Originally published in:
Journal of Taxation **July 1, 2011**

'And If Tommy Told You To Jump Off The Brooklyn Bridge?'
Taxpayers Follow Advice Straight Into An Accuracy Penalty

By: Elliot Pisem and David A. Weintraub

Readers of a certain age may recall a *Sesame Street* episode in which Big Bird sings, "Big people, small people, matter of fact, all people! Everyone makes mistakes, so why can't you?" Unfortunately for many of us, the federal tax system is not as forgiving as Big Bird and the rest of the *Sesame Street* crew, and significant penalties are imposed on taxpayers—big or small—who make mistakes that favor themselves to the detriment of the fisc. Among such penalties is the accuracy-related penalty of **Section 6662** , imposed for various underpayments of tax, including those attributable to negligence, to a "substantial understatement of income tax," or to various sorts of valuation misstatements.

Although the Code does not freely overlook mistakes, it does offer a bit of wiggle room. In particular, **Section 6664(c)(1)** provides that "[n]o penalty shall be imposed under section 6662 ... with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion."[1] **Reg. 1.6664-4(b)(1)** explains: "Reliance on ... professional advice ... constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith." So, if singing "Everyone Makes Mistakes" doesn't help our taxpayer escape a penalty for his understatement, perhaps we'll do better with blaming the return preparer.

> *IRS:* Who left the liability off the tax return? Taxpayer left the liability off the tax return.
> *Taxpayer:* Who, me?
> *IRS:* Yes, you!
> *Taxpayer:* Couldn't be!
> *IRS:* Then who?
> *Taxpayer:* Preparer left the liability off the tax return.[2]

In two recent cases before the Tax Court, taxpayers asserted this defense of reliance on professional advice. In one, *Seven W. Enterprises, Inc.*, **136 TC No 26** , Tax Ct Rep Dec (RIA) 136.26, 2011 WL 2260389 , the defense was at least partially successful. In the other, *Woodsum*, **136 TC No 29** , Tax Ct Rep Dec (RIA) 136.29, 2011 WL 2416379 , the court rejected the defense entirely and upheld the Service's imposition of an accuracy-related penalty.

BACKGROUND

The Regulations discussing the reasonable cause and good faith exception of **Section 6664(c)(1)** are lengthy, but just a few sentences lay at the heart of the disagreements between the taxpayers and the Service regarding the applicability of the penalty. **Reg. 1.6664-4(b)(1)** provides:

"The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances.... Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge, and education of the taxpayer. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Reliance ... on the advice of a professional tax advisor ... does not necessarily demonstrate reasonable cause and good faith.... Reliance on ... professional advice ... constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith."

Reg. 1.6664-4(c)(1) states that "[a]ll facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer ... under Federal tax law.... The fact that [the requirements of **Reg. 1.6664-4(c)(1)** , relating to consideration by the advisor of all facts and circumstances, absence of unreasonable assumptions, and, in the case of asserted invalidity of a Regulation, disclosure] are satisfied ... will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a tax advisor) in good faith."

Under **Reg. 1.6664-4(c)(2)** , "[a]dvice is any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the section 6662 accuracy-related penalty."

The Regulations repeatedly disclaim the existence of a "per se rule" under which a taxpayer's reliance on a qualified professional tax advisor is automatically equated with "reasonable cause." Nevertheless, such a rule has at least some support in the case law. Perhaps the most notable example is the Supreme Court's oft-quoted dictum in *Boyle,* **55 AFTR 2d 85-1535** , 469 US 241, 83 L Ed 2d 622 , 1985-1 CB 372 (1985): "When an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a 'second opinion,' or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place.... 'Ordinary business care and prudence' does not demand such actions."[3]

By contrast, in *Neonatology Associates, P.A.*, **115 TC 43** (2000), *aff'd* **90 AFTR 2d 2002-5442** , 299 F3d 221 (CA-3, 2002), the Tax Court stated: "In sum, for a taxpayer to rely reasonably upon advice so as *possibly* to negate a section 6662(a) accuracy-related penalty ..., the taxpayer must prove ... that ...: (1) The adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment" (emphasis added). The Tax Court thereby recognized that there may be circumstances in which all three prongs of the court's test might be met, yet reasonable cause and good faith still will not be found.[4]

More recently, in *Montgomery*, **127 TC 43** (2006), the Tax Court was faced with an accuracy-related penalty asserted against taxpayers whose return had been prepared by Deloitte & Touche, to whom the taxpayers had supplied all relevant information and on whom they had relied to "accurately and properly prepare their return." The court found nothing in the record "to indicate it was unreasonable for petitioners to accept the advice of their return preparer."

