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TOPIC: Court of Appeals Imposes Accuracy Related Penalties in Code Section 419 Case.

CITATIONS: *Prosser, III, et al v. Commissioner of Internal Revenue*, Nos. 13-4526-ag (L), 13-4527-ag (CON), 2015 WL 450535, (2nd Cir, 02/04/15) *affg.* T.C. Memo. 2010-202 (9/15/2010); *Curcio v. Commissioner*, 689 F.3d 217 (2d Cir.2012); IR Notice 95-34, 1995-1 C.B. 309; IRC Section § 6662A; IRC Section § 6664(d)(2)(A); IRC Section § 6707A(c)(2); IRC Section § 419A(f)(6); IRS Regulation § 1.6011-4(c)(4).

SUMMARY: The taxpayers challenged the IRS's determination of tax deficiencies and assessment of penalties against them under Internal Revenue Code ("IRC" or "I.R.C.") § 6662.

The IRS had determined that the petitioners were deficient based on a contribution by the McGehee Family Clinic to a multiple-employer welfare benefit plan, insuring its owner, Dr. Robert Prosser, III. The IRS concluded that the plan:

(1) was not an "ordinary and necessary" business expense within the meaning of Code Section 162(a) and

(2) was "substantially similar" to the listed tax-avoidance transaction described by the IRS in IR Notice 95-34.

The court agreed with the IRS in all respects. It held that the taxpayers' plan is substantially similar to the listed tax-avoidance transaction under Notice 95-34. Therefore, it upheld the assessment of accuracy-related penalties. It also concluded that petitioners had adequate notice of the potential for penalties under section § 6662A and that the increased penalty rate under section § 6662A(c) is applicable to the clinic.

RELEVANCE: Once again, the courts have put practitioners on notice. A plan that reflects tax consequences or a tax strategy described in the IRS's published guidance will be considered a tax avoidance transaction. Likewise, if the taxpayer knows or has reason to know that the taxpayer's tax benefits are derived directly or indirectly from tax consequences or a tax strategy described in published guidance, it will fall within the same purview.

Such transactions subject the taxpayer to a denial of deductions, additional income to the taxpayer, and, potentially, could result in suits against agents and insurers.

This case adds another potential legal problem and significant financial cost, i.e. the imposition of the 30% accuracy-related penalty.

Proponents of tax-aggressive strategies often face a dilemma. Is it better to file all possible paperwork with the IRS to avoid possible penalties? Alternately, is it better to make a quiet implementation and hope the plan never gets scrutiny by the IRS? The *Prosser* decision demonstrates the penalties that may be imposed in connection with the "implement and cross your fingers" strategy.

FACTS: The IRS determined that a contribution by the McGehee Family Clinic to a Section 419 plan which insured its owners was not an "ordinary and necessary" business expense within the meaning of IRC 162(a). The Service also determined that the plan was "substantially similar" to the listed tax-avoidance transactions described by the Internal Revenue Service in Notice 95-34.

In *Curcio v. Commissioner*, the Second Circuit Court of Appeals had affirmed the Tax Court's decision that employer contributions to a similar plan were not "ordinary and necessary" business expenses within the meaning of IRC 162(a). According to that court, "contributions [to the plan] were made solely for the personal benefit of petitioners" and "were a mechanism by which petitioners could divert company profits, tax-free, to themselves, under the guise of cash-laden insurance policies that were purportedly for the benefit of the businesses, but were actually for petitioners' personal gain."

In the current case, the taxpayers had stipulated that they would be bound by the outcome of *Curcio*, since this case would also be decided by the same court that decided *Curcio.* Since the Second Circuit in *Curcio* affirmed the Tax Court's conclusion that contributions to the plan were not "ordinary and necessary" business expenses within the meaning of the IRC 162(a), that finding also determined the issue in this case.

However, there was an additional issue here. It was the issue of accuracy-related penalties. After the *Curcio* decision, the Tax Court then reviewed and upheld the IRS's determinations of deficiency and imposition of I.R.C. § 6662A penalties against the taxpayers. The only issue appealed from the Tax Court's decision was whether the Commissioner properly imposed penalties against the petitioners under § 6662A for understatements attributable to a listed tax-avoidance transaction.

I.R.C. § 6662A provides:

> If a taxpayer has a reportable transaction understatement for any taxable year, there shall be added to the tax an amount equal to 20 percent of the amount of such understatement.

