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To Our Clients and Friends:

Re: Tax Act Raises Standard for Tax Return Positions

The enactment of the Small Business and Work Opportunity Tax Act of 2007 (the "2007 Tax Act") on May 25, 2007, effectively raised the standard for what constitutes appropriate tax advice and can be expected to result in more conservative tax advice from attorneys and accountants. This change was accomplished by amending the income tax return preparer penalty imposed under Section 6694 of the Internal Revenue Code of 1986, as amended (the "Code"). The amended provision (i) extends the scope of the tax return preparer penalty beyond income tax returns to all federal tax returns, (ii) alters the standard of conduct that must be met by a tax return preparer to avoid the imposition of the penalty and (iii) increases the amount of the tax return preparer penalty. The amended return preparer penalty is applicable to returns prepared after May 25, 2007. The legislation does not specify when a return is considered to have been "prepared."

The following is a general description of the return preparer penalty rules prior to their amendment by the 2007 Tax Act ("Former Section 6694") and subsequent to their amendment by the 2007 Tax Act ("Amended Section 6694"):

Former Section 6694. Former Section 6694, which applies to federal income tax returns prepared on or before May 25, 2007, imposes a penalty on an income tax return preparer who prepared a return with respect to which there was an understatement of the taxpayer's tax liability if such understatement resulted from a tax position which (i) did not have a realistic possibility of being sustained on its merits, (ii) was known (or reasonably should have been known) to the return preparer and (iii) was not disclosed or was frivolous. Treas. Reg. §1.6694-2(b) provides that a position is considered to have 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 person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits. The amount of the return preparer penalty under Former Section 6694 is \$250 for each such return. Former Section 6694 also imposes a \$1,000 penalty on income tax return preparers with respect to understatements of tax liabilities if such preparer acted willfully or with reckless or intentional disregard for the rules in preparing a return based on the position.

Amended Section 6694. Amended Section 6694, which is applicable to federal tax returns prepared after May 25, 2007, altered Former Section 6694 in several respects.

1. Whereas Former Section 6694 applied only to “income tax return preparers,” Amended Section 6694 applies to “tax return preparers” which, as defined by amended Code Section 7701(a)(36), includes any person who prepares for compensation any federal tax return. Thus, Amended Section 6694 applies to preparers of federal estate and gift tax returns and employment tax returns, among others, as well as to preparers of income tax returns. Note that, as was the case under Former Section 6694, the definition of a “preparer” for this purpose is not necessarily limited to the person who signs the return.

2. Most significantly, Amended Section 6694 also replaced the *realistic possibility* standard with a requirement that there be a reasonable belief that the position would *more likely than not* be sustained on its merits. That is, the penalty can now be avoided only if the preparer believes that it is *more likely than not*, rather than *a realistic possibility*, that the undisclosed tax position resulting in the understatement would be sustained on its merits. Thus, the standard that must be met with respect to the potential sustainability of positions taken on tax returns has been raised from a likelihood of at least one in three to a likelihood of greater than one in two.

The significance of this change should not be underestimated. While Section 6694 applies specifically only to “return preparers,” it has long been the standard by which tax advisors have distinguished between what constitutes appropriate tax advice and which constitutes overly aggressive advice. Imposing a “more likely than not” standard, which can be difficult to meet in many situations in which the tax law is underdeveloped, is likely to result in more conservative tax advice from practitioners.

Note that the standard applicable to whether the taxpayer is subject to penalties with respect to a substantial understatement of income tax under Section 6662 has not changed. The taxpayer can still avoid penalties with respect to federal income tax returns by having “substantial authority” for a position, which is a lower standard than “more likely than not.” This divergence between the standards applicable to taxpayers and their return preparers may create tensions in client relationships.

3. The higher standard of practice is coupled with a higher penalty. The amount of the penalty imposed under Amended Section 6694 was increased from \$250 per return to the greater of (i) \$1,000 or (ii) 50% of the income derived by the preparer with respect to the return. The penalty for understatements due to willful or reckless conduct of the preparer was increased from \$1,000 per return to the greater of (i) \$5,000 or (ii) 50% of the income derived by the preparer with respect to the return.

Please let us know if you wish to discuss Amended Section 6694 in greater detail.

This memorandum is not intended as advice of a type which may be relied upon and, therefore, may not be relied upon, for the purpose of avoiding penalties which may be imposed pursuant to U.S. tax law.