The court observed "that the complex issues underlying the deficiency in this case [relating to the application of the alternative minimum tax to incentive stock options] had yet to be litigated at the time petitioners filed their return." After paraphrasing the language from *Boyle* quoted above, the Tax Court concluded that the taxpayers had satisfied the requirements for the reasonable cause and good faith exception and declined to uphold the asserted penalty.

The *Montgomery* opinion provides little guidance requiring how much weight was assigned to each of the elements identified by the court—reasonable reliance on a qualified professional, absence of affirmative factors indicating unreasonableness, and complexity and novelty of the underlying issue of substantive tax law.

The Tax Court's recent decisions add some nuances to our understanding of when a reasonable cause and good faith defense, based on reliance on professional advice, will—and will not—be available.[5]

SEVEN W. ENTERPRISES

Prior to 1990, William Mues, a certified public accountant, had been employed by Deloitte Haskins & Sells and by Peabody Coal Co. Mues had experience in these positions preparing corporate tax returns, including consolidated returns. Mues also had experience relating specifically to personal holding company tax matters.

The Weder family controlled two affiliated groups of corporations (the HSC Group and the 7W Group), each of which filed its own consolidated federal income tax return. In 1990, the two groups hired Mues to serve as tax manager, and he was promoted the following year to vice president of taxes.

Mues began attending law school on a part-time basis while employed by the groups, and he resigned his employment in January 2001 in order to complete his legal studies on a full-time basis. He entered into a consulting agreement with the groups, however, under which he provided them with services related to tax matters. In March 2002, after Mues had completed law school, he was rehired by the groups to serve again as their vice president of taxes.

Mues prepared the 7W Group's consolidated return for 2000 during the period that he was serving as a non-employee consultant, and he prepared and signed, as an officer, the 7W Group's returns for 2001, 2002, and 2003 and the HSC Group's returns for 2003 and 2004 after he had been re-employed. An asserted accuracy-related penalty with respect to each of these years was at issue before the court.

In the case of all these returns, the groups provided Mues "with full access to all resources necessary to handle petitioners' tax matters," including access to personnel, records, and outside professionals. Nevertheless, notwithstanding this access and notwithstanding his relevant experience in personal holding company tax matters and tax return preparation, Mues apparently made a significant legal mistake. He determined, erroneously, that certain interest income received by a member of each of the groups had been derived from other members of the recipient's group, rather than from non-members, as was in fact the case, for purposes of certain personal holding company computations.

This erroneous premise led Mues to the equally erroneous conclusions that the members of the groups did not constitute personal holding companies and that they were therefore not liable for the personal holding company tax imposed by **Section 541** . The Service determined that the groups were liable for accuracy-related penalties with respect to their underpayments in the full amount of the personal holding company tax that should have been reflected on their respective tax returns. The groups petitioned the Tax Court seeking a redetermination of those penalties.[6]

With respect to the returns that Mues had prepared and signed when he was an officer of the groups (all of the returns other than the 7W Group's return for 2000), the Tax Court was unconvinced by the taxpayers' assertion that their reliance on the professional "advice" of Mues, an apparently competent (if, in this case, mistaken) tax advisor, demonstrated reasonable cause and good faith. In the court's view, Mues could not, while he was an officer and employee of the taxpayers, give them "advice" within the meaning of the Regulations quoted above, that is, "any communication ... setting forth the analysis or conclusion of a *person, other than the taxpayer*" (emphasis by the Tax Court).

Since a corporation can act only through its officers, the taxpayer was, in effect, communicating with itself when Mues implicitly expressed his view that the return was correct by signing it. Accordingly, there was no reliance on "advice" within the meaning of the Regulations. The court did explicitly leave open the question of whether "reliance on an in-house professional tax advisor may establish reasonable cause in other circumstances," presumably referring to circumstances in which the advisor does not also sign the return in question.[7]

Turning to the question of whether facts and circumstances, apart from reliance on professional advice, established reasonable cause, the Tax Court noted the taxpayers' sophistication, the relatively fundamental nature of the mistakes (at least within the context of the admittedly complex personal holding company provisions) made by Mues in identifying incorrectly whether the payors of interest to the taxpayers were or were not themselves members of the groups, and the groups' history of having been audited by the Service and of having agreed to substantial adjustments in connection with such audits. In light of these facts, the court found that reasonable cause had not been established with respect to any of the returns that had been signed by Mues as an officer of the groups.

