

Taxpayer not liable for accuracy related penalty in Son of BOSS Tax Shelter Case

In a recent decision, the Seventh Circuit Court of Appeals affirmed the District Court's decision, finding no reversible error in the District Court's conclusion that the partnership had reasonable cause for its tax position with respect to a Son of BOSS transaction. *American Boat Company, LLC et al v. U.S.*, No. 09-1109 (7th Cir. October 1, 2009). Additionally, the Court held that a partnership may raise an entity-level reasonable cause defense to accuracy-related penalties, giving the courts jurisdiction over such issues.

Background

This case involved a Son of BOSS tax shelter. The issue, however, was not whether the underlying transaction was a tax shelter, but instead whether the taxpayer had reasonable cause for the underpayment so as to avoid the imposition of the accuracy-related penalty.

In this case, a St. Louis businessman ("the taxpayer") followed the advice of his banker and contacted an attorney at a Chicago law firm for advice on planning his estate in 1996. As part of the estate plan, the attorney restructured the taxpayer's business entities and provided a written opinion, on which the taxpayer relied for purposes of preparing income tax returns. According to the opinion, these transactions appeared to be Son of BOSS tax shelter transactions; however, the Internal Revenue Service (IRS) discovered these transactions after the statute of limitations on assessment had already expired.

In 1998, one of the taxpayer's towboats struck a bridge in St. Louis, and some of the barges that it was towing broke free and hit a floating casino. This incident could have caused the taxpayer's businesses to incur huge liabilities, but for the last-minute actions taken by the operator of the towboat. The taxpayer was advised that he should re-adjust the ownership structure of his businesses to limit potential liability in the future.

In order to achieve the recommended asset protection, the taxpayer again went to the same attorney. The attorney recommended and implemented a series of complex restructuring transactions, which were later determined to be Son of BOSS tax shelter transactions. The attorney again provided the taxpayer with a written opinion regarding the validity of the transactions. The Court stated that the two accounting firms that provided tax services to the taxpayer did not raise any concerns about the tax ramifications.

The IRS determined that the 1998 transactions were an invalid tax shelter. The IRS claimed that American Boat LLC ("the partnership"), an entity owned by the taxpayer, had overstated its basis in its assets as a result of the 1998 transactions and proposed a forty percent accuracy-related penalty for gross valuation misstatement pursuant to Section 6662(h). The District Court agreed that the underlying transactions were Son of BOSS tax shelters, but it found that the taxpayer had reasonable cause for the valuation misstatement and the accuracy-related penalty did not apply.

Partnership may raise reasonable cause defense

In addressing whether it had jurisdiction, the Seventh Circuit Court of Appeals noted that "the vast majority of courts" have held that a partnership may raise a reasonable cause defense on its own behalf based on the conduct of its general or managing partner. Further, the Seventh Circuit rejected the Court of Federal Claims' recent decision in *Clearmeadow Investments LLC v. United States*, 87 Fed. Cl. 509 (2009), which held that the reasonable cause exception in Section 6664(c) applies only at a partner-level determination.

Reasonable cause defense upheld by Seventh Circuit Court of Appeals

The Seventh Circuit Court of Appeals upheld the District Court's decision and held that the taxpayer was not liable for the forty percent Section 6662(h) accuracy-related penalty on gross valuation misstatements. The Court found that the Section 6664(c) and Treas. Reg. Section 1.6664-4 reasonable cause exception applied.

The IRS argued that "any time an adviser incorporates a potential tax shelter into a restructuring plan, the taxpayer may not reasonably rely on that adviser's legal advice and must obtain a second opinion. Such a benefit to the adviser . . . should render any subsequent advice regarding the transaction's legality unreliable as a matter of law." The Appeals Court, however, rejected the IRS' request for a bright-line rule regarding when a taxpayer may not rely on an advisor who has

incorporated a potential tax shelter into a business restructuring plan. The Court acknowledged that “in many instances, perhaps even most, a taxpayer might be unreasonable in relying on an adviser who stands to gain significantly from a transaction.”

The Court held that the taxpayer’s reliance on the advisor was reasonable because the attorney was recommended by the taxpayer’s banker; the taxpayer did not approach the law firm seeking a tax shelter and was unaware that the law firm was marketing similar transactions to other customers; the taxpayer got other advice, including both estate planning and business restructuring advice in response to valid business and asset protection concerns; two reputable accounting firms raised no objections to the tax treatment of the transactions; and the taxpayer paid a flat fee for the advice and not a percentage of the sheltered capital gains. An important fact highlighted by the Court in this case was that the taxpayer was not aware that he was not getting tailored advice and that the law firm that advised him structured similar transactions for thousands of other taxpayers.

Different result would likely be reached under the newly enacted Section 6662A

The American Jobs Creation Act of 2004 added Section 6662A, which provides a new penalty for understatements with respect to reportable transactions, applicable to taxable years ending after October 22, 2004. The Act also added Section 6664(d), which provides a reasonable cause and good faith defense to the Section 6662A penalty. The reasonable cause exception in Section 6664(d) is more stringent and does not allow a taxpayer to rely on an opinion of a disqualified advisor, which includes a material advisor as defined in Treas. Reg. Section 301.6112-1. While the taxpayer prevailed in the instant case, it should be noted that a different result would likely have been reached under the provisions in Section 6664(d) because the Son of Boss transaction in issue would have been a reportable transaction subject to the provisions in Section 6662A.

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