US Tax Court hears cases on professional reliance in tax preparation

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The most common penalty facing an individual taxpayer is the "substantial understatement" penalty. It is imposed for any taxable year if the understatement exceeds the greater of (i) 10 percent of the tax or (ii) $5,000. The penalty is 20 percent of the underpayment for federal tax purposes, Internal Revenue Code Section 6662(a), but 40 percent for California tax purposes, Revenue and Taxation Code Section 19164(a)(1)(B)(i).

Lucy Lawyer, a sole proprietor, reports $400,000 in gross receipts from her law practice and deducts $100,000. Her federal and state tax liabilities are $81,020 and $24,796. (Approximations.) On audit, an IRS agent proposes to disallow $60,000 of expenses. Lucy's federal and state tax liabilities would become $100,820 and $30,376, respectively. The proposed underpayments ($19,800 federal and $5,580 state) are both greater than (i) 10 percent of the tax required to be shown on the return and (ii) $5,000. Therefore, the total tax penalty is $6,192 (20 percent times $19,800 equals $3,960 federal and 40 percent times $5,580 equals $2,232 state). On a $60,000 disallowance Lucy is facing an additional (i) $25,380 tax (state tax is deductible for federal purposes if Lucy is not subject to the alternative minimum tax); (ii) $6,192 in penalties; and (iii) $4,500 of interest (depending on the years), for a total of over $36,000.

What can Lucy do to avoid the penalty? First, Lucy can avoid the penalty if she "adequately disclosed" the relevant facts affecting the items' tax treatment on her return or in a statement attached to the return and there is a "reasonable basis" for the treatment. IRC Section 6662(d)(2)((B)(ii). The "reasonable basis" standard is higher than "not frivolous" or "not patently improper." Reg. Section 1.6662-3(b)(3). It is not satisfied by a position that is merely arguable or a colorable claim. It is less than the "substantial authority" standard mentioned below. In other words, if Lucy's return gives the IRS notice of her position and it is "reasonable," even if it is not "substantial," she can avoid the penalty. Disclosure is normally done on an IRS Form 8275 or (if the position is contrary to an IRS regulation) 8275-R.

Second, Lucy can argue that she had "substantial authority" for the tax treatment of any items that the IRS proposes to disallow. IRC Section 6662(d)(2)(B)(i). This is stricter than the "reasonable basis" standard discussed above. However, it is less stringent than "more likely than not," i.e., greater than a 50 percent likelihood of being upheld in litigation. Authorities include the Internal Revenue Code, regulations, court cases, IRS rulings and notices and Congressional intent. Professional articles are not "authorities."

Another section of the code offers a third defense. IRC Section 6664(c) provides that "No penalty shall be imposed under Section 6662 ... with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion." The burden is on Lucy to prove that she had reasonable cause and good faith. For Lucy's reliance on professional

Tuesday, October 2, 2012

Labor/Employment
Governor signs series of employment laws, vetoes domestic workers bill
While Gov. Jerry Brown signed seven employment -related bills into law by the end of this legislative session, he vetoed a controversial bill that would have created new regulations for domestic workers.

Litigation
Judge rejects Groupon class action settlement
A federal judge in San Diego has denied a class-action settlement involving online deals giant Groupon Inc. over concerns the settlement's proposed cy pres payments were inappropriately tailored to the suit.

Law Practice
Procopio adds first startup to business incubator
San Diego-based startup EndoPodium Inc. is the first company to join Procopio, Cory, Hargreaves & Savitch LLP's business incubator, the firm announced Friday.

Mergers & Acquisitions
Study: law firms making cautious acquisitions this year
Law firms across the country are continuing to make acquisitions, but are doing so with more caution in 2012, according to a study released by Altman Weil Mergerline on Monday.

Judges and Judiciary
Lew to return to LA federal court after Thailand hospitalization
U.S. District Judge Ronald S.W. Lew will return to his Los Angeles courtroom this week after recovering from a head injury suffered nearly two months ago in Southeast Asia.

Labor/Employment
Bank of America gender discrimination suit can go forward
A federal judge denied a motion to dismiss Thursday in a gender discrimination lawsuit against Bank of America Corp., Merrill Lynch & Co. Inc. and Merrill Lynch, Pierce, Fenner & Smith Inc.

Mergers & Acquisitions
Dealmakers
A roundup of recent mergers and acquisitions and financing activity and the lawyers involved.

