



It's a Matter of (Misplaced) Trust—Taxpayer Reliance on Advice
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Reliance on Advice

This week the Tax Court decided two separate cases that dealt a taxpayer who received bad advice and acted upon it. In the case of *Lehrer v. Commissioner* (TC Memo 2006-156) the taxpayer had relied on the work of a tax preparer who was eventually convicted of filing false income tax returns. However, reliance on bad advice was not limited to a bad preparer, for the same day the Tax Court also decided the case of *Diem v. Commissioner*, (TC Summary 2006-121) where the taxpayer was given bad advice on a tax matter by both the City of San Francisco and a representative of the Internal Revenue Service.

But My Tax Was So Much Lower...

In *Lehrer* we take a look at a California taxpayer who fired the tax accountant he was using and began using the services of a preparer located in St. Louis, Missouri. Mr. Lehrer told the court he was upset with his prior accountant for a number of reasons, including

- She did not timely answer his questions
- She was not responsive to his needs *and*, oh yeah,
- She did not sufficiently reduce his income tax liability.

Mr. Borrelli, the St. Louis preparer, was hired to solve these issues. The court notes that Mr. Lehrer, prior to hiring Mr. Borrelli, took the following steps to qualify him:

Petitioner contacted Mr. Borrelli by telephone a few times, and the two spoke for approximately one-half hour each time. Mr. Borrelli mentioned Code provisions, and petitioner assumed Mr. Borrelli was familiar with them. Petitioner hired Mr. Borrelli without determining whether he had the education, experience, or credentials to prepare returns professionally. Petitioner never asked Mr. Borrelli to provide references or information regarding Mr. Borrelli's credentials or experience.

In the two years Mr. Borrelli's prior accountant had prepared his returns that included his construction business, which grossed between \$2.5 and \$3.0 million each year, Mr. Lehrer's returns showed liabilities of about \$45,000 in federal and state taxes. Mr. Borrelli certainly improved on that result, as the court notes:

Mr. Borrelli prepared returns for petitioners for the years at issue. Mr. Borrelli provided petitioners with a tax organizer he requested they complete. Petitioners completed the tax organizer and sent all their records to Mr. Borrelli as requested. Petitioners reported gross revenues from the construction business of approximately \$3.5 million in 1999, \$2.7 million in 2000, and \$3.4 million in 2001 on Schedules C, Profit or Loss from Business. Additionally, petitioner was day trading during the years at issue. Petitioners reported a \$44,004 net gain in 1999, a \$313,715 net loss in 2000, and a \$377,079 net loss in 2001 from petitioner's day trading on Schedules D, Capital Gains and Losses. The returns reported a zero income tax liability for 1999, a \$1,523 income tax liability for 2000 (entirely offset by a claimed earned income credit of \$2,353), and a \$2,325 income tax liability for 2001.

Mr. Borrelli certainly seems to have met the third criteria Mr. Lehrer outlined to reduce his liability and, we should presume, was also responsive. However, it appears that Mr. Lehrer did not actually test his first criteria, as the court notes:

Petitioner said "alarm bells did go off" when the returns Mr. Borrelli prepared resulted in such reduced tax liabilities compared to those on the returns Ms. Irussi

had prepared. Petitioners spent only minutes in reviewing the returns Mr. Borrelli prepared. They focused exclusively on determining whether a refund or tax was due and where they needed to sign. In addition, petitioners failed to notice that a \$53,000 gain from the sale of real property, for which they had provided documentation to Mr. Borrelli, was omitted from the return for 1999. Petitioners did not question how Mr. Borrelli managed to reduce their income tax liability despite consistent gross revenues from the construction business in the millions of dollars.

Eventually Mr. Lehrer appears to have gotten concerned about Mr. Borrelli's computations and in 2001 asked another accountant to review Mr. Borrelli's work. As the court notes:

Petitioner asked another accountant, Ed Lampe, to review the return for 2000 that Mr. Borrelli had prepared. Mr. Lampe informed petitioner that a few things on the return caused him concern about Mr. Borrelli. The return reported not only did petitioners owe no taxes, but that petitioners were claiming an earned income credit, despite the \$2.7 million Schedule C gross revenues. Petitioner became concerned about Mr. Borrelli after hearing from Mr. Lampe, but petitioner did not fire Mr. Borrelli at that time.

