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MESSAGE FROM THE CHAIR

Greetings to the Tax Procedure and Litigation Committee!

Hopefully, you have all signed up for the upcoming 2009 Annual Meeting of the California Tax Bar & California Tax Policy Conference. This conference should be another excellent event. I also hope that you have planned to attend our committee luncheon meeting on Friday the 13th. I look forward to seeing you there.

I thank all of you for giving me the opportunity of serving you, and it is with great pleasure that I follow in the steps of our outgoing Chair, Kornelia Davidson, who provided an example of excellence during her term. Thank you, Korn. Thank you to Robert Horwitz for his work last year and for his support as incoming Chair Elect. Thank you to Brian Lynn, as well, for putting together our newsletters last year. We were disappointed to accept his resignation as 1st Chair. We have recommended that Michel Stein, who was elected as 2nd Chair at our last Committee meeting be moved up to 1st Chair/Secretary, and that David Klasing be appointed 2nd Chair/Network Editor — David has prepared and edited this newsletter. Please contact David when you have an article you would like published in our Tax Network Newsletter. We hope to confirm the 1st and 2nd Chair at the luncheon meeting.

Finally, thank you to those who have helped to make our Tax Network Newsletter and Committee meeting successful. We look forward to hearing about more “Hot Topics” at our upcoming luncheon meeting. Our members continue to lead, teach and provide guidance in various ways through programs such as SEI, the Washington D.C. Delegation, and more. This is in addition to their regular activities. So, there is a lot to share. And if there is a topic that you think needs to be addressed, there is a venue for it!

With respect to the Washington D.C. Delegation, please let us know of any topics you would like the Committee to propose to the Executive Committee, and if you would like to write such. We need to have our topics finalized at the upcoming luncheon meeting.

Enjoy the conference!

MEETING INFORMATION

2009 Annual Meeting of the California Tax Bar and
California Tax Policy Conference
November 13, 2009
11:45 am. - 12:45 a.m.
Sheraton Harbor Island, San Diego

MEETING AGENDA

1. Welcome 11:45 A.M.
2. Approval of Minutes.
3. Approval of Committee Officers
4. Quarterly Committee Meeting Topics & Locations
5. Discussion of Topics for the Washington Delegation
6. Hot Topic Discussions.
7. Adjourn 12:45 P.M.

SCHEDULE OF UPCOMING MEETINGS

To be determined at November Meeting

MINUTES OF THE JULY 31, 2009, COMMITTEE MEETING

Submitted by Robert S. Horwitz, Esq.

The July 31, 2009, meeting of the Tax Procedure & Litigation Committee of the Tax Section of the State Bar of California was held at the offices of Holmes, Roberts & Olson, San Francisco, California. Present were the chair, Kornelia Danielson, the chair-elect, Michael Sanders, and the first vice chair, Robert Horwitz.

WELCOME AND INTRODUCTIONS

The Chair welcomed members to the meeting. The members present at the meeting introduced themselves. The Chair also welcomed and introduced guests from the IRS and the FTB.

APPROVAL OF MINUTES AND BYLAWS

The first order of business was the approval of the minutes of the last meeting. The minutes were approved. The second order of business was the approval of the by-laws. The by-laws were approved.

ELECTION OF SECOND VICE CHAIR

Brian Lynn had recently tendered his resignation as second vice chair. The next order of business was, therefore, the election of a second vice chair. There were two candidates, Michel Stein and Dave Klasing. After a vote of the members present at the meeting, Michel Stein was elected as second vice chair. It was brought to the Committee's attention that before the Chair Elect can become Chair, he/she must be approved by the Executive Committee of the Tax Section.

BUSINESS ITEMS

Michelle Ferreira announced that seven programs from the Tax Section will be presented at the Annual Meeting of the State Bar in Monterrey in October. Only one of these topics was from the Tax Procedure & Litigation Committee.

The Committee then discussed the upcoming Washington, D.C., trip. Members have until September to submit topics to be presented on the trip and until October to submit written proposals. During the trip, members meet with the IRS, the House Ways & Means Committee, the Senate Finance Committee and the Tax Court. Members spend two or three days making presentations. Members of the Tax Section submit topics. The topics to be presented are selected by the Executive Committee.

The written proposal for a topic should be approximately one page. In November, the proposals are submitted to the Executive Committee, which selects the topics. In January, draft papers are to be submitted for review. The final drafts of the papers are to be submitted in February. In March, the papers are finalized. Historically, the Tax Litigation & Procedure Committee and the Los Angeles County Bar Association have been the most active in submitting topics that are chosen to be presented on the Washington trip. If a topic is selected for presentation, the paper is published in the spring issue of the California Tax Lawyer. The person who presents the paper is also given the name of his/her counterpart at the IRS on the topic. The Committee needs at least two submissions from

members.

Michelle Ferreira stated that while the IRS is reluctant to suggest topics, it does approach the Tax Section on an informal basis about the issues that it is interested in hearing about. The Committee would be well served to find topics that are “hot.” The IRS would like to hear from a senior lawyer. When the Executive Committee gets topics, they need to have the proper tone and the proper topic.

Steve Jaeger raised the fact that preparer penalties are coming up more frequently in audits. Joe Broyles stated that the IRS is issuing CDP notices sooner. Taxpayers often lose their CDP rights before they contact a tax professional. He asked whether administrative efficiency a potential topic for a paper? The Chair stated that whoever submits a topic has to be careful on how to frame the topic.

Michelle Ferreira stated that with respect to programs for the Annual Meeting of the Tax Section, Julie Divalos is handling programs on the federal side and Carly Roberts is handling topics on the state side. The number of programs this year is being pared down to 28 topics from 36 programs last year. The Executive Committee wants to mix up the types of speakers and to get well-known speakers, similar to those who make presentations at ABA conferences. The committees turn in topics for the Annual Meeting and the Executive Committee tries to select topics with broad appeal.

For this year’s Annual Meeting, the Tax Procedure & Litigation Committee has nine programs that it is sponsoring or co-sponsoring: (1) Penalties; (2) Officer-Owner Personal Liability for Tax Owed by a Business; (3) Preparing a Tax Court Case for Trial; (4) When Tardiness May Be Excused by the IRS; (5) The Economic Substance Doctrine; (6) Privileges and Client Confidentiality; (7) Conflicts of Interest in Tax Cases; (8) Tax Shelters, Federal & State; and (9) FBAR.