Litigation
Girardi, Lack, Shernoff firms sued over 1997 settlement
Three elite plaintiffs' law firms might not have properly accounted for a reported nine-figure settlement they secured from State Farm Insurance Co. after the 1994 Northridge earthquake, more than 30 former clients have alleged in a lawsuit

Criminal
Defendants claims Internet pharmacy law murky when alleged crimes committed

advice to be sufficiently reasonable so as to negate the penalty she must meet three tests: (i) the advisor was a competent professional who had sufficient expertise to justify reliance; (ii) she gave the advisor the necessary and accurate information; and (iii) she actually relied in good faith on the advisor's judgment.

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Two cases decided by the U.S. Tax Court on Aug. 27 show the different circumstances in which the reliance defense arises. In *Abarca v. Commissioner*, TC Memo 2012-245, the taxpayer deducted property taxes for properties on which he was not the record owner. He also deducted mortgage interest even though he was not a borrower. Omar Abarca offered into evidence partnership agreements that he had with the property owners. Judge Joseph Robert Goeke found it curious that (i) the agreements were forms intended for use in the U.K.; (ii) it was unclear whether title to the properties were contributed to the partnerships; (iii) partnership formalities were not followed; and (iv) Abarca's tax returns did not reflect the partnerships' existence (his returns showed him owning the properties directly). The court acknowledged that the taxpayer could deduct the mortgage if he was an equitable owner, even if not directly liable on the mortgage. However, the evidence was insufficient to raise him to the status of an equitable owner. Abarca tried to escape the understatement penalty by citing the fact that he used the same accountant for many years and supplied all the relevant information. However, he failed to introduce any evidence about the accountant's expertise or showing that he actually supplied the accountant with the necessary and accurate information. So the "reliance" defense failed.

In *Neff v. Commissioner*, TC Memo 2012-244, a corporation had paid premiums on an insurance policy and had a fixed right to receive a $842,000 reimbursement for the premiums. However, on advice of counsel, the taxpayers bought the corporation's interest for the present value of the corporation's reimbursement right, which was only $132,000. The determination of present value was prepared by the taxpayers' accounting firm at the request of the taxpayers' counsel. Judge Stephen J. Swift carefully reviewed the law regarding this type of life insurance arrangement and concluded that the taxpayers should have included as taxable income the $710,000 difference between the corporation's reimbursement right and the amount paid. However, in light of the transaction's complexity, the difficult tax issues and the fact the taxpayers acted under supervision of their counsel, the court exercised its discretion to not sustain the understatement penalty. Judge Swift believed that the taxpayers acted with reasonable cause and in good faith in relying on their professional tax advisors in omitting the $710,000 from their income.

The substantial understatement penalty is the most common penalty to rear its ugly head in an income tax audit. Relying on high quality advisors is an excellent way to avoid it/

Attorneys for three defendants in an online prescription drug case argued Monday that when their business was operating in 2006, the law covering such operations was still murky.

Family
Brown vetoes legislation allowing for more than two parents
Gov. Jerry Brown vetoed legislation over the weekend that would have allowed the courts to find a child has more than two legal parents if doing so would be in the best interests of the child.

Tax
US Tax Court hears cases on professional reliance in tax preparation
Two recent tax cases demonstrate the circumstances in which a "reliance" defense arises. By **Bruce Givner and Owen Kaye** of Givner & Kaye APC

Law Practice
Raising money for your start-up
A few tips on getting cash for your growing start-up. By **Joel Fishman** of Gladstone Michel Weisberg & Sloane ALC

Perspective
Fixing the fixer
Your practice can reach enhanced levels of efficiency with help from an experienced attorney-coach. This is the message of "The Lawyer's Guide to Professional Coaching: Leadership, Mentoring & Effectiveness." By **Panda Kroll**

Law Practice
Dante's white-collar justice
According to Dante, both people and animals can be violent, but only humans can twist their reason towards evil by willfully committing fraud against their fellows. By **Abraham Meltzer**

Letter to the Editor
Misleading attack on death penalty propostion
A recent op-ed attacking Proposition 34, a measure to end the death penalty, among other things, does a disservice to voters. By **Stephen F. Rohde**

Criminal
Making the case for Proposition 36
Proposition 36 is a modest reform of the Three Strikes Law originally passed by the voters in 1994. It protects a very valuable tool to appropriately punish serious or violent recidivist offenders. By **Steve Cooley**

Judicial Profile
Jean P. Rosenbluth
Magistrate Judge U.S. District Court for the Central District (Santa Ana)

Corporate
Future of patent marketplace remains uncertain
Bay Area lawyers have developed an expertise in patent-only transactions that have become big-money deals.