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Equitable Estoppel Blocks Taxpayer: *New Capital Fire, Inc. v. Commissioner*

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When a taxpayer seeks a tax result inconsistent with an earlier position of that same taxpayer, and the fisc is adversely affected by the change in position, the government may argue that the taxpayer's current position is precluded by a "duty of consistency" or doctrine of equitable estoppel. In *New Capital Fire, Inc. v. Commissioner*, the Tax Court, in prior litigation, had upheld a taxpayer corporation's position that the period of limitations to assess tax with respect to the final tax period of another corporation that had merged into the taxpayer had run before tax was assessed for that period. Thereafter, the taxpayer corporation reversed its prior position that the merger qualified a "reorganization" for income tax purposes, and instead urged that gain should have been recognized by the merged corporation at the time of the merger (TC Memo 2021-67). The Tax Court concluded that this further result was precluded by equitable estoppel.

Facts in New Capital Fire

Capital Fire Insurance Company ("Old Capital"), formerly a closely held insurance company, had by 2002 largely left the insurance business and was a family investment company holding a securities portfolio. As some of its shareholders desired to liquidate their investment in Old Capital, but the sale of its securities would result in a large corporate tax, a buyer was sought for the stock of Old Capital. DGI, which specialized in "designing tax-oriented structures and assisting corporations in solving tax problems," offered to purchase the stock of Old Capital for a price equal to 100% of its cash and 90% of the fair market value of its securities. DGI also said that it would adopt a "stand alone tax strategy intended to generate a taxable loss" that would offset any gain from the sale of Old Capital's investments, and required the termination by Old Capital of its insurance license before closing.

To effectuate the sale, Old Capital formed a subsidiary corporation ("New Capital") and then merged with and into New Capital. CF Acquisition Corp. and CF Merger Corp. (owned by CF Acquisition) were formed by DGI. An hour after the downstream merger of Old Capital into New Capital on December 4, 2002, CF Merger merged with and into New Capital, with New Capital surviving.

In the second merger CF Acquisition received all the stock of New Capital, and the former shareholders of New Capital received cash borrowed by CF Acquisition for the transaction. Thereafter, the securities were sold by December 12 and the proceeds used to pay off the loan.

Later in December, New Capital purchased stock in a foreign company that then entered into various option transactions. Those transactions were ultimately reflected on New Capital's Form 1120 for 2002 as resulting in capital losses that exceeded the reported gains from sale of the securities.

The merger agreement provided that the parties would report the first merger as a reorganization under IRC section 368(a)(1)(F). Under Reg. section 1.381(b)-1(a)(2), the tax year of the transferor corporation in such a reorganization does not end by reason of the transfer, and the acquiring corporation receives the assets of the transferor corporation with a carryover basis. The 2002 return for New Capital included a pro forma return for Old Capital for the pre-merger period of Old Capital that also disclosed the merger, without characterizing the merger as a reorganization.

Following an audit, the IRS disallowed deductions attributable to the option losses and asserted a tax deficiency and penalties, and New Capital filed a petition for review by the Tax Court.

Thereafter, and while the New Capital Tax Court litigation relating to the option transactions was pending, the IRS focused further on the merger of Old Capital into New Capital and ultimately issued a notice of deficiency in 2012 against Old Capital. The notice of deficiency asserted that the combination of Old Capital with New Capital did not qualify as a non-taxable "reorganization," but was, instead, a taxable transaction requiring the recognition of gain, that Old Capital was required to file a tax return for its final tax period ending with the date of the merger, and that -- because no such return was filed -- the period of limitation for assessment of tax against Old Capital for its final tax period ending in 2002 had not yet closed (IRC § 6501(c)(3)).

The Tax Court held in 2017 that this attempted assessment against Old Capital was time-barred. The court concluded that it did not need to decide the correctness of the IRS determination that the merger between Old Capital and New Capital failed to meet the requirements for a reorganization under section 368(a)(1)(F). This was so because, even if there were no reorganization, the return filed by New Capital for the tax period ended December 31, 2002, sufficed, for reasons discussed below, to constitute a return of Old Capital and thereby to start the running of the ordinary three-year period of limitations with respect to Old Capital's tax liability under IRC section 6501(a).

