

TAX UPDATE

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Heeding Warnings-Taxpayer Penalized After Preparer Shopping
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Ignoring Preparer's Advice

Given all of the interest that has arisen in the area of tax return return positions, penalties and competent authority, this week's case of *Wadsworth v. Commissioner*, TC Memo 2008-171 is especially timely, as it addresses a number of the issues we've discussed over the past year or so when talking about the §6694 changes. This case deals with client reliance on professionals, disclosed positions and even discusses, in commentary that didn't have an impact on the ultimate opinion, applying the reasonable basis standard to a position.

In the case in question the taxpayers were potentially going to be forced to reimburse the state of California for alleged significant overpayments to their pharmacy business for products and services provided to beneficiaries of the California Medical Assistance Program. While the taxpayers continued to dispute the proposed repayment, they wanted to amend tax returns for the years in which they received the payments to claim a refund. When their long time CPA refused to amend the returns after concluding there was no

support under the law for such a claim for refund, the taxpayers went to another preparer recommend to them by the attorney who was representing them in the overpayment matter who prepared the refund. The good news was that they prevailed in their case with California—but the bad news was that the IRS came back later and looked to collect back the refunds paid and apply the penalties for substantial understatement of tax.

California Looks for a Refund

As noted above, the issue first arose when the state of California Department of Health Services decided to audit the taxpayer's pharmacy business, Gold Coast Medical Services (GCMS), for payments made to beneficiaries of the California Medical Assistance Program during 2001 and 2002. GCMS was a partnership, and Larry Wadsworth was the general partner. At the conclusion of its examination on August 19, 2003, the Tax Court noted the following result:

DHS concluded that GCMS had been overpaid for those periods and directed GCMS to remit \$2,311,634.39 within 60 days of the issuance of the audit report or be subject to interest and an offset of 100 percent withholding on current billings.

GCMS did not agree with these findings and contested the original audit report. In the end GCMS prevailed in its position that no overpayments had been made to it, and that the entity did not owe DHS the \$2.3 million shown on the initial audit report. The Tax Court notes:

The DHS Office of Administrative Hearings and Appeals concluded on September 7, 2004, that GCMS did not engage in discriminatory billing and had not been overpaid. Consequently, GCMS made no reimbursement payments to DHS.

However, things didn't go quite so well for Mr. and Mrs. Wadsworth with regard to the tax positions they took in response to this contingent liability that the partnership faced.

The Amended Tax Returns

When DHS proposed that the taxpayers repay \$2.3 million, the taxpayers and their attorney (Robert Rothstein) contacted the Wadsworth's long time tax CPA, Keith Borges, to see if they could prepare amended partnership income tax returns to reduce the partnership's income for the years in question by the contingent liability and, of course, then amend the partners' individual returns to claim a refund for overpaid tax.

The Tax Court summarized Mr. Borges' qualifications as follows:

He had prepared returns for petitioners since 1994. Mr. Borges received a bachelor of science degree with an emphasis in accounting in 1979 and has been an accountant ever since. He has been a certified public accountant since 1981 and is a partner in the

accounting firm of Anderson Lucas Somerville & Borges. He is a member of the American Institute of Certified Public Accountants and the California Society of Certified Public Accountants.

Mr. Borges took the request under consideration and hit the books to see if a deduction was justified. He concluded that, under the law, there was no support for claiming such a deduction and informed the taxpayers and their attorney of his findings. The Tax Court also noted:

He requested that Mr. Rosenstein send him any supporting information or legal authority to justify claiming a deduction for a contingent liability. Mr. Borges never received any additional information.

At this point, based on what the opinion relates, everything was done according to the book—Mr. Borges did exactly what was required of a competent tax professional faced with this situation should do, and even offered that if the other professional had information that led to a contrary conclusion to provide that information to him. Most important for CPAs to note is that Mr. Borges did not subordinate his judgement to that of the other professional—something prohibited by the Code of Professional Ethics Rule 102. But he also did not presume that his research might have failed to uncover some information that might justify the position it appeared the client and his attorney wanted to take.

However, at this point the taxpayer veers off course and, per the Tax Court, reacts not by coming up with information to support the deduction, but rather with a preparer who would amend the returns. The court notes that the taxpayer and Mr. Rosenstein went to Douglas Huff to do the amended returns. The Court summarizes Mr. Huff's qualifications as follows:

Mr. Huff had a background in finance and had been preparing returns for Mr. Rosenstein's clients for some time.

Note the much more limited background that the Court gave for Mr. Huff vs. what was listed for Mr. Borges, and generally it's not a good thing when the court implies some sort of “referral relationship” when looking at reasonable cause—as we'll discover, that applied in this case as well. The Court also gave a less than flattering explanation of what Mr. Huff did to make his determination on the validity of the amended filings:

He amended the GCMS returns after discussions with Mr. Rosenstein but without consulting tax cases or any other information. Mr. Huff had several conversations with Mr. Rosenstein about the amended returns because Mr. Borges' refusal to amend the returns concerned Mr. Huff, yet he went ahead with amending the returns. Mr. Huff described Mr. Rosenstein as a “bankruptcy-tax attorney” who had been preparing returns

for many years. Mr. Huff amended petitioners' returns based on what he described as a "possible contingent liability."

