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Small-Business Owners Fret Over Large IRS Fines

By LAURA SAUNDERS

Five years ago, car-wash owner Orman Wilson set up a pension plan for himself and six employees. For that, he may owe the IRS a \$1.2 million tax penalty.

Mr. Wilson, the owner of 19 coin-operated car washes in Houston, says he relied on four advisers, including a certified public accountant, to set up a plan that received approval from the Internal Revenue Service. Then, in late 2007, the IRS found fault with the plan and assessed it \$250,000 -- plus special penalties of \$1.2 million.

The penalties "would wipe us out," Mr. Wilson says.

Hundreds of small-business owners have been hit with similar penalties in connection with pension or benefit plans, says Alex Brucker of the Small Business Council of America, an association representing small firms on pension, tax and health-care issues. Hundreds more are likely to get hit with these penalties in the near future, he says.

All are anxiously awaiting relief from Congress, where alarm about the penalties' impact came to a head this summer. In June, Senate Finance Committee leaders Charles Grassley and Max Baucus issued statements saying they hope to change the law that mandated the fines. They also asked the IRS to stop collections of the penalties because they were threatening to throw small-business owners like Mr. Wilson into bankruptcy. In July, the agency agreed.

But new laws have yet to appear, and the IRS's moratorium on penalty collections expires Sept. 30. An agency spokesman says only that an extension is "under review." Meanwhile, the IRS has continued to audit firms and assess the penalties. It also is imposing liens.

The source of the distress: tax-law changes made by Congress in 2004. At the time, lawmakers were worried that tax shelters, especially from large corporations, were costing the Treasury billions in revenue. To combat it, they imposed enormous fines on taxpayers who failed to tell the IRS of participation in any transaction the agency might consider a tax shelter.

"The fines are not for the shelter itself," says Mr. Brucker, "but merely for failing to file the form disclosing the transaction."

The penalty is \$100,000 per offense, per year for individuals and \$200,000 for businesses. In order to put teeth into the law, the provisions gave the IRS no leeway in imposing the fines and taxpayers no way to get them reviewed in Tax Court.

As drafted, they hit small businesses particularly hard because their entities of choice, Subchapter S and Limited Liability Companies, can incur both corporate and individual fines for every infraction.

National Taxpayer Advocate Nina Olson, an IRS employee charged with protecting taxpayers' rights, has said the fines "have the effect of bankrupting middle-class families who had no intention of entering into a tax shelter."

Many of the small firms now facing huge fines incurred them in connection with customized defined-benefit pension plans that allow older taxpayers to make large contributions. Other business owners set up plans to fund health and life insurance, health and welfare plans that the IRS deemed to be abusive shelters.

All these plans were funded with cash-value life-insurance policies. And the owners relied on experts, who often received commissions, to help them through the maze of laws and certify that the plans were correct.

In the case of the pension plans, the owners took comfort from IRS "determination letters" giving initial approval to the plans. What they didn't understand was that the IRS's approval was only a partial blessing.

IRS staffers later determined, using complex formulas, that the plans were overfunded, meaning the owners put in too much life insurance even for the law's generous limits. That landed the plans on the IRS list of abusive tax shelters.

That designation triggered the huge penalties for those who didn't file the annual form, even if the taxpayer owed a much smaller amount of tax. "Finding \$60,000 for extra tax is hard enough, but I'm facing up to \$900,000 in penalties, and there's just no way," says Michael Forristal, who owns a steel-fabrication firm in Salina, Kan., with 10 employees.

The law also imposes full fines on taxpayers who misfile their IRS notification form. A Baltimore physician faces a \$400,000 fine for failing to notify the IRS of a transaction on his individual return, even though he fully disclosed it on his business return. "There was nothing hidden here," he says.

Many firm owners maintain that they had no idea the arrangements were shelters. "My partner and I thought we were providing a retirement plan for ourselves and eight employees," says Gregory Biddulph, an orthopedic surgeon in Idaho Falls, Idaho, whose plan faces penalties of more than \$1.8 million. "It was vetted by three advisers and the IRS. We would never have gone into it if we thought it was a tax shelter."

Some affected taxpayers have filed lawsuits naming life insurers and advisers who sponsored and sold these plans, including American General Life Insurance Co., Indianapolis Life Insurance Co., Pacific Life Insurance Co., and Hartford Life & Annuity Insurance Co.

All the insurers declined to comment except Hartford, which said the suits have "no merit" and that it would defend itself vigorously.

Congress is looking at proposals to allow judicial review of the penalties, give the IRS some discretion in imposing them, and make penalties more proportional to the infraction, among other things. Changes would be retroactive, meaning the affected business owners would come under the new rules.

Attorney Kathleen Barrow of Jackson Lewis in Houston, who is representing more than 100 taxpayers before the IRS, says clients remain "scared to death" the IRS won't extend its moratorium and that law changes will fall through the cracks. Lately the agency has been making more settlement offers, she says, "but my clients can't even afford to pay 60% of the penalties."

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