The result was different, however, for the 7W Group's 2000 return, which had been prepared by Mues when he was a non-employee consultant for the groups and presumably had been signed by some other individual as an officer of the 7W Group. As to that return, the Tax Court (paraphrasing the *Neonatology Associates* factors very closely) considered Mues to be an "experienced and knowledgeable tax professional,"[8] who had been supplied "with all of the relevant information necessary to prepare the return" and on whom the taxpayer had "relied, in good faith, ... to accurately and correctly prepare 7W Group's 2000 return."

The Service attempted to convince the Tax Court that Mues should not be considered an "independent" advisor as to that return, particularly in light of the similarity of his duties during the consulting period to his employment responsibilities during the periods that preceded and followed it. The court, however, viewed Mues, with respect to that return only, as an independent contractor who should be treated no differently from any other outside advisor or preparer.

The fact that the same individual prepared the returns for all the years at issue in *Seven W. Enterprises* led to an interesting result that focused on "which hat the individual was wearing" with respect to each year, based on the Tax Court's close reading of the Regulations' reference to "a person, other than the taxpayer" in the definition of "advice." The novelty of the court's approach is perhaps exemplified by the fact that the only case authority cited for the proposition that a "corporation can act (e.g., sign the corporation's return) only through its officers" is *DiLeo*, **96 TC 858** (1991), *aff'd* **69 AFTR 2d 92-998** , 959 F2d 16 (CA-2, 1992). In *DiLeo*, the officer's action was imputed to the corporation in order to determine that the corporation was subject to a fraud penalty, a result that seems a far cry from the Tax Court's holding in *Seven W. Enterprises* that an officer cannot be a "person other than the taxpayer" for purposes of determining whether or not the taxpayer has received "advice."

In any event, the Tax Court's discussion of Mues's status as an "advisor" has a "good news, bad news" quality to it—having been an employee at some times is not inconsistent with being an independent advisor at other times; but having been an independent advisor at some times is not sufficient to overcome the "taint" of being an employee at other times. More encouraging to taxpayers perhaps is the ease with which the Tax Court concluded that reasonable cause did exist with respect to the 7W Group's 2000 return, once it found that the three *Neonatology Associates* factors were present, without either searching for other favorable facts or circumstances or considering the possible existence of even the unfavorable ones that the court itself laid out in its discussion of the other years in issue.

While one opinion is far too few to be called a trend, perhaps we are seeing a harbinger of a more ready acceptance of application of the reasonable cause exception when a taxpayer can truly show good faith reliance on advice of an independent and experienced professional.

WOODSUM

Stephen G. Woodsum, the Tax Court's opinion tells us, is not a tax expert, but he "is financially sophisticated, and he has a basic understanding of the taxation of interest income, dividend income, and income from the sale of stock and bonds."

In 1998, Woodsum entered into a "ten year total return limited partnership linked swap." The counterparty originally was the London branch of Bankers Trust Company, later succeeded by Deutsche Bank (DB). During 2006, Woodsum terminated the swap and received a "net payout" of approximately $3.4 million.

Woodsum conceded before the Tax Court that this amount constituted taxable income to him. DB had filed with the IRS, and had sent to Woodsum copies of, Forms 1099 reporting this amount. In particular, DB issued a Form 1099-MISC reflecting approximately $3,380,000 as "other income" and a Form 1099-INT reflecting approximately $60,000 of interest income.

The AGI of Woodsum and his wife on their joint return for 2006 was almost $33 million. They received more than 160 information returns, such as Forms 1099 and Schedules K-1, for that year. The Tax Court noted that the amounts reported on the DB Forms 1099 were not the largest amounts reported on such information returns. Nevertheless, the amounts shown on the DB Forms 1099, had they been properly reflected on the Woodsums' return, would have constituted the third largest long-term capital gain line item on Schedule D, Capital Gains and Losses.

Woodsum provided all of the Forms 1099 to his return preparer, Venture Tax Services, Inc. (VTS), a "niche firm specializing in tax work for private equity and hedge funds as well as such funds' general partners." VTS employed an unnamed certified public accountant with extensive tax compliance experience to prepare the Woodsums' return, and David H. Hopfenberg, an attorney with extensive tax experience, to act as reviewer.