The Chair stated that the FTB has been asserting extended statutes of limitations on collection by claiming that the statute starts to run again when

it assesses additional penalties, etc. Problems are more with the State than with the IRS. She asked whether an ad hoc committee be formed for input to the California Conference of Delegates. Michelle Ferreira stated that the State & Local Tax Committee has an annual tax conference. John Harbin stated that the Los Angeles County Bar Tax Section has a state & local tax committee that is active on state tax issues.

There will be a number of state and local programs at the annual meeting of the Tax Section. The meeting will be held on November 12 through November 14 in San Diego at the Sheraton Harbor Island.

SPEAKER PRESENTATION

The Speaker Presentation was on Voluntary Disclosure of Undisclosed Foreign Accounts and Entities. The speakers were introduced by the Chair. The speakers were Alan Astengo of the IRS, Arlette Lee of IRS Criminal Investigation, and Lila Felder of the FTB. Because the program terminated in October, 2009, it will be discussed only briefly.

Ms. Lee stated that Criminal Investigation is like any other federal law enforcement agency, except that its focus is on federal taxes. On the Tuesday immediately before the meeting, the IRS announced new procedures for persons wishing to participate in the Voluntary Disclosure Program, because the ones that were initially put in place were too time consuming due to the requirement for taxpayer interviews.

For people who are accepted for participation in the program, Criminal Investigation has no discretion with respect to penalties. If a taxpayer disagrees with the penalties and asserts that he/she should not be subject to penalties, at the Revenue Agent level, the case goes out of the Voluntary Disclosure Program and the Revenue Agent will then determine the penalties. In such a case, the taxpayer can be subjected to larger penalties than those under the program.

The FBAR penalties can be assessed, but unlike other penalties, the IRS cannot collect them

administratively. It can only collect the FBAR penalties by bringing a lawsuit against the taxpayer.

The agents then addressed the issue of “Quiet Disclosures.” Because of the penalties, many people want to do a “quiet disclosure” by filing amended returns with the IRS without going through the program. The problem is that if the taxpayer is audited, they can face larger penalties, including the maximum FBAR penalties annually, fraud penalties, and potential criminal investigations.

If a taxpayer is accepted into the program, even if he/she is a bona fide tax evader, if they disclose and if the source of income is legal, they will not be subjected to penalties in excess of those under the program.

Alan stated that San Francisco has lots of experience with investigative tools. The Permanent Subcommittee on Intelligence has helped build skill sets to work offshore cases. Seventeen revenue agent groups will be set up to work these cases. The US government is putting pressure on other countries to cooperate with information exchanges and the IRS and other jurisdictions are more cooperative on information exchanges. The IRS in California is “in the bull’s eye” because it has the experience and skill sets to deal with offshore cases.

Alan’s email address is Alan.astengo@irs.gov.

His phone number is 415-522-6222. You can contact him if you have a technical question and he will forward it to the appropriate analyst or unit that can address the issue. If the issue is one that is not addressed in the FAQs on the Voluntary Disclosure Program, it can be elevated. Arlette Lee’s email address is arlette.lee@ci.irs.gov.

Lila Felder stated that the FTB is not participating in the Voluntary Disclosure Program. The FTB had the tax amnesty program and the Voluntary Compliance Initiative. If a taxpayer participates in the Voluntary Disclosure Program, he/she must expect to report to the FTB if a federal amended return is filed or there are final federal

adjustments. Taxpayers participating in the Voluntary Disclosure Program will be subject to California tax penalties. Ms. Felder pointed out that under California law, all trusts having a non-contingent California beneficiary must file in California. FTB’s special investigation unit is not participating in the Voluntary Disclosure Program. But if a taxpayer does not file amended returns with California, the chance of criminal or civil fraud being asserted will increase.

The FTB will not disclose the types of information it receives from the IRS, but the FTB knows what type of case it is when the IRS provides information to the FTB under its information sharing agreement. If a client files with the FTB, he must do it within 6 months of the IRS adjustment to limit the California statute of limitations and penalty issues.

Alan Astengo stated that a case goes to the civil side when it comes back from Philadelphia. The IRS is not looking to target people who go into the program. It is trying to get people into compliance.

HOT TOPICS

Members discussed the following topics. The FTB has not changed its position on interest suspension in Voluntary Compliance Initiative cases. The members also discussed *In re Ilko*, the bankruptcy case involving the statute of limitations for dual determinations. The Board of Equalization appealed to the Ninth Circuit Bankruptcy Appellate Panel. The case is fully briefed. Oral arguments will be held in late September. [Subsequent to the meeting the 9th Circuit Bankruptcy Appellate Panel reversed the Bankruptcy Court and held that the statute of limitations does not begin to run until after the corporation went out of business; thus the tax in the debtor’s case was assessable but not assessed on the date of the petition. The taxpayer has filed an appeal to the 9th Circuit Court of Appeals.]

In a recent decision (*Salman Ranch v. US*), the Federal Circuit followed the Ninth Circuit’s decision in the *Bakersfield* case on the application of the 6-year statute of limitations in

TEFRA partnership level cases. The Court held that an overstatement of basis is not an understatement of gross income for purposes of the statute of limitations. The members also discussed the fact that on the day of the meeting, a settlement was announced in the UBS summons enforcement case.

There being no further business, the meeting was adjourned.

Representing Income Tax Non-Filers and Non-Payers

By E. Rhett Buck, Esq., CPA

There are important criminal and civil issues facing Federal income tax return non-filers, including what to do to avoid criminal liability, and what to do about the large tax debts which usually result from the filing of a group of delinquent returns, or from the IRS's assessment of the tax under its own substitute for return (SFR) filing procedures.

[Willful failure to file](#)

Under Internal Revenue Code (IRC) § 7203, the government can prosecute for willful failure to file income tax returns. This type of prosecution is relatively rare. Most non-filer cases are resolved without resort to criminal prosecution. But where there are egregious indications of "willfulness", IRS criminal investigations can lead to indictment, conviction and fine and incarceration. Violation of § 7203 is punishable by incarceration of up to one year, and fine of \$25,000.

