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Lack of Consistency in S Corporation Reporting – How Onerous Are the Results?

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As part of the major changes to the taxation of S corporations made by the Subchapter S Revision Act of 1982 (SSRA), Congress added to the Code a regime under which the shareholders of an S corporation would have the tax treatment of the corporation's items of income, loss, deduction, and credit determined in "unified" administrative and judicial proceedings, rather than on a shareholder-by-shareholder basis. [1] Although Congress became disenchanted with this procedural regime and repealed most of it in 1996, [2] one small portion of the SSRA rules was retained—under Section 6037(c), a shareholder of an S corporation must, on the shareholder's tax return, treat all "Subchapter S items" consistently with such items' treatment on the S corporation's return or else file a statement with the Service identifying the inconsistency. [3]

In a recent reviewed opinion, *Winter*, 135 TC No 12, Tax Ct Rep Dec (RIA) 135.12, 2010 WL 3341807 , the Tax Court determined that it has jurisdiction to consider issues related to the tax treatment of S corporation items that were reported by an individual shareholder inconsistently with the corporation's return and without any identification by the shareholder of the inconsistency. Although the court's opinion, written by Judge Goeke for an 11-judge majority, [4] addresses only a jurisdictional question, [5] the Tax Court's willingness even to consider the substantive issue may eviscerate a key safeguard enacted by Congress to ensure consistency between the returns of S corporations and the returns of their shareholders.

Rules identical to the S corporations rule require beneficiaries of estates or trusts to report consistently with information that is reported to them by the fiduciary. [6] Accordingly, everything written here regarding the meaning and scope of the *Winter* decision should apply equally to such beneficiaries as to S corporation shareholders. [7]

A FOOLISH CONSISTENCY?

When the SSRA was enacted, it marked the extension into the S corporation arena of the "unified" administrative and judicial procedures that had been adopted for partnerships just a few months earlier as part of TEFRA. Under these procedures, the tax treatment of partnership or S corporation items was to be determined at the entity level, in a unified partnership or S

corporation proceeding, rather than in separate proceedings with the partners or shareholders (as previously had been the case). One of the stated reasons for adoption of the TEFRA procedures was that, under prior law, "[i]nconsistent results could be obtained for different partners with respect to the same item." [8]

The Tax Court has stated that the "principal purpose behind TEFRA is to provide consistency and reduce duplication in the treatment of 'partnership items' by requiring that they be determined in a unified proceeding at the partnership level." [9] The TEFRA rules, as extended by the SSRA to S corporations, and as still applicable to partnerships, include a requirement for consistent reporting, except in the event notification is made to the IRS, as part of a complex and coordinated set of "unified" audit, settlement, judicial review, and refund procedures.

In 1996, Congress determined that "the TEFRA audit procedures should be inapplicable to entities with a limited number of owners" [10] and repealed those provisions to the extent that they had theretofore applied to S corporations, effective for tax years beginning after 1996. Nevertheless, Congress wanted to continue to "require consistency between the returns of the S corporation and its shareholders."

To that end, Congress preserved in Section 6037(c) one limited vestige of the SSRA's extension of the TEFRA rules to S corporations, [11] even as it repealed the rules under which the tax treatment of S corporation items would be determined at the corporate level and, in effect, restored the pre-1982 system under which each shareholder of an S corporation litigates individually any questions concerning the amount of such items and the shareholder's federal income tax liability that arises from them. Under Section 6037(c), a shareholder of an S corporation must, on the shareholder's tax return, treat all Subchapter S items consistently with such items' treatment on the S corporation's return, or file a statement with the Service identifying the inconsistency.

Section 6037(c) does not merely require an S corporation shareholder to report consistently with the corporation's return, unless the shareholder notifies the IRS of any inconsistency. [12] The section also prescribes the effect of a failure to notify: "any adjustment required to make the treatment of the items by such shareholder consistent with the treatment of the items on the corporate return shall be treated as arising out of mathematical or clerical errors and assessed according to section 6213(b)(1)."

