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Business Law Update

For clients of Taylor English Duma LLP

Taxpayer Wins Tax Shelter Penalty Issue

In a ruling that should give taxpayers hope, the United States Tax Court in *Swanson v. Commissioner,* T.C. Memo 2009-31 confirmed that the usual rules of penalty abatement law apply equally to coordinated tax shelter cases. The ruling is significant because in the past taxpayers have seldom won penalty abatement issues in coordinated tax shelter cases.

Tax shelters are financial products that are generally marketed to high income individuals to generate losses to shelter income for that individual. A tax shelter becomes the target of a coordinated IRS audit effort when the IRS learns that the transaction is being marketed and the IRS determines that a significant purpose for the transaction is the avoidance or evasion of federal income tax. A common sense test for whether a transaction is a sham is whether the taxpayer would have made the business decision to engage in the transaction absent the tax benefits. If the IRS believes the answer to that question is “no” then, on audit, the IRS will disallow the tax benefits of the transaction as a sham and impose penalties to deter the taxpayer from future similar investments.

Mr. Swanson's "tax shelter" investment was in a partnership called California Jojoba Investors. The jojoba plant produces oil that scientists touted as an alternative to petroleum back in the 90's and early 80's. In California, when Mr. Swanson's partnership was formed, public transit buses were using jojoba oil rather than petroleum. Prompted by the appeal of an alternative power source, Promoters developed partnership investments in jojoba plantations with the partnerships taking large research and development losses that then flowed through to the partners on their individual K-1's.

The jojoba transactions became the subject of a coordinated IRS audit effort in the early 80's. Because the partnerships were TEFRA partnerships, the audit of the underlying transaction was handled at the partnership level. At the conclusion of the partnership case the IRS issued notices of deficiency for the affected item adjustments to the individual partners.

Mr. Swanson received his notice of deficiency in 2005 alleging negligence penalties and filed a Tax Court petition denying he owed any negligence penalties. The Tax Court agreed with Mr. Swanson and abated penalties arising from his investment in the jojoba partnership. The Tax Court determined that penalties were inappropriate because of the taxpayer's lack of sophistication and his good faith belief in his licensed tax preparer who verified the investment with independent certified public accountants. Also important to the Court was the fact that the taxpayer was not investing in a partnership offering "too good to be true" tax benefits. Mr. Swanson's investment actually exceeded the tax dollars he saved because of the investment.

The IRS pursued multiple jojoba partnerships in the 80's and 90's with most partnerships agreeing to be bound by various test cases. Most partners paid the taxes and penalties at the conclusions of the partnership cases. Of the partners who contested the imposition of penalties only Mr. Swanson was granted relief.

Vivian Hoard of Taylor English Duma LLP successfully represented Mr. Swanson in this matter. Ms. Hoard has successfully represented investors in other coordinated tax shelter cases as well as partnerships wrongfully accused of being sham transactions. For more information on this topic, contact Vivian at 770-541-2223.

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