The IRS and Woodsum stipulated before the Tax Court that "[p]etitioners relied upon Venture Tax Services to prepare their 2006 tax return and include all of the items relating to the over 160 information returns provided to Venture Tax Services on said return." For reasons not disclosed by the record before the court, however, VTS neglected to include the amount reflected on the Form 1099-MISC received by Woodsum from DB in the Woodsums' 115-page long return.[9]

On 10/15/07, the final extended due date for the filing of the Woodsums' 2006 return, Woodsum met with Hopfenberg and reviewed the return with him. Woodsum stipulated before the Tax Court, however, that he could recall neither which specific items of income and deduction were discussed nor how much time they spent reviewing the entire return or Schedule D in particular. Woodsum signed the return without comparing it to the information returns that he had provided to VTS, and the return was filed that day.

The omission of the nearly $3.4 million of income from the Woodsums' return caused an underpayment of more than $500,000, which they paid when it was brought to their attention by the Service. Woodsum contested the accuracy-related penalty asserted by the Service, however, contending that there was reasonable cause for the underpayment.

The Tax Court sustained the penalty in full. In the first portion of its opinion, the court explained why Woodsum could not show that he had relied on professional advice. Using the *Neonatology Associates* factors, Woodsum argued that VTS's omission of $3.4 million of income from the return that was presented to him for his review constituted "advice" to the effect that the income was properly omitted. The court once again read the Regulations closely, but now focused on words that were not in issue in *Seven W. Enterprises.* It noted that the definition of "advice" incorporates the concepts of "analysis or conclusion" (or, to use a term from *Neonatology Associates,* "judgment"). In the absence of any evidence in the record regarding *why* VTS had omitted the income, it could not be said that VTS had "analyzed," "concluded," or "adjudged" anything.

Intertwined with this discussion, although it seems to your authors to be a distinct point, the Tax Court also emphasized that Woodsum *knew* that the omission of the income was an error—indeed, he had gotten the Service to stipulate that he had engaged VTS to include all of the income reflected on the Forms 1099 on his return. Thus, he could not have been relying on VTS's judgment, if it had made one, to omit that income.

The Tax Court then turned to the argument that perhaps Woodsum *should* have made, i.e., the omission of income was an "isolated computational or transcriptional error," which "generally is not inconsistent with reasonable cause and good faith." The court's discussion of its actual holding on this issue is brief—Woodsum had "provided no evidence to explain the nature or the reason for VTS's omission of the $3.4 million," and the court was not willing to conclude, based on mere speculation, that the omission was the result of VTS's failure to notice "one Form 1099 among 160 such forms."

If the Tax Court had stopped there, this case's lesson for the future would be limited and relatively benign—a taxpayer seeking to defend against an accuracy-related penalty on the grounds of computational or transcriptional error would need to be sure to get the return preparer to confess, on the record, to an oversight or mistake. Given that the preparer might well be the party who, as a result of a malpractice claim, ultimately bore the burden of the penalty asserted by the Service against the taxpayer, obtaining such a confession might not be overly difficult.

Nevertheless, under the rubric of "[e]ven if we assume that the $3.4 million omission was an innocent oversight by the return preparer," the Tax Court decided to address another ground for denying Woodsum the protection of the computational or transcriptional error defense. In a series of cases dating back at least to 1928,[10] the Tax Court has held that failure of a taxpayer to review a return to ensure that income has not gone unreported can demonstrate a lack of reasonable cause, even if the taxpayer provided full and accurate information to the return preparer.[11]

At times, the Tax Court has held taxpayers to quite a high standard in reviewing their returns, imposing a penalty even when a "careful review" by the taxpayer had missed the omission of an income item, recognition of which "requires a fair degree of expertise and sophistication in the tax field."[12] In *Woodsum,* the court articulated a far more modest standard:

"We do not hold that a taxpayer must duplicate the work of his return preparer, or that any omission of an income item in a return prepared by a third party is necessarily fatal to a finding of reasonable cause and good faith on the taxpayer's part. Rather, for purposes of this opinion, we assume that the reasonable cause defense may be available to a taxpayer who conducts a review of his third-party prepared return with the intent of ensuring that all income items are included, and who exerts effort that is reasonable under the circumstances, but who nonetheless fails to discover omission of an income item."

In this case, Woodsum's efforts, at least insofar as they were reflected in the record before the court, failed to meet even this modest standard. The omission of income was "substantial," both in absolute terms and as a percentage of the Woodsums' total income. "[E]ven a review undertaken only to make sure that the major income items had been included ... should, absent a reasonable explanation to the contrary, have revealed an omission so straightforward and substantial," especially in light of Woodsum's personal involvement in ordering the termination of the swap transaction that gave rise to the unreported income. Moreover, the Woodsums—to their credit, in your authors' opinion—had candidly admitted that they did not affirmatively recall having spent extensive time reviewing the return or this specific item, and that they had not compared the reported income on the return with the Forms 1099 that they had received.

