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Small Business Tax Act: Tax Revenue Provisions

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In the September 2007 column, we discussed The Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28, Small Business Act) by concentrating on the key tax relief provisions for taxpayers. This article continues our discussion by exploring the revenue-raising provisions, including the age increase for the "kiddie" tax, permanent extension of IRS user fees, increase in penalties for bad checks and tax return preparer understatement of a taxpayer's liabilities, and the imposition of penalties for filing erroneous refund claims.

Kiddie Tax

The "kiddie" tax refers to the special rules that apply to the net unearned income of certain children. Generally, the kiddie tax applies to a child if:

1. The child is under age 18 by the end of the 2006 tax year (under age 14 for tax years prior to 2006) and either of the child's parents is alive at such time;

2. The child's unearned income exceeds $1,700 (for 2007); and

3. The child does not file a joint return.

The kiddie tax applies regardless of whether the child may be claimed as a dependent by either or both parents. Under these rules, the child's net unearned income exceeding $1,700 in 2007 is taxed at the parents' tax rates if their rates are higher than the child's tax rates. For these purposes, unearned income is income other than (1) wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered and (2) the distribution from qualified disability trusts. The remainder of the child's taxable income (i.e., all earned income plus any unearned income up to $1,700 less the child's standard deduction) is taxed at the child's rates. Under certain circumstances, a parent may elect to report a child's unearned income on the parent's return (see the December 2006 column for an in-depth discussion).

So how can the kiddie tax be made worse? How about by expanding it to apply to children who are 18 and under or are full-time students over 18 but under 24 years old? Beginning in tax years after May 25, 2007 (2008 for calendar year taxpayers), the new age limits apply. Looks like the kiddie tax needs a new nickname—maybe "kiddie/teenager/young adult tax"!

IRS User Fees

Sometimes it becomes necessary for a taxpayer to request the IRS to rule on a tax issue before the taxpayer takes certain action. This is known as a letter ruling. Currently, the IRS charges a fee for a letter ruling—as well as for determination letters, opinion letters, or other similar rulings or determinations. Until the Small Business Act was signed into law, the IRS was authorized by statute to charge a user fee for these services through September 30, 2014. The new provision, however, permanently extends the statutory authorization for IRS user fees.

Penalty Increases

Bad Checks: Under present law, IRC §6657 imposes a penalty for any individual who tenders a bad check or money order to the IRS. The penalty is 2% of the amount of the bad check or money order. The minimum penalty for items less than $750 is $15. If the check or money order is less than that, the penalty is equal to the amount of the check. The new provision became effective after May 24, 2007, and increased the minimum penalty to $25. This new provision is applicable to checks and money orders under $1,250.

Tax return preparer understatement of a taxpayer's liabilities: A tax preparer is defined as a person who prepares or who employs others to prepare all or a substantial portion of an income tax return or a claim for refund for compensation. It should be noted that, for this purpose, "income tax return" doesn't include nonincome tax returns such as estate, gift, excise, or employment. Under present law, if a tax preparer prepares a tax return that understates the tax liability because of an "undisclosed position for which there was not a realistic possibility of being sustained on its merits, or a frivolous position," then the preparer is subject to a $250 penalty (referred to as a first-tier penalty) provided that the preparer knew of the position or *reasonably* should have known of the position. On the other hand, if a tax preparer prepares a return and engages in specified willful or reckless conduct with respect to preparing an income tax return, then the tax preparer is liable for a $1,000 penalty (referred to as a second–tier penalty). For purposes of the penalty, an understatement is generally defined as any understatement with respect to *any* tax imposed by subtitle A (i.e., income taxes).

It's looks like the kiddie tax needs a new nickname.

The Small Business Act extends the penalties to now include preparers of estate and gift tax, employment tax, and excise tax returns and exempt organization returns. The new provision also increases the amount of penalties that may be imposed. The first-tier penalty is increased to the greater of $1,000 or 50% of the income derived by the tax return preparer from the preparation of the return or claim for which the penalty is being imposed. The second-tier penalty increases 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 for which the penalty is being imposed.

More importantly, the new tax act alters the standards of conduct that must be met to avoid the penalties for preparing a return with an understatement of tax. First, the provision replaces the "realistic possibility" standard for undisclosed positions with a requirement that there be a reasonable belief that the tax treatment of the position was "*more likely than not*" the proper treatment. The provision also replaces the not-frivolous standard accompanied by disclosure with the requirement that there be a reasonable basis for the tax treatment of the position accompanied by disclosure.

Many tax preparers believe this provision raises a potential conflict of interest for them. According to Tom Ochsenschlager, vice president-taxation at the American Institute of Certified Public Accountants (AICPA), "The new provision puts tax preparers in a position of supporting the IRS rather than their taxpayer clients" (www.aicpa.org/mediacenter, July 13, 2007). This conflict of interest "…consequently affects the nature of taxpayers' representation," Ochsenschlager said. In order to protect themselves from penalties, tax preparers may feel a necessity to include disclosures for virtually every item on the tax return for which there is uncertainty regarding the proper treatment. Talk about overburdening the administration!

Filing erroneous refund claims: IRC §6662(b)(3) and (h) impose accuracy-related penalties on a taxpayer in cases involving a substantial valuation misstatement or gross valuation misstatement relating to an underpayment of tax. For this purpose, a substantial valuation misstatement generally means a value claimed that is at least twice (200% or more) the amount determined to be the correct value, and a gross valuation misstatement generally means a value that is at least four times (400% or more) the amount determined to be the correct value.

As provided in the Committee reports, the penalty is 20% of the underpayment of tax resulting from a substantial valuation misstatement, rising to 40% for a gross valuation misstatement that exceeds $5,000 ($10,000 in the case of a corporation other than an S Corporation or a personal holding company). Under present law, no penalty is imposed with respect to any portion of the understatement attributable to any

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[TAXES] *cont'd from p. 10*

item if (1) the treatment of the item on the return is or was supported by substantial authority or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return and there is a reasonable basis for the tax treatment. Remember, special rules apply to tax shelters.

The provision imposes a penalty on any taxpayer filing an erroneous claim for a refund or credit. The penalty is equal to 20% of the disallowed portion of the claim for refund or credit for which there is no reasonable basis for the claimed tax treatment. The penalty doesn't apply to any portion of the disallowed portion of the claim for refund or credit relating to the earned income credit or any portion of the disallowed portion of the claim for refund or credit that is subject to accuracy-related or fraud penalties.

The Small Business Act provides many tax relief provisions, but it also provides for some "meaty" revenue sources. The important question when evaluating new tax provisions is, "Am I getting more money in my pocket, or am I putting more money in the IRS's pocket?" So which way does the scale tilt for you? ■

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