Current Federal Tax Developments

Nichols Patrick CPE, Incorporated

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SECTION: 61
DUTY OF CONSISTENCY REQUIRES TAXPAYER TO PICK UP INCOME IN "WRONG" YEAR ONE LAST TIME

Citation: Squeri, et al v. Commissioner, TC Memo 2016-116, 6/15/16

The IRS discovered that an S corporation had been "holding back" a large number of checks received in the fourth quarter of its tax year and not depositing them until January of the following year and, not surprisingly being on the cash basis of accounting, not reporting that income until it was deposited in the bank account. Given that the income was constructively received in the earlier year, the IRS issued notices of deficiency that required the taxpayers to pick up that income in the earlier year.

However while the IRS removed the January deposits that were from checks received in the prior year in two of the three years for which it issued notices, the IRS left the January deposits in gross receipts for the first year under exam. The taxpayers in *Squeri, et al v. Commissioner*, TC Memo 2016-116 protested that the IRS could not do that.

Of course the IRS didn't remove the January deposits in the first year under exam (2009) because those checks, received in 2008, had not been reported in 2008 and the statute for assessing tax against 2008 was closed by this time. The taxpayers, of course, took the position that was just tough luck for the IRS.

However the IRS argued that even though the income was not properly included in 2009 generally, the taxpayers had to include it under the doctrine of the duty of consistency. The taxpayers had incorrectly asserted that the income was not taxable in 2008 but rather in 2009, thus they could not now take advantage of the statute to now gain an advantage by making use of the correct interpretation of the law.

The Tax Court noted that the Ninth Circuit Court of Appeals, to whom this case would be subject to appeal, had outlined the following standards that must be me for the doctrine of consistency to require a taxpayer to maintain a consistent position on a particular item despite that position being contrary to the law:

> The Court of Appeals for the Ninth Circuit has held that for the duty of consistency to apply, the following requirements must be met: (i) a representation or report by the taxpayer, (ii) reliance by the Commissioner, and (iii) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the Commissioner. *Estate of Ashman v. Commissioner*, 231 F.3d at 545. If all those elements are present, the Commissioner may act as if the previous representation, on which he relied, continues to be true, even if it is not. Id. The taxpayer is estopped to assert the contrary.

The taxpayers argued that although they had made a representation, they had done so consistently and argued that the case of *Rivers v. Commissioner*, 49 TC 663 (1968) held for the position they did not need to report the income.

The Tax Court did not agree:

In *Rivers* the taxpayer transferred assets to two corporations in exchange for shares of stock and promissory notes. The corporations made payments on the notes, but the taxpayer did not include any portion of the principal payments on the notes in his tax returns for 1951 through 1960. The Commissioner argued that the taxpayer should be required to report the income under the duty of consistency and the payments should be construed such that all of the early payments, made during years that were not at issue in the case, were payments for the recovery of basis in their entirety, rather than prorating the basis among all of the payments. *Id.* at 667.

We stated that the duty of consistency requires the taxpayer to take a consistent position with regard to a similar transaction for different tax years. We reasoned that the taxpayer had taken a consistent position with respect to the notes for all of the tax years. *Id.*

Rivers is distinguishable from the instant cases because we are not being asked to reach a conclusion that conjures a scenario. In *Rivers* the taxpayer failed consistently to report income from the notes and the Commissioner asked that we disregard the consistency of his reporting. In the instant cases petitioners consistently reported income on the basis of their bank deposits, and respondent is asking that we hold them to this consistent reporting.

Rather the Court the case more analogous to that found in the case of *Estate of Ashman v. Commissioner*, 231 F.3d 541 where a taxpayer attempted to argue that even though she took the position that a distribution had been rolled into an IRA in a closed year, that later when she took a distribution it should not be taxed in that year because, in fact, the transaction in the closed year had not met the requirements for a rollover. In that case the taxpayer was required to report the income in the year of the distribution to be consistent with her prior reporting.

