

‘BLAME THE TAX PREPARER’ DEFENSE SHOT DOWN

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Taxpayers received a Form 1099-MISC reporting \$3.4 million in income. This income item never made it to the income tax return. The IRS noted the missing item and assessed tax on it, and an accuracy-related penalty under Code §6662(a) of \$104,295. That Code section imposes a 20% penalty on substantial understatements of income tax.

The taxpayers had engaged a specialty firm to prepare their income tax return. The return was over 115 pages long, and involved the integration of 160-plus information returns.

Code §6664(c)(1) overrides the above accuracy-related penalty if the taxpayer can show reasonable cause for the underpayment. In the instant case, the taxpayers claimed reasonable reliance on their tax preparer to show reasonable cause.

The Regulations allow reliance on “professional advice” to constitute reasonable cause if such reliance was reasonable and the taxpayer acted in good faith. Nonetheless, the Tax Court did not permit the IRS to use this reasonable cause exception.

The problem for the taxpayers was that “advice” is defined in the Regulation. To constitute “advice,” the advisor must reflect the adviser’s “analysis or conclusion.” No evidence was offered that the advisor conducted any analysis or provided any substantive advice on the item that was omitted. Instead, it just appeared to be a clerical omission. Thus, reliance on “professional advice” was not allowed to avoid the penalty.

The Regulations also note that an isolated computational or transcriptional error is not inconsistent with reasonable cause. There are cases that support the defense when an item is unintentionally left off the return by a third party preparer. However, a number of items conspired to disallow such a defense in this case, including a taxpayer’s duty to conduct a reasonable review of the return to assure all income items are reported. All of

these were noted by the Tax Court, so it is uncertain what the result would be if some of them were absent:

- a. It was assumed that the omission was a computational or transcriptional error, but no evidence was submitted to support that.
- b. The large dollar amount of the omitted item raises questions whether the taxpayers conducted a reasonable review of the return. This amount was both large in amount and in the percentage of income omitted.
- c. The omitted income item was specifically and intentionally triggered by one of the taxpayers during the tax year.
- d. The taxpayers could not remember how much time and effort they put into reviewing the return.
- e. One of the taxpayers had the knowledge and general sophistication to have been able to notice the missing item.

Stephen G. Woodsum, et ux. v. Commissioner, 136 T.C. No. 29, 06/13/2011

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