
MEMORANDUM

RE: **UNREPORTED INCOME (IRS):** UNDERSTATEMENT OF TAX
 LIABILITY (TAX PREPARER PENALTIES)

DATE: NOVEMBER 28, 2007

1. Tax Understatement Penalty (Pre 5/26/07)

For income tax returns prepared prior to May 26, 2007, a preparer is subject to a \$250 penalty (for each understatement of tax liability on a tax return or refund claim he prepared) if the understatement:

- a. Was caused by a position that did not have a realistic possibility of being sustained on its merits,
- b. The preparer knew or should have known of the position, and
- c. The position was not disclosed or was frivolous (IRC § 6694, prior to amendment by Pub.L. 110-28, the Small Business and Work Opportunity Act of 2007, Section 8246(b)).

2. Tax Understatement Penalty (Post 5/25/07) IRC § 6694

Under IRC § 6694, effective after May 25, 2007, a tax preparer may be subject to a penalty for each understatement of tax liability on a tax return (or refund claim) he prepares if the understatement results from a tax return position in which the preparer did not have a reasonable belief the tax treatment was more likely than not the proper treatment.

If the preparer can not meet the more likely than not standard but has at least a reasonable belief for the position, the preparer may avoid the penalty for an understatement of tax by specifically disclosing the position taken on the tax return.

If the preparer cannot demonstrate at least a reasonable basis for the position, specific disclosure of that position will not insulate the preparer from the understatement penalties (IRC § 6694(a)(2))

Penalty (\$1,000/50% Income)

The amount of the penalty is the greater of:

- a. \$1,000 or
- b. 50% of the income derived from the preparation of the tax return (the penalty is not imposed if the understatement is due to reasonable cause)

3. Willful Tax Understatement

Penalty (\$5,000/50% Income)

- a. Willfully understates liability for a return (or refund claim), or
- b. The understatement is caused by the preparer's reckless or intentional disregard of rules or regulations,
- c. For willful or reckless conduct the penalty is equal to the greater of \$5,000, or 50% of the income derived by the tax return preparer from the preparation of the return or claim with respect to which the penalty is imposed (IRC § 6694(b)(1))

Both tax understatement penalties: \$1,000 or \$5,000 cannot be imposed with respect to the same tax return (or refund claim) (IRC § 6694(b)(3))

An understatement of liability for the purpose of these penalties is any understatement of the net amount of tax payable or any overstatement of the net amount of such taxes that may be credited or refunded.

Any understatement is not reduced by any carryback. (Treas. Reg. Section 1.6694-1(c)).

The preparer generally may rely in good faith without verification upon information furnished by the taxpayer. The preparer does not have to audit, examine or review books and records, business operations, or documents or other evidence to verify independently the taxpayer's information. The preparer must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete. The preparer must inquire to determine whether a claimed deduction is supported by any facts and circumstances that the tax laws require as a condition to claiming the deduction. (Treas. Reg. Section 1.6694-1(e)).

The understatement penalty is an assessable penalty that is due after notice and demand from the IRS. However, unless the statute of limitations may expire without adequate opportunity for assessment, the IRS will send, before assessment the penalty, a 30-day letter to the preparer notifying the preparer of the proposed penalty and the opportunity of the preparer to request a review of the proposed assessment by IRS Appeals. (Treas. Reg. Section 1.6694-4(a)(1)).

The penalty may not be challenged in Tax Court prior to payment of the penalty because the deficiency procedures do not apply. (IRC § 6696(b)). However, a special procedure allows preparers to sue for a refund of an understatement penalty without having to pay the full amount of the penalty. A preparer may, within 30 days after the day that the IRS demands payment of the penalty, pay at least 15 percent of the penalty and file a refund claim for the amount paid. (IRC § 6694(c)(1)).

If the refund claim is denied, the preparer may, within 30 days after the denial file a refund suit. The suit may also be filed within 30 days of after six months have passed since the filing of the claim if the claim has not been denied by that time. (IRC § 6694(c)(2)).

The IRS can counterclaim for the remainder of the penalty in the refund suit. The IRS cannot levy or begin a court proceeding to collect the remainder of the penalty until the final resolution of the refund suit.

A court may enjoin the IRS from levying or beginning a collection proceeding during this period. (IRC § 6694(c)(1)). If the preparer does not begin a refund suit within the time allowed, the restrictions on IRS collection action expire on the day after the last day that the suit could have been filed. (IRC § 6694 (c)(2)). The running of the period of limitations for collecting the penalty is suspended for the period that the IRS is prohibited from collecting the penalty. (IRC § 6694(c)(3)).

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