Under IRC §7203, it is a misdemeanor crime to willfully fail to pay the tax or to file a return. There are actually four types of violations under the statute:

- (1) Failure to pay a tax;
- (2) Failure to file a return;
- (3) Failure to keep records; and
- (4) Failure to supply information.

§7203 is used most often to prosecute the willful failure to file income tax returns, and less often, willful failure to pay. About half the cases recommended by the IRS Criminal Investigation

Division (CID) are accepted by the Department of Justice for prosecution, and about 90% of prosecutions result in convictions.

Each time the obligation to file arises and the taxpayer willfully fails to comply, a separate offense is committed. Failing to file five years' worth of returns may result in five separate criminal charges. The statute of limitations on prosecution is six years from the due date of the tax return in question, including extensions to file.

The three elements of the offense of willful failure to file, each of which must be proven by the government beyond a reasonable doubt, are as follows:

- The defendant was a person required to file a return.
- The defendant failed to file at the time required.
- The failure to file was willful.

The requirement to file an individual income tax return is based on the taxpayer's gross income, so to sustain its burden of proof the government must show that the taxpayer had the requisite amount of gross income. See U.S. v. Wade, 585 F.2d 573 (5th Cir. 1978). This may be proven by direct or indirect methods, such as analysis of bank deposits, or analysis of the taxpayer's assets, debts, income and expenses.

Clients often do not understand how a criminal liability for their own failure to file could apply to them. Usually, they did not intend purposely, or make an affirmative decision, not to file. Often, they just have not given a priority to filing the returns. Illness, medical problems, emotional difficulties, divorce, alcohol and drug abuse, mental illness, or even just very busy lifestyles and careers intervene, and once they have gotten behind, they may not file subsequent years currently, because they owe returns for the prior years. However, the U.S. Supreme Court has upheld the validity of the laws requiring timely filing of returns. In Spies v. U.S., 317 U.S. 492, the Court said "punctuality is important to the fiscal system, and the criminal sanctions assure punctual as well as faithful performance of these duties."

However, the facts and circumstances as to why the taxpayer is late in filing do bear on the important

question of willfulness. The IRS reviews over a million returns each year for possible referral to the Criminal Investigation Division. The Internal Revenue Manual (IRM 4.19.1.6.12.2) lists the factors considered in deciding to make the referral:

- History of non-filing (3 years or more of unfiled returns).
- Repeated contacts by the Service.
- Indication of knowledge of the filing requirements (i.e. a professional with an advanced education, or a person who works directly in the tax field).
- Age and occupation of the taxpayer.
- Substantial tax liability after credits and payments.
- Large number of cash transactions.
- Indications of significant unreported income.

Willfulness

Willfulness is a state of mind. It is a "voluntary, intentional violation of a known legal duty." Cheek v. U.S., 498 U.S. 192 (1991). The IRS does not need to prove an evil motive or a bad purpose, such as intent to cheat or defraud the government. U.S. v. Moylan, 417 F.2d 1002 (4th Cir. 1969). Criminal intent is proven when the government shows that the taxpayer's non-filing was "voluntary and purposeful and with the specific intent to fail to do that which he knew was required." U.S. v. Wilson, 550 F.2d 259 (5th Cir. 1977). Mere "careless and reckless disregard" does not constitute willfulness. U.S. v. Eilertson, 707 F.2d 108 (4th Cir. 1983). Also, reasonable belief that the returns were not required may also negate willfulness.

Proving willfulness is the biggest challenge facing the government in criminal tax prosecutions. Because taxpayers seldom make clear, unambiguous inculpatory statements about their intent, the IRS must prove intent through indirect evidence. The most common evidence is a pattern of failing to file year after year. U.S. v. Greenlee, 517 F.2d 899 (3rd Cir. 1975). Missing one or even two returns may be a mistake, but failing to file for many years is difficult to explain. Intent to file and pay the tax in the indefinite future is not a defense.

Later filing the returns and paying the tax due does not "relieve a taxpayer from criminal liability for failure to file tax returns on or before their due date." U.S. v. Bourque, 541 F.2d 290 (1st Cir. 1976), unless done in compliance with the IRS voluntary disclosure policy.

Evidence of intent can include conduct that may indicate the taxpayer's knowledge, planning or purpose. For example, avoiding normal tax withholding by filing a false W-4 claiming exemptions beyond anything that could be justified can show that the taxpayer planned all along to fail to file his tax returns. U.S. v. Shivers, 788 F.2d 1046 (5th Cir. 1986). Also, filing returns for years when refunds were due, but not filing returns for years when tax was owed indicates thoughtful planning and decisions inconsistent with honest mistakes or misunderstanding. U.S. v. Garguila, 554 F.2d 59 (2nd Cir. 1977).

Tax evasion

Violations of IRC §7203 are misdemeanors with a maximum sentence of one year per count. In extreme cases, a taxpayer's willful failure to file returns can be shown to be part of a scheme to evade tax, and in such cases the government can prosecute for the felony offense of tax evasion under IRC §7201. The punishment is \$100,000 fine (\$500,000 for a corporation) and/or 5 years imprisonment. Each tax year is a separate offense.

Tax evasion can be one of two crimes, or both:

- (1) Attempting to evade assessment, or
- (2) Attempting to evade payment.

Failing to file can be part of a scheme to evade both assessment and payment, and can be charged if, in addition to the failure to file itself, the government can prove certain "affirmative acts." However, failing to file alone is not an attempt to evade. Spies v. U.S., 317 U.S. 492; U.S. v. Nelson, 791 F.2d 336 (5th Cir. 1986).

Affirmative acts constituting evidence of tax evasion include

- the making of false statements, U.S. v. Callanan, 450 F.2d 145 (4th Cir. 1971), especially false W-4s reducing or eliminating the withholding of taxes on the defendant's

wages. U.S. v. DiPetto, 936 F.2d 96 (2nd Cir.), *cert. denied* 502 U.S. 866 (1991).

- placing assets in others' names,
- dealing in currency,
- paying other creditors instead of the government; U.S. v. Shorter, 809 F.2d 54, 57, (D.C. Cir.), *cert. denied*, 484 U.S. 817 (1987).
- lying to IRS agents; U.S. v. Brimberry, 961 F.2d 1286, 1291 (7th Cir. 1992).
- laundering money or moving funds offshore. U.S. v. Voorhies, 658 F.2d 710, 712 (9th Cir. 1981).

