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# 'Kelly v. Commissioner': Loans Recharacterized as Distributions

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The tax consequences of the repetition of ordinary business transactions, such as transfers of funds between affiliated entities recorded as loans, may change not because of either a change in the documentation of such transactions or a change in the applicable legal standards, but rather because a change in underlying circumstances causes the prior characterization of such transfers for tax purposes in accordance with their form no longer to be defensible. The recent Tax Court decision in *Kelly v. Commissioner*, TC Memo 2021-76, illustrates the unfortunate tax consequences that may ensue from a change in underlying circumstances. The taxpayer's disclosure of information to his accountants, however, and reliance on their advice, was helpful in causing assertion of certain penalties, including fraud penalties, to be rejected by the court.

## Facts in *Kelly*

Beginning in the 1990's, Michael Kelly engaged in numerous ventures involving the purchase of nonperforming loans and other troubled assets. In many instances he would foreclose on the collateral securing a loan, make improvements to the business and related real property, and then either operate the business or sell it. He frequently borrowed from entities under his control, as well as from unrelated lenders, to finance new acquisitions.

In 2003, Mr. Kelly acquired a publicly traded corporation (NSI) with the intent of selling its assets and investing the proceeds in other ventures. At the time of acquisition, NSI had two active (albeit unprofitable) trades or businesses and approximately $20 to $30 million of cash, but was also subject to asbestos-related claims attributable to a company formerly owned by it and ongoing litigation relating to those liabilities. Analysis of those liabilities and related insurance coverage at the time of the acquisition indicated that all but $16 million of the liabilities would be covered by insurance.

The two businesses owned by NSI at the time of the acquisition were sold in 2005 and 2006 and the proceeds, together with interim cash flow of the businesses it had owned, were sufficient to fully repay the loans incurred to finance the acquisition. Thereafter NSI was used to fund other business ventures of Mr. Kelly through intercompany loans.

During the years at issue in proceedings before the Tax Court (2007 through 2011), NSI filed S corporation tax returns. Its loans following the acquisition were generally made either to Mr. Kelly or to single member limited liability companies owned by him. The loans from NSI to affiliated entities were documented with promissory notes providing for the payment of interest at the short-term applicable federal rate (AFR), and accrued interest on the loans was recorded on the books of NSI. Between 2004 and 2011, the total amount transferred by NSI to Mr. Kelly and his affiliated companies and recorded as loans was approximately $175 million, and approximately $6 million of those loans were repaid by one of the affiliates in 2007. The IRS argued that many of these loans should be treated for tax purposes as distributions to Mr. Kelly, while he argued that they should be respected in accordance with their form.

In February 2008, Mr. Kelly organized a foreign corporation (KY&C) to purchase a Cayman Islands - flagged yacht from a distressed seller, with the intent of refitting the yacht and then either selling or chartering it. The stock of KY&C was owned by Mr. Kelly, which caused him to be subject to the reporting requirements of Internal Revenue Code (IRC) sections 6038 and 6046 with respect to KY&C. An accountant employed by one of Mr. Kelly's companies sent an email to the outside accounting firm that prepared Mr. Kelly's returns noting that the corporation was incorporated in the Cayman Islands and that the staff accountant was unsure as to the resulting tax filing obligations. Form 5471 is used to meet these reporting requirements, but no Form 5471 was filed with Mr. Kelly's returns for 2008 and 2009.

By 2008, it was becoming difficult for Mr. Kelly to pay his creditors. In 2007 and 2008 NSI reduced the debt owed to it by distributing to its shareholders (predominantly a single member LLC owned by Mr. Kelly) debt owed to NSI. In addition, over a multi-year period ending in 2010, affiliates "wrote off" (and presumably forgave) debt owed to them by other Kelly affiliates of more than $100 million. The resulting discharge of indebtedness income reported in 2010 was excluded from Mr. Kelly's income on the basis of his insolvency. In 2012, NSI filed for bankruptcy, with the bankruptcy petition of NSI reporting liabilities consisting primarily of asbestos claims that greatly exceeded its relatively minimal assets.

The IRS audit of Mr. Kelly commenced in 2012 with an examination of his personal income tax return for 2010, and Mr. Kelly cooperated in the audit. He ultimately received two notices of deficiency, one in 2015 for tax years 2010 and 2011, and another in 2016 for tax years 2007 through 2009.

