Seven W. Enterprises, Inc. & Subsidiaries v. Commissioner of Internal Revenue, 136 T. C. 539 (U. S. Tax Ct. 2011)

In a significant ruling, the U. S. Tax Court determined that Seven W. Enterprises and its subsidiaries could not avoid accuracy-related penalties for tax years 2001-2004, despite relying on their in-house tax advisor. The court held that the advisor, who also signed the returns as the taxpayer's representative, did not qualify as an independent advisor for penalty relief under the tax code. However, the company was exempt from penalties for the year 2000, when the advisor was an independent consultant. This decision clarifies the limits of relying on internal tax professionals to establish reasonable cause for tax underpayments.

Parties

Seven W. Enterprises, Inc. & Subsidiaries and Highland Supply Corporation & Subsidiaries were the petitioners, collectively referred to as "petitioners. " The Commissioner of Internal Revenue was the respondent.

Facts

The Weder family controlled two closely held businesses: Highland Supply Corporation (HSC), the parent of a group of corporations (HSC Group) manufacturing floral, packaging, and industrial wire products, and Seven W. Enterprises, Inc. (7W), the parent of a group of entities (7W Group) engaged in leasing nonresidential buildings. Both groups filed consolidated Federal income tax returns. William Mues, a certified public accountant, was initially hired as their tax manager in 1990 and promoted to vice president of taxes in 1991. Mues resigned in January 2001 to pursue legal studies but continued providing consulting services until March 2002, when he was rehired as vice president of taxes. During the period from 2001 to 2004, Mues incorrectly applied personal holding company tax rules, resulting in substantial understatements of tax liabilities for both groups. The IRS issued notices of deficiency for these years, asserting accuracy-related penalties.

Procedural History

The IRS issued notices of deficiency to 7W Group for tax years 2000-2003 and to HSC Group for tax years 2003-2004, asserting accuracy-related penalties under Section 6662(a). Petitioners timely filed petitions with the U. S. Tax Court seeking redetermination of these penalties. The court's review was de novo, examining the facts and circumstances surrounding the underpayments and the applicability of the penalties.

Issue(s)

Whether petitioners are liable for accuracy-related penalties under Section 6662(a) for the tax years 2000, 2001, 2002, 2003, and 2004?

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Whether petitioners can establish reasonable cause and good faith for the underpayments based on their reliance on the advice of William Mues, their tax advisor?

Rule(s) of Law

Section 6662(a) and (b)(2) impose a 20-percent penalty on the portion of an underpayment of tax attributable to any substantial understatement of income tax. Section 6664(c)(1) provides that no penalty shall be imposed if a taxpayer demonstrates reasonable cause for the underpayment and acted in good faith. The determination of reasonable cause and good faith depends on the taxpayer's efforts to assess their tax liability, their experience, knowledge, and education, and their reliance on the advice of a professional tax advisor, as per Section 1. 6664-4(b)(1) and (c)(1), Income Tax Regulations. Section 1. 6664-4(c)(2) specifies that "advice" for the purpose of establishing reasonable cause must be from a "person, other than the taxpayer. "

Holding

The court held that 7W Group was not liable for the accuracy-related penalty for the tax year 2000 because it reasonably relied on Mues, who was an independent consultant at the time. However, petitioners were liable for accuracy-related penalties for tax years 2001 through 2004 because Mues, as their vice president of taxes who signed the returns on their behalf, did not qualify as a "person, other than the taxpayer" under Section 1. 6664-4(c)(2), Income Tax Regulations.

Reasoning

The court's reasoning for the year 2000 was based on the fact that Mues was an independent contractor during this period, having resigned as vice president of taxes and worked under a consulting agreement. The court found that petitioners had provided Mues with all relevant information and relied in good faith on his professional judgment, which was deemed reasonable under Section 6664(c) and related regulations.

For the years 2001 through 2004, the court found that petitioners failed to exercise ordinary business care and prudence. Mues' repeated errors in applying the personal holding company tax rules, despite his experience and access to resources, indicated a lack of due diligence. Furthermore, the court determined that Mues did not qualify as an independent advisor for these years because he was acting as an officer of the corporation when he signed the returns. The court emphasized that a corporation can only act through its officers, and thus Mues was considered the taxpayer for the purposes of Section 1. 6664-4(c)(2), Income Tax Regulations.

The court also addressed petitioners' argument that reliance on in-house counsel should constitute reasonable cause, but found that the cited regulations were

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inapplicable to the accuracy-related penalty context. The court did not opine on whether reliance on in-house professionals could establish reasonable cause in other circumstances.

Disposition

The court entered decisions holding petitioners liable for accuracy-related penalties under Section 6662(a) for tax years 2001 through 2004 and not liable for the penalty for the year 2000.

Significance/Impact

This case clarifies the limitations of relying on in-house tax professionals to establish reasonable cause and good faith for purposes of avoiding accuracy-related penalties. It highlights the importance of the independence of the tax advisor from the taxpayer, particularly when the advisor is acting as an officer of the corporation. The ruling may impact how corporations structure their tax departments and seek external advice to mitigate potential penalties. Subsequent cases and IRS guidance may further refine the application of the "person, other than the taxpayer" requirement in the context of reasonable cause determinations.

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