Probably the most quoted list of actions evidencing an affirmative, willful attempt to evade tax was presented by the Supreme Court in Spies v. U.S., 317 U.S. 492, 499 (1943):

- keeping a double set of books
- making false entries or alterations, or
- false invoices or documents
- destruction of books or records
- concealment of assets or
- covering up sources of income,
- handling of one's affairs to avoid making the records usual in transactions of the kind, and
- any conduct, the likely effect of which would be to mislead or to conceal.

[Voluntary disclosure policy](#)

From time to time, a taxpayer, especially one who has the benefit of informed representation, will decide to correct his non-filing before he gets caught. This can be safely accomplished under the IRS and Department of Justice "voluntary disclosure" policies. The basic rule is a prosecution will not be pursued if a non-filer (with income from legal sources only) corrects his past mistakes by filing his delinquent returns before investigation by the IRS Criminal Investigation Division. IRM 9.5.3.3.1.2.1, IRS News Release IR-2002-135.

A voluntary disclosure occurs when the communication is truthful, timely, complete, and:

- a. the taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining his or her correct tax liability; and

- b. the taxpayer makes good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable.

The most significant requirements are: (1) the disclosure must be timely, and (2) the taxpayer must cooperate with the government.

A disclosure is timely if it is received before:

- a. the IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation;
- b. the IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer's noncompliance;
- c. the IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer; or
- d. the IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena).

The disclosure is not timely, if the IRS has already initiated an investigation, or if the taxpayer is aware of some event, which is likely to lead to such an investigation.

An example of complying too late is U.S. v. Crawford, 121 F.3d 700 (4th Cir. 1997). Mr. Crawford got a call from an IRS Special Agent, who set up an appointment to interview him the next day. That evening, Crawford went to his accountant, and they worked all night to prepare four delinquent tax returns. The returns were filed the next day, with payment, prior to the meeting with the Special Agent. The IRS determined there was no "voluntary disclosure" and Mr. Crawford was prosecuted and convicted of failure to file.

Although in some cases it may be too late for voluntary compliance once the Special Agent calls, the voluntary disclosure policy confirms that the

IRS wants to bring noncompliant taxpayers back into the system. It clarifies that someone who has received a "non-filer notice" inquiring about missing returns is not deprived of the chance to get right with Uncle Sam without being prosecuted. Specifically, the following is an example of a timely voluntary disclosure:

A disclosure made by an individual who has not filed tax returns after the individual has received a notice stating that the IRS has no record of receiving a return for a particular year and inquiring into whether the taxpayer filed a return for that year. The individual files complete and accurate returns and makes arrangements with the IRS to pay the tax, interest, and any penalties determined by the IRS to be applicable in full. This is a voluntary disclosure because the IRS has not yet commenced an examination or investigation of the taxpayer or notified the taxpayer of its intent to do so.

Note that not paying the tax in full is not an impediment to a voluntary disclosure. It is sufficient if the taxpayer "makes arrangements with the IRS to pay the tax." This could include an installment payment plan agreement, an offer in compromise, or other reasonable and cooperative method to deal with the liability.

Note also that even if it is too late to take advantage of the safe harbor of the voluntary compliance program, it may still be possible to file returns, get in filing and payment compliance, and show the IRS investigators that the facts giving rise to their investigation may be explained or justified in a sufficient way to avoid a referral to DOJ. Less than 50% of CID investigations result in a DOJ criminal referral.

[Preparing to make the disclosure](#)

It should now be clear, filing the missing returns before the IRS goes after the taxpayer can mean the difference between simply filing the missing returns and dealing with the tax payment problem, or being prosecuted and sent to jail (and/or heavily fined). Therefore, it is of utmost importance to get the voluntary disclosure process moving as soon as possible. However, it may take weeks or months to actually assemble the missing tax returns. Should

one avoid any contact with the IRS until the returns are ready? Each case must be carefully considered in light of its own unique facts, but often it is best to make a preliminary disclosure to the Service stating that certain returns are unfiled, that the taxpayer has arranged for the preparation of the returns, and that they will be filed as soon as possible. This preliminary disclosure could offer protection if a criminal investigation begins before the delinquent returns are actually filed. Further, since non-filers are procrastinators by nature, taking the first step of notifying the IRS that the taxpayer exists and has not filed, forces the client quickly complete the process.

Methods to start voluntary disclosure:

1. Request Freedom of Information Act (FOIA) request from local Disclosure Office.
2. Request transcript record of accounts for all possible missing return years and Information Returns of Payers (IRP's) for each missing return year.

In addition to information from the IRS, the practitioner will also need information from the client, and possibly from his employers, banks and brokers. It may also be necessary to rely on reasonable, good faith estimates for some items. Estimates should be disclosed in the returns, and the calculations, assumptions and methods should be carefully documented in case the IRS wants to know how the estimates were determined.

[Period of retroactive compliance](#)

A non-filer client will want to know how far back you will have to go in preparing returns. The three-year statute of limitations on assessment begins to run on the date the tax return is filed, with the result that if the return has never been filed the IRS can assess the tax forever. However, for its own administrative reasons, the IRS generally will demand tax returns going back only six years. Managerial approval, based on consideration of various factors (history of non-compliance, illegal income, amount of income, time and effort required, and other special circumstances which may apply), is required if an agent wishes to pursue enforcement activity for anything more than a six

year retroactive compliance period. IRM 9.5.3.3.1.2.1.

Interest and penalties

Once the missing returns are prepared, they will show how much tax is owed. Interest and penalties, however, must be calculated so that the full magnitude of the client's problem will be known. Numerous penalties can be asserted against non-filers, including the late filing penalty, late payment penalty, and civil fraud penalty.

The late filing penalty is 5% for each month, or part thereof, to a maximum of 25% (IRC §6651(a)(1)). It is computed on the net amount due on the return after any timely payments or credits. It accrues on the due date of the return, so interest runs on the penalty itself as well as on the tax. If the failure to file is due to fraud, the penalty is tripled to 15% per month to a maximum of 75% (§6651(f)).

In addition, a late payment penalty is imposed at 0.5% per month for failure to pay the tax shown on a return or an assessed deficiency, again to a maximum of 25% (§6651(a)(2)). If the IRS has issued a Notice of Intent to Levy or a jeopardy assessment, this penalty increases to 1% per month (§6651(d)). If the taxpayer has entered into an installment payment agreement, it can be reduced to 0.25% per month (§6651(h)). The late filing and late payment penalties are "coordinated" so that the combination is limited to 5% for any month for which both penalties would apply.