A number of factors stand out from the above description. Clearly Mr. Huff's ultimate justification was that he did it because he relied upon Mr. Rosenstein, based partially on the fact that Mr. Rosenstein had been preparing returns for many years. He also was concerned about Mr. Borge's refusal to amend the returns, but he did no original research to determine if those concerns were valid. Rather, he apparently took comfort in Mr. Rosenstein's implied determination that such a deduction was proper.

The amended returns were filed before they prevailed in the appeal of DHS audit report. Their amended individual returns claimed a refund of \$147,708 for 2001 and \$56,958 for 2002. Those claims were paid by the IRS.

The IRS Strikes Back

After paying the refunds, the IRS decided to examine the taxpayers returns for the years in question. The IRS assessed the taxpayers for the refunds, plus demanded payment of the penalties for substantial understatement of tax under §6662(b)(2) for 2001 and 2002. The claims for refund exceeded the thresholds under §6662(d)(1)(A) for application of this penalty.

The taxpayers argued they were not subject to the penalty based on two separate positions. First, they argued they qualified they had disclosed the position and had a reasonable basis for the treatment, qualifying for the exception under §6662(d)(2)(B). Second, they argued that their refund claim did not trigger the application of §6662 since the original return had reported the correct tax.

Disclosure and Reasonable Basis for Treatment

The taxpayers had attached the revised Form K-1 to their claim for refund, and argued that this provided the IRS with disclosure about the nature of their claim for refund, such that the IRS should not be able to impose the penalty for substantial underpayment. They did not attach a Form 8275 or explain the basis of the changes when they amended their return. It appears that what the taxpayers told the IRS was that they were amending the return to reflect the amended K-1 prepared by the partnership, but did not disclose the reason the K-1 had been changed—a reason they were very much aware of.

The Tax Court did not find this adequate. The Court notes:

No accuracy-related penalty may be imposed for a substantial understatement of income tax, however, when the taxpayer adequately discloses the relevant facts affecting the tax treatment of an item and there existed a reasonable basis for the treatment of that item. Sec. 6662(d)(2)(B); sec. 1.6662-4(e), Income Tax Regs. A taxpayer may disclose on a

Form 8275, Disclosure Statement, a Form 8275-R, Regulation Disclosure Statement, or on the return itself. Sec. 1.6662-4(f)(1) and (2), Income Tax Regs. The Commissioner has prescribed other circumstances in which information provided on a return is adequate. Sec. 1.6662-4(e)(1) and (f)(2), Income Tax Regs. A Schedule K-1 is not listed as a proper form for disclosure. Rev. Proc. 2001-52, 2001-2 C.B. 491; Rev. Proc. 2002-66, 2002-2 C.B. 724.

The Tax Court also goes on to note that even if the position had been disclosed, it finds that the position did not have a reasonable basis—and the taxpayers should have been aware of that fact. The Tax Court notes to begin the analysis that:

Disclosure will not have an effect, moreover, where the position on the return has no reasonable basis. Sec. 1.6662-4(e)(2)(i), Income Tax Regs. The reasonable basis standard is not satisfied by a return position that is merely arguable. Secs. 1.6662-4(e)(2)(i), 1.6662-3(b)(3), Income Tax Regs.

The Court then notes that even at trial it did not find a coherent explanation of why there was authoritative support sufficient to give reasonable basis to the taxpayers' position. The Court explains:

Petitioners essentially argue that they elected the “modified cash” method of accounting, yet fail to explain what that is or how it absolves them from the penalty. The partnership, if on the cash method of accounting, would have been entitled to a deduction for a liability to the State of California for the year in which the liability was paid. See sec. 1.461-1, Income Tax Regs. Petitioners presented no evidence that the partnership paid any portion of the \$2,311,634.39 during 2001 or 2002 to the State of California. Nor was the partnership entitled to a deduction for “returns and allowances” in 2001 or 2002 under the accrual method of accounting. An accrual basis taxpayer generally cannot accrue a deduction for a contested liability unless conditions of section 461(f) are met. The partnership contested DHS's report and made no transfer within the meaning of section 461(f) to provide for the satisfaction of the liability. An accrual method taxpayer who fails to satisfy the conditions of section 461(f) ordinarily is not entitled to claim a deduction for a contested liability before the year in which the contest is eliminated by compromise or settlement or through a final disposition. *Dixie Pine Prods. Co. v. Commissioner*, 320 U.S. 516 (1944). We find that petitioners had no reasonable basis for their position, and accordingly the adequate disclosure exception does not apply.

Thus, even if a Form 8275 had been filed, the court found that the position lacked reasonable basis.