Section 6213(b)(1), in turn, provides that, on a taxpayer's being notified by the IRS that additional tax is due on account of mathematical or clerical errors on the taxpayer's return, the taxpayer has no right to file a petition with the Tax Court before such additional tax is assessed, and the assessment and collection of such additional tax is not prohibited by Section 6213(a). [13] Thus, immediate assessment and collection are permitted, notwithstanding Section 6213(a), which generally prohibits assessment or collection until 90 days after mailing of a notice of deficiency and, if a petition with the Tax Court is filed, until the decision of the Tax Court has become final. [14]

Although Treasury has not complied with the statutory mandate to prescribe Regulations specifying how notification of inconsistent treatment should be made by an S corporation

shareholder, the Service has issued Form 8082, "Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)," to be used for this purpose. The Form 8082 instructions state: "If you are a ... S corporation shareholder ..., you generally must report items consistent with the way they were reported to you on Schedule K-1 .... However, there may be reasons why you wish to report these items differently. Use Form 8082 for this purpose." With this background in mind, we turn to *Winter*.

FACTS AND PROCEDURAL HISTORY

Builders Financial Corporation (BFC) was an S corporation. Michael Winter, an owner of more than 26% of the stock of BFC, was an employee of a bank that was a subsidiary of BFC. [15] During 2002, the bank subsidiary paid a $5 million bonus to Winter.

BFC's treatment of the bonus for financial and regulatory accounting purposes was different from its treatment of the bonus for tax accounting purposes. In particular, BFC treated the entire $5 million as a current expense for financial and regulatory purposes. Based on that treatment, BFC reported a 2002 *loss* for financial and regulatory purposes of approximately $4.6 million. For tax purposes, however, BFC treated only $1 million of the $5 million bonus as deductible.

As a result of the $4 million difference between the amounts deducted as compensation expense, together with other "book-tax differences," BFC reported on its tax return that it had *positive taxable income* of approximately $3 million for 2002, of which Winter's share, as reported on a Schedule K-1 attached to BFC's return, was approximately $800,000.

On his return for 2002, Winter reported the full amount of the $5 million bonus as income, but, in his capacity as a 26% shareholder of the S corporation, Winter claimed a deduction of approximately $1.2 million, or 26% of the amount of BFC's $4.6 million loss as computed for financial and regulatory purposes. Winter, who had been fired by BFC in early 2003, asserted before the Tax Court that he had not received a Schedule K-1 from BFC, [16] that he had accordingly based his computation of the loss "passing through" to him from BFC on BFC's regulatory financial statements posted on the FDIC's website, and that he had correspondingly reported no "pass-through" income as a shareholder of BFC. Winter took no steps to notify the IRS of the inconsistency between the amount reported by him as his share of BFC's loss and the amount reported by BFC as his share of BFC's income. [17]

Notwithstanding Winter's failure to provide the required notification, the inconsistency did come to the attention of the Service. The IRS did not immediately take advantage of its authority to assess Winter's tax attributable to the inconsistency on a summary basis. Rather, the Service initially issued to Winter a notice of deficiency including a number of adjustments, including one that would make his reporting of income or loss "passed through" to him by BFC during 2002 consistent with the amount shown on BFC's return, and it was only after issuance of this notice of deficiency and the filing of Winter's Tax Court petition that the IRS made a summary assessment. [18]

Winter filed a petition in the Tax Court challenging the asserted deficiency and, in an amended petition, asserted that he had, in fact, made an overpayment of his tax for 2002. Judge Holmes, to whom the case was originally assigned, raised on his own the question of whether the Tax Court's jurisdiction extended to the notice of deficiency's adjustment relating to Winter's having reported inconsistently with BFC. [19] A majority of the Tax Court judges held that jurisdiction was present.

DOES THE TAX COURT HAVE JURISDICTION?

