

Study Unit Two

Tax Preparers and Penalties

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A tax return preparer does **not** have to be a practitioner (i.e., an enrolled agent, a CPA, an attorney, or any other person authorized to practice before the IRS) in order to prepare tax returns. Additionally, a tax return preparer is subject to Circular 230 **only if** (s)he is also a practitioner.

However, **all** tax return preparers are subject to preparer penalties. Preparer penalties include penalties for understatement of a taxpayer's liability due to unreasonable positions or willful or reckless conduct, for disclosing taxpayer information, and for promoting abusive tax shelters.

2.1 Tax Preparers

Defining Tax Return Preparer

A tax return preparer is any person who prepares for compensation, or employs one or more persons to prepare for compensation, all or a substantial portion of any return of tax or claim for refund under the IRC (Title 26).

- Preparation of certain information returns is also within the scope of the tax return preparer rules.

Unless stated otherwise, tax return preparers include the following persons:

- A person who furnishes to a taxpayer or other preparer sufficient information and advice so that completion of the return is simply a mechanical matter is considered a tax return preparer.
- **Substantial portion.** A tax return preparer is a person who prepares for compensation, or employs another who prepares for compensation, a substantial portion of an applicable return.
 - Preparation outside the U.S. is included.
 - Length and complexity of the portion (or a schedule) are compared to the return as a whole.

- **Insubstantial Portion**

- A portion or a schedule of a return is not considered substantial if it involves gross income, deductions, or amounts on the basis of which credits are determined of less than either
 - ▶ \$10,000 or
 - ▶ \$400,000 and less than 20% of the AGI (or GI if not an individual) shown in the return.
- A person who gives advice only on specific issues is generally not considered to be a tax return preparer.
- A tax return preparer of one return is not considered a preparer of another return because an entry or entries reported on the first may affect an entry reported on the second, unless the entries
 - ▶ Are directly reflected on the other return, e.g., a partnership and partner return, and
 - ▶ Represent a substantial portion of the second return. A substantial portion of the return includes gross income over \$400,000 or greater than 20% of the gross income of the return.

- **Primary responsibility.** If more than one tax return preparer is involved in preparing a return or claim for refund, the one with primary responsibility for the overall substantive accuracy is considered the (only) preparer for purposes of the signing requirement.

- The tax preparer with primary responsibility cannot be relieved of that responsibility by sharing any of the following functional tasks:
 - ▶ Acquiring needed information
 - ▶ Applying tax law
 - ▶ Completing the return
 - ▶ Reviewing the information, the application of tax law, and the return
 - ▶ Applying taxpayer policy
 - ▶ Advising a position regarding the law
 - ▶ Obtaining final determination or approval

- **Compensation.** If no compensation is provided for a person (or for his or her employee) to prepare a return or claim for refund, the person is not a tax return preparer.

- Absent an explicit or implicit agreement for compensation, a person is not a tax return preparer, even if (s)he receives a gift, return service, or favor.

A person can be a tax return preparer without regard to educational qualifications or professional status.

The following are not tax return preparers:

- An employee who prepares a return for the employer by whom (s)he is regularly and continuously employed
- A fiduciary who prepares a return or refund claim for any person (the trust)
- A person who prepares a refund claim in response to a notice of deficiency issued to another
- A person who furnishes typing, reproducing, or other mechanical assistance
- A person who merely gives an opinion about events that have not happened, i.e., planning

Mechanics of Preparing a Return

Significant aspects of tax return preparation are making factual inquiries and taking a position relative to tax law.

Inquiry of Client Financials

A tax return preparer may rely, if in good faith, upon information furnished by the taxpayer without having to obtain third-party verification.

- The preparer may not ignore the implications of the information furnished.
- The preparer must make reasonable inquiries if the information appears inaccurate or incomplete.
- **Deductions.** The preparer should make appropriate inquiries of the taxpayer to determine the existence of facts and circumstances required by an IRC section or regulations incidental to a deduction, including, e.g., substantiating documentary evidence, even if for a minimal amount.