A "reportable transaction understatement" is defined as including any understatement attributable to a "listed" transaction. A listed transaction is a transaction that "is the same as, or substantially similar to, a transaction specifically identified by the Secretary [of the Treasury] as a tax avoidance transaction." A transaction is considered "substantially similar to" a listed tax-avoidance transaction if it is "expected to obtain the same or similar types of tax consequences and ... is either factually similar [to] or based on the same or similar tax strategy" as the listed tax-avoidance transaction.

I.R.C. § 6662A(c) increases the penalty rate to thirty percent when the disclosure requirements under § 6664(d)(2)(A) are not satisfied.

Did the plan violate Notice 95-34? The taxpayers argued that to be "substantially similar" to a listed transaction, the plan must meet *all four* of the requirements enunciated in Notice 95-34:

1. The arrangements may actually be providing deferred compensation.

2. The arrangements may be, in fact, separate plans maintained for each employer. As separate plans, they do not qualify for the 10-or-more-employer plan exemption in § 419A(f)(6).

3. The arrangements may be "experience rated" with respect to individual employers in form or operation. This is because, among other things, the trust maintains, formally or informally, separate accounting for each employer. The employers have reason to expect that, at least for the most part, their contributions will benefit only their own employees. Arrangements that are experience rated with respect to individual employers do not qualify for the exemption in § 419A(f)(6).

4. Even if the arrangements qualify for the exemption in Section § 419A(f)(6), employer contributions to the arrangements may represent prepaid expenses that are nondeductible under other sections of the Internal Revenue Code.

However, the Court of Appeals disagreed. It held that it did not have to examine each of these requirements separately. Instead, it quoted Notice 95-34 and analyzed it as follows:

> [i]n general, these arrangements and other similar arrangements do not satisfy the requirements of the § 419A(f)(6) exemption and do not provide the tax deductions claimed by their promoters for any one of several reasons." By using "in general" and "for any one of several reasons," Notice 95-34 clearly indicates it is not necessary that an arrangement fail to satisfy § 419A(f)(6)'s exemption requirements for every one of the reasons provided. Indeed, Notice 95-34 itself identifies a fifth reason: contributions to such plans may not qualify as "ordinary and necessary business expenses of the taxpayer [under I.R.C. § 162(a)]." Id. That is the very reason contributions to the Benistar Plan are not deductible. See *Curcio*, 689 F.3d at 226 (describing the Benistar Plan as "a mechanism by which [owners of participating businesses] could divert company profits, tax-free, to themselves, under the guise of cash-laden insurance policies"). Nor do the reasons provided constitute an exhaustive list as to why plans like these do not satisfy the requirements for § 419A(f)(6)'s exemption.

The court found that the taxpayer's plan was within Notice 95-34's purview since:

> 1. The plan claimed to satisfy the requirements for the multiple-employer exemption under I.R.C. § 419A(f)(6), and the purported benefits of enrollment included "Virtually Unlimited Deductions."

2. The plan offered life insurance policies that allowed large contributions relative to the cost of the amount of term insurance required to provide the corresponding death benefits under the arrangement.

3. Plan participants acted as though they personally owned the underlying policies, and, as such, the plan was merely a conduit to the policies rather than the actual insurer.

4. The plan maintained separate accounting of each employer's assets based on that employer's contributions, which helped insulate contributions and benefits from the participation of other subscribing employers. Correspondingly, contributions were used only for the policies to which they were allocated. There were no elements of the plan as being a multi-employer plan.

5. Plan participants had the right to receive—and most participants did in fact receive—the value reflected in the underlying insurance policies with minimal expense by terminating participation in the plan, despite payment of benefits supposedly being contingent upon unanticipated events.

6. The plan is similar to the transaction described in Notice 95-34. The plan is "experience rated" in that the plan maintained, formally or informally, separate accounting for each employer. The employers had reason to expect that, at least for the most part, their contributions would benefit only their own employees.

As a result, the court concluded that the "…only issue in this consolidated appeal is whether the Tax Court was justified in upholding the Commissioner's imposition of additional accuracy-related penalties under I.R.C. § 6662A…" On this issue, the court found that although IRS Form 8886, a "Reportable Transaction Disclosure Statement," was available to the taxpayers, the taxpayers did not file any document disclosing its involvement in the Plan with its tax return. It found that the transaction was a "listed transaction," and the court thus held that the taxpayers were liable for the increased thirty-percent penalty rate under § 6662A(c) for failing to make such disclosures.

As noted above, the court concluded that the plan is substantially similar to the listed tax-avoidance transaction identified by the IRS in Notice 95-34 and upheld the IRS assessment of accuracy-related penalties. It also held that the petitioners had adequate notice of the potential for penalties under § 6662A and that the increased penalty rate under § 6662A(c) applies to the clinic.

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