TAX PROCEDURE: SOMETIMES EVEN BAD ADVICE IS HELPFUL

Posted on **July 19, 2017** by **Jim Malone**

Bad tax advice can be expensive, but sometimes it's better than no advice at all.

Last week, the Tax Court issued an opinion in a complicated international tax case that illustrates the principle that incorrect advice can still help a taxpayer, as it may support a defense to a penalty. *Grecian Magnesite Mining, Indus. & Shipping Co. v. Comm'r*, No. 19215-12, 2017 U.S. Tax Ct. LEXIS 36 (July 13, 2017).

In *Grecian Magnesite*, the taxpayer was a foreign corporation formed in the Hellenic Republic and based in Athens. 2017 U.S. Tax Ct. LEXIS 36 at *3. The taxpayer had an interest in Premier Chemicals, LLC ("Premier"), which was its sole connection to the United States. *Id.* Premier was a Delaware limited liability company that was taxed as a partnership. *Id.* at *4. In 2008, the taxpayer entered into an agreement providing for Premier to redeem its partnership interest as of the end of that year in return for two payments totaling $10.6 million. *Id.* at *5. The first payment of $5.3 million was made in July 2008; as the taxpayer's basis in its partnership interest was $4.3 million, the sale triggered a gain of $1 million. *Id.* The second $5.3 million payment came in early 2009, triggering another $5.2 million in gain. The taxpayer and Premier also agreed that $2.2 million of the gain was attributable to Premier's U.S. real estate holdings. *Id.* at *6.

Several years earlier, the taxpayer had retained a lawyer in the United States to handle its legal business, including tax matters. *Id.* The lawyer, in turn, had recommended a return preparer who was a CPA with a J.D. degree named Elihu Rose. Rose had years of experience preparing returns, including partnership returns, but he had never handled a non-U.S. client's returns. *Id.* For 2008, the taxpayer's return included its distributive share of partnership items, but, at Rose's advice, it did not reflect the gain of $1 million that the taxpayer had realized that year. *Id.* at *7. For 2009, the taxpayer did not file a return at Rose's advice because the only income it derived from Premier was its gain. *Id.* at *7-*8.

The IRS saw things differently; it audited the taxpayer and asserted that the entire gain was taxable. As the case progressed in Tax Court, it became apparent that a portion of Rose's advice was demonstrably wrong: To the extent that $2.2 million of the gain realized by the taxpayer was attributable to Premier's real estate holdings, it was plainly taxable under section 897(g) of the Internal Revenue Code. Accordingly, the taxpayer stipulated that it was subject to tax on $1 million in gain for 2008 and $1.2 million for 2009. *Id.* at *8-*9. As to the remaining $4 million in gain, the taxpayer prevailed, as the Tax Court held that the remaining gain was not connected with a U.S. trade or business and therefore not subject to tax in the United States. *Id.* at *15-*44.[1]

That disposition left open the question of the penalties for the portion of the gain that was plainly taxable. For 2008, the taxpayer faced an accuracy-related penalty under section 6662 of the Code that would add twenty percent to the tax due. *Id.* at *44-*45. For 2009, it faced the twenty percent accuracy-related penalty, plus a failure-to-file penalty under section 6651(a)(1) of the Code and a failure-to-pay penalty under section 6651(a)(2). *Id.* at *45-*46. The failure-to-file penalty accrues at five percent of the tax due for each month a return is delinquent and then is capped at twenty-five percent, while the failure-to-pay penalty accrues at 0.5 percent per month up to a twenty-five percent limit. I.R.C. § 6651(a)(1), (2).

