In Case You Missed It – September 2020

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Almost every day, federal and state courts issue opinions that affect taxpayers. And the IRS and state taxing authorities often publish guidance on a myriad of topics.

So, each month, this column will review a selection of recent court cases or guidance that tax professionals should know about when advising their clients and preparing tax returns.

For more extensive detail on any of these items, please feel free to reach out to the author.

Gregory v. United States
Importance of obtaining proper signatures

In this case, *Gregory v. United States*, the taxpayers were U.S. citizens living and working in Australia. They timely signed and filed their Form 1040 for tax year 2015 on or about Apr. 15, 2016, claiming a refund of $348.

In late 2018, the taxpayers retained a return preparer to prepare an amended 2015 return claiming the employer-provided lodging exclusion, correcting other income reporting errors, and requesting a refund in the amount of $22,291.

The Form 1040X was timely filed but wasn't signed by the taxpayers. The tax preparer signed the amended return but didn't submit a Form 2848 authorizing her to sign amended returns on the taxpayers' behalf.

On Dec. 3, 2018, the IRS sent the taxpayers a Form Notice CP21B indicating approval of many of the requested changes and issued the taxpayers a refund in the amount of $21,252. On Mar. 13, 2019, the taxpayers filed a tax refund suit seeking the additional tax refund of $1,039.

The Court of Federal Claims noted that it has jurisdiction over tax refund suits if three prerequisites are met:

- the plaintiff fully pays the principal tax deficiency;
- the plaintiff duly files a tax refund claim; and

- the plaintiff provides the amount, date, and place of each payment to be refunded, as well as a copy of the refund claim when filing suit in the Court of Federal Claims.

The United States sought to dismiss the taxpayers' complaint on the theory that the court lacked subject matter jurisdiction because the taxpayers failed to meet the second requirement, submitting a "duly filed" tax return with the IRS.

The taxpayers had failed to sign their 2015 amended tax return, so the United States argued that the return was not "duly filed." The taxpayers argued that the United States had waived this formal signature requirement when it investigated their amended return and granted a refund of over 95% of their requested refund. The United States responded that the signature requirement cannot be waived.

As stated above, a taxpayer refund return must be duly filed in order to file a refund claim with the Court of Federal Claims. Treasury Regulations section 301.6402-2(b)(1) explain that in order to be "duly filed," a return:

> "[M]ust set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof. The statement of the grounds and facts *must be verified by a written declaration that it is made under the penalties of perjury*. A claim which does not comply with this paragraph will not be considered for any purpose as a claim for refund or credit." [emphasis added]

The only exception to the signature requirement listed in the regulations is if a legal representative certifies the claim and attaches evidence of a valid power of attorney to the return. The power of attorney must specify that the representative has the power to sign tax returns on behalf of the taxpayers.

As no Form 2848 was physically attached to the amended return, the taxpayers are not considered to have duly filed their refund claim. Nevertheless, they argued that the IRS waived the signature requirement by investigating the merits of the amended return and granting a partial refund.

The IRS may waive certain regulatory requirements by investigating the merits of a refund claim and taking action upon it, per *Angelus Milling Co. v. Commissioner*. However, the IRS can only waive regulatory requirements, not statutory requirements established by Congress. The court noted that the taxpayer signature requirement is statutory in nature and thus the waiver doctrine is inapplicable. (IRC sections 6061 and 6065)

Since the taxpayers' 2015 amended return didn't contain a valid signature and thus was not duly filed, and the IRS cannot waive this statutory taxpayer signature requirement, the Court lacked jurisdiction to hear their refund suit and their complaint was dismissed.

Takeaway: Remember to follow the procedural requirements — proper signatures are required on all original and amended returns.

In the Matter of the Petition of MARS HOLDINGS, INC
New York City doesn't always follow federal law

In this case, the taxpayer owned, through a joint venture, an interest in several LPs that leased and managed real estate in New York City. The joint venture sold its LP interest in one of the entities and reported its gains from the sale on its federal, New York State, and New York City (NYC) tax returns.

The taxpayer reported its share of the capital gain from the sale on its federal corporation income tax return and on its NYC general corporation tax (GCT) return but excluded it when calculating entire net income (ENI), on the theory that it was gain realized on the sale of an LP interest and not from assets used in a trade or business in NYC.