The Court also found that the IRS had relied upon the taxpayers' representation that the income was not taxable in 2008, but rather 2009, when it accepted the 2008 tax returns and, as well, that their position now that the income was properly reportable in 2008 was a change in position—thus all three prongs of the test being met, the income for the checks received in 2008 but deposited in 2009 had to be recognized in 2009, consistent with the taxpayers' prior practice.

SECTION: 139F
IRS RELEASES GUIDANCE ON EXCLUSION FOR WRONGFUL INCARCERATION DAMAGES

Citation: IR-2016-88, 6/16/16

The IRS has released information regarding how taxpayers who received payments for wrongful incarceration that Congress retroactively made not subject to income tax as part of the Protecting Americans from Tax Hikes Act of 2015. The IRS issued both a news release (IR-2016-88) and a set of frequently asked questions regarding new IRC §139F.

The new provision provides for an exclusion from income for "any civil damages, restitution, or other monetary award" related to incarceration of an individual for a "covered offense" for which the taxpayer was convicted.

A covered offense is "any criminal offense under Federal or State law" which represents a broad definition. Wrongful conviction under IRC §139F(b) is defined as:

- Who was convicted of a covered offense,
- Who served all or part of a sentence of imprisonment relating to that covered offense, *and*
    - Who was pardoned, granted clemency, or granted amnesty for that covered offense because that individual was innocent of that covered offense, *or*
    - For whom the judgment of conviction for that covered offense was reversed or vacated, *and*
    - For whom the indictment, information, or other accusatory instrument for that covered offense was dismissed or who was found not guilty at a new trial after the judgment of conviction for that covered offense was reversed or vacated.

Congress also provided that, regardless of when the taxpayer received this income, a claim for refund may be filed up to one year after the date of enactment (December 18, 2015) even though the statute for claiming a refund on the year would otherwise be closed. [Act Section 304(d)]

The new guidance indicates that a taxpayer will need to file a Form 1040X for each year in which a damage award was received. The deadline for filing the claims for years otherwise not closed to claims for refund is Monday, December 19, 2016.

The IRS has also provided a special address to which the claims are to be mailed:

> Internal Revenue Service
> 333 W. Pershing,
> Stop 6503 5th Floor,
> Kansas City, MO 64108

The FAQ indicates that the claim for refund should contain the following information:

> The Form 1040X must include two different types of documentation. The first type of documentation must establish that the award was previously reported in income, when it was reported, and in what amount. Examples of such documentation include copies of federal income tax returns, Forms 1099-MISC (Miscellaneous Income), and any other retained records relating to the reported income. However, if a wrongfully incarcerated individual no longer has documentation establishing that he or she previously reported the award in income, then he or she must submit a written statement

> affirming that the income was reported and that he or she no longer has relevant records. The second type of documentation must establish that the award was made on account of the wrongful incarceration. Examples of such documentation include copies of federal or state court orders awarding the compensation, signed settlement agreements accepting the amount of the award, and letters by governmental agencies or private payment sources that may have accompanied the payment of the award that include an explanation of the reason for the payment.

The FAQ also contains information on records that the taxpayer must maintain who claims this exclusion.

> To substantiate the Wrongful Incarceration Exclusion, the individual must retain documents establishing that the award was made on account of wrongful incarceration. Generally, these documents must be retained for three years from the date the return is filed. Examples of such documentation include copies of federal or state court orders awarding the compensation, signed settlement agreements accepting the amount of the award, and letters by governmental agencies or private payment sources that may have accompanied the payment of the award that include an explanation of the reason for the payment.

Merely being incarcerated and later having it determined the taxpayer was innocent isn't enough to earn this exclusion—there must be a conviction. But, as the FAQ explains:

> However, section 104(a)(2) excludes from gross income damages received on account of personal physical injuries or physical sickness. Individuals who received a damage award generally may exclude an award from income to the extent the award was received on account of a personal physical injury or physical sickness. See IRS Publication 4345, Settlements — Taxability, for more information.

The FAQ also notes that only the wrongly incarcerated individual's damages qualify:

> The Wrongful Incarceration Exclusion does not apply to damage awards an individual receives for derivative claims such as loss of consortium or loss of companionship of the wrongfully incarcerated individual.

