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It's not just 'income' anymore

by Donna M. Greenspan, J.D., Edwards Angell Palmer & Dodge LLP

On May 25, 2007, the president signed into law H.R. 2206, the Iraq emergency supplemental appropriations bill, which includes the Small Business and Work Opportunity Act of 2007.

The act provides small business tax relief in connection with an increase in the federal minimum wage. *It also increases the potential liability for income tax preparers and expands that liability to all tax return preparers.*

The new legislation broadens a tax return preparer's liability for the understatement of a taxpayer's liability in three respects. It:

1. Amends Section 6694 of the Internal Revenue Code to apply penalties to "tax return" preparers – not solely "income tax return" preparers as under the prior Code
2. Heightens the standard of conduct required to avoid Section 6694(a) penalties
3. Increases the amount of Section 6694(a) and (b) penalties

The amendments are effective for tax returns prepared after the date of the act's enactment, May 25, 2007.

Under the prior version of Section 6694, an "income tax return preparer" was defined as "any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any [income tax return] or any claim for refund of [income tax]." Under the act, Section 6694 penalties now apply to "any tax return preparer," defined as "any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by [the Internal Revenue Code] or any claim for refund of tax imposed by [the Internal Revenue Code]." Thus, tax return preparers subject to Section 6694 penalties now include preparers of estate and gift tax, employment and excise tax returns, as well as returns of exempt organizations.

Prior to the act, an income tax return preparer was liable under Section

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6694(a) for any part of any understatement of income tax liability with respect to a position: (1) that had no "realistic possibility" of being sustained on the merits; (2) of which the preparer knew or reasonably should have known; and (3) that was frivolous or was not disclosed as provided in section 6662(d)(2)(B)(ii) [i.e., by adequately disclosing the relevant facts affecting the item's tax treatment in the return or in a statement attached to the return].

Under the act, the Section 6694(a) penalty now applies where (1) the tax return preparer knew (or reasonably should have known) of the position; (2) there was not a "reasonable belief" that the position would "more likely than not" be sustained on its merits; and (3) the position was not disclosed as provided in section 6662(d)(2)(B)(ii) *or* there was no reasonable basis for the position.

Thus, for undisclosed positions, the Act replaces the "*realistic possibility*" standard with the more stringent requirement of a "*reasonable belief*" that the position was "*more likely than not*" the proper treatment. The new *reasonable belief* standard requires a fifty percent likelihood (i.e., "more likely than not") that the position would sustain a challenge. Pursuant to the *Code of Federal Regulations* – which has not yet been updated to reflect the change in law – a position has a *realistic possibility* of being sustained on its merits if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a *one in three*, or greater, likelihood of being sustained on its merits. Treas. Reg. § 1.6694-2(b)(1).

For disclosed positions, the act replaces the "*not frivolous*" standard with the requirement that there be a "*reasonable basis*" for the position. See Joint Committee on Taxation, *Technical Explanation of the "Small Business and Work Opportunity Tax Act of 2007" and Pension Related Provisions Contained in H.R. 2206 As Considered by the House of Representatives on May 24, 2007*, (JCX-29-07), May 24, 2007.

Both the current and former versions of Section 6694 provide for a defense from the subsection (a) penalty where it is shown that there is "reasonable cause" for the understatement and that the tax return preparer acted in good faith. In order to provide sufficient time to address issues pertaining to the implementation of the act, the Internal Revenue Service is providing certain transitional relief. See Notice 2007-54, *Preparer Penalty Provisions Under the Small Business and Work Opportunity Act of 2007*, Part III-Administrative, Procedural, and Miscellaneous.

The act did not impact the applicability of the Section 6694(b) penalty. Under both the current and pre-act versions of Section 6694, the subsection (b) penalty applies if an understatement of tax liability was due to the preparer's (1) "willful attempt" to understate tax liability; or (2) "reckless or intentional disregard" of rules or regulations.

In addition to heightening the standard required to avoid Section 6694(a) penalties, the act increased the amount of the penalty under both subsections (a) and (b). The act increased the Section 6694(a) penalty for unreasonable positions from \$250 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 a return or claim with respect to which the penalty was imposed. Further, the act increased the Section 6694(b) penalty for willful or reckless conduct from \$1,000 to the *greater* of \$5,000 or 50 percent of the income derived (or to be

derived) by the tax return preparer.

A tax return preparer can take certain steps to minimize the risk of being subjected to Section 6694 penalties. First, of course, the preparer should act in good faith and not attempt to understate tax liability or disregard the applicable rules and regulations. Second, the preparer should be certain that the tax position is grounded on a reasonable basis. Third, the preparer should disclose the position by including the relevant facts in the tax return or in a statement attached to the return.

Under both the prior and current law, disclosure under section 6694(a) is adequate if made on IRS Form 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement) attached to the return, amended return or refund claim. Form 8275 is used by taxpayers and income tax return preparers to disclose items or positions, except those taken contrary to a regulation, that are not otherwise adequately disclosed on a tax return. Form 8275-R is used by taxpayers and income tax preparers to disclose positions taken on a tax return that are contrary to Treasury regulations.

The following table provides a side-by-side comparison of Section 6694 before and after enactment of the Small Business and Work Opportunity Act of 2007.

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