Fortunately for the taxpayer, all of these penalties are subject to a reasonable cause defense. Section 6651 provides that the failure-to-file and failure-to-pay penalties will not apply where "such failure is due to reasonable cause and not due to willful neglect." I.R.C. § 6651(a)(1), (2). Similarly, the accuracy-related penalty is not applicable where a taxpayer demonstrates that he had "good cause" and "acted in good faith." I.R.C. § 6664(c)(1). In considering whether a taxpayer had "reasonable cause," or had "good cause" and "acted in good faith," courts will consider professional advice that the taxpayer received if it was reasonable for the taxpayer to rely upon it. *See United States v. Boyle*, 469 U.S. 241, 251 (1985); *see also Neonatology Assocs., P.A. v. Comm'r*, 115 T.C. 43, 99 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

In *Grecian Magnesite*, the court thus focused on whether the taxpayer's reliance upon Rose was sufficient to establish a defense to the potential penalties. The Tax Court emphasized several things about the taxpayer, including the fact that it was a Greek corporation, that its only U.S. investment was its interest in Premier, and that its principal financial officer did not understand U.S. tax law governing partnerships or income from real estate. 2017 U.S. Tax Ct. LEXIS 36 at *49. The court also emphasized that Rose came to the taxpayer at the recommendation of a trusted adviser and that he had relevant credentials including a bachelor's degree, an MBA, a law degree, and a CPA license. *Id.* at *50. Rose also had many years of experience preparing tax returns, and he believed he was qualified to handle the taxpayer's filings. *Id.*

In the Tax Court's view, this sufficed. While the government argued that the taxpayer should have investigated Rose's background, the court rejected that argument: "Given what little [the taxpayer] knew about the U.S. system of taxation, we cannot imagine [it] would have known how to conduct such an investigation, let alone what value such uninformed inquiries would have added." *Id.* at *51. The Tax Court also rejected the government's contention that someone with greater expertise should have been consulted. It was incumbent on the taxpayer to show that Rose "was a competent professional who had sufficient expertise to justify reliance," and in the court's view, Rose met that requirement. *Id.* at *51-*52 (quoting *Neonatology Assocs.,* 115 T.C. at 99). As a consequence, the taxpayer was not subject to penalties.

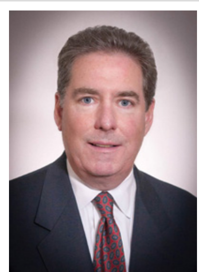
Of course, not all professional advice will suffice, as the cases turn on their facts. The taxpayer in *Grecian Magnesite* was helped by the fact that it was relatively unsophisticated. Similarly, in *Boree v. Commissioner*, 837 F.3d 1093 (11th Cir. 2016), the Eleventh Circuit overturned a Tax Court ruling that a married couple did not act in good faith when they relied upon their accountant's preparation of a tax return that claimed deductions for business expenses associated with ownership of real property and also claimed capital gain

treatment when it was sold, a position that was inconsistent with the claimed business expense deductions. The husband was a former logger with no accounting experience, and his wife had been favorably impressed by how “detail-oriented” the accountant’s staff was. *Id.* at 1107.

In contrast, more sophisticated parties have typically had a tougher time showing that they had a reasonable basis for an incorrect tax position. For example, in *Green Gas Delaware Statutory Trust v. Commissioner*, 147 T.C. 1 (2016), the Tax Court rejected a reasonable cause defense based on professional advice because the taxpayers did not produce any formal opinion letters and offered only vague testimony about the advice. *Id.* at 77-78. Those problems were compounded by the fact that one of the tax advisors was a promoter with an interest in the transaction, making reliance upon his advice unreasonable. *Id.* at 78.

Still, a plausible reasonable cause defense may be enough to drive a favorable resolution in an administrative appeal. In contrast, a taxpayer who formulates an incorrect position on his own is saddled with the consequences of his mistakes.

1Although fairly esoteric, this ruling is noteworthy in its own right as it deals with one of the constant tensions in the area of partnership taxation, which is whether a partnership should be viewed as an entity or an aggregation of assets; the court holds that the sale of a partnership interest should be treated as a disposition of an interest in an entity absent a specific statutory directive providing for different treatment, such as section 897(g). The Tax Court also rejected Revenue Ruling 91-32, 1991-1 C.B. 107, which supported the government’s position that the entire gain was subject to U.S. tax.



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