The government asserted that years 2007 through 2009 remained open, notwithstanding the normal three-year statute of limitations period under IRC section 6501(a), because the returns filed for those years were false or fraudulent with the intent to evade tax (see IRC § 6501(c)(1)). The government also asserted that (even if the returns were not fraudulent) 2008 and 2009 remained open at the time the notice of deficiency for those years was issued, by reason of the failure to timely file Form 5471.

**Discussion**

There was no dispute that Mr. Kelly was required to file a Form 5471 for each of 2008 and 2009 by reason of his ownership of all the stock of a foreign corporation, and the forms were not been filed by him until 2019 (after Mr. Kelly was contacted regarding the omissions). Under IRC section 6501(c)(8), failure to file such a return would generally cause the time for assessment of any tax imposed under the IRC against him for the relevant tax years to not expire until three years after the form was actually filed. However, if the failure to file the Form 5471 was due to "reasonable cause" and not willful neglect, the extension of time to assess tax would apply only with respect to tax items related to such failure -- in this case, the adjustments relating to KY&C itself.

The court concluded that reasonable cause in this context should be determined in a manner similar to how it has been defined for purposes of IRC penalty provisions, under which taxpayers have been able to establish reasonable cause on the basis of reliance on a tax adviser where (i) the adviser was a competent professional, (ii) the taxpayer provided the necessary information to the adviser, and (iii) the taxpayer relied in good faith on the adviser. Mr. Kelly's returns were prepared by a CPA with decades of experience in Federal tax preparation and with no history of disciplinary actions or IRS preparer penalties. Mr. Kelly's staff had informed the CPA that KY&C was a Cayman Islands entity and that the client did not know what additional filing requirements might therefore apply in the Cayman Islands or the United States.

The government implied, according to the court, that the taxpayer should have advised the CPA that a Form 5471 was required, but the court rejected that contention. The CPA testified credibly at trial regarding the reasons his firm failed to prepare the Form 5471. In the court's view, while it could be argued that the accounting firm of the CPA should have done more to ascertain Mr. Kelly's filing obligations, it was reasonable for Mr. Kelly to rely on the accounting firm to make such further investigation.

With respect to the government's assertions that the returns filed for 2007 through 2009 were fraudulent (which determination, if correct, would have prevented the closing of the limitations periods), the court found that the government's list of "badges of fraud" all derived from an assertion that intercompany transfers by NSI were not properly treated as loans and instead constituted distributions by the S corporation that were concealed with intent to defraud the United States. The court concluded, in brief, that although some of those transfers were not loans for tax purposes (for reasons further discussed below), the record did not indicate that the purported loans were part of a fraudulent tax scheme; rather, they represented Mr. Kelly's established business practice over two decades, and were consistent with his overall practice of respecting the separate corporate entities and their accounting records.

Regarding the appropriate tax treatment of the intercompany transfers by NSI, the opinion lists objective factors normally considered in determining whether a bona fide debtor-creditor relationship existed. The factor critical to the court's analysis in *Kelly* was whether the borrowers had reasonable prospects of repaying the loans when the advances were made. By 2008, and in light of the downturn in the economy and the specific challenges faced by Mr. Kelly's businesses, there was no longer a reasonable prospect of repayment, and the court viewed his apparent assertions that he expected repayment of transfers made in 2008 and thereafter to be lacking in credibility.

The court also noted that, although Mr. Kelly's companies carefully accounted for intercompany loans through 2007, and there were some repayments in that year, "respect for the loan characterization and repayments gradually disappear[ed] after 2007." Thus, the court concluded, the transfers made after 2007 were shareholder distributions by NSI.

**Observations**

The results in *Kelly* with respect to the issues discussed above underscore that the treatment of transfers of funds to affiliated entities as intercompany loans, even if carefully documented and reflected on financial records as loans, may not be sustainable once circumstances develop that make repayment highly speculative at best. With respect to the issue of reasonable cause for failure to file Form 5471, the court's finding that Mr. Kelly's reliance on accountants sufficed to establish "reasonable cause" for statute of limitation purposes is welcome. However, it should not be assumed that the same result will apply in a context where a taxpayer has greater experience with cross-border investments and therefore reason to be familiar with the Form 5471 reporting requirement.

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