Judge Holmes's opinion dissenting from the majority's conclusion contains a lengthy (44 double-spaced pages on the Tax Court's website) exposition of the arguments in favor of the positions that, when a deficiency arises from an inconsistency between an S corporation shareholder's return and the corporation's return, the Service *must* use the "mathematical and clerical errors" and summary assessment procedures and that, accordingly, the Tax Court would not have jurisdiction over such adjustments giving rise to such a deficiency.

The much briefer majority opinion (only 12 double-spaced pages, of which approximately half is devoted to a recitation of the facts) supports its finding of jurisdiction. The primary ground was that, once a case is properly before the Tax Court—as this case clearly was, based on the Service's inclusion of non-S corporation adjustments in the notice of deficiency, [20] as well as on Winter's assertion that he had made an overpayment [21]—all of the issues necessary to compute the proper amount of deficiency or overpayment are within the court's jurisdiction. The majority opinion also noted that the IRS had, in fact, assessed the tax attributable to the inconsistency between Winter's return and that of BFC, as required by Section 6037(c), [22] and that Section 6037(c) contains no reference whatsoever to Tax Court jurisdiction.

Finally, the majority argued that the 1996 repeal of the "unified" procedures applicable to S corporation items at the same time that Section 6037(c) was enacted made it "inconsistent with [the] legislative history to assume that Congress intended to eliminate S corporation items from the deficiency jurisdiction of this Court involving individual shareholders, because there is no provision [analogous to the provision that does exist in the TEFRA rules governing "unified" partnership proceedings] for a separate judicial determination of the inconsistently reported item in the case of an S corporation. Thus, there is no necessity [and, indeed, no possibility] to defer the individual case for an action at the level of the corporation."

This final portion of the majority opinion seems to be aimed at a straw man. There are possible answers, other than Tax Court jurisdiction, to the question of how disputes between the IRS and taxpayers regarding the proper amount of S corporation items, in cases where the taxpayer has reported such items inconsistently with the corporation's return and without notification to the Service, should be resolved. Those answers include the availability of a suit for refund in district court or the Court of Federal Claims, an alternative advanced by Judge Holmes in his dissent but not expressly addressed by the majority.

Another possible answer, not raised in any of the opinions in *Winter* but discussed in greater detail below, is that the "penalty" for such improper reporting by a shareholder is that the corporation's reporting will, as a matter of law, be considered to be correct and that the

shareholder will necessarily be unsuccessful challenging the corporation's reporting *in any forum.* If Section 6037(c) in fact creates such a "penalty," the presence of Tax Court "jurisdiction" may prove to be scant comfort to Winter when the Court addresses the merits of his case.

PROCEDURAL INCONVENIENCE OR SUBSTANTIVE ROADBLOCK?

The majority of the judges of the Tax Court held that, at least in the procedural posture of the case before them, the court had "jurisdiction" to determine the proper amount of Winter's Subchapter S items. Judge Holmes would have held that Section 6037(c)(3), when read in the context of other provisions relating to Tax Court jurisdiction, relegated Winter to a refund suit in another court, but there is no discussion in his opinion regarding whether or not the refund forum could make a *de novo* determination of the proper amount of those items.

The interesting question to your authors is whether even Judge Holmes's view gives insufficient weight to Congress's underlying policy in favor of "consistency." Is that policy advanced by a rule that prescribes, as consequences for failure to provide the required notification of inconsistent reporting, nothing more severe than a requirement of pre-litigation payment and in some (but, according to the Tax Court majority, not all) cases an inability to litigate in the Tax Court? [23] Or should Section 6037(c) be read to mean that, as a matter of substantive tax law, a shareholder's tax liability can and must in such a case be computed by the IRS and the courts (including the Tax Court, when it has "jurisdiction") in accordance with the amounts shown on the corporation's return?