NYC argued that the taxpayer was doing business in NYC due to its ownership of interests in LPs that owned, leased, and managed property within NYC, and thus the capital gain was properly included in its ENI for GCT purposes.

The taxpayer argued that this violated the federal conformity doctrine.

Under IRC section 741, as in effect prior to the Tax Cuts and Jobs Act of 2017, the entity approach would be applied to the sale of a partnership interest. Under that theory, the taxpayer is treated as selling an intangible asset (the LP interest), rather than a proportionate share of the LP's assets. (See *Grecian Magnesite Min., Indus. & Shipping Co., SA v. Commissioner*. Side note: the author of this article litigated the Grecian case at both the Tax Court and the D.C. Circuit).

Thus, the taxpayer argued that the gain from the sale of the LP interest should be sourced its domicile and excluded from its ENI, as the doctrine of federal conformity requires treating the capital gain as it would be under IRC section 741.

NYC responded by arguing that there is no comparable city or state law that prevents using the aggregate approach to source the gain from a sale or other disposition of a partnership interest. The GCT imposes a tax on any corporation for the privilege of doing business, owning or leasing property, or engaging in various other activities in NYC. (NYC Admin. Code section 11-603.1)

Under the NYC rules, "a corporation shall be deemed to be doing business in the City if it owns a limited partnership interest in a partnership that is doing business, employing capital, owning or leasing property, or maintaining an office in the City." [19 RCNY section 11-06(a)]

The underlying LP conducted business within NYC because it leased, held, and managed real property in it. The taxpayer indirectly owned a 14.167% interest in the LP, and through this ownership was deemed to be doing business in NYC.

Therefore, the capital gain from the disposition of the LP interest was held to be properly included in the taxpayer's ENI.

Takeaway: States and cities often have different sourcing rules from the federal law; don't just assume they conform.

Babu v. Commissioner
No lenience for tax advisors

In *Babu v. Commissioner*, the taxpayer conceded that he failed to report almost $3 million of income from a pass-through entity of which he was the sole member. The issue before the court was whether his failure to report this income should be subject to an accuracy-related penalty for an underpayment attributable to a substantial understatement of income tax under IRC section 6662(a), (b)(2), (d)(1).

The taxpayer had a finance degree, then attended law school. There, he took tax law classes, assisted in the low-income taxpayer clinic, worked part time at one of the largest tax return preparation firms in the country, and admitted to graduating "with a pretty good understanding of tax."

He eventually formed an S corporation that used tax processing software to process tax returns for another company. His agreement with his customer was that his entity would be paid a fee of $100.95 for each return that it processed that claimed a refund.

Rather than receiving the fees into his entity's bank account, the taxpayer entered into a deposit account control agreement that allowed him to withdraw cash directly from the customer's bank accounts. His company processed almost 30,000 returns in 2014, and he withdrew over $3 million out of his customer's bank account that year.

His entity filed a tax return for the year on which it elected the cash basis of accounting. The company reported zero gross receipts, and the taxpayer correspondingly reported no flow-through income, on the theory that the cash was never transferred into the company's bank account and thus was not "received."

The taxpayer eventually conceded that the amounts earned and deposited into his client's bank account should have been reported as income, since he had unfettered access to the funds. He argued, though, that he shouldn't be subject to a penalty with respect to these amounts because he relied on professional advice in preparing his returns. Yet, he never gave his return preparer information about the number of tax returns that the company processed during the year and didn't tell him about the fees deposited into his client's bank account on behalf of his company.

As discussed previously in this column, the IRC section 6662 penalty doesn't apply 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… [it]." [IRC section 6664(c)(1)]

The regulations further explain that the relevant facts include the experience, knowledge, and education of the taxpayer, and whether the taxpayer relied in good faith on the advice of a qualified tax professional. [IRC section 1.6664-4(b)(1), (c)]

To show reliance, the taxpayer must fully disclose all of the relevant facts to the tax professional.

The court held that it didn't believe that the taxpayer, with his educational background and at least seven years of experience in the business of preparing federal income tax returns, truly misunderstood the tax law and believed that because his fees were deposited into his costumer's account instead of his bank account, he hadn't received the income in 2014. His failure to inform his return preparer of the activity of his entity prevents him from relying on that professional advice.

The taxpayer was held liable for the penalties

Takeaway: The taxpayer should've known better and was held to a standard fitting of his educational background and work experience.

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