The Tax Court turned again to the language of the Regulations. As noted above, **Reg. 1.6664-4(b)(1)** states: "Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." Because Woodsum had "failed to prove the 'most important factor'—i.e., 'the taxpayer's effort,'" because "his routine was so casual that a half-million-dollar understatement of that [tax] liability could slip between the cracks," the court declared it "cannot hold that this understatement was attributable to reasonable cause and good faith."[13]

Woodsum highlights an important limitation on a taxpayer's ability to rely even on the most experienced and skilled independent return preparer. The taxpayer always retains a nondelegable duty to file an accurate return, or, at the least, to exert "effort" to do so, and fulfillment of that duty requires that the taxpayer review the return, prior to filing, for omissions of gross income and likely some other errors as well. If the taxpayer notices what appears to be an omission, an inquiry should be made, and, if the preparer provides an explanation that can be characterized as "analysis," "conclusion," or "judgment," the inquiry and response should be documented.

CONCLUSION

While the decisions in *Seven W. Enterprises* and *Woodsum* perhaps should be unsurprising in light of their repeated focus on the words of the relevant Regulations, those decisions serve as important reminders that the reasonable cause and good faith defense is subject to significant limitations, even when the taxpayer attempts to act in reliance on a qualified tax professional. The involvement of such a professional in the return preparation process will not serve as a talisman to ward off an accuracy-related penalty unless a variety of other requirements are met. In particular cases, they may include separation or independence of the professional from the taxpayer, the professional's exercise of "judgment" to "analyze" or "conclude," the "communication" of that "analysis" to the taxpayer, and the taxpayer's own efforts, reasonable in the circumstances, to ensure the accuracy of the return. When these pieces fall into place, the reasonable cause and good faith defense may be available, but the absence of one or more of them may leave the taxpayer exposed to some very unpleasant consequences.

[1] The **Section 6664(c)(1)** exception is also stated by the Code to apply to the **Section 6663** fraud penalty. Section 6663(d) provides, however, that the fraud penalty does not apply to any portion of an underpayment that is not attributable to fraud, and it is hard to imagine a situation in which a taxpayer who failed to satisfy the "no fraud" standard of Section 6663(d) as to a portion of an underpayment could nevertheless satisfy the "reasonable cause and good faith" standard of **Section 6664(c)(1)** . For a "reportable transaction understatement" subject to penalty under **Section 6662A** , a "reasonable cause and good faith" exception that is somewhat more limited than that applicable to the **Section 6662** and **Section 6663** penalties is found in **Section 6664(d)**.

[2] With apologies to Wikipedia, "Who Stole the Cookie From the Cookie Jar?" Preparers, of course, are potentially subject to penalties under **Sections 6694** and **6701** , and under Circular 230, section 10.22, with respect to understatements of liability on returns that they prepare; such penalties are beyond the scope of this article.

[3] Emphasis by the Supreme Court. The case involved a late-filing penalty under **Section 6651(a)(1)** asserted against an estate whose executor had delegated the duty of filing the estate tax return to an attorney. The Court opined that relying on an attorney to see to fulfillment of the executor's own duty to file the return on a timely basis—the executor had repeatedly called the attorney and had been assured that "the return would be filed 'in plenty of time'"—was not the same as relying on attorney for legal advice and sustained the imposition of the penalty.

The late-filing penalty statute contains an exception for failure to file timely "due to reasonable cause and not due to willful neglect," and **Reg. 301.6651-1(c)(1)** provides that "[i]f the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause." Notwithstanding the differences between the words of these provisions and those of **Section 6664** and the Regulations thereunder, Boyle is frequently cited in **Section 6664** cases, including those discussed in this article.

In the circumstance of an asserted reasonable cause defense to a "reportable transaction understatement," **Section 6664(d)** has, since 2004, disqualified opinions rendered by advisors involved in structuring the transaction, thereby effectively requiring a taxpayer to seek a "second opinion" in many such cases.

[4] There does not appear to be any authority discussing how the Tax Court's test might be applied where the burden of persuasion has shifted to the Service under **Section 7491(a)** . See generally Jones, "The Burden of Proof Under the '98 Act—Not Much Substance Under All That Smoke," **90 JTAX 133 (March 1999)**.