Well, the following year, Mr. Borrelli had a few developments in his life that would prove significant. As noted:

...Mr. Borrelli was arrested and charged in 2002 for filing fraudulent tax returns. In November 2002, respondent sent a letter to petitioners notifying them that they were under audit for the years at issue. Petitioners relied on Mr. Borrelli to represent them, but they ultimately fired him in November 2003 because of his mishandling of the audit. Mr. Borrelli has been serving a 33-month prison sentence for crimes relating to filing fraudulent returns since May 2004.

The result of the exams was not very favorable for the taxpayer. The IRS eventually assessed the taxpayers as follows:

For 1999, respondent determined a \$650,411 deficiency and a \$130,082 accuracy-related penalty. For 2000, respondent determined a \$1,013,341 deficiency and a \$202,668 accuracy-related penalty. For 2001, respondent determined a \$1,240,280 deficiency and a \$247,936 accuracy-related penalty.

At trial the question of the tax due was no longer an issue—rather the only issue being decided was whether the taxpayers had reasonable cause for and acted in good faith in originally determining their tax liability for the years in question.

Conduct Fell Short

The Tax Court decided that the taxpayer did not reasonably rely on Mr. Borrelli's work in determining their tax liabilities. In its analysis, the court looked at three factors that Mr. Lehrer needed to show in order to be relieved of the penalties:

- Did Mr. Lehrer do sufficient work to determine that Mr. Borrelli was a competent tax professional on whom he could rely?
- Did Mr. Lehrer provide accurate and necessary information to the professional in order for him to have properly prepare their return?
- Did Mr. Lehrer act in good faith in relying on Mr. Borrelli?

In the end the court found that Mr. Lehrer only met one of those tests. The court did find that Mr. Lehrer provided sufficient information. The court noted:

Petitioners sent Mr. Borrelli the tax organizer he requested every year and additionally sent all supporting documentation requested. We find that petitioners provided Mr. Borrelli with the necessary and accurate information to prepare their income tax returns.

However, on the issue of Mr. Lehrer's determination of Mr. Borrelli's competence, the court found his method of qualifying Mr. Lehrer to be lacking:

Petitioners hired Mr. Borrelli after a relative's recommendation and a few telephone conversations in which Mr. Borrelli cited some Code provisions. Petitioners introduced no evidence regarding Mr. Borrelli's credentials or his experience in preparing tax returns. Mr. Borrelli was not called as a witness at trial. In short, petitioners failed to introduce any credible evidence that Mr. Borrelli was a competent tax adviser with sufficient expertise to justify their reliance.

And the court didn't find Mr. Lehrer's explanation of two of his reasons for firing his former accountant and hiring Mr. Borrelli credible. As the court noted:

Finally, we address whether petitioners relied in good faith on Mr. Borrelli's advice. Petitioner stated he wanted a return preparer who would be more readily available and more responsive to his questions. Yet he chose Mr. Borrelli, who lives in St. Louis, Missouri, without evaluating any local northern California alternatives.

While the court doesn't explicitly say so, it seems clear the court decided that Mr. Lehrer's real reason for hiring Mr. Borrelli was only because he promised to deliver a lower tax liability and then decided to invent other reasons when things went bad and he was trying to get out of the rather substantial penalties. As the court concludes:

We find that petitioners failed to perform the due diligence that a reasonably prudent person would perform before hiring an income tax return preparer.

Petitioner did little to investigate Mr. Borrelli's qualifications before hiring him. Petitioner did not determine whether Mr. Borrelli was a CPA or had relevant education and experience.

Although petitioner may have graduated only from high school, he has been managing a construction business generating millions of dollars in revenues for several years, and he personally engaged in hundreds of thousands of dollars of day trading during the years at issue. Petitioners' income tax liability went from more than \$40,000 a year when Ms. Irussi prepared returns for them to essentially zero when Mr. Borrelli prepared the returns. Yet the gross revenues from the construction business remained consistent. Petitioners offered no explanation for the reduced income tax reported on the returns other than the change in return preparer. We cannot excuse a taxpayer who makes little or no effort to discern whether the person the taxpayer has chosen to prepare a return is competent to give tax advice. We find that petitioners did not act in good faith in relying on Mr. Borrelli's advice.

In essence, Mr. Lehrer is being told that if the result seems too good to be true, he can't just close his eyes to that fact.

Well, We Can Trust the Government, Can't We?

In the *Diem* case we see a somewhat different issue—that of whether a taxpayer can rely upon the representations of the IRS and representatives of his employer (the City of San Francisco) on the taxable nature of a proposed lawsuit settlement when the taxpayer is agreeing to give up the right to pursue a remedy that clearly would be tax exempt. Unfortunately for Fireman Diem, the answer is no.