A strong argument can be made that Section 6037 must prescribe, as the cost of failure to provide the required notification of inconsistent reporting, something more severe than a requirement of pre-litigation payment. Otherwise, Section 6037 might give insufficient weight to Congress's expressed policy in favor of "consistency," because a reading of the statute that required no more than pre-litigation payment would not penalize in any meaningful way at least some of those who did not "play by the rules."

For example, shareholders who could afford to pay an income tax liability attributable to inconsistently reported treatment of an S corporation item, if failure to provide the required notification were found by the IRS on audit and the tax were summarily assessed and collected by the Service, would scarcely be disincentivized by a regime that simply required pre-litigation payment of the assessed income tax liability. Such shareholders might conclude that the detriment of increased risk of audit, caused by providing the required notification of inconsistent treatment, was more severe than the detriment of being forced to pay before litigating in the event that the inconsistent reporting were ultimately discovered on audit. [24]

Moreover, any S corporation shareholder who preferred district court litigation, because it affords the opportunity for a jury trial, or Court of Federal Claims litigation, also might be "under-deterred" by a regime that simply eliminates the opportunity for prepayment litigation of the income tax liability. A broad reading of Section 6037(c), one that makes the S corporation's reporting conclusive of the shareholder's tax treatment if the shareholder does not comply with the notification requirement, would go far toward eliminating such gamesmanship.

Nevertheless, a cogent argument can be made that Section 6037 prescribes, as the cost of failure to provide the required notification of inconsistent reporting, nothing more severe than a requirement of pre-litigation payment. Such a reading of Section 6037 comports with the "plain language" of the provision, the best (in this case, only) evidence of congressional intent, and it could be thus argued that it thereby gives precisely the correct weight to the policy in favor of "consistency."

Section 6037(c)(3) expressly penalizes S corporation shareholders who report inconsistently and do not provide the required notification by arming the Service with summary assessment and collection procedures and, by its words, does nothing more. By adding another consequence—preclusion of *de novo* review of the relative substantive correctness of the positions adopted by the S corporation and by the shareholder—a court would be going above and beyond the regime Congress put in place. If Congress had wanted to impose that additional consequence, it certainly could have added words to that effect in the statute itself.

Indeed, in a different context, the Tax Court recently grounded, at least in part, its decision that it lacked jurisdiction over an asserted penalty—jurisdiction that would have prevented the Service from summarily assessing and collecting the asserted liability—on the notion that the Code afforded the taxpayer the opportunity to pay the penalty and sue for a refund.[25] A reading of Section 6037(c) that penalizes those "who do not play by the rules" with nothing more than the loss of the opportunity for prepayment litigation may hew closer to the actual text than any other reading.

CONCLUSION

The Tax Court has now held that it has jurisdiction over the adjustment to an S corporation shareholder's distributive share of S corporation income, even when the shareholder has not complied with the notification requirement of Section 6037(c). Implicit in this jurisdictional holding may be a willingness to address the relative substantive correctness of the positions adopted by the S corporation and by the shareholder.

While the peculiar procedural posture of the *Winter* case may likely arise only rarely, the broader import of the decision is in its causing tax practitioners to focus on the precise consequences of a "summary assessment" regime. From the taxpayer's perspective, it would be beneficial if the courts determine that such a regime strips taxpayers only of a prepayment forum in which to contest the underlying substantive issues, while leaving open the possibility of the taxpayer's prevailing in refund litigation. But advisors may wish to warn their clients that there remains a risk that such a regime may preclude judicial review of the underlying substantive issues if taxpayers do not comply with the notification requirement so clearly mandated by the Code.

PRACTICE NOTES

S corporation shareholders who fail to report Schedule K-1 amounts consistently with the Form 1120S violate the requirement of Section 6037(c), and will be subject to the summary assessment and collection procedures that short-circuit the usual notice of deficiency that is a

"ticket" to prepayment litigation in the Tax Court. In *Winter*, the taxpayer was lucky enough to have the IRS include the inconsistency in a notice of deficiency that also involved other adjustments, and the Tax Court had the case. This will not happen for most taxpayers who roll the "inconsistency" dice. For them, the bigger question is whether the court—whichever court it turns out to be—will engage in a *de novo* review of the merits of the positions taken by the shareholder and the S corporation, or will adopt the S corporation's position as conclusively correct.