[5] The Tax Court recently refused to apply the penalty for a substantial estate tax valuation understatement under **Section 6662(g)** in Estate of Giustina, **TC Memo 2011-141** , RIA TC Memo ¶2011-141 . An estate tax return had understated the value of a partnership interest by more than 50% (the threshold percentage necessary for the undervaluation penalty to apply to pre-8/17/06 estates). The court nevertheless found that the taxpayer had acted with reasonable cause and in good faith, noting that the executor had reasonably relied on the attorney who had prepared the estate tax return and who had hired a qualified appraiser to determine the value of the limited partnership interest.

[6] The Tax Court's opinion does not contain a complete discussion of why Mues's error was relevant to the question of whether or not the groups were subject to personal holding company tax, but **Section 542(b)** was apparently implicated. Under **Section 542(b)(1)** , in the case of certain affiliated groups that file consolidated returns, the application of the "adjusted ordinary gross income requirement" for personal holding company status of each corporation that is a member of the group is determined on the basis of the "consolidated adjusted ordinary gross income" and the "consolidated personal holding company income" of the group, rather than on the basis of the adjusted ordinary gross income and the personal holding company income of that particular corporation. (Under the adjusted ordinary gross income requirement, a corporation will not be a personal holding company unless at least 60% of its adjusted ordinary gross income consists of personal holding company income, a term that, under **Section 543(a)(1)** , includes interest income.)

Section 542(b)(2) provides that a group can use the special rule of **Section 542(b)(1)** only if less than a specified portion of the adjusted ordinary gross income of each member of the group consists of personal holding company income derived from sources outside the group. Moreover, once a group can use this special rule (i.e., if the group *does* determine, on a consolidated basis, whether or not it meets the adjusted ordinary gross income requirement), it appears that, in making the determination of what portion of the consolidated adjusted ordinary gross income consists of consolidated personal holding company income, any income derived by one member of the group from another is ignored. See White, 756-3d T.M. (BNA), *Computation of Consolidated Tax Liability* (2007) page A-49, citing the predecessor to Dubroff, Countryman, Duvall, and Teplinsky, *Federal Income Taxation of Corporations Filing Consolidated Returns* (2d ed., Matthew Bender, 2008), §61.03[4].

The Tax Court opinion in Seven W. Enterprises states that Mues erroneously determined that certain interest income received by a member of each of the groups had been derived from sources within, rather than outside, that group. It is not clear exactly *how* correction of this error affected the personal holding company tax liability of the groups—whether, by making them ineligible to do their "adjusted ordinary gross income" computations on a consolidated basis or, instead, by causing each group's consolidated personal holding company income to be greater than 60% of its consolidated adjusted ordinary gross income—but, one way or the other, the correction caused one or more members of each group to be determined to be subject to the personal holding company tax. In the Tax Court, the groups did not challenge the Service's determination that the personal holding company tax applied to them, but they did contest the penalties asserted by the Service.

Under **Section 547** , the groups might be able to eliminate their liability for personal holding company tax by paying a "deficiency dividend." **Section 547(a)** , however, provides that the deficiency dividend procedure does not reduce the taxpayer's liability for penalties.

[7] The Court noted in a footnote (as we do here) that several Regulations in the excise tax and REIT areas specifically permit reliance on "house counsel," but declined to infer from those Regulations a right to rely in cases beyond their scope.

[8] This description of Mues as "knowledgeable" and the Tax Court's citation to the reference in Montgomery, **127 TC 43** (2006), to a "competent tax adviser" stand in contrast to the court's discussion, only two paragraphs removed in the opinion, of the other years in issue: "The personal holding company rules certainly are complex, but Mues failed to apply some of the most basic provisions of those rules.... He simply did not read the entire test.... Furthermore, Mues testified that he knew at the time he prepared HSC Group's returns that the note's debtor was outside the group, yet he inexplicably treated the interest income as if it was derived from within HSC Group...."

[9] The $60,000 of interest income reflected on the Form 1099-INT issued by DB was included on the return.

[10] See Mackay, **11 BTA 569** (1928) (reviewed by the Board).

[11] See, e.g., Metra Chem Corp., **88 TC 654** (1987); Bailey, **21 TC 678** (1954).

[12] Pritchett, **63 TC 149** (1974).

[13] The Tax Court added in a footnote that the result might perhaps have been different if Woodsum had in place "internal controls and procedures, reasonable under the circumstances," to avoid such errors.