However, penalties can be waived by showing that the late filing or late payment was due to "reasonable cause and not willful neglect." It is therefore important to gather and fully document any facts that might support a reasonable cause argument. The IRS's interpretation of reasonable cause for this purpose is presented in Part 20 of the Internal Revenue Manual. According to the Manual, "any reason which establishes that the taxpayer exercised ordinary business care and prudence, but was unable to comply with a prescribed duty within the prescribed time, will be considered." A reasonable cause argument has a much better chance of success if it provides answers to the questions, which the Manual instructs agents to consider:

- What happened and when did it happen?
- What facts and circumstances prevented the taxpayer from filing a return, paying a tax, or otherwise complying with the law?
- How did the facts and circumstances prevent the taxpayer from complying?
- How did the taxpayer handle the remainder of their affairs during this time?
- Once things changed, what attempt did the taxpayer make to comply?

The greatest problem facing most non-filers in securing relief from the delinquency penalties is their long history of noncompliance. The Internal Revenue Manual specifically requires considering the taxpayer's compliance history in deciding whether to abate penalties.

Given the magnitude of the penalties, all available arguments are worth making, especially if there is evidence of something that was outside the taxpayer's control.

Filing status

Determining the appropriate filing status for the returns of married taxpayers requires thought and analysis. It is not appropriate to merely assume that because the taxpayers are married their returns should be filed "married filing jointly." There are two key questions:

- (1) Who is my client?
- (2) Once the returns are filed, can the tax be paid?

You can always amend from separate returns to a joint return, but you cannot go the other way. The decision to file married filing jointly is irrevocable. Consideration of the limitations to claim innocent spouse may suggest separate returns.

Also, whether the tax is owed jointly or only by one spouse has important consequences when it comes to resolving the liabilities through bankruptcy, an offer in compromise, payment plans, or other collection alternatives, including consideration of IRS collection powers against community property assets and incomes, and protective use of post-nuptial agreements.

The minor savings resulting from filing joint is meaningless if the total amount owed is so large that it cannot be paid anyway, and will have to be resolved through bankruptcy, an offer in compromise, a partial payment plan, or other methods.

[Time-barred refunds](#)

Most non-filer cases involve substantial unpaid tax liabilities. Sometimes the fear of filing a return showing a balance due that the taxpayer cannot afford to pay is what started the series of non-filed returns. However, the taxpayer may be due a refund for at least some of the years for which returns are un-filed, except that these refunds may be time-barred. The IRS cannot issue a refund if a claim (here, the tax return itself) is not filed by the later of three years from the return due date or two years from the date of payment. This rule prohibits not just a refund check, but also crediting the overpayment against underpayments in other tax years.

Because of the harsh effect of the statute of limitations on refunds, tax professionals should check for any possible statute of limitations bar dates at the initial meeting with the client, and ask that those (usually most recent) returns be filed first, by the bar date.

[IRS substitute for return procedures](#)

The IRS focuses on finding non-filers and bringing them back into the tax system, while prosecuting some particularly extreme cases so that the resulting publicity will foster "voluntary compliance" among others. The IRS identifies non-filers primarily by matching W-2s, 1099s and K-1s to taxpayer accounts, a process which is becoming increasingly automated and efficient. When non-filers are found, the IRS often utilizes its authority under §6020(b) to assess the tax, penalties and interest.

These substitute for return (SFR) procedures are sometimes thought of as the IRS preparing the delinquent taxpayer's returns, although legally speaking, the SFR may not qualify as a "return". Procedurally, the taxpayer is given a "non-filer notice," which includes a report explaining the amount and basis of the proposed assessment, and

he then has 30 days to agree or to file a protest letter seeking a conference with the appeals office. If no response is received, the Service issues a statutory notice of deficiency, often called the "90-day" letter), whereupon the taxpayer can file a petition with the Tax Court. If no petition is filed within the 90 days, the tax is assessed and the collection process begins.

Just as it is best to correct the non-filing before a criminal investigation starts, it is also advisable to file the missing tax returns before an SFR assessment is made. SFR assessments are often wrong. The IRS gives the taxpayer credit for only one personal exemption and the standard deduction. They also take income from 1099's and K-1s, while ignoring possible unknown expenses or losses, and even expenses and losses shown on the K-1's. Also, the IRS does not have information on substantial itemized deductions, additional personal exemptions, or loss carry-forwards. The IRS includes the income reported by a broker on Form 1099-B, showing the gross proceeds from sale of securities, but the IRS does not know the taxpayer's basis in the securities sold, so uses a cost basis of zero.

Perhaps even more importantly, there is a split of opinion among the federal courts as to whether a document purporting to be a tax return and properly signed under penalties of perjury is effective as a return if it is filed after an SFR assessment has been made. See In re Hindenlang, 164 F.3d 1029 (6th Cir. 1999). Contrary, see Woods v. IRS, 2002 Bankr. LEXIS 1092 (Bankr. S.D. Ind. 2002), In re Crawley, 244 B.R. 121 (Bankr. N.D. Ill. 2000), In re Nunez, 232 B.R. 778 (BAP 9th Cir. 1999), and In re Savage, 218 B.R. 126 (BAP 10th Cir. 1998).

This can be crucial if the taxpayer later seeks relief in bankruptcy. Under Bankruptcy Code (BC) §523(a), an income tax debt is dischargeable in a Chapter 7 case only if the bankruptcy petition is filed more than two years after the filing of the tax return for that year. But if a delinquent tax return given to the IRS after an SFR assessment has been made, is not considered a tax "return", then this two year requirement can never be met.

Therefore, it is best to file the returns as soon as possible, prior to IRS criminal investigation

activity, and before the IRS can prepare SFR's. Typically, the client's attorney will retain the accountant to prepare the returns, in order to preserve attorney-client privileged information.