The IRS also warns that processing of the claim may take up to 16 weeks. The IRS also notes that in the future no reporting of such awards will be required under the law.

SECTION: 263
TARGET CORPORATION IN SECTION 338(H)(10) ELECTION MAY NOT ADOPT SAFE HARBOR SUCCESS-BASED FEES ALLOCATION UNDER REVENUE PROCEDURE 2011-39

Citation: CCA 201624021, 6/10/16

In CCA 201624021 the IRS considered whether the success-based fee safe harbor election under Revenue Procedure 2011-29 is available to a taxpayer to allocate

success-based fees between actions that facilitate a transaction (expenses which must be capitalized) and those that do not (and may be currently be expensed) when the taxpayer elects to treat a stock sale as an asset sale under IRC §338(h)(10).

The election under IRC §338(h)(10) treats an acquisition of the stock of a target corporation as the purchase of the underlying assets from the acquired corporation, with the acquired corporation recognizing a gain immediately before the transaction. The election is available if the acquired corporation is:

- A member of a selling consolidated group
- A selling affiliate or
- An S corporation

Regulation §1.263(a)-5 outlines costs that must be capitalized to intangible assets. As the IRS notes in the letter ruling:

> A taxpayer must capitalize amounts paid to facilitate certain enumerated business transactions, regardless of whether the transactions are comprised of a single step or a series of steps carried out as part of a single plan, and without regard to whether gain or loss is recognized in the transactions. Treas. Reg. § 1.263(a)-5(a). The list of enumerated business transactions includes, but is not limited to, "an acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition)." Treas. Reg. § 1.263(a)-5(a)(1)-(10).

An amount paid that is contingent on the closing of the transaction is referred to as a "success -based fee" described in Reg. §1.263(a)-5(f). Generally such fees are presumed to facilitate the transaction in question and must be capitalized rather than expensed unless the taxpayer maintains documentation to show the portion of the fee that does not facilitate the transaction.

Revenue Procedure 2011-29 provides that, for a covered transaction as defined by Reg. §1.263(a)-5(e), a taxpayer may elect to treat 70% of the costs as not facilitating the transaction, generally freeing the costs up for an immediate deduction.

In the case in question stock of a target corporation had been acquired. A deemed asset sale was created via a §338(h)(10) election. The target corporation incurred certain success based costs and elected the application of Revenue Procedure 2011-29 to allow an immediate deduction for 70% of those costs, allowing the seller to use those costs to offset the gain incurred.

The National Office ruled that the transaction was not one which was eligible for the election under Revenue Procedure 2011-29. The ruling notes that Reg. §1.263(a)-5(e)(3) lists three transactions as "covered transactions" noting:

> Target cannot, however, treat the Transaction as a "covered transaction." Treas. Reg. § 1.263(a)-5(e)(3)(i) uses the phrase "taxable acquisition by the taxpayer," which means that the provision only applies to acquiring taxpayers and not to acquired taxpayers. Nowhere in Treas. Reg. § 1.263-5(e)(3)(i) is there language like the parenthetical "(whether the taxpayer is the acquirer in the acquisition or the target of the acquisition)," which is found in Treas. Reg. §

1.263(a)-5(a). Accordingly, with regard to an asset acquisition, the term "covered transaction" under Treas. Reg. § 1.263(a)-5(e)(3)(i) only applies to the acquiring taxpayer and not the acquired taxpayer.

The National Office therefore concludes:

> Accordingly, Target is not eligible to elect safe-harbor treatment under Rev. Proc. 2011- 29 for its success-based fees paid in 2012. Taxpayer must capitalize the successbased fees that it claimed as a current expense on its 2012 return, unless it establishes through documentation that a portion of the costs are allocable to activities that do not facilitate the transaction. Treas. Reg. § 1.263(a)-5(f).

SECTION: 1041
SALE OF INTEREST IN BUSINESS IN SEPARATE DOCUMENT ENTERED INTO AFTER FAILED ATTEMPT TO RUN BUSINESS JOINTLY FOUND TO BE RELATED TO THE CESSATION OF MARRIAGE

Citation: Belot v. Commissioner, TC Memo 2016-113, 6/13/16

Transfer of property incident to a divorce that is covered by IRC §1041 is a nonrecognition transaction, with each spouse getting a carryover basis, even if the transaction otherwise appears to be a sale. The taxpayer in the case of *Belot v. Commissioner*, TC Memo 2016-113 argued that this nonrecognition provision should apply in his case.

