CNT Investors, LLC v. Commissioner of Internal Revenue, 144 T. C. 161, 2015 U. S. Tax Ct. LEXIS 11, 144 T. C. No. 11 (2015)

In CNT Investors, LLC v. Commissioner, the U. S. Tax Court addressed the use of a Son-of-BOSS tax shelter to avoid recognizing gain on property distribution. The court applied the step transaction doctrine to collapse the series of transactions but upheld the real estate transfer, ruling it had economic substance. The court found the IRS timely issued an FPAA against the tax matters partner, Charles Carroll, due to omitted income from the distribution. However, no penalties were applied as Carroll reasonably relied on professional advice, despite the transaction's ultimate failure under scrutiny of sham transaction principles.

Parties

CNT Investors, LLC, a limited liability company formed in Delaware, was the petitioner in this TEFRA partnership-level proceeding. Charles C. Carroll, as the tax matters partner (TMP), represented CNT. The respondent was the Commissioner of Internal Revenue. The case involved the individual partners of CNT, including Charles C. Carroll and his wife Garnet, Nancy Cadman and her husband, and Teri Craig and her husband, who were shareholders of Charles Carroll Funeral Home, Inc. (CCFH), an S corporation that owned the real estate assets involved in the transactions.

Facts

In 1999, Charles Carroll and his family, who owned and operated a funeral home business through CCFH, sought to sell the business while retaining ownership of the underlying real estate. CCFH held five mortuary properties with a fair market value of $4,020,000 and an adjusted tax basis of $523,377. To avoid recognizing the built-in gain on the transfer of the real estate out of CCFH, the Carrolls engaged in a series of transactions designed by Jenkens & Gilchrist, a law firm, involving a Son-of-BOSS tax shelter strategy.

The transactions involved creating CNT as a partnership and executing short sales of Treasury notes, with the proceeds and related obligations purportedly contributed to CNT. The real estate was then transferred to CNT, and subsequently, the individual partners transferred their CNT interests back to CCFH. On December 31, 1999, CCFH distributed interests in CNT (New CNT) to its shareholders, which was intended to effectively transfer the real estate to them without recognizing the built-in gain.

Procedural History

On August 25, 2008, the Commissioner issued a notice of final partnership administrative adjustment (FPAA) to CNT for its taxable period ending December 1, 1999. The FPAA adjusted CNT's reported losses, deductions, distributions, capital

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contributions, and outside basis to zero, asserting that CNT was a sham partnership and the transactions lacked economic substance. The FPAA also determined accuracy-related penalties under I. R. C. sec. 6662. Charles Carroll, as TMP, timely petitioned the U. S. Tax Court on November 12, 2008, challenging the timeliness of the FPAA and the penalties determined therein.

Issue(s)

Whether the six-year limitations period under I. R. C. sec. 6501(e)(1)(A) applied to the partners of CNT for their 1999 taxable years, such that the FPAA was timely?

Whether the adjustments in the FPAA should be sustained?

Whether a penalty under I. R. C. sec. 6662 applies to any underpayment attributable to the partnership-level determinations made in the FPAA?

Rule(s) of Law

I. R. C. sec. 6229(a) establishes a three-year limitations period for assessing tax attributable to partnership items, starting from the later of the date the partnership return is filed or the last day for filing such return without extensions.

I. R. C. sec. 6501(e)(1)(A) extends the limitations period to six years where a taxpayer omits from gross income an amount properly includible therein which is in excess of 25% of the amount of gross income stated in the return.

I. R. C. sec. 6662 imposes a 20% or 40% accuracy-related penalty on underpayments attributable to a gross or substantial valuation misstatement, negligence, or a substantial understatement of income tax.

I. R. C. sec. 6664(c) provides that no penalty shall be imposed with respect to any portion of an underpayment if there was reasonable cause for such portion and the taxpayer acted in good faith.

Holding

The court held that the six-year limitations period under I. R. C. sec. 6501(e)(1)(A) applied to Charles and Garnet Carroll, making the FPAA timely as to them. The court sustained the adjustments in the FPAA, finding that CNT was a sham partnership and the Son-of-BOSS transaction was a sham. However, the court determined that no penalty under I. R. C. sec. 6662 applied because Charles Carroll relied reasonably and in good faith on independent professional advice.

Reasoning

The court reasoned that the step transaction doctrine applied to collapse the series of transactions into a single transfer of real estate from CCFH to the Carrolls, but

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the transfer itself had economic substance and was not a sham. The court analyzed the sham transaction doctrine and determined that the short sale and related transactions were shams but the real estate transfer was not. The court also found that the omitted income from the real estate distribution was not adequately disclosed on the tax returns, thus triggering the six-year statute of limitations under I. R. C. sec. 6501(e)(1)(A) for Charles and Garnet Carroll.

The court applied the economic substance doctrine, finding that the Son-of-BOSS transaction lacked economic substance and was designed solely to avoid taxes. The court considered the impact of the Supreme Court's decision in United States v. Home Concrete Supply, LLC, which held that a basis overstatement does not trigger the extended limitations period if the omitted income was entirely attributable to the basis overstatement. Here, even accepting the overstated basis, the court found that some gain was still omitted, triggering the extended period for Charles and Garnet Carroll but not for the other partners.

The court examined the applicability of the penalty under I. R. C. sec. 6662, finding that the Commissioner met the burden of production for the gross valuation misstatement penalty. However, the court concluded that Charles Carroll had reasonable cause and acted in good faith in relying on the advice of his attorney, J. Roger Myers, who had conducted due diligence on the proposed transactions. The court found that Myers' advice was sufficient given Carroll's limited sophistication in tax and financial matters.

Disposition

The court sustained the adjustments in the FPAA and determined that the FPAA was timely issued with respect to Charles and Garnet Carroll. The court declined to impose any penalty under I. R. C. sec. 6662 due to Carroll's reasonable reliance on professional advice.

Significance/Impact

This case reinforces the application of the step transaction and sham transaction doctrines in tax shelter cases, particularly those involving Son-of-BOSS transactions. It clarifies that while a series of transactions may be collapsed under the step transaction doctrine, the economic substance of individual steps within the series must still be considered. The case also highlights the importance of adequate disclosure on tax returns to avoid triggering extended limitations periods and the necessity of reasonable reliance on professional advice to avoid penalties. The ruling has implications for taxpayers engaging in complex tax planning strategies and the IRS's ability to challenge such transactions through FPAA proceedings.

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