The Committee Officers are trying something new in this issue of the Tax Network. We have included a link to a 36-page article entitled:

**THE MORNING AFTER.....
WHAT YOU NEED TO KNOW
ABOUT
THE FBAR AND INTERNATIONAL
INFORMATION RETURNS
INCLUDING
DEFENDING AGAINST AND
LITIGATING THE PENALTIES**

Written by Caroline D. Ciralo of:
Rosenberg | Martin | Greenberg, LLP
Baltimore, Maryland

The article by Ms. Ciralo focuses on FBAR issues now that the October 15, 2009 deadline for FBAR Voluntary Disclosures has passed.

To access the article, hover your mouse over the link below; hold the control key and simultaneously right click to link to the article through Adobe Acrobat.

Alternatively you may cut and past the link into your favorite Internet browser to link to the article through Adobe Acrobat.

<https://share.acrobat.com/adc/document.do?docid=ce425883-e2c8-4f30-b3c0-6c4755cb5682>

Recent Cases of Interest

By Robert Horwitz, Esq.

[U.S. v. Textron, Inc.](#)

The First Circuit did the right thing (by the IRS) on reconsideration en banc in [U.S. v. Textron, Inc.](#), 8/13/2009. As you may recall, the IRS issued a summons seeking, among other things, tax accrual work papers of Textron that were prepared for use by its outside accountant to prepare an audited financial statement. The IRS sought the work

papers after it found evidence that Textron had engaged in a number of sale-in lease-out transactions, which had been identified as potentially abusive tax shelters. Textron refused to comply with the summons on the ground that the tax accrual work papers were protected by the attorney work product doctrine since they were prepared in anticipation of litigation.

The district court held that the work product doctrine applied. On appeal, a three-judge panel of the First Circuit affirmed. After reviewing the history of the case and the history of the work product doctrine, the en banc court reversed.

The en banc opinion started by noting that the undisputed "purpose of the [tax accrual] work papers was to make book entries, prepare financial statements and obtain a clean audit." Not only did the government's experts so testify, but those of Textron concurred. The only difference was that Textron's witnesses often used the word "litigation" and testified that if there was no possibility of litigation the tax accrual work papers would not have been necessary. All the witnesses at trial agreed, however, that even if litigation was extremely remote the tax accrual work papers would have to be prepared.

The work product doctrine was meant to protect materials that were prepared for use in litigation, whether the litigation was underway or was merely anticipated. Documents prepared for a purpose other than litigation are not protected by the privilege, even if the subject matter of the document relates to a subject that might be litigated.

The court emphasized that the materials had to be "prepared for" litigation. That documents were prepared by lawyers or reflected their legal thinking was not enough to protect them under the work product doctrine. It is only if the work is done in anticipation of or for trial that it is protected. According to the court, any lawyer worth his or her salt would realize that tax accrual work papers are not work product. They are nothing more than "tax reserve figures" prepared "to support a financial statement and the independent audit of it."

Only two circuits had addressed the issue of whether tax audit work papers are entitled to work product protection: the First Circuit itself and the Fifth Circuit, and both held that they were not entitled to such protection.

Addressing Textron's argument that allowing the IRS access to its tax accrual work papers would be unfair, the Court stated that "tax collection is not a game," that underpayment of taxes "threatens the essential public interest in revenue protection" and that the problems in discovering underreporting of taxes by corporations "are serious." Since the tax accrual work papers were prepared for purposes of preparing financial statements, and not in anticipation of litigation or for use in litigation, and the work product doctrine only protects work done for litigation, the doctrine was inapplicable. Therefore, the en banc panel vacated the 3-judge panel decision and remanded the case to the district court.

Two judges filed a lengthy dissent arguing that the work product doctrine was needed to protect tax accrual work papers prepared with the input of attorneys, since they were prepared "in anticipation of litigation," even though they might never be used for purposes of litigation. According to them, the majority opinion was "a dangerous aberration in the law" crafted to please the IRS.

[*Intermountain Insurance Services of Vail, LLC v. Commissioner*](#)

[*Intermountain Insurance Services of Vail, LLC v. Commissioner*](#), TC Memo 2009-195 (9-1-09). The issue in this case was the same one as confronted the Court in [*Bakersfield Energy Partners v. Commissioner*](#): whether "substantial understatement of gross income" for purposes of the six-year statute of limitations on assessment under IRC secs. 6229(c)(2) and 6501(e)(1)(A), included an understatement due to an alleged overstatement of basis. Following [*Bakersfield Energy*](#), the Court held that it did not.

The partnership engaged in a series of transactions, including several that increased its tax basis, that culminated in the sale of all of its business assets in 1999. As a result of the stepped-up basis reported on Form 4797, it reported a loss from the sale on

the return it filed on September 15, 2000. The IRS issued its FPAA on September 14, 2006.

Beginning its analysis, the Court stated that there was no statute of limitations for issuing a FPAA, but that any assessment is time barred if the IRS does not issue the FPAA within the period of limitations for assessing tax attributable to partnership items. While both 6501(e)(1)(A) and 6229(c)(2) provide for a six-year period of limitations where there has been an omission of more than 25% of gross income reported on the return, based on the Tax Court's holding in [*Bakersfield Energy*](#), recently affirmed by the Ninth Circuit, an alleged overstatement of basis is not an omission from gross income. Given the fact that the only other case to address the issue, the Federal Circuit's decision in [*Salman Ranch Ltd. v. U.S.*](#), followed the decision in [*Bakersfield Energy*](#), the Tax Court refused the IRS's "invitation to overrule it."

[*FTB v. Superior Court, Gonzalez, Real Party in Interest*](#)

[*FTB v. Superior Court, Gonzalez, Real Party in Interest*](#) (Cal. Ct. App.). This was a case of first impression on the question of whether there is a right to a jury trial in a tax refund action against the FTB under R&T Code sec. 19382. According to the Court of Appeal, this turned on whether there was an analogous action would have been cognizable under common law when the California Constitution was adopted in 1850.

The deceased taxpayer's estate sought a refund of \$15 million paid under the voluntary Compliance Initiative. The FTB had filed a cross claim to recover a penalty of \$2.5 million. In its complaint, the taxpayer had demanded a jury trial. The Superior Court denied the FTB's motion to strike the jury demand and the Court of Appeal affirmed. It further held that there was no right to jury trial on the FTB's cross claim for penalties.

The issue before the Court was a "pure question of law." Due to differences between common law and modern pleadings and forms of action, "the critical inquiry is whether the cause of action at issue in the present case is analogous to an action cognizable in the common law courts in 1850." This turned on whether the cause of action is of the

same nature or class as one that existed at law in 1850. The Court therefore conducted a historical analysis of common law cases seeking a tax refund.

