



"Creative Planning" Creates Fraud Penalty  
September 22, 2008



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## **Fraud Penalty and the CPA**

This week we are looking at the case of a certified public accountant who engaged in "creative" self-employment tax planning for his own practice—planning that ended up being held to be a bit overly creative, subjecting the CPA to the fraud penalty under §6663. The case is the one of *Baisden v. Commissioner*, TC Memo 2008-215.

This week I've got two speaking engagements, the first in Roanoke, Virginia on Monday and Tuesday with a technology update for CPAs, while on Wednesday I will be speaking in Towson, Maryland (a suburb of Baltimore) on Fringe Benefits before returning to Phoenix. My travels continue the following week as I speak Tuesday in Bloomington, Minnesota on Advanced LLC and Partnership issues. That pretty much takes care of my speaking before October 15, though on October 16 I do a session on Current Federal Tax Developments in Casper, Wyoming, followed the following week by a week of California Education Foundation presentations on partnerships and S corporations.

As well, it appears I will be doing an online presentation for the California Education Foundation on various issues related to home mortgages, concentrating first on the issues regarding Section 108 when the mortgage turns out to be more than the value of the underlying property and the taxpayer loses the property, as well as a quick review of the more mundane issues.

This week's podcast is being prepped (including writing this document) as I am flying to Baltimore on a Southwest Airlines 737 and is to be recorded at the Hotel Roanoke in Roanoke Virginia using a Blue Snowflake portable microphone (or at least hopefully doing so). This document is being written on the Eee PC—and right now the 7" screen is doing its job, as the person in front of me has reclined her seat, most likely for the duration of the flight.

## **Self-Employment Tax**

The CPA in question was trying to reduce the self-employment tax he was paying due to his practice, and he came upon what the following strategy as described by the Tax Court in its opinion:

In an effort to explain his bookkeeping and accounting methods, petitioner explained that since approximately 1998 he had developed for his use and for the use of his clients a novel and insightful tax strategy that may be described generally as follows:

- (1) Booked sole proprietorship income would be totally or almost totally offset by the payment by the sole proprietorship of "royalties" to the owner of the business;
- (2) the so-called royalties would not be paid directly to the owner but rather would consist of payments by the sole proprietorship of the owner's personal and family expenses;
- (3) the "royalty" payments would be treated as fully deductible by the sole proprietorship, and they would reduce the booked net income of the sole proprietorship to zero; and
- (4) the owner would report "royalties" paid with regard to personal and family expenses as "other income" not subject to employment taxes.

The primary savings were apparently intended to be derived from petitioner's tax strategy through the conversion of sole proprietorship business income subject to self-employment taxes into royalties not subject to self-employment taxes.

Self-employment tax is governed by IRC §1402(a) which contains the following definition for self-employment income:

(a) Net earnings from self-employment

The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss...

The key issue in that sentence is "trade or business carried on" for the question of whether royalty income is subject to self-employment tax. Unlike other items, like rental income excluded by §1402(a)(1), royalties are not automatically excluded from self-employment tax.

Revenue Ruling 68-498 dealt with a number of issues related to royalties, but outlines the following discussion of whether royalties are subject to self-employment tax. It notes:

Whether or not an individual is engaged in a trade or business depends upon the facts in the particular case. As a general rule, a person who is regularly engaged in an occupation or profession for profit which constitutes his livelihood, in whole or in part, and who is not regarded as an employee for Federal Insurance Contributions Act purposes, is engaged in a trade or business for self-employment tax purposes. If an individual writes only one book as a sideline and never revises it, he would not be considered to be 'regularly engaged' in an occupation or profession and his royalties therefrom would not be considered net earnings from self-employment. However, where an individual prepares new editions of the book from time to time, and writes other books and materials, such activities reflect the conduct of a trade or business, and, if it is not one of the excluded professions of section 1402(c) of the Self-Employment Contributions Act, the income from it is includible in computing net earnings from self-employment, subject to the limitations of section 1402(b) of the Act. See Rev. Rul. 55-385, C.B. 1955-1, 100.

