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IRS Tackles Four-Time Super Bowl Champion for a $5 Million Loss

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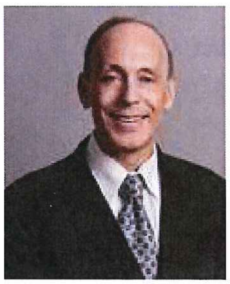

Back in 1925, a taxpayer won the first case in the Board of Tax Appeals involving the deduction for horse-breeding activity expenses. Deducting expenses related to the "sport of kings" was so attractive that the estate of Cornelius Vanderbilt tried, and lost, two years later. In the intervening 88 years, about 200 taxpayers have litigated the issue, most with unattractive results. The IRS and the courts have essentially told taxpayers to "stop horsing around."

In less than a month (February 20 - March 13, 2013) the Tax Court recently decided three more horse-breeding cases. Unsurprisingly, all three taxpayers lost. However, one had quite a surprise when it came to the penalty.

During his 16-year NFL career, Bill Romanowski was the only linebacker to start five Super Bowl Games. He compiled 1,105 tackles, 39.5 sacks, 18 forced fumbles and 18 interceptions. However, the IRS tackled him for a $4,752,736 loss in Romanowski v. Commissioner, T.C. Memo 2013-55 (Feb. 20, 2013).

After he retired from football, Romo had a problem with a real estate investment, so his long-time financial advisor referred him to a tax lawyer at a firm with over 1,000 lawyers in 20 locations. In other words, a big reliable firm. Once the real estate problem had been addressed, the conversation turned to other tax planning, and the tax lawyer told Romo about a horse-breeding program that had retained the law firm. The program materials included a 53-page opinion letter from a well-respected Chicago law firm. Although the tax lawyer had a conflict of interest, which he fully disclosed, Romo agreed to invest $13,092,732 into the ClassicStar program. (That tax lawyer is now a sole practitioner.)

How did he come up with such an odd number? The answer is that ClassicStar fed Romo's tax returns into their computer and determined the precise amount needed to offset his taxable income from 1998 – 2003. Romo did not invest the $13 million out of pocket; the investment was financed with non-recourse loans from a lender related to ClassicStar.

The court's decision includes an interesting piece of information: Romo's financial advisor, the one who referred him to the tax lawyer, adamantly opposed the investment and warned him that it was a "tax scheme and a significant threat to petitioners' financial security." She later resigned as Romo's financial advisor.

The rest of the story is achingly dull. Imagine trying to claim to be a professional golfer, so that you can deduct your country club membership and vacations, and claiming that part of your training consists of watching the Golf Channel. If you can imagine that, then you will not be surprised to learn that: (i) despite the written agreement to lease only thoroughbreds, Romo did not complain when over 90 percent of the horses he received were quarter horses; (ii) he never consulted anyone other than ClassicStar for advice about horses; and (iii) in the two years in which he invested over $13 million, he spent 193 hours and 88 hours, respectively, on the activity.

What makes the case legally noteworthy was the court's handling of the 20 percent accuracy-related penalty. The penalty does not apply if the taxpayer establishes that he or she (1) had reasonable cause, and (2) acted in good faith. The Supreme Court has stated that it is reasonable for a taxpayer to rely on the advice of an accountant or attorney on a matter of tax law. However, the Tax Court has held that reliance upon an advisor is generally unreasonable when that advisor has an inherent conflict of interest that the taxpayer knew or should have known about.

Clearly Romo's tax lawyer had a conflict of interest, which was disclosed. However, the court felt that the mere fact that Romo was aware that the lawyer received a financial benefit due to Romo's participation in the program was "not sufficient to show that [Romo] could not rely on him in good faith…." Buttressing the court's conclusion was that the tax lawyer had Romo hire an independent CPA who: (i) had a master's in tax law; (ii) was familiar with the rules regarding claiming NOLs due to farming activities; (iii) had no prior relationship with the tax lawyer; (iv) discussed ClassicStar with another accountant in his firm who was familiar with it; and (v) told Romo that the ClassicStar-related expenses were tax deductible.

On that same day the same judge handed down another opinion involving the ClassicStar program. William G. Pederson, et ux v. Commissioner, TC Memo 2013-54 (February 20, 2013). Again, the amount of investment was determined by "an NOL calculator." However, this taxpayer did not consult with a tax lawyer. This taxpayer consulted a corporate lawyer who advised that the "tax opinion [provided by ClassicStar] appeared in order." The taxpayer's CPA agreed. In this case the taxpayer's reliance on the attorney was deemed to be unreasonable because the attorney (i) was not a tax specialist; and (ii) did not testify at trial. Reliance on the CPA was unreasonable because (i) the taxpayer did not provide the CPA with all materials regarding the program and (ii) the CPA did not testify at trial.

On March 13, a case involving a non-ClassicStar taxpayer was decided, but with the same sad results. Dodds v. Commissioner, T.C. Memo 2013-76 (March 13, 2013). This taxpayer was an accountant with a master's degree in business taxation. However, he never had a written business plan; did not maintain a separate bank account for his breeding activity; never made financial projections; and had losses for 17 years in a row. Since Mr. Dodds earned $240,000 in 2007 and $280,000 in 2008 as an accountant, the court effectively told him to stick to his day job. In terms of the penalty, since he relied on himself for advice, he had a fool for a client.

Bruce Givner has practiced tax law for more than three decades and is president of Givner & Kaye, based in Los Angeles. He specializes in income tax planning, estate tax planning, asset protection, sophisticated retirement planning, tax litigation, charitable giving and more. Givner represents high net worth individuals and families, including A-list celebrities. In addition, he is frequently called upon by other attorneys, financial planners, accountants, and investment and insurance professionals to consult on their own clients. He graduated from UCLA, received his juris doctorate from Columbia Law School and also studied at New York University. He has served on the Executive Committee-Taxation for the American Bar Association, the Los Angeles County Bar Association, is past chair of the Beverly Hills Bar Association, and has an AV Rating with Martindale-Hubble. He has been quoted in Reuters and the Daily Journal. He also is a contributing writer for Accounting Today.