

Legal Alerts

New ‘Bailout’ Law Bails Out More than Just Financial Institutions – More Likely Than Not Standard for Tax Return Preparers is Replaced by Substantial Authority Standard

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Garvey Schubert Barer Legal Update, October 7, 2008.

Section 506 of recently enacted H.R. 1424, The Emergency Economic Stabilization, Energy Improvement and Extension, and Tax Extenders and AMT Relief Acts of 2008 (the Act), modified the standard for tax return preparers under Internal Revenue Code (Code) Section 6694(a).

Prior Law - More Likely Than Not Standard. Under pre-Act law, the Code provided that a tax return preparer was liable for a penalty for which any part of an understatement of tax liability was due to an “unreasonable position.”

A position was “unreasonable” if all of the following applied:

- The tax return preparer knew (or reasonably should have known) of the position;
- There was not a reasonable belief that the position would more likely than not be sustained on its merits; and
- The position was not disclosed as provided in Code Section 6662(d)(2)(B)(ii), or there was no reasonable basis for the position.

The “more likely than not” standard required a greater than 50 percent likelihood, and was much stricter than the substantial authority standard that applied to the tax return preparer’s client for under Code Section 6662 with respect to substantial understatement penalties. Thus, tax return preparers were held to a higher standard than taxpayers for reporting questionable positions on a return. The above rules were the result of changes that were enacted by the 2007 Small Business Act (Pub. L. 110-28, May 25, 2007).

To provide guidance for preparers trying to adapt to the changes, the IRS provided interim rules effective as of: (1) Jan. 1, 2008, for all tax returns, amended tax returns, and claims for refund (other than 2007 employment and excise tax returns) filed after Dec. 31, 2007 for advice provided after Dec. 31, 2007; and (2) Feb. 1, 2008, for all 2007 employment and excise tax returns filed after Jan. 31, 2008 for advice

provided after Jan. 31, 2008. The IRS said tax return preparers may rely on the interim guidance until further guidance is issued, but noted also that the regulations expected to be finalized in 2008 might be substantially different from the interim rules and, in some cases, more stringent.

New Law - Substantial Authority Standard for Undisclosed Positions. The 2008 Act changes the standard for tax return preparers with respect to understatements due to unreasonable positions, described above. Under the Act, a position is “unreasonable” unless there is or was substantial authority for it. Code Section 6694(a)(2)(A).

New Law - Reasonable Basis Standard for Disclosed Positions. Under the 2008 Act, the standard for tax return preparers with respect to disclosed positions is the same as that of taxpayers - the position is unreasonable unless there is a reasonable basis for it. Code Section 6694(a)(2)(B).

Therefore, under the 2008 Act, the “more likely than not” standard has been replaced with the “substantial authority” standard for cases where disclosure is not made, and when disclosure is made, the reasonable basis standard determines whether the penalty applies. Thus, the new law eliminates the disparity between the standard for preparers under Code Section 6694 and taxpayers under Code Section 6662.

Tax Shelters and Reportable Transactions - More Likely Than Not Standard Retained. Under an exception to the above rules, if the position is with respect to a tax shelter as defined in Code Section 6662(d)(2)(C)(ii) or a reportable transaction to which Code Section 6662A applies, the position is unreasonable unless it is reasonable to believe that the position would more likely than not be sustained on its merits. Code Section 6694(a)(2)(C).

Effective Date: The changes made by the 2008 Act are generally effective for tax returns prepared after May 25, 2007. Essentially, the above rules retroactively repeal the “more likely than not” standard as of the date it was enacted, except in the case of tax shelters and reportable transactions.

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