Under the relevant test set out in prior cases and summarized by the Tax Court in its 2017 decision, the return filed by New Capital would suffice for this purpose, so long as it (i) contained enough information to calculate tax liability, (ii) purported to be a return, (iii) was an honest and reasonable attempt to satisfy the requirements of the tax law, and (iv) was executed under penalties of perjury. The Commissioner argued that the New Capital return did not meet the third requirement, because it was "purposefully misleading." The court concluded that, even if this were the case, the return would suffice for limitations purposes, so long as it was not false or fraudulent with intent to evade tax, and noted that even returns reflecting a frivolous deduction or other legal claim to reduce tax liability have been held to be sufficient to meet this standard. The Commissioner did not allege (and the court did not find) the return to be false or fraudulent, and it was therefore, in the view of the court, the duty of the Commissioner to determine within the period of limitations whether or not the amount of Old Capital income reported thereon was erroneous.

New Capital, having prevailed on the issue of whether Old Capital could be assessed additional tax for its final taxable period ending with the date of Old Capital's merger with New Capital, then amended its Tax

Court petition with respect to the assessment of additional tax against New Capital for the taxable period ending December 31, 2002. New Capital asserted that the transfer of assets by Old Capital to New Capital was a taxable transaction resulting in the recognition of gain, and that, once the bases of the assets were adjusted to fair market value to reflect that transaction, there was no remaining gain to be realized in the sale of the securities by New Capital.

New Capital conceded that the losses previously claimed from the options transactions were not allowable, and stipulated that it had reported on its return gains from the sale of the securities. The government asserted that the doctrine of equitable estoppel or a duty of consistency precluded New Capital from taking a position now with respect to the qualification of the merger as a nontaxable "reorganization" that differed from the position that had led to New Capital's victory in the 2017 Tax Court decision.

New Capital argued that the Court of Appeals for the Second Circuit, to which the Tax Court case would be appealable, has not recognized a duty of consistency. The Tax Court concluded, however, that it was well established that doctrine of equitable estoppel could apply in tax matters; that, as further discussed below, New Capital's current position was precluded by the doctrine of equitable estoppel; and that the court therefore need not consider the applicability of a duty of consistency. The opinion lists four requirements for the application of equitable estoppel against a taxpayer in the Second Circuit: that the taxpayer either made a false representation or engaged in a "wrongful misleading silence"; that the erroneous tax treatment originated in a statement of fact and was not a mistake of law; that the Commissioner was not aware of the correct facts; and that the Commissioner was adversely affected by the actions or statements of the taxpayer.

As to the first requirement, the court found that the assertion by New Capital on its initial return that New Capital was in the business of investment was erroneous. In fact, New Capital had no intention of continuing Old Capital's investment activities and did not do so. To the contrary, the activities of New Capital were limited to the liquidation of the securities portfolio and the pursuit of a tax strategy intended to avoid a resulting tax liability. Further, the reporting of a carryover basis for the investment securities was effectively a false representation that the securities had been acquired pursuant to a reorganization.

With respect to the second requirement, the opinion noted that, under the regulations as in effect at the time of the merger, the requirements for a reorganization included a valid business purpose, continuity of business enterprise, and continuity of interest; and that the parties to the current litigation agreed that the merger of Old Capital with New Capital did not meet all these requirements and was not a reorganization. The opinion characterized the erroneous treatment as a reorganization as a mistake of fact or a mixed question of fact and law, rather than a pure mistake of law (in respect of which equitable estoppel would not apply).

The court further concluded that the IRS did not have actual or constructive knowledge of the correct facts in respect of New Capital, including facts pertinent to the question of whether the merger was a reorganization, until after the period to assess tax against Old Capital for 2002 had elapsed. Further, the IRS was adversely affected by this lack of knowledge, because it did not have sufficient information to assess tax against Old Capital before the expiration of the limitations period.

Finally, the court found that equitable considerations weighed against the petitioner -- in particular, that evidence before the court established that New Capital was familiar with the issues of law relating to qualification as a reorganization and should not have been surprised that its position on its return that the assets had a carryover basis was ultimately rejected.

OBSERVATIONS

The Tax Court's 2017 decision that the tax return of New Capital for 2012 was sufficient for statute of limitation purposes to constitute a return for Old Capital as well is helpful in providing some comfort to taxpayers that periods of limitations may not remain open indefinitely, even where, upon analysis, further returns should have been filed. The later decision, holding that the surviving taxpayer would not be permitted to change its position on the nature of the merger as a reorganization in a manner that would effectively preclude the government from ever collecting tax on the gains realized from the assets transferred in the merger, is entirely unsurprising.

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