The Court noted that while the California Supreme Court had characterized tax refund actions as “based on equitable principles,” it had consistently held that such actions were in the nature of an action in assumpsit for money had and received, which is a common law action. Furthermore, the relief sought in a tax refund suit was monetary, which confirmed its nature as an action at law.

This did not, however, end the inquiry, since if an action otherwise identifiable as one at law “did not include a right to jury trial in 1850, then none exists under the California constitution.” Although at common law individuals could not sue the sovereign, they could seek a refund of tax by suing the tax collector. Such cases had been heard as common law actions for money had and received. Several English cases involving such actions described special findings of fact by juries, thus showing that English courts recognized actions for tax refund against tax collectors as common law actions.

The Court then turned to American cases. In US v. New Mexico, 642 F.2d 397 (1981), the Tenth Circuit held that a district court erred in denying New Mexico’s demand for jury trial in a tax refund action brought by the United States to recover a state tax collected from a subcontractor of a federal contractor. This was based on a determination that refund actions were analogous to common law actions against the tax collector that both English and American courts recognized were triable by jury.

The Court rejected the FTB’s argument that there was no right to a jury trial since at common law an individual could not sue the sovereign, noting that the cases allowing suits against the tax collector recognized that it was a legal fiction, since ultimately the sovereign would pay the refund if the taxpayer prevailed.

The Court also rejected the FTB’s argument that if such a right existed at common law, it only existed in those cases where the taxpayer asserted that he was not subject to a tax, and not to cases where the taxpayer admitted he was subject to tax, but

claimed that he paid more than was due. The Court stated that while some early actions were in trespass on the ground that the tax collector was without jurisdiction over the taxpayer, such as where the taxpayer claimed he was not an inhabitant of the locality over which the tax collector had jurisdiction, other early English cases allowed actions in assumpsit against the tax collector where the claim was that an excessive amount of tax was collected.

The Court then turned once more to early American cases. In Elliot v. Swartwout, 35 US 1372 (1836), the Supreme Court held that a customs collector could be held liable in an action for money had and received to recover an alleged overpayment of import duties. Although subsequently in Cary v Curtis, 44 US 236 (1845), the Court overruled Elliot, it did so because of a change in the law that prohibited the tax collector from holding funds paid under protest, which thus made it unjust to hold the tax collector personally liable for repayment. Shortly after Cary v. Curtis, Congress enacted a law to make it clear that its prior law was not meant to impair the right to sue for refunds and obtain a jury trial. The Court noted that even after its decision in Cary v. Curtis, the Supreme Court continued to cite its decision in Elliot v. Swartwout as a statement of basic common law principles.

Based on its reading of 18th and 19th century English and American cases, the Court of Appeal held that a taxpayer’s “tax refund action is a type of actions which was cognizable in a common law court, and triable by a jury.” Thus, it concluded that “Gonzalez has a state constitutional right to a trial by jury of the issues of fact in this action.”

The Court also rejected the FTB’s argument that it should deny the right to jury trial in refund cases based on the case law holding that there is no right to a jury trial in tax collection cases. Historically, tax collectors had the right to seize and sell property to collect tax without judicial interference.

The action brought by the taxpayer, however, was for a refund, therefore cases involving tax collection were inapposite.

The Court also rejected the FTB’s argument that under common law any action for refund only was

available where the taxpayer paid under protest. By statute, a taxpayer is required to pay the tax before suing for a refund and nothing in the case before it indicates that the taxpayer's payment was "a voluntary payment for which a common law cause of actions for money had and received would have been unavailable."

The Court rejected the FTB's argument that since under common law no one could sue the sovereign, there was no common law cause of action against the FTB. While noting that in Wickwire v. Reinecke, 275 US 101 (1927), the Supreme Court held that a taxpayer did not have a right to jury trial in a tax refund action against the sovereign, and several state courts had followed Wickwire, the Court of Appeal refused to do so because the California Supreme Court had described its task as one of determining whether an action of the same class or nature was cognizable at common law and, thus, was triable to a jury. To hold that the California Legislature, when it enacted the statute allowing refund actions against the FTB, took away the right to a jury trial that previously existed in suits against the tax collector would allow the form of the action to take precedence of the nature of the right involved. Since at common law a taxpayer could bring an action to determine his substantive right to a refund, it is a type of action for which there is a right to jury trial under California law. The Court also noted that the statements in Wickwire were dicta, and neither Wickwire nor the state cases following it analyzed the historical cases involving jury trials in tax refund actions.

The Court also rejected the FTB's argument that any action for a tax refund was statutory in nature and, thus, there was no right to jury trial unless expressly provided by statute, since the Legislature cannot abrogate the Constitution.

Finally, the Court held that while there was a common law right to jury trial in refund actions, no such right existed in actions by the sovereign to collect a tax. Thus, there was no right to jury trial as to the FTB's cross complaint for penalties.

Kudos to Marty Schainbaum, Tax Warrior, for his work on this case.

[Consolidated Edison v. U.S.](#)

The IRS lost a LILO. Well, a LILO transaction case in Consolidated Edison v. U.S., Fed. Cl. 10/21/09. The LILO transaction in that case occurred after the New York Public Utility Commission, in a push to deregulate energy companies, entered into an agreement with Con Ed to restructure and to sell 50% of its New York utility assets and allowed it to invest a portion of its capital without PUC approval. Con Ed, through subsidiaries, began investing in energy projects overseas. In 1997, a subsidiary of Con Ed entered into a LILO transaction with EZH, a Dutch public utility. Under the transaction, Con Ed, through a subsidiary, leased a 47.47% interest in EZH's RoCa3 gas-fired combined cycle cogeneration plant for a term of 43.2 years and then leased the 47.47% interest back to EZH for a term of 20.1 years. At the end of the base lease term, EZH had an option to purchase the leasehold interest from Con Ed. If EZH did not exercise the option, Con Ed could require EZH to renew the lease term for an additional 16 years. Alternatively, Con Ed could operate the facility itself for the remainder of the leasehold or lease it to a third party.

Con Ed was to make two rental payments, one at the beginning of the lease and one at the end. The payment at the beginning of the lease was amortized over a 6-year period while the payment to be made at the end was amortized over the remaining 34 years.