IRC §1041(a) provides:

> (a) General rule
>
> No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)—
>
> (1) a spouse, or
>
> (2) a former spouse, but only if the transfer is incident to the divorce.

The term"incident to a divorce is defined at IRC §1041(c) which provides:

> (c) Incident to divorce
>
> For purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer—
>
> (1) occurs within 1 year after the date on which the marriage ceases, or
>
> (2) is related to the cessation of the marriage.

Regulation §1.1041-1T(b), Q&A 7 provides more detail on the second test provided above, dealing with transaction outside the one year automatic window that are still "related to the cessation of the marriage."

> Q-7: When is a transfer of property related to the cessation of the marriage?
>
> A-7: A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument, as defined in section 71(b)(2), and the transfer occurs not more than 6 years after

> the date on which the marriage ceases. A divorce or separation instrument includes a modification or amendment to such decree or instrument. Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than 6 years after the cessation of the marriage is presumed to be not related to the cessation of the marriage. This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. For example, the presumption may be rebutted by showing that (a) the transfer was not made within the one- and six-year periods described above because of factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage, and (b) the transfer is effected promptly after the impediment to transfer is removed.

The issue in this case involved a transfer that was not pursuant to a divorce or separation instrument.

After the taxpayer's marriage ended the couple agreed to continue to operate their business as equal owners. Not surprisingly it turned out that they didn't work well as partners in business and eventually Mr. Belot's former wife filed suit to end this arrangement, contending "had mismanaged the business" and asked the court "to remove petitioner as director and employee of Gotta Dance and to compel him to sell his shares of Gotta Dance either to the corporation or to Ms. Belot."

The former partners in marriage did eventually enter into a settlement agreement in this matter:

> On April 11, 2008, petitioner and Ms. Belot entered into a settlement agreement (2008 settlement agreement) regarding the lawsuit. Pursuant to the 2008 settlement agreement, Ms. Belot agreed to purchase from petitioner all of his interests in Gotta Dance, Boutique, and Jobee for a total of $1,580,000, paid as follows: (1) $900,000 to be paid at closing and (2) the balance of $680,000, [*6] evidenced by a promissory note, payable in equal monthly installments on the first of each month beginning June 1, 2008, over 10 years bearing interest at the fixed rate of 5% on the principal amount outstanding. The amount of each monthly payment under the promissory note was $7,212.46.
>
> On May 22, 2008, petitioner and Ms. Belot executed a stock and membership interest purchase agreement regarding the ownership of the businesses. The stock and membership interest purchase agreement allocated the total $1,580,000 among the interests in the businesses as follows: (1) $1,080,000 for the interest in Gotta Dance; (2) $475,000 for the interest in Jobee; and (3) $25,000 for the interest in Boutique. Petitioner's basis in each business is not in dispute. Petitioner executed a stock power instrument in which he sold, assigned, and transferred his 500 shares of Gotta Dance, representing a 50% interest, to Ms. Belot. Petitioner also executed an assignment of membership interest in which he transferred his 50% interest in Jobee and 50% interest

in Boutique to Ms. Belot. On July 18, 2008, the general equity court entered a consent order of dismissal in the lawsuit.

Mr. Belot contended that the transaction was a nonrecognition transaction governed by IRC §1041 since the transaction related the cessation of his marriage. But the IRS objected that this was a separate transaction not governed by any divorce document, thus it simply represented a sale by Mr. Belot of his interest in the businesses.

