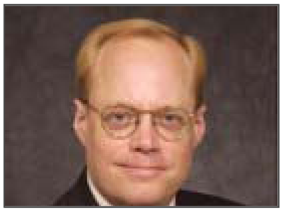
Forbes



Robert W. Wood

THE TAX LAWYER

Jan. 27 2011 — 8:56 am

Relying On Tax Advisers May Not Prevent Penalties

When you take tax positions that are challenged, the IRS usually adds penalties and interest to your tax bill. Interest generally can't be waived, but "I relied on my tax adviser" can be a potent defense to penalties. Unfortunately, claiming you relied on your tax lawyer or accountant doesn't always work, as a recent Tax Court case reveals.

In *106 LTD, David Palmlund, Tax Matters Partner v. Commissioner*, Palmlund claimed he reasonably relied on his attorney and accountants. Classifying them as promoters, the Tax Court ruled it was unreasonable of him to rely on them.

Accuracy-Related Penalty? The accuracy-related penalty is 20% of a tax underpayment, and the penalty goes up to a whopping 40% in certain cases. For the 2001 tax year involved here, one could avoid the penalty if there was reasonable cause and the taxpayer acted in good faith. Reasonable reliance on professional advice qualifies as reasonable cause.

Palmlund was a sophisticated businessman and investor, and this was a "son-of-boss" tax shelter. His lawyer prepared a tax opinion (the Tax Court called it "sloppy") based on apparently bogus representations by Palmlund that this was a real economic deal (which it clearly was not). Palmlund's regular accounting firm approved it and charged extra for the return preparation.

Like many other shelters, this one failed. Palmlund admitted he owed the additional taxes, but tried to avoid the accuracy-related penalty by saying he relied on his lawyer and accounting firm. The Tax Court said no.

Three factors determine whether a taxpayer properly relied on professional advice:

1. Whether the adviser was a competent professional with sufficient expertise to justify the reliance;

2. Whether the taxpayer provided the adviser with necessary and accurate information; and

3. Whether the taxpayer actually relied in good faith on the adviser's judgment.

Despite a sloppy opinion, the Tax Court said Palmlund's advisers ***were*** competent professionals who gave him necessary and accurate information! However, Palmlund couldn't satisfy the third test because:

- His business sophistication and experience made it hard to believe he didn't know this transaction was improper. It seemed doubtful that he acted in good faith in light of his experience, knowledge, and education.

- The opinion letter was filled with Palmlund's representations, many of which were not true. The Tax Court found it hard to believe that someone as sophisticated as Palmlund would not suspect something was amiss.

- The lawyer and accounts were "promoters" of the transaction.

What's a Promoter? A "promoter" is "an adviser who participated in structuring the transaction or is otherwise related to, has an interest in, or profits from the transaction." See *Tiger's Eye Trading, LLC v. Commissioner*. Both the lawyer and accountants did here. Because they structured the transaction and profited from implementing it, they were "promoters." Palmlund could not rely on their advice in good faith.

The Tax Court quipped, "promoters take the good-faith out of good-faith reliance." Clever but true.

For more on tax shelters, see:

Know Tax Shelters When You See Them?

Tax Shelters Not Über Alles

For more on tax opinions, see:

Why Tax Opinions Are Valuable

What Good is a Tax Opinion Anyway?

Liability for Tax Opinions: What's an Opinion and Who Can Sue?

Robert W. Wood practices law with Wood & Porter, in San Francisco. The author of more than 30 books, including Taxation of Damage Awards & Settlement Payments (4th Ed. 2009, Tax Institute), he can be reached at wood@woodporter.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.