The key question comes down to whether the royalties are generated by the efforts of the individual that rise to the level of a trade or business. If the royalties are being generated

from, say, a piece of real estate for which a royalty is being paid by a third party who is extracting minerals from a piece of property with no real involvement by the taxpayer that wouldn't be a trade or business. But if I am paid a royalty for something for which my services in a trade or business created the income, then it's not automatically exempt from self-employment income.

It should be clear by now that the taxpayer may have had some basic misunderstandings of how self-employment taxes, perhaps arising from the fact that Schedule E mentions royalties and since rental income doesn't normally end up subject to self-employment tax the same must be true of any royalty. And that ignores the whole issue of the simple economic reality of whatever this taxpayer may have been paid royalties for.

The taxpayer went a bit further—these “royalties” were generally used to pay personal expenses, and it turned out that not all of the royalty payments were reported on the taxpayer's tax returns for the years in question.

The taxpayer did try to offer some explanation during the audit, albiet not a very good one:

With regard to the so-called royalties paid by his accounting firm, petitioner offered respondent's agent a number of inconsistent explanations. In conversations with respondent's agent, petitioner explained that because corporations are allowed deductions for certain employee education expenses, an individual taxpayer/sole proprietor also was entitled to deduct children's school expenses on his/her individual Federal income tax returns.

Later the taxpayer decided to take one more step to slow down the process, as the Tax Court noted:

In an effort to delay respondent's audit, petitioner filed a spurious complaint with the Taxpayer Advocate's Office.

However, in the end this was all for naught, and the taxpayer ended up agreeing to the proposed tax, interest and various penalties.

In fact, the opinion we are looking at doesn't deal with the merits of his position at all except as it relates to the fraud penalty, since the taxpayer had already conceded that tax was due. The key question was whether the accountant was subject to the fraud penalty.

## **Fraud Penalty**

Section 6663(a) provides a penalty for understatements due to fraud:

(a) Imposition of penalty

If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud.

The Tax Court explains the test for whether fraud exists as follows:

Fraudulent intent is defined as "actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing." *Estate of Temple v. Commissioner*, 67 T.C. 143, 159 (1976) (quoting *Mitchell v. Commissioner*, 118 F.2d 308, 310 (5th Cir. 1941), revg. 40 B.T.A. 424 (1939)). To prove a taxpayer's tax fraud, the Commissioner must establish by clear and convincing evidence: (1) The existence of an underpayment of tax; and (2) the taxpayer's fraudulent intent. *Akland v. Commissioner*, 767 F.2d 618, 621 (9th Cir. 1985), affg. T.C. Memo. 1983-249; *Parks v. Commissioner*, 94 T.C. 654, 660-661 (1990).

Whether petitioner's fraudulent intent has been established is to be analyzed on the basis of all of the facts and circumstances in evidence. See *Stratton v. Commissioner*, 54 T.C. 255, 284 (1970).

Fraud is never to be imputed or presumed; however, "its proof may depend to some extent upon circumstantial evidence, and may rest upon reasonable inferences properly drawn from the evidence of record." *Stone v. Commissioner*, 56 T.C. 213, 224 (1971); see also *Rowlee v. Commissioner*, 80 T.C. 1111, 1123 (1983); *Stephenson v. Commissioner*, 79 T.C. 995, 1006 (1982), affd. 748 F.2d 331 (6th Cir. 1984).

The Court then goes on to describe the badges of fraud test that has been developed in this area:

Courts have developed several objective "badges" of fraud, including: (1) Understatements of income; (2) the absence of records; (3) implausible or inconsistent explanations of behavior; (4) asset concealment; (5) cash dealings; and (6) lack of cooperation with tax authorities. *Bradford v. Commissioner*, 796 F.2d 303, 307-309 (9th Cir. 1986), affg. T.C. Memo. 1984-601; *Paschal v. Commissioner*, T.C. Memo. 1994-380, affd. without published opinion 76 AFTR 2d 95-7975, 96-1 USTC par. 50,013 (3d Cir. 1995).

A one sentence paragraph gives us a warning that our taxpayer being a CPA likely is not

going to go well for him in the court's view. It says:

A taxpayer's experience and education may also be considered. *Niedringhaus v. Commissioner*, 99 T.C. 202, 211 (1992); *Grosshandler v. Commissioner*, 75 T.C. 1, 19-20 (1980).