As in all LILO transactions, risk was minimized to the max. Con Ed borrowed part of the upfront purchase price for the leasehold interest from banks on a nonrecourse basis. The money it borrowed was deposited in accounts at the same banks for the benefit of EZH. EZH pledged the accounts to Con Ed to secure payment of rent under the sublease and Con Ed repledged these funds to the banks to secure repayment of its loans. EZH directed the banks to make the rental payments to Con Ed out of the accounts and Con Ed directed the banks to apply the rental payments from EZH to its loans.

In 1997, Con Ed deducted interest and rent and included the sublease rentals from EZH in income. The IRS treated the transaction as a sham and assessed a deficiency. After payment of the deficiency and filing a refund claim, Con Ed sued in the Court of Federal Claims.

In a 150 plus page opinion, the Court held that the transaction had substance, was not a sham, that Con Ed had the benefits and burdens of ownership of a leasehold interest, and that the loans from the bank were bona fide debt. The Court recited extensively from the record, including that Con Ed's experts testimony that it was not a certainty that EZH would exercise the purchase option and that under any of the possible scenarios Con Ed could make a profit or could lose money. The Court pointed out that on cross-examination the Government's experts admitted that it was not a certainty that EZH would exercise the purchase option and that under different scenarios Con Ed could potentially have a profit or a loss from the transaction.

Con Ed also offered expert accounting testimony that under FASB rules, the treatment of the transaction was beneficial for both its profit and loss statement and its balance sheet. Con Ed representatives testified about all of the non-tax business benefits that Con Ed purportedly anticipated from entering into the transaction.

Noting that under Frank Lyon Co., 435 US 561, whether the transaction was to be respected for tax purposes required a close analysis of the facts and circumstances of the entire transaction, the Court found Con Ed's witnesses persuasive and determined that Con Ed had met its burden of proof.

As a side note, the Court addressed the Government's spoliation claim based on the fact that in 2000, when Con Ed switched its email system from a Linux-based to a Microsoft based system, it did not migrate over to the new system all existing emails. Instead, it opted to direct its employees to save on their hard drives the emails that they considered important. This was several years before the IRS raised the LILO issue. The Government took the position that since Con Ed was audited virtually every year, and the IRS issued a revenue ruling in 1999 designating LILO transactions as potentially abusive, Con Ed should have reasonably anticipated that the case would end in litigation. The Court disposed of this by noting that Con Ed in virtually every audit resolved all issues administratively and that it had no reason to believe that the LILO transaction would not be resolved short of litigation. Thus, in 2000,

litigation of the LILO issue was not reasonably anticipated.

American Boat Company, LLC v. U.S.

The Seventh Circuit upheld a district court decision that a taxpayer who engaged in Son of BOSS transactions was not liable for accuracy related penalties. In American Boat Company, LLC v. U.S. (7th Cir. 10/1/2009), the ultimate taxpayer was a wealthy St. Louis businessman who owned both the LLC and a subchapter S corporation that was the tax matters partner. In 1996, the taxpayer was referred by his banker to a Chicago law firm to do estate planning. The attorney who handled the case recommended that the taxpayer engage in a Son of BOSS transaction to offset gains. The law firm provided an opinion letter that was relied on by the taxpayer's accountant in preparing the return. That transaction was never audited by the IRS.

By 1998, the attorney had moved to another firm, the Chicago office of Jenkins & Gilchrist. The taxpayer sought to have his businesses reorganized after an accident jeopardized the businesses and exposed them to substantial liability. As part of the reorganization, J&G set up another Son of BOSS transaction to increase the basis in assets that were used in the business. J&G provided an opinion letter. Deloitte prepared the return and relied on the opinion letter and advised the taxpayer that it believed that J&G's opinion was correct. The taxpayer used another accountant in subsequent years to prepare his return and his businesses. This accountant did not object to the basis reported for business assets, although aware of the Son of BOSS transaction.

The IRS audited the LLC for a subsequent year and issued an FPAA determining that depreciation was overstated. The FPAA also asserted accuracy related penalties. The taxpayer filed an administrative proceeding in district court. The district court held that the transaction was invalid but that the taxpayer had reasonable cause for his treatment of the items on the return and, therefore, was not liable for any penalty.

The court of appeals affirmed. First, the court addressed the issue of whether penalties are a partnership item or an affected item. If an affected

item, it can only be challenged by an individual partner in the context of a refund suit. If a partnership item, it can be challenged in the TEFRA proceeding. The court held that although a partner could raise a reasonable cause defense, the partnership could also raise the defense based on the conduct of its managing or general partner.

Turning to the merits, the court addressed the IRS's principal arguments: that the taxpayer could not rely on the J&G opinion letter because the attorney who drafted the letter had an inherent conflict of interest and that the letter did not reach the threshold requirements of Treas. Reg. sec. 1.6664-4(c)(1).

The court began its analysis by noting that a taxpayer can show reasonable cause by showing that he relied in good faith on the advice of a competent and independent professional advisor. Whether a taxpayer acted reasonably in a case depends on the circumstances. The taxpayer doesn't need to challenge the advisor's advice or seek a second opinion.

The IRS's conflict of interest argument was based on the fact that J&G charged a large fee to structure the transaction, which generated substantial tax write offs. The IRS argued that where the advisor structures the plan for a large fee, the taxpayer is obligated to obtain a second opinion. The court rejected this argument. It concluded that the LLC's reliance on J&G's advice was not unreasonable merely because it structured the transaction.

The court held that it is undisputed that the attorney at J&G was technically competent and that the taxpayer, on behalf of the businesses, provided the attorney with all relevant information. Although the court stated that based on the record it may have reached a different conclusion, the district court was not clearly erroneous in determining that the LLC was not liable for any penalties. The court further noted that while the taxpayer did not request advice from either of his accountants about the J&G opinion, the fact that neither of them challenged it and both relied on it to prepare the return supported the district court's determination that there was reasonable cause for the partnership to rely on the opinion.

NOTES FROM THE EDITOR

Articles and comments for the next newsletter are requested and are being actively solicited.

If you have material that would be informative and relevant to the members of the Tax Procedure and Litigation Committee, please contact me at my office at 949-681-3502, or at dave@taxesqcpa.net.

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