The Tax Court notes that while there is a presumption in the regulation that a transaction not covered by divorce instrument is not related to the cessation of the marriage, that presumption can be overcome by sufficient evidence, noting:

> The third sentence of the regulation provides that there is a presumption that section 1041 does not apply to "[a]ny transfer not pursuant to a divorce or separation instrument". Consistent with section 1041, the fourth sentence makes clear that the presumption may be rebutted "by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage." See, e.g., *Young v. Commissioner*, 240 F.3d 369, 374 (4th Cir. 2001), aff'g 113 T.C. 152 (1999); see also *Barnum v. Commissioner,* 19 T.C. 401, 407 (1952). Petitioner has made that showing here.

The Court also disagrees with the IRS's view that the presumption can only be overcome if some legal or business issue prevented the matter from being included in the divorce decree, finding that while that is offered as an example of how the presumption may be overcome, the regulation does not provide that as a specific condition to be able to overcome the presumption.

Finding this case similar to the matter decided in the case of *Young v. Commissioner,* 240 F.3d 369, 374 (4th Cir. 2001), aff'g 113 T.C. 152 (1999):

> In both *Young* and here, a former spouse alleged shortcomings with implementation of the first settlement agreement by the other spouse, and as a result in both cases the parties negotiated a second settlement agreement employing different terms for disposition of their marital assets than were contained in their first settlement agreement. The transfers made pursuant to the second settlement agreements in *Young* and here were made (as required by the fourth sentence of the regulation) to "effect the division of property owned by the former spouses at the time of the cessation of the marriage"; and as required by section 1041 were "related to the cessation of the marriage.

SECTION: 1362
PARTNERSHIP PROVISIONS IN LLC OPERATING AGREEMENT RENDERS S ELECTION INVALID

Citation: PLR 201624003, 6/12/16

PLR 201624003 reminds us that when it comes to S corporations, the "check the box" regulations can be more complicated than they first appear.

Under the check the box provisions found at Reg. §301.7701-3 an entity that is not automatically classified as a corporation is allowed to elect whether to be treated as a corporation or, if it has one owner, a disregarded entity or, with two or more owners, a partnership. Since, once an entity elects to be treated as a corporation under check the box it is treated as a corporation for the entire IRC (IRC §7701 applies "for purposes of this title" which means the entire Internal Revenue Code found at Title 26 of the United States Code), if the entity is otherwise eligible it may elect to be treated as an S corporation.

In fact, Reg. §301.7701-3(c)(1)(v)(C) provides:

> (C) S corporations. An eligible entity that timely elects to be an S corporation under section 1362(a)(1) is treated as having made an election under this section to be classified as an association, provided that (as of the effective date of the election under section 1362(a)(1)) the entity meets all other requirements to qualify as a small business corporation under section 1361(b). Subject to § 301.7701-3(c)(1)(iv), the deemed election to be classified as an association will apply as of the effective date of the S corporation election and will remain in effect until the entity makes a valid election, under § 301.7701-3(c)(1)(i), to be classified as other than an association.

Unfortunately, some taxpayers and their adviser skip over that "otherwise eligible" clause and treat this provision to mean any LLC can become an S corporation simply by filing a Form 2553. The problem is that to be an eligible corporation to make an S election, the corporation must only have "one class of stock" as defined by the IRC.

For this purpose we are looking at federal definition. Generally "stock" becomes any sort of ownership interest in the corporation or the entity we wish to treat as a corporation. To see if we have only one class of stock, we look to the definitions found in Reg. §1.1361-1(l)(1) which provides:

> (1) General rule. A corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in paragraph (l)(4) of this section (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

Most "boilerplate" operating agreements for LLCs provide that rights in liquidation will be governed by the complex rules found in the regulations under IRC §704. Most LLCs with more than one owner end up electing to be taxed as partnerships and compliance with those regulations is mandatory to assure that the various

allocations under the operating agreement will be respected for federal tax purposes. Those regulations mandate liquidation proceeds be distributed in accordance with "book capital," a legal definition provided in those regulations that is similar, but not identical to, concepts of partners capital from a traditional accounting standpoint.

The problem is that such a set of liquidation rights sets up the possibility that liquidation payments would not go on a "per unit" basis. And the mere possibility of such a development is enough to cause the interests to be deemed multiple classes of stock if there is more than one owner.

We also may find that, for an entity that has operated as a partnership for some period of time, there already exist provisions that provide for allocations on a basis other than per unit, per day. Since that allocation would move on to the capital accounts, those provisions would also lead to significant problems.

