and Instructions Not Yet Updated -- Various forms, instructions, and publications for the types of taxes that are subject to the new rules may not reflect the change in the penalty standard, so practitioners should exercise caution until these are updated.

SSTS No. 1 Under Review -- The AICPA's ethical standard for tax practice, Statement on Standards for Tax Services No. 1, reflects the realistic-possibility-of-success standard and is currently under review by a Tax Division Task Force. In the meantime, practitioners should be aware that they must also follow the higher Federal standard, where applicable, to avoid preparer penalties.

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