BE A LITTLE SUBTLE: A LOOK AT BAD TAX PLANNING

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Aggressive tax planning can be bad, as it can come back to haunt you. Aggressive tax planning that is *obvious* is worse, as the taxpayer can be left to defend an indefensible position.

Robert Smith learned the hard way: In June 2009, Smith sold his company, National Coupling, and retired; he received a $600,000 bonus, $248,246 from the sale of his stock, and $181,170 from two life insurance policies that his company had owned. *Smith v. Comm'r,* No. 21707-15, T.C. Memo 2017-218, 2017 Tax Ct. Memo LEXIS 217, **3 (Nov. 6, 2017). Mr. Smith expected to receive patent rights to a sprinkler design as well, but that was not addressed in the sale documents. At a financial advisor's suggestion, Mr. Smith hired a lawyer to handle some estate planning. The lawyer provided Smith and his wife with wills and medical directives. He also provided them with a "tax planning strategy." 2017 Tax Ct. Memo LEXIS 217 at **4.

The strategy called for the Smiths to transfer cash and marketable securities to an S corporation, which in turn would transfer the assets to a family limited partnership. *Id.* at **4-**5. A revocable management trust would hold the general partnership interest in the limited partnership, and the S corporation would hold the limited partnership interest. *Id.* at **5. The plan was to trigger a loss, which was to be accomplished as follows:

- The S corporation would be liquidated the same year it was formed;
- On liquidation, the Smiths would receive the limited partnership interests in the family limited partnership; and
- The limited partnership interests would be discounted from the value of the assets held in the partnership on the basis of lack of control and lack of liquidity.

The discount from net asset value applied to the partnership interests would trigger a loss, and the Smiths would realize that loss by dissolving Ventures and receiving the partnership interests that it held in a liquidating distribution. *Id.* The lawyer told the Smiths that the structure would generate "either a capital loss or an ordinary loss deduction on the basis of the business purpose of the S corporation." *Id.* at **5-**6. That advice was sound as far as it went; the only problem was there really wasn't any business purpose for the S corporation. Its sole function was to generate losses to shelter some of Mr. Smith's income from tax.

In July 2009, the plan moved forward. The Smiths formed RACR Ventures, Inc. (“Ventures”) and elected S corporation treatment. They also formed RACR Partnership, Ltd. (the “Partnership”), and the Smith Management Trust (the “Trust”). The relationships among these entities were as follows:

- Mr. and Mrs. Smith each owned one-half of Ventures. Mr. Smith was its president; Mrs. Smith was its vice-president, and both of them were directors.
- Ventures owned a 98% limited partnership interest in the Partnership.
- The Trust owned a 2% general partnership interest in the Partnership; and
- Mr. and Mrs. Smith were the cotrustees and beneficiaries of the Trust. *Id.* at **6.

Beginning on August 3, 2009, the Smiths transferred cash and marketable securities from their brokerage accounts to new accounts opened on behalf of Ventures, and Ventures then transferred the cash and securities to the Partnership. *Id.* at **7. The Partnership then purchased long-term care insurance for the Smiths and extended a $500,000 line of credit to them.

By November 18th, the Smiths had completed their transfers of assets to the Partnership through Ventures, which totaled $1,881,737. *Id.* at **9. At that point they met with their lawyer and began the process of dissolving Ventures. On December 10th, the Smiths filed documents with the Texas secretary of state to terminate Ventures; that filing indicated that it had been organized “to pursue business opportunities” and that it was being dissolved “because they had not found any profitable opportunities.” *Id.* at **10. On December 10, 2009, Ventures transferred to each of the Smiths a 49% limited partnership interest in the Partnership; the Smiths, in turn, transferred to each of their two children a 1% limited partnership interest in the Partnership.

The tax filings followed. The Smiths’ lawyer prepared a return for Ventures that listed the $1,870,527 it had invested in the Partnership as cost of goods sold. *Id.* at **11. The interests in the Partnership that Ventures received were treated as gross receipts and were valued at a 40% discount to net asset value. *Id.* at **12. This was designed to create an ordinary loss, rather than a capital loss, but it was a poor fit on the facts. *Id.* at **13. The Smiths then claimed the resulting loss of $749,852 on their 2009 tax return, but the IRS disallowed the loss.