One or more of these issues seems to have been the problem that led to this request for relief found in the letter ruling. As the ruling notes in the facts:

> At the time of its S corporation election, X's operating agreement included provisions relating to partnerships that caused X to have more than one class of stock. When X's members later discovered the effect of the partnership provisions, they amended the operating agreement to remove the provisions and provide identical distribution and liquidation rights to X's members.

Based on these facts the ruling states "we conclude that X's S corporation election was ineffective for having more than one class of stock." But the ruling goes on to note that the IRS concluded the circumstances that resulted in the ineffective election were inadvertent, and thus will treat the entity as always an S corporation under the following conditions:

> X further represents that no federal tax return of any person has been filed inconsistent with a valid S corporation election having been made for X effective D2 . X also represents that all distributions and allocations of income to its shareholders have been made pro rata in accordance with their interests in X. X and its shareholders have agreed to make any adjustments required by the Service consistent with the treatment of X as an S corporation.

So all ends well—except for the cost of having to file for the private letter ruling (both the user fees and the professional fees).

Since this entity had more than one owner when it tried to make the S election it never became a tax corporation per the terms of the regulations cited above. Things are messier if the entity only had a single owner when the S election was filed (since there, virtually by definition, there is only one "class" of stock) but later gains additional owners. Under the regulations, the entity would have converted to a corporation on the S election effective date, and then would have had its S status terminated when another equity holder was brought in if the operating agreement had the §704 language in it. Normally having something the taxpayer

thinks is an S corporation suddenly become a C corporation will not be a good tax result.

An adviser who is working with a taxpayer that wishes to have an LLC elect to be a corporation should make sure the operating agreement is reviewed to insure that no "special rights" can be found that could violate the identical rights rules. Normally that will require knowledge of both the tax law, the language in the agreement and the applicable of relevant local law, so quite often requires the tax adviser and the LLC's counsel to consider the agreement in tandem.

If the adviser takes on a new client that is an LLC taxed as an S corporation (or claims to be), prudence suggests taking a look at the operating agreement to see if there appear to be any issues that could either put the initial election in question or might result in the entity now being treated as a C corporation. If there is a problem, the client needs to seriously consider applying for a private letter ruling rather than hoping the IRS never notices the problem.

Note that if the client wants to do the latter, the adviser may need to disengage, since the adviser would not be able to sign the return in question knowing it is asserting a position that is not true (this entity is not properly taxed as an S corporation). While there are numerous problems and violations of standards if the CPA signs that return, the simplest to understand is to simply read the jurat above the paid preparer's signature—which is signed under penalties of perjury.

SECTION: 6501
BASR OPINION DOES NOT CHANGE TAX COURT'S VIEW THAT PREPARER'S FRAUD TAINTS CLIENT'S RETURN

Citation: Finnegan v. Commissioner, TC Memo 2016-118, 6/17/16

The Tax Court in the case of *Finnegan v. Commissioner*, TC Memo 2016-118 a question the court had dealt with before in the 2007 case of *Allen v. Commissioner*, 128 TC No. 4. If the taxpayer hires a "less than fully ethical" tax preparer that, in an effort to gain and retain business, prepares returns that fraudulently understate the taxpayer's tax, can the IRS use the fraud rule to argue that the statute of limitations on that return never closes—even if the taxpayer was never aware of the fraudulent nature of the return?

In *Allen* the Tax Court held that the answer was yes—a fraudulent return keeps the statute open even if the taxpayer him/herself did not have the required fraudulent intent in filing the return to evade the payment of tax. So you'd expect this would be a simple question for the Court to answer—but in the interim a federal appeals court in the case of *BASR Partnership v. United States*, CA FC (2015), 116 AFTR 2d ¶2015-5100 had rejected that view in dealing with flow through items from a partnership return where there had existed fraudulent intent at the partnership level.

Or, I should say, had sort of rejected that view. In reality the three judge panel each wrote opinions that separately arrived at an answer of whether the statute was open, with one completely rejecting the *Allen* analysis, another writing a narrow

opinion that held the statute wasn't open due to technical details relating to this flowing from a TEFRA partnership and the third agreeing with the *Allen* analysis.