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[1] These rules generally applied to tax years beginning after 1982.
[2] Small Business Job Protection Act of 1996 (SBJPA).
[3] Section 6037(c)(4) defines a Subchapter S item as "any item of an S corporation to the extent that regulations ... provide that ... such item is more appropriately determined at the corporation level than at the shareholder level." No Regulations have been issued (or even proposed) under Section 6037(c). Nevertheless, during the period after the 1982 enactment of the SSRA and before the 1996 repeal of the provisions creating unified administrative and judicial procedures for S corporations, Temp. Reg. 301.6245-1T was issued under Section 6245, which then defined Subchapter S item identically to current Section 6037(c)(4); that Temporary Regulation continues to be outstanding.
[4] Judge Halpern concurred in the result only and wrote a brief opinion, with a portion of which Judge Goeke (the majority opinion's author) and Judge Gustafson agreed. Judge Holmes alone dissented.
[5] Neither of the parties had questioned the Tax Court's jurisdiction to consider the substantive issues, and the jurisdictional issue was raised by the court itself.
[6] See Section 6034A(c).
[7] As discussed in greater detail below, the S corporation consistent reporting and summary assessment rules had their genesis in similar provisions contained in the TEFRA partnership audit rules (Section 6222), and it is conceivable that the Tax Court's decision in Winter may have relevance to the treatment of partners who fail to report consistently with the partnership return. The procedures created by the TEFRA partnership audit rules, however, significantly differ from those that apply to S corporation shareholders (or to beneficiaries of trusts or estates). Thus, in the absence of authority, both within the four corners of the partnership consistent reporting rule and regarding its interaction with the S corporation rule, the impact of Winter in the partnership context is uncertain. Similarly, it is difficult to draw inferences from the TEFRA partnership audit procedures regarding the proper resolution of some of the issues raised by Winter.
[8] Staff of the Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, page 268.
[9] Greenberg Bros. Partnership #4, 111 TC 198 (1998), *aff'd in part, vacated and remanded in part, rev'd and remanded in part, dismissed in part sub nom.* Cinema '84, 89 AFTR 2d 2002-2598, 294 F3d 432 (CA-2, 2002).
[10] Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress*, page 118. The S corporation "limit" on the number of owners can be somewhat illusory. Prior to enactment of the SBJPA, S corporations generally could have no more than 35 shareholders, but SBJPA increased that limit to 75 shareholders. Subsequent legislation has liberalized the rules even further. See Sections 1361(b)(1)(A) (100-shareholder limit), 1361(c)(1) (all members of "family" descending from a common ancestor up to six generations back (and their spouses) count as only one shareholder for purposes of the limitation). Compare Section 775, which defines an "electing large partnership," potentially subject to substantive and procedural rules even more "unified" than those under TEFRA, as one with 100 or more partners.
[11] Section 6037(c) appears to apply to all S corporations, even though the SSRA predecessor of that provision did not apply to "small S corporations," generally those with five or fewer shareholders, each of whom or which was a natural person or an estate. See Temp. Reg. 301.6241-1T(c)(2).
[12] Where a shareholder can demonstrate "to the satisfaction of the Secretary" that the treatment of an item on the shareholder's return, although inconsistent with the treatment of that item on the corporation's return, is nevertheless consistent with its treatment on the Schedule K-1 furnished by the corporation to the shareholder, the shareholder may be treated as having made the required notification. The notification requirement does apply, however, if the shareholder does not receive any Schedule K-1 and either the shareholder's reporting is, in fact, inconsistent with the corporation's return or the corporation does not file any return at all for the year.
[13] The last sentence of Section 6037(c)(3) provides that an alternative procedure ordinarily applicable under Section 6213(b), pursuant to which a taxpayer can request an abatement of a "mathematical or clerical errors" assessment, so