The taxpayer had applied for and been awarded in arbitration benefits for a job related disability as Industrial Disability Benefits from the City of San Francisco. However, the city indicated that it was going to challenge the determination of the arbitrator in court and settlement negotiations began. As the court notes:

The parties agree that the benefits under this program were equivalent to workmen's compensation benefits, and, accordingly, such benefits would not constitute gross income since petitioner's disabling condition was sustained within the scope of and in the course of his employment. Sec. 104(a)(1).

In settlement negotiations, the city indicated that it would not oppose settling if Mr. Diem would agree to receive not the Industrial Disability Benefits he was entitled to, but instead a “nonindustrial” disability retirement from the city. The benefits under that program were based on age and years of service.

Mr Diem and his attorney were concerned that these benefits might be taxable, so he asked the city about that issue. The court notes that:

Petitioner received an assurance by the city, which was attested to by a representative of the IRS who was present at one of the conferences, that the benefits from a nonindustrial disability retirement program would not constitute gross income.

The court goes on to note specifically that:

Because of the representation that the nonindustrial disability benefits did not constitute gross income, and considering further that the litigation that was threatened by the city could be protracted and the outcome uncertain, petitioner and his attorney agreed that petitioner would accept the nonindustrial benefits.

The Problem of the Regulation

However, the court noted that Regulation §1.104-1(b) explicitly deals with this situation—and not coming up with the result that Mr. Diem had been assured would occur:

Section 104(a)(1) excludes from gross income amounts which are received by an employee under a workmen's compensation act * * * or under a statute in the nature of a workmen's compensation act which provides compensation to employees for personal injuries or sickness incurred in the course of employment. * * * However, *section 104(a)(1) does not apply to a retirement pension or annuity to the extent that it is determined by reference to the employee's age or length of service, or the employee's prior contributions, even though the employee's retirement is occasioned by an occupational injury or sickness.* * * * [Emphasis added.]

As noted earlier, Mr. Diem's disability retirement was determined solely by reference to his age and years of service.

Mr. Diem claims that this simply isn't right and the IRS shouldn't be allowed to now collect a tax that their representative had assured him was not due. While that sounds reasonable, it simply isn't how the law works:

The law is well settled that the Commissioner is not estopped and cannot be bound by erroneous acts or omissions of his agents or representations by other parties such as the employer. Authoritative tax law is contained in statutes, regulations, and judicial decisions. *Zimmerman v. Commissioner*, 71 T.C. 367, 371 (1978), affd. without published opinion 614 F.2d 1294 (2d Cir. 1979); *Green v. Commissioner*, 59 T.C. 456, 458 (1972). A taxpayer cannot prevail simply because he relied on incorrect advice from his attorney regarding the tax consequences of the settlement. *Coats v. Commissioner*, T.C. Memo. 1977-407, affd. without published opinion 626 F.2d 865 (9th Cir. 1980). The representations that were made by the city of San Francisco and an IRS agent do not carry the

weight of law. Respondent, therefore, is sustained on this issue as the benefits petitioner received were based on age and years of service.

And, we also discover that if you submit a copy of a return you claim was timely filed to escape a failure to file penalty, it's useful if the signature on that copy isn't dated years after the due date of the return.

The remaining issue is respondent's determination of the addition to tax under section 6651(a)(1). At trial, respondent offered into evidence certification that there was no record of filing of an income tax return by petitioner for the year at issue. Petitioner argued otherwise and submitted to the Court a copy of the return he claimed he filed for 1997. The Court need not address whether a return was in fact filed. The copy of the return petitioner offered into evidence for 1997 bears a signature date of July 29, 2004. Under section 6072(a), calendar year taxpayers, such as petitioner, are required to file their income tax returns by April 15 following the close of the taxable year. For the year 1997, in the absence of any extensions, the return for that year should have been filed on or before April 15, 1998. The return claimed to have been filed by petitioner bears the signature date of July 29, 2004, several years after the return was due to be filed. Respondent, therefore, is sustained on this issue, since the 1997 return, if filed, was not timely.

Conclusions

These cases are somewhat useful in explaining to clients both why they shouldn't simply "tax shop" for their tax advice, going with whomever promises the lowest tax and why it may not matter what the IRS told them when they called the help line. For that reason, this pair of cases may prove useful in your practice of examples of why there is a value to hiring competent tax advisers, even if they from time to time may tell you things you don't want to hear.