Nevertheless the Finnegan case presented the Tax Court with its first chance to revisit the issue following the issuance of the *BASR* opinion. Those who thought the Tax Court might be persuaded to change its views would be quickly disappointed, as the Tax Court made clear in a footnote that it doesn't consider BASR to be reason to revisit the idea of who must have the fraudulent intent it had dealt with in *Allen*.

As opinion notes in footnote 6:

> We see no reason to revisit *Allen v. Commissioner,* 128 T.C. 37 (2007), on account of *BASR P'ship v. United States*, 113 Fed. Cl. 181 (2013), *aff'd*, 795 F.3d 1338 (Fed. Cir. 2015). In the Court of Appeals for the Federal Circuit's opinion, a persuasive dissent was filed, as well as a concurring opinion that relied on sec. 6229, a provision inapplicable in the instant case. Accordingly, even in cases appealable in the Federal Circuit, it is unclear whether, in the absence of the application of sec. 6229, which interpretation of sec. 6501(c)(1) would prevail. Moreover, there is no jurisdiction for appeal of any decision of the Tax Court to the Court of Appeals for the Federal Circuit. Sec. 7482(a)(1). Additionally, the parties have not cited *BASR P'ship* and do not contend we should revisit *Allen*. Thus, *Allen* is controlling precedent in the instant case, and we do not revisit the analysis and conclusion in that Opinion.

In this case the preparer that the taxpayer had used had been indicted for his actions in preparing the returns and had entered into plea agree in 2007 where he plead guilty to such conduct. Like a number of other preparers who stopped worrying about troubling details like the actual facts or the state of the law, his returns for each taxpayers tended to have a number of identical items that related to the fraudulent attempt to reduce the tax.

As the Court pointed out:

> During the investigation, the special agents ordered and examined the original individual income tax returns and the related partnership returns of Mr. Howell's clients, as well as transcripts from the Internal Revenue Service's Integrated Data Retrieval System. The special agents were able to identify common characteristics on returns prepared by Mr. Howell, including: (a) large refunds and partnership losses; (b) purported payments between partnerships and their respective partners; (c) the filing of partnership returns with different Internal Revenue Service Centers from year to year; (d) partnerships whose addresses changed every year; and (e) the issuance of Forms 1099-MISC to partners or other partnerships.
>
> Other common characteristics of returns prepared fraudulently by Mr. Howell included repeating numbers, such as expenses of $312, $364, $499, $572, $4,896, all of which were created by Mr. Howell and not supplied by his clients, income on Schedules C that netted to exactly $2, deductions for Keogh/self-employment retirement plans, along with guaranteed payments based upon a client's desired retirement plan contribution or deduction, and

purported transfers between Schedules C and related partnerships that were reported as expenses.

Some of these steps, like filing with multiple IRS Service Centers and varying the name of the paid preparer, were meant to frustrate any IRS attempts to link the returns together to realize what was actually happening. And some were just plain laziness (using the exact same numbers for nonexistent expenses), presumably making it easier to "automate" the fraud.

In the case of the taxpayers in this case, the preparer had suggested they form a partnership with their rental property where each spouse would be a partner, and then fund a Keogh plan based on the rental income. Of course, there's the minor problem that the rental income doesn't represent earned income on which a Keogh deduction can be claimed. He eventually also "created" another partnership, this one wholly fictitious, which generated losses and a flurry of fictitious information returns (including 1099-MISC) to make it appear like a truly functioning partnership.

As the Court noted:

> Mr. Howell (the preparer) also set up false partnerships that were not connected with any existing businesses or activities. Mr. Howell believed partnerships were less vulnerable to audits than sole proprietorships reported on Forms 1040, Schedule C, and so he placed false income and expenses on partnership returns and used the partnership form to avoid scrutiny from the Internal Revenue Service. The false expense deductions that Mr. Howell placed on the partnership returns created large losses that flowed through to the clients' individual income tax returns, thereby lowering their income tax liabilities. Mr. Howell prepared Forms 1099-MISC and Forms 1096, Annual Summary and Transmittal of U.S. Information Returns, that maintained the appearance of legitimate partnerships, and reported purported payments made by the partnerships to related partnerships or partners.

