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# Tax Court Demands Greater Due Diligence From Taxpayer

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In the recently decided case of *Woodsum v. Commissioner*, the U.S. Tax Court rejected the claim of a sophisticated individual taxpayer that his reliance upon tax professionals should constitute a defense to the imposition of a 20 percent accuracy-related penalty in connection with the failure to report $3.4 million of income.

This decision highlights the limits the IRS and the courts impose on the ability of a taxpayer to avoid penalties based upon the claim that the taxpayer relied upon tax professionals and establishes an obligation on the part of every taxpayer to review the accuracy of their own tax returns.

The facts in *Woodsum* are relatively straightforward. Stephen G. Woodsum is the founding managing director of Summit Partners, a private equity investment firm. The court noted that Woodsum is a graduate of Yale University and received a masters in management from the Kellogg School of Management at

Northwestern University. Woodsum's wife, Anne Lovett, who also signed the tax return in question, is also a graduate of Yale University.

In 1998, Woodsum entered into a complicated partnership swap transaction that was scheduled to terminate in 2008. However, Woodsum decided that the transaction was not performing as intended and directed that the transaction be terminated in 2006. As a result of the termination of the swap transaction, Woodsum realized a taxable gain of $3.37 million. After the end of 2006, Deutsche Bank, one of the parties to the swap transaction, issued Woodsum a Form 1099-MISC, Miscellaneous Income, reporting a gain of $3.38 million and a Form 1099-INT, Interest Income, reporting $60,291 of interest income.

The record indicates that in 2006 Woodsum had adjusted gross income of $33 million (including the approximately $3.4 million from terminating the swap). To prepare his 2006 federal income tax return, Woodsum hired TVS Tax Services Inc., an accounting firm specializing in tax work for private equity and hedge funds.

Woodsum provided TVS with 160 information returns he received for 2006, including the Forms 1099 received from Deutsche Bank reporting the $3.4 million realized upon the termination of the swap. TVS prepared Woodsum's return (115 pages long) and met with Woodsum and his wife on the morning the filing of the tax return was due. Although Woodsum and his wife signed the return, they did not notice that TVS had omitted the Form 1099-MISC issued by Deutsche Bank, which reported the $3.38 million of gain arising from the termination of the swap.

The IRS detected the omitted income, probably as a result of a computerized "match" of information returns, and assessed Woodsum and his wife a tax deficiency of $521,473 and an accuracy-related penalty under Tax Code Section 6662(a) of $104,295. Woodsum and his wife paid the assessed tax, but contested the accuracy-related penalty on the basis of reasonable cause.

Code Section 6662(a) imposes a 20 percent accuracy-related penalty on any portion of an underpayment of tax required to be shown on a return that is attributable to a substantial understatement of income tax. An understatement of tax is defined in the Treasury Regulations to be "substantial" if it exceeds 10 percent of the tax required to be shown on the return for the taxable year, as per Treas. Reg. § 1.6662-4(b).

The regulations further provide that the accuracy-related penalty will not be imposed with respect to any portion of an underpayment if the taxpayer is able to demonstrate that it acted with reasonable cause and in good faith. Such determination is made on a case-by-case basis, taking into account all pertinent facts and circumstances. The regulations specifically provide that an isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Moreover, reliance on professional advice constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.

In *Woodsum*, the taxpayer argued that he should not be liable for the accuracy-related penalty since he relied on professional advice in the preparation of his tax return. However, the Tax Court rejected the notion that the mere assembly of a tax return and the reporting of income shown on a Form 1099 constitutes "advice" within the definition of the regulations. Rather, the court, citing earlier case law, concluded that "advice" for purposes of establishing reasonable cause must constitute "substantive advice" resulting from the tax adviser's professional analysis or judgment. Here, there was no dispute that the income arising from the termination of the swap was intended to be reported as taxable income and TVS rendered no "advice" with respect to the inclusion of such income; it merely committed a clerical error.

After dismissing the taxpayer's claim that the accuracy-related penalty should be abated due to reliance upon professional tax advice, the Tax Court focused on whether the failure to report the income from the Form 1099 issued by Deutsche

Bank constituted "an isolated computational or transcriptional error" as described in the regulations and which could support Woodsum's claim that the omission of income was due to reasonable cause.

On this issue, the Tax Court stated that the burden was on every taxpayer to review his third-party prepared return for the purpose of insuring that all income items are included and that every taxpayer must exert a level of "effort" that is reasonable under the circumstances. Under the facts in *Woodsum*, the court concluded that the taxpayer made no reasonable effort under the circumstances to determine the accuracy of his tax return and therefore could not claim that he acted with reasonable cause and in good faith.

Specifically, the court cited the fact that the taxpayer could not describe the nature or duration of his review of the tax return in question. The Tax Court also noted that the omitted income of $3.4 million was substantial not only in absolute terms, but also in relative terms, i.e. — it equaled about 10 percent of the taxpayer's adjusted gross income.

Other factors that the court noted included the educational levels of the Woodsums and the fact that the underlying swap transaction was actively managed by Woodsum and was terminated at his direction.

In his opinion, Judge David Gustafson stated that had Woodsum undertaken any level of review of his tax return, he should have found that such a significant item of income had been omitted.

Finally, the court again cited the regulations, which provide that in evaluating whether a taxpayer may assert the reasonable cause defense, "the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." The court concluded that Woodsum failed to exert the appropriate level of effort under the circumstances.

The *Woodsum* case is instructive with respect to the level of effort that is imposed upon a taxpayer in the preparation and filing of the taxpayer's tax

returns. Depending on the facts and circumstances, including the sophistication and education of the taxpayer and the size of the items in question, some level of due diligence is imposed upon every taxpayer; reliance upon professionals will not serve as an absolute defense to accuracy-related penalties.