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## Dramatic Change in Standards for Tax Advice

The IRS has issued proposed regulations that would modify the standards for tax advice given by tax practitioners and income tax return preparers. These proposed regulations reflect changes made to the return preparer penalty by the Small Business and Work Opportunity Tax Act ("Small Business Act"). These changes will be effective when the proposed regulations are finalized, but not earlier than January 1, 2008.

## The Small Business Act

The Small Business Act broadened and made tougher the return preparer rules. As part of this revision, the Act changed Code Sec. 6694(a) by:

- (1) Raising the minimum comfort level needed for an income preparer for signing a tax return without disclosure
- (2) Increasing the penalty amount for failing to comply with the provision

The Small Business Act significantly increased the penalty under Code Sec. 6694(b) for practitioners exhibiting willful or reckless conduct. In addition, the Small Business Act modified the definition of which practitioners must comply with the revised provisions.

Under revised Code Sec. 6694(a), a tax return preparer who prepares a return or refund claim for which any part of a tax liability understatement is due to an "unreasonable position" must pay a penalty for each return or claim. A position is "unreasonable" if: (1) the tax return preparer knew or reasonably should have known of the position; (2) there was no reasonable belief that the position would more-likely-than-not be sustained on the merits; and (3) the position was not adequately disclosed on the tax return. A position also is deemed "unreasonable" even if it is adequately disclosed on a tax return if the preparer did not have a reasonable basis for taking such a position on a tax return. This change in law replaces the realistic possibility standard (33%) disclosure

threshold with a significantly higher threshold. The more-likely-than-not standard means the tax practitioner must have an informed subjective belief that he or she is more than 50% certain that a position will be sustained (if challenged) before he or she can sign a tax return without disclosure. In addition, the revised penalty on the practitioner for failing to meet the Code Sec. 6694 requirements is now the greater of \$1,000 or 50% of the income derived (or to be derived) by the tax return preparer with respect to the return or claim. This change makes what was a relatively insignificant penalty amount (\$250/return) into a very significant one.

### **Proposed Regulations Under Circular 230 to Match Civil Penalty for Return Preparers**

The IRS has determined that the professional standards for attorneys and certified public accountants under Section 10.34 of Circular 230 should match the civil penalty standards for return preparers. Thus, the proposed regulations would amend these standards under Circular 230 to reflect the changes made to Code Sec. 6694 through the Small Business Act.

Under these proposed regulations, a practitioner cannot sign a tax return as a preparer unless he or she has a reasonable belief that the tax treatment of each position on the return will more likely than not be sustained on its merits, or there is a reasonable basis for each position and each position is adequately disclosed to the IRS. A practitioner cannot advise a client to take a position on a tax return, or prepare portions of a tax return on which a position is taken, unless:

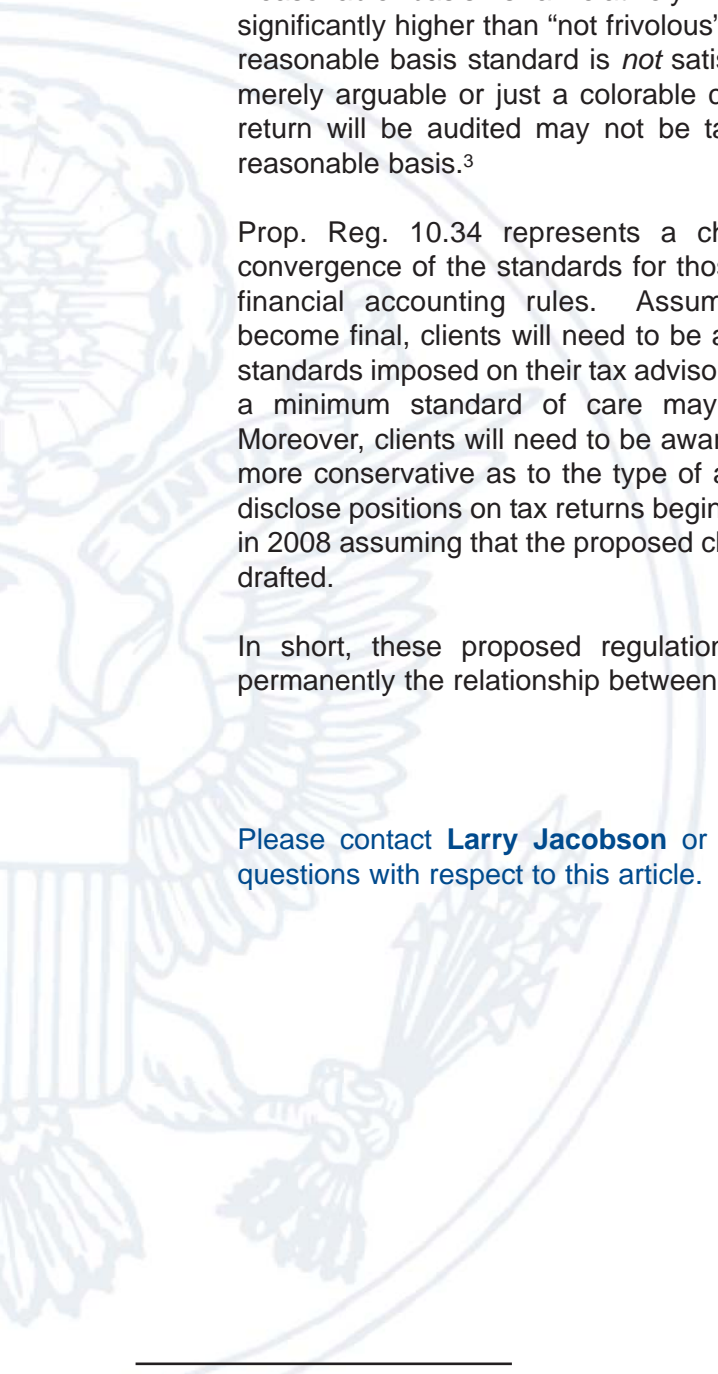
- (1) the practitioner has a reasonable belief that the position satisfies the more-likely-than not standard; *or*
- (2) the position has a reasonable basis *and* is adequately disclosed to the IRS.<sup>1</sup>

The more-likely-than-not standard is met if the practitioner analyzes the pertinent facts and authorities, and based on this analysis, reasonably concludes, in good faith, that there is a *greater than 50%* likelihood that the tax treatment will be upheld if the IRS challenges it.<sup>2</sup>

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<sup>1</sup> Prop. Reg. 10.34(a).

<sup>2</sup> Prop. Reg. 10.34(e)(1).



The “reasonable basis” standard is met if it is reasonably based on one or more of the authorities described in Treas. Reg. 1.6662-4(d)(3)(iii). Reasonable basis is a relatively high standard of tax reporting, significantly higher than “not frivolous” or “not patently improper.” The reasonable basis standard is *not* satisfied by a return position that is merely arguable or just a colorable claim. The possibility that a tax return will be audited may not be taken into account in assessing reasonable basis.<sup>3</sup>

Prop. Reg. 10.34 represents a change based on the growing convergence of the standards for those rendering tax advice and the financial accounting rules. Assuming the proposed regulations become final, clients will need to be aware of the higher duty of care standards imposed on their tax advisors. Tax advisors who fail to meet a minimum standard of care may be subject to IRS sanction. Moreover, clients will need to be aware that their tax advisors may be more conservative as to the type of advice given and/or the need to disclose positions on tax returns beginning with their 2007 returns filed in 2008 assuming that the proposed changes are finalized as currently drafted.

In short, these proposed regulations have the potential to alter permanently the relationship between tax advisors and their clients.

Please contact **Larry Jacobson** or **Robert Pluth** if you have any questions with respect to this article.

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<sup>3</sup> Prop. Reg. 10.34(e)(2).

Our tax attorneys advise clients on the federal, state, local and foreign tax aspects of their business and investment activities. We counsel in the structuring of complex business transactions including mergers and acquisitions, reorganizations, other business combinations and restructurings, financing transactions (including leveraged leases and sale-leasebacks), joint ventures, and private equity and investment funds. We also assist in the implementation of affirmative tax planning opportunities such as the choice of business entity, the award of equity-based compensation for services rendered to businesses including LLCs, tax-deferred exchanges and maximizing the use of foreign tax credits. We also counsel businesses in connection with FIN 48 tax disclosure issues.

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