The taxpayer's main defense was that the IRS did not have the preparer testify in this case, thus they argued the IRS could not show the requisite fraudulent intent. The Tax Court did not agree, nothing that most often fraud is shown by extrinsic evidence, not a full-blown confession by the misbehaving party. And, in any case, the preparer had testified elsewhere that "every return he prepared included at least some fraudulent entries, and because of these false entries, was 'dirty'."

The Court noted that the taxpayer's returns showed a number indications of fraud, including:

- The repeating figures that were a key part of the fraudulent return scheme of the preparer
- The creation of false partnerships with losses flowing on the return that created similarly false information returns that were also a key component of the preparer's fraudulent scheme

- The random changes in the paid preparer organization (all of which were really the same preparer) and IRS Service Center in which returns were filed to avoid detection

The Court distinguished these facts from those in the case of *Eriksen v. Commissioner*, noting:

> Comparing the instant case to *Eriksen v. Commissioner,* 2012 WL 2865875, is instructive. Eriksen involved six taxpayers whose return preparer was convicted of preparing false and fraudulent returns with the intent to evade tax. In *Eriksen*, the taxpayers' returns were not included among the 51 returns considered as part of the preparer's guilty plea. Id. at *4. Although the preparer testified in *Eriksen*, he was unable to recall at trial preparing any of the returns there in issue. Id. at *2. The Court held for five of the taxpayers but against the sixth. The key distinction of the sixth taxpayer, although she had not committed fraud herself, was her testimony that her return included deductions for expenses she had not in fact incurred. Id. at *12. The Commissioner then established that the expenses were of the type the preparer had pleaded guilty to fabricating. Id. Viewing these facts in conjunction with other badges of fraud, the Court determined that the sixth taxpayer's returns were false or fraudulent. Id.

While the taxpayers were citing *Eriksen* as standing for the proposition that they shouldn't be held liable, the Court noted they were like the one taxpayer who was found to be subject to the open fraud statute—the IRS was able to link the return to the fraudulent pattern of the preparer because of similar deductions. So the Court found that, in fact, *Eriksen*_supported the methods the IRS had use to establish the applicability of the fraud statute in this case.

The Court also decided that the taxpayers should be subject to accuracy related penalties, as their ignorance of the preparer's fraud existed principally because they had shirked their duty to actually review the returns they received.

As the Court noted:

> For purposes of section 6662, the term "negligence" includes any failure to make a reasonable attempt to comply with the income tax provisions of the Code. Sec. 6662(c). This includes failing to make "a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable prudent person to be 'too good to be true' under the circumstances". Sec. 1.6662-3(b)(1)(ii), Income Tax Regs. Taxpayers should be able to show, at a minimum, that they fulfilled a duty of inquiry with regard to whether their return properly reported their tax liability. Eriksen v. Commissioner, 2012 WL 2865875.
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> Petitioners testified that they signed and filed the returns Mr. Howell prepared for them without reading them. We do not doubt this testimony, as petitioners filed returns for an entire partnership, which was also reflected on their personal return, without noticing that it was wholly unrelated to their affairs. Petitioners were unfamiliar with even the most basic line items on the

returns, such as their professions, addresses, and total income. Respondent has shown that petitioners failed to fulfill their duty of inquiry. See id. Petitioners' failure to review the returns is especially reckless considering that the sizes of their returns and refunds grew significantly when they became clients of Mr. Howell. These were signals that Mr. Howell's changes may have been "too good to be true" and petitioners should have made reasonable attempts to ascertain the correctness of the new deductions. See sec. 1.6662-3(b)(1)(ii), Income Tax Regs. Petitioners, in fact, recognize that a lack of review can give rise to an inference of negligence, and are silent as to any defense against the penalties. Consequently, we conclude [*30] that respondent has met his burden of production for determining accuracy-related penalties due to negligence or disregard of rules or regulations.