Preparer's Position on Law

A tax return preparer may not adopt a position without **substantial authority** for the position.

- There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment.
 - What constitutes substantial authority is defined by statute and IRS statements.
 - ▶ A revenue ruling, for example, constitutes legal authority that, together with other authority, may be found substantial.
 - All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists.
 - The weight of authorities is determined in light of the pertinent facts and circumstances.
 - A tax return preparer may not rely on unreasonable assumptions.
 - There may be substantial authority for more than one position with respect to the same item.
 - A taxpayer's belief that there is a substantial authority for the tax treatment of an item is a subjective determination. It is important to note that the IRS definition of the substantial authority standard is an objective standard and this objective standard is the one the IRS holds tax return preparers to.
- A penalty will not apply if the position was disclosed and there is a reasonable basis for the position.

Substantial and Reasonable Belief

For tax shelters, tax preparers are required to have both substantial authority and a reasonable belief for their position and this belief must be "more likely than not" the proper treatment.

The penalty for unreasonable undisclosed positions is an amount equal to the greater of \$1,000 or 50% of the income derived from the position.

Errors and Omissions

Circular 230 addresses the possibility of an omission from a taxpayer's tax return in Sec. 10.21.

- It states that, when a practitioner discovers that a client has made an error or omission from any document filed with the IRS, (s)he must notify the client of the error or omission immediately.
- In addition, the practitioner must advise the client on the consequences of such an omission as provided by the IRC and regulations.

Procedural Requirements

Signature

A tax return preparer is required to sign the return or claim for refund after it has been completed and before it is presented to the taxpayer.

- If the preparer is unavailable for signature, another preparer must review the entire preparation of the return (or claim) and then must sign it.
- If more than one preparer is involved, the preparer with primary responsibility for the overall accuracy of the return or claim is considered the preparer for purposes of the signing requirement.
- A valid signature is defined by state law and may be anything that clearly indicates the intent to sign.
- Requirements exist for the use of alternative methods when signing as a tax return preparer and not on behalf of the taxpayer.
 - Original returns, amended returns, or requests for filing extensions that include a separate signature line for a paid tax preparer may be signed via computer software programs, mechanical devices, or rubber stamps.
- Preparers physically unable to manually sign returns must indicate "unable to sign" as the signature.
- In a situation in which one or more persons are employed as tax return preparers, only the employer is considered to be a tax return preparer.

Identifying Number

A return or refund claim prepared by a tax return preparer and filed with the IRS must include the preparer's identifying number.

- The identifying number of an individual is his or her preparer tax identification number (PTIN).
- The identifying number of the partnership or employer [employer identification number (EIN)], if applicable, also must be included.
- The address of the preparer's place of business where the return was prepared also must be included.
- The preparer is not required to sign or affix an identification number to the taxpayer's copy of a tax return.

Copy to Taxpayer

A tax return preparer is required to furnish a completed copy of the return or refund claim to the taxpayer no later than the time it is presented for the taxpayer's signature.

Employer of Preparers

A person who employs one or more tax return preparers is required to file a return setting forth the name, identifying number, and principal place of work of each employed tax return preparer.

- The IRS may approve an alternative reporting method.
- The requirements are satisfied if the tax return preparer
 - Retains a record of the information and
 - Makes it available for inspection upon request by the commissioner for the 3-year period following the relevant return period.
- A partnership is treated as the employer of the partners and shall retain and make available a record with respect to the employees (e.g., partners, others).
- A sole proprietor shall retain and make available a record with respect to himself or herself.

Records

A tax return preparer is required to retain a completed copy of each return or claim prepared for 3 years after the close of the return period.

- Records relating to employment taxes and federal withholding taxes must be maintained for at least 4 years after the later of (1) the due date of the tax or (2) the date such tax was paid.
- Alternatively, a list may be kept that includes, for the returns and claims prepared, the following information:
 - ✓ The taxpayers' names
 - ✓ Taxpayer identification numbers
 - ✓ Their tax years
 - ✓ Types of returns or claims prepared
- The return period means the 12-month period beginning July 1 each year.