Note that under the revised §6694 that means the position also would not have been one the preparer could have escaped penalties under as well for having signed the return, even with disclosure, absent being able to show he/she reasonably believed the position was

more likely than not. Whether Mr. Huff's reliance on Mr. Rosenstein would have qualified to insulate him is open to question, especially given that he was aware another qualified professional had refused to prepare the return—suggesting that professional had decided the position was one that did not meet the minimum requirements under the then applicable §6694, Circular 230 and professional standards for CPAs.

But It's An Amended Return

The fact the position was outlined on an amended return did not exempt it from coverage. The Court noted that since it involved the recalculation of their tax liabilities, it was a rebate under §6211(b)(2), and thus was subject to all of the penalty provisions found in §§6211 through 6216.

Reasonable Cause and Good Faith

The taxpayers still had one more possibility—if they could show they had reasonable cause for the understatement and had acted in good faith, they could avoid the penalty. The taxpayers claim to have relied upon Mr. Huff and Mr. Rosenstein for the return position—and it seems clear they did. However, a key question is whether that reliance was reasonable given the facts.

The Court notes the general rule for reliance on a professional to escape penalties:

Reliance on the advice of a professional tax adviser constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. *Id.* To prove reasonable cause due to reliance on the advice of a tax adviser, however, the taxpayer must show that the adviser was a competent professional with sufficient expertise to justify reliance. *Neonatology Associates, P.A. v. Commissioner*, 115 T.C. 43, 99 (2000), *affd.* 299 F.3d 221 (3d Cir. 2002); *Ellwest Stereo Theatres v. Commissioner*, T.C. Memo. 1995-610.

A real problem that the Wadsworths faced is they knew a disagreement existed on whether or not the position was justified under the law. While the Wadsworths aren't required to be tax experts and learn enough tax law to conclude the proper answer between that offered up by Mr. Borges and that offered by Mr. Rosenstein and Mr. Huff, they must show they acted in reasonably in determining the qualifications of those they did rely upon, and didn't just accept the advice solely based on the fact it gave them the lowest tax liability.

The Court notes that they clearly were aware there was a significant dispute:

We agree with respondent that petitioners lacked reasonable cause for, and failed to act in good faith with respect to, their substantial understatements of income tax for 2001 and 2002. Petitioners made very little effort to assess their proper tax liability, and they

failed to heed the advice of their longtime return preparer, Mr. Borges. Petitioners ignored Mr. Borges' advice, and Mr. Huff amended the returns instead. We find that Mr. Borges' refusal to amend the returns should have raised a red flag for petitioners, but petitioners disregarded that warning.

While the Court does not say so, it seems likely that Mr. Borges understood that the failure to accommodate the position that Mr. Rosenstein was advancing could cost him the client. It does not seem unreasonable that the client should also consider that fact in understanding that the adviser likely is not refusing to cooperate simply on a whim, but rather has run into an issue that he feels professionally prohibits him from doing the work requested.

We do not know what exactly Mr. Borges told his clients on this matter. If faced with such a matter, it does advisable for the professional to outline in detail the fact that in order to hit a position where he cannot prepare the return, even with disclosure, the preparer has come to the conclusion that the position has so little support not to have a reasonable basis of prevailing—or, back in this time period, in fact had so little support to make it a frivolous position (while the taxpayer faced penalties if there was no reasonable basis, a preparer could still do the return with disclosure if the position was not frivolous).

Does that mean the taxpayers are stuck once told this even if the preparer is unreasonable? No, but they do have a duty to inquire of the qualifications of those on whom they later do decide to rely on, something that Wadsworth did not do in the eyes of the Court:

Petitioners offer no explanation for their reliance upon Mr. Rosenstein and Mr. Huff in spite of their longtime preparer Mr. Borges' refusal to amend their returns. Petitioners also failed to establish that Mr. Huff and Mr. Rosenstein were competent professionals with sufficient expertise to justify their reliance. Mr. Rosenstein never testified. Mr. Huff did. Mr. Huff does not appear to have a background in tax, and he offered no legal authority to explain why he amended the returns other than that Mr. Rosenstein directed him to do so.

Since Mr. Rosenstein doesn't testify, the Court is “stuck” with Mr. Huff—and Mr. Huff simply says the attorney told him to do it—the attorney who isn't testifying in the case. As well, the Court finds the taxpayers themselves could give no justification.

As well, the Court also tends to consider the taxpayers' own level of sophistication—and in this case, that worked against the Wadsworths:

Petitioner is a successful businessman who, as a partner of GCMS, operated a multimillion-dollar business. It is reasonable to assume that such a person would investigate the basis for amending his returns when his longtime accountant advised against the position taken in those returns. Petitioners' decision to amend their returns

appears to have been motivated not by the demands of the law but by their desire for tax refunds.

The last sentence is likely the most telling—the Court seems to have decided here that what we had was a taxpayer who was “opinion shopping” for preparers, and the primary qualification they were looking for was someone who would take the position they wanted, rather than seeking advice on what was the proper position under the law. When taxpayers use results oriented criteria in selecting an adviser, they aren't going to be allowed to claim they relied on the advice of that adviser (only advisers that gave the advice they wanted to hear would be chosen).