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The IRS Goes Easy on a Noncompliant Taxpayer

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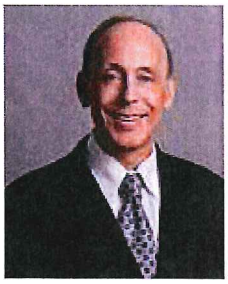

A recent Tax Court case involving listed transactions is important for what did not happen: The Internal Revenue Service did not "throw the book" at the taxpayer.

On Jan. 28, 2013, U.S. Tax Court Judge Kathleen Kerrigan decided *Soni v. Commissioner*. This case can be viewed as another in a surprisingly short line of taxpayer defeats involving listed transactions. See, for example, the 2010 case, *McGehee Family Clinic, P.A., et al. v. Commissioner*, involving a welfare benefit plan. However, in the Soni case, the fact that the IRS could have charged the taxpayers with harsher penalties may be helpful in other matters involving listed transactions. It may also forecast the IRS's approach to the non-willful penalties in the Offshore Voluntary Disclosure Initiative; and help reassure the public that the IRS uses penalties to promote compliance, not raise revenue.

Mr. and Mrs. Soni owned an S corporation that adopted a defined benefit plan. Instead of a run-of-the-mill pension plan in which the contributions might be invested in publicly traded stocks and bonds, Soni Inc. adopted the type of plan that the IRS plainly does not like: a fully insured defined benefit plan under Section 412(i) of the Tax Code. The IRS viewed these plans as abusive because they were used to generate larger deductions than would have been available through a "regular" pension plan.

The IRS issued Revenue Ruling 2004-20 in an attempt to put a stop to this type of fully insured plan, labeling them "listed transactions." As a result of that categorization, a group of rules and penalties enacted in 2004, aimed at listed and other "reportable" transactions, apply. For example, Section 6662A of the Tax Code imposes an excise tax of 20 percent on the amount of the understatement attributable to a reportable transaction. That penalty increases to 30 percent if the reportable transaction is not properly disclosed on the return under Section 6662A(d).

The more onerous penalty is Internal Revenue Code Section 6707A. As enacted, it imposes a $100,000 penalty on a "natural person" who fails to report a listed transaction. That resulted in some situations that were difficult to justify. For example, assume a taxpayer engaged in a non-disclosed listed transaction in which the tax savings was $1,000 per year for three years.

Under the law as in effect in 2004, the taxpayer would owe a $300 per year penalty under Section 6662A and a $100,000 per year penalty under Section 6707A. The absurdity of the result led then IRS chief counsel Donald Korb

to announce that the IRS would suspend enforcement of IRC Section 6707A to give Congress a chance to remedy the situation.

On Sept. 27, 2010, President Obama signed into law H.R. 5297, the Small Business Jobs Act of 2010. Section 2041 of that law amended Section 6707A to limit the penalty for failure to disclose listed transactions assessed after Dec. 31, 2006 to 75 percent of the decrease in tax, not to exceed $100,000, in the case of a natural person, under Section 6707A(b)(2)(A).

The years involved for Mr. and Mrs. Soni pre-dated the change in the law. They conceded that they engaged in a listed transaction. However, they argued that they met the disclosure requirements because the corporation submitted the pension plan to the National Office of the IRS for a favorable determination letter. Judge Kerrigan pointed out that a determination letter only addresses a plan's qualified status as written, not in operation. For example, a determination letter does not address whether the actuarial assumptions are reasonable or whether a specific contribution is deductible.

The Sonis next argued that they had substantially complied with the rules because Soni Inc. attached IRS Form 8886, Reportable Transaction Disclosure Statement, to its tax return, in compliance with Reg. Section 1.6011-4T(a)(1). However, Mr. and Mrs. Soni had a separate filing obligation, as the shareholders, and failed to do so. Judge Kerrigan rejected that argument.

Mr. and Mrs. Soni then argued that they had reasonable cause and acted in good faith. To qualify for reasonable cause from this particular penalty, the taxpayer must follow the disclosure provisions, have substantial authority for his or her position, and reasonably believe that the position was more likely than not the proper treatment.

Since the Sonis failed the first requirement—disclosure—they could not meet the reasonable cause defense. Finally the Sonis asked the Commissioner to abate the penalty due to the Commissioner's allegedly erroneous written advice (the favorable determination letter). The court had no trouble rejecting this argument.

Despite the failure of the taxpayers' arguments, this was a pro-taxpayer result because the IRS did not try to collect the Section 6707A penalty. The IRS was well within its rights to collect that penalty. Arguably the IRS was required to collect the penalty. Section 6707A provides that "any person who fails to include on any return...any information with respect to a reportable transaction...shall pay a penalty...." [emphasis added] The IRS's failure to assert the penalty is even more extraordinary when you consider that the statute specifically prohibits the IRS from rescinding a listed transaction penalty and prevents a taxpayer from seeking judicial review of the penalty!

Has the IRS suddenly gone soft? Certainly not. Based on the penalty involved for the three years (less than $30,000), the Sonis' total pension contributions were about $300,000. The IRS was obviously uncomfortable with the prospect of asking for a penalty equal to 100 percent of the deduction. This was not a decision made by an auditor. In a case tried in Tax Court, this was a decision made at a very high level of the IRS.

We hear advertisements about how the IRS is the "toughest" or most "vicious" tax collection agency in the world. Of course, if a taxpayer owes money, it is the job of the IRS to collect it. However, the IRS is also trying to do a good and fair job. And this case is just another example of what many practitioners already know: the IRS tries to reach a sensible result, wherever possible.

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