Before the Tax Court,[1] the main focus was on whether there was any economic substance to all of the machinations that the lawyer had set in motion. The taxpayers’ story was that they had set up Ventures to manufacture a sprinkler device that Mr. Smith had invented. Then they dissolved it a few months later because of unforeseen circumstances, which included the fact that Mr. Smith did not receive the patent rights from his former company, as well as the fact that he was busy with consulting work. *Id.* at **17.

The Tax Court didn’t buy that story: “We find that petitioners’ claims with respect to their purpose for organizing and dissolving Ventures in 2009 are not credible.” *Id.* The court concluded that the structure created by the Smiths’ lawyer lacked economic substance and should not be respected for tax purposes.

Applying the Fifth Circuit’s multi-factor test from *Klamath Strategic Inv. Fund ex rel. St. Croix Ventures v. United States*, 568 F.3d 537, 544 (5th Cir. 2009), the Tax Court focused first on whether the Smiths arrangements had “objective economic reality.” Given the circular flow of funds among related entities, this was an easy question to answer, and the court concluded that the arrangements had not made “real dollars to meaningfully change hands or created a realistic possibility that they would do so.” *Smith*, 2017 Tax Ct. Memo LEXIS 217 at **18 (quoting *Klamath*, 568 F.3d at 481 & n.41).

Next, the court turned to the remaining two *Klamath* factors, which focus on the taxpayer's subjective purpose. After questioning the credibility of Mr. Smith concerning the details of the patent rights for the sprinkler that Ventures was to manufacture, the court then turned to the evidence showing that the Smiths planned to terminate Ventures from the outset. There was quite a lot of it.

The Smiths had kept handwritten notes from their meeting with the lawyer and the notes referred to an S corporation as "the vehicle to minimize tax event this year." *Id.* at **22. A July 2009 email from one of the lawyer's employees referenced a liquidation. On August 5, 2009, Mrs. Smith wrote an email to the lawyer asking whether a new corporation would be formed since "Ventures goes away after 2009." *Id.* at **25. He responded the following day, indicating that a new corporation would be formed. *Id.* And the lawyer's bills did not help:

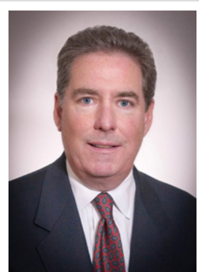
- He charged the Smiths a flat $23,000 to create the structure;
- When Ventures was liquidated, he sent the Smiths an invoice for $0.00 because that service was included in the flat fee he charged to create the structure.

Since it was obvious to the court that the liquidation of Ventures was planned from the outset, the Tax Court concluded that the entire arrangement lacked any subjective business purpose and "Ventures was organized for the sole purpose of tax avoidance." *Id.* at **26. As a consequence, the Tax Court concluded that Ventures lacked economic substance and that the associated loss should be disallowed. *Id.*

Next, the Tax Court turned to the accuracy-related penalty that the IRS had assessed. While the taxpayers tried to argue that they had relied on their lawyer's advice, the court concluded that their reliance was not reasonable and that they did not act in good faith. This determination rested in part upon the fact that the Smiths knew from early in the process that Ventures did not have a business purpose. *Id.* at **29-**30. It was also apparent that the court weighed the taxpayers' testimony against them in considering the penalty, as it specifically observed that "they continued to perpetuate their tax-avoidance scheme through their testimony at trial that we have found not to be credible or reliable. Nor do we find credible petitioners' attempts to explain away multiple inconsistencies in the record." *Id.* at **30.

The complete lack of any plausible business purpose for Ventures doomed this arrangement from the outset. Their testimony didn't help matters: It was not sufficient to demonstrate a business purpose, and the court perceived it poorly.

[1] A different lawyer represented the Smiths before the Tax Court.



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