that review in the Tax Court may become available, does not apply to Section 6037(c) items.
[14] Although a decision of the Tax Court does not become "final" under Section 7481(a) until the completion of appellate review, Section 7485(a) provides that any deficiency determined by the Tax Court can be assessed and collected unless a bond is filed by the taxpayer with the Tax Court.
[15] Although the Tax Court's opinion does not state so explicitly, the subsidiary for which Winter worked appears to have been a "qualified Subchapter S subsidiary," all of whose items of income, deduction, and credit were treated as items of the parent S corporation under Section 1361(b)(3)(A)(ii). Accordingly, a deduction for a portion of the compensation paid by the subsidiary to Winter was claimed on BFC's return.
[16] The Tax Court's recitation of the facts leaves the distinct impression that the Tax Court was skeptical of Winter's claim and was troubled by his failure to have asked BFC or the Service for another copy of the Schedule K-1. The court did not need to decide, however, whether Winter had in fact received a Schedule K-1, since only S corporation shareholders who report consistently with an erroneous Schedule K-1, and *not* those who receive no Schedule K-1 at all, are relieved of the statutory requirement of notifying the Service of any inconsistency between their returns and those of the corporation.
[17] For some reason, the Tax Court recites this important fact only in the "Discussion" portion of its opinion, rather than in the "Background" portion where the other facts of the case appear.
[18] The time at which the assessment was made is also tucked away in the "Discussion" portion of the opinion, rather than in the "Background" portion where the other facts of the case appear. The "Discussion" notes that the Service had suspended collecting the assessment pending the Tax Court's resolution of the jurisdiction issue.
[19] As noted in note 4, *supra*, Judge Holmes was the sole dissenter from the Tax Court majority's conclusion that the court did have jurisdiction over that adjustment. Simultaneously with the issuance of the Tax Court's opinion on the jurisdictional issue, the case was reassigned from Judge Holmes to Judge Goeke, the author of the majority opinion.
[20] See Section 6214(a) ("the Tax Court shall have jurisdiction to redetermine the correct amount of the deficiency even if the amount so redetermined is greater than the amount of the deficiency, notice of which has been mailed to the taxpayer, and to determine whether any additional amount, or any addition to the tax should be assessed, if claim therefor is asserted by the Secretary at or before the hearing or a rehearing").
[21] See Section 6512(b)(1) ("... if the Tax Court finds that there is no deficiency and further finds that the taxpayer has made an overpayment of income tax for the same taxable year ... with respect to any act (or failure to act) to which such petition relates, in respect of which the Secretary determined the deficiency, or finds that there is a deficiency but that the taxpayer has made an overpayment of such tax, the Tax Court shall have jurisdiction to determine the amount of such overpayment, and such amount shall, when the decision of the Tax Court has become final, be credited or refunded to the taxpayer").
[22] The court reserved for another day the question of whether "respondent *must* summarily assess to raise the jurisdictional issue" (emphasis added).
[23] Once one concedes the possibility of a refund forum, there seems to be little reason that the Tax Court in a case like Winter could not reach the merits either, so long as the Service is allowed to assess *and collect* while the Tax Court litigation is still going on. If not, then whatever is left of the Section 6037(c) penalty may lose much of its bite in any case in which the Service happens to issue a notice of deficiency making unrelated adjustments.
[24] Section 6037(c)(5) contains a cross-reference suggesting that the reader "see" the negligence penalty provisions, but Section 7806(a) says that such cross-references are of "no legal effect."
[25] See Smith, 133 TC No 18, Tax Ct Rep (CCH) 58028, Tax Ct Rep Dec (RIA) 133.18, 2009 WL 4980885 , fn. 6. For a discussion of the Smith case, see Pisem, "Tax Court Decisions on Section 6707A Penalty Deny Prepayment Forum and Extend S/L," 112 JTAX 133 (March 2010).