## Applying the Law to This Case

For 1998 through 2003 the taxpayer had developed this “creative” method of dealing with reducing his tax liability, a method that was under review for 2001 to 2003. The Court notes that consistently understating tax is an issue:

Consistent, substantial understatements of income over several years are highly persuasive evidence of intent to defraud the Government, particularly when combined with other indicia of fraud. As the U.S. Court of Appeals for the Ninth Circuit has stated: "repeated understatements in successive years when coupled with other circumstances showing an intent to conceal or misstate taxable income present a basis on which the Tax Court may properly infer fraud." *Furnish v. Commissioner*, 262 F.2d 727, 728-729 (9th Cir. 1958) (citing *Anderson v. Commissioner*, 250 F.2d 242, 249-250 (5th Cir. 1957), affg. in part and remanding T.C. Memo. 1956-178), affg. in part and remanding in part *Funk v. Commissioner*, 29 T.C. 279 (1957).

The Court then turned to our taxpayer in this case, giving the following evaluation of the underlying strategy:

The evidence supports imposition against petitioner of the fraud penalties for each year. Petitioner's use of so-called royalty payments to pay personal expenses and to offset or reduce business income is patently improper and nothing more than a fantasy creation of petitioner in an effort to evade the payment of taxes due and owing.

Suffice it to say it's clear the Court wasn't amused by the creation of the taxpayer. The Court specifically invoked the issue of the taxpayer's education and background against him, noting:

In spite of petitioner's education, training, and experience as an accountant, on the 2001, 2002, and 2003 Federal income tax returns in issue petitioner failed to report substantial income from his business activities and claimed obvious personal expenses as deductible business expenses. Further, petitioner failed to otherwise report (as royalty income) substantial business income.

The conduct during the audit and the nature of materials provided also worked against the taxpayer, as the Court noted:

Petitioner's books and records intermingled business and personal items. Petitioner provided ridiculous explanations for his tax return treatment of income and expenses, and petitioner did not cooperate with respondent's audit.

The Court thus, not surprisingly, concludes:

Petitioner's use of so-called royalty expenses to offset business gross receipts and to eliminate or minimize reported income, income taxes, and self-employment taxes is unfounded and improper.

Petitioner's liability for the fraud penalties determined by respondent is sustained, and the fraud penalty for each year applies to the entire tax deficiency for each year.

For the reasons stated, we sustain respondent's imposition on petitioner of the fraud penalty for each of the years in issue.

In some ways, you have to wonder why the taxpayer decided to fight this issue, though I would guess it was simply the amount of the penalty. But despite having his day in Court, the taxpayer lost the position entirely.

## **Lessons**

It's tough to know the rationale behind the taxpayer's use of the methods he used, but all explanations I can think of don't end up being flattering to the preparer. However, clients often run into preparers who are similarly “creative” that their friends tell them about. In Arizona most of us are very aware of recent cases of creative tax preparation where the Arizona Department of Revenue finally came down on the preparer, sending their clients scattering to many of us to clean up the mess.

However there are a number of reasons why a preparer might end up pushing such positions. Unfortunately simple incompetence can explain many of them. Although the Tax Court might be incredulous at the explanation, in reality there are preparers we all run into who would simply conclude that royalties aren't subject to self-employment taxes since they are reported on Schedule C, so you could simply pay yourself a royalty and through a bookkeeping entry manage to eliminate self-employment tax.

Similarly, they would conclude the payment of personal expenses was simply a “fringe

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benefit” and as we “all know” fringe benefits aren't subject to tax—except for the minor problem that §61(a) explicitly says they are...

The other option is that it we simply have audit lottery positions where the preparer is simply playing the odds. In that case the taxpayer is hoping that since the IRS doesn't have a simple method of separating royalties subject to self-employment tax from those not subject to the tax, they will be able to escape detection. Unfortunately, this tactic works far too often and has the unfortunate side effect that some taxpayers look at someone else's success in not being questioned by the IRS as “proof” that the technique is perfectly allowable.

Note that in this case the taxpayer had begun doing this in 1998, but it wasn't until a number of years later that the IRS actually managed to open an examination of the taxpayer. That fact might be useful to point out to clients who come to us with that “but Joe has been doing this for the last two years and hasn't been questioned” line.