



TAX COURT CORNER

Can a Taxpayer Change the Income and Deductions after the IRS Has Prepared an SFR?

Kevin M. Baker, Petitioner

v.

Commissioner of Internal Revenue, Respondent

T.C. Memo 2008-247

October 30, 2008

By Steven R. Diamond, CPA

Pursuant to IRC Sec. 6020, the IRS is authorized to prepare a tax return for a taxpayer that is considered legally binding and valid. The IRS, under the provisions of IRC Sec. 6020, is authorized to file a taxpayer's return in three circumstances. The first is when the taxpayer fails to file but agrees to furnish the necessary information so the IRS can prepare a return. The return becomes effective when the taxpayer signs it. The second circumstance where the IRS may file the return is when the taxpayer fails to both file and provide the IRS the necessary information for filing. In this situation, the IRS is authorized to prepare the return from any information already known or that can be obtained through testimony or otherwise. The third circumstance is when the taxpayer files a false or fraudulent tax return.

When the taxpayer signs a return prepared by the IRS, the three-year statute of limitations on assessment begins to run. However, if the IRS-pre-

pared return is prepared due to failure to file or for filing a false or fraudulent return, the return does not start the limitations period.

About the Author

Steven R. Diamond is a CPA with a tax practice located in Westport, CT. His practice is limited to compliance issues and representation before the IRS. He has his M.S.M. degree in taxation from Florida International University and is admitted to practice before the United States Tax Court. Steven also taught a course preparing EAs and CPAs to take the Tax Court admission exam for non-attorneys.

FACTS

Kevin Baker (petitioner) did not timely file his 2002 tax return and the commissioner prepared a "substitute for return" (SFR) using the information available to determine petitioner's tax liability. Subsequently, petitioner filed a return that reported much more income but also much higher deductions than the commissioner knew about.

Petitioner earned income from various sources in 2002, the largest source being his wages as president of Blue World Technologies, an S Corp. He also had income from a forty-five percent interest in Blue World and was a member in Guardian Enterprises, LLC. Additionally, he had some interest and other miscellaneous income.

The commissioner was aware of the \$165,038 in wages as well as \$157 in interest income. When the commissioner learns, based on information from third parties, that an individual had income but failed to file a return, the commissioner is empowered to file an SFR for that taxpayer. Typically, when preparing an SFR, the commissioner will either use the filing status of single or married filing separately, allow only one personal exemption, and allow no business or personal deductions.

In preparing the SFR for petitioner, the commissioner used the \$165,195 of wages and interest as income, used the married filing separately status, and allowed one deduction. The commissioner calculated that petitioner owed a deficiency of \$47,629 after crediting him for taxes withheld by Blue World. The commissioner then determined additions to tax for failure to timely file and pay.

Petitioner then received a notice of deficiency with the SFR attached. Petitioner filed a timely petition with the Tax Court, however he subsequently filed his own return which greatly increased the reported income. Rather than the \$165,195 shown on the SFR, the petitioner reported over \$575,000 of income due to his passthrough income from Blue World and Guardian.

Petitioner also reported, in addition to the increased income, enough deductions so that he claimed a refund. The tax return was submitted before the commissioner filed his answer, but the commissioner neither asserted an increased deficiency nor filed an amended answer. Additionally, in his pretrial memo, the commissioner again stated the only amount at issue was the original deficiency of \$47,629.

This case was tried in Chicago. The trial consisted of petitioner offering the unaudited corporate tax returns from petitioner's passthrough businesses, the accompanying K-1 forms, and petitioner's old 1040s with assertions as to their accuracy. Petitioner's accountant added his own statements as to the accuracy of the tax returns, even though the returns were actually prepared by one of his colleagues.

OPINION

The first question the Tax Court had to tackle was the amount at issue. The notice of deficiency was based upon the SFR, but the petitioner reported substantially more income on the tax return he prepared. The Tax Court has jurisdiction to increase the amount of a deficiency if the commissioner makes the claim at or before the hearing.

The procedure for the commissioner to assert an increase in the deficiency is by formally pleading for an increase in either the answer or an amended answer. Even if the parties stipulate an increase in income the commissioner must still formally plead for the increase of the deficiency. In this case, the commissioner did not do that nor did he file an amended answer.

The Tax Court further noted that the commissioner's pretrial memorandum and amended memorandum both claimed the \$47,629 as the amount in dispute, as well as sticking to that amount in the post-trial brief. The commissioner did mention the increased income in the finding of fact section of his brief and listed the amounts of the increase, but this was not an amendment to the pleadings and therefore was not a claim for an increased deficiency. Therefore the Court concluded that the deficiency is \$47,629 and it was up to the petitioner to prove that amount to be incorrect.

The petitioner claimed he had sufficient deductions in 2002 to offset most of his income: however he argued his claimed deductions were new matters and that the commissioner had the burden of disproving them. In *Widemon v. Commissioner*,¹ the Tax Court held that the burden of proof remained with the taxpayer because his deductions were a new theory and not a new matter. In *Rappaport v. Commissioner*² the taxpayer filed a tax return claiming extra income and large deductions subsequent to the notice of deficiency. The Tax Court held that because the taxpayer had raised the matter of the new deductions, the burden would not shift to the commissioner.

While the Tax Court believed *Widemon* and *Rappaport* were still good law, they noted that the petitioner alleged in his petition that he was not liable for the

¹ T.C. Memo 2004-162

² T.C. Memo 2006-87

www.smallbiztaxadvisor.com/join/

TaxAdvisor.com
SMALL BIZ

The Web's comprehensive tax resource for individuals and small businesses includes a directory of tax advisors

... **grow your tax practice** with a listing for a fraction of the cost of yellow page listings. Introductory rate of \$99 per advisor a year (regular retail is \$499).

Be among the first in your state to have a listing on this small business resource and connect with prospective clients now.

**First 500 to join
pay only \$99**

Only for qualified tax advisors.

Save 80%
www.smallbiztaxadvisor.com/join/



Online CPE

ClientWhys has made it easier to meet your Enrolled Agent CPE Requirements.

Our online CPE library provides instant access to hundreds of courses, automatic grading and instant CPE certificate.

Try out our industry-leading **ethics courses** to stay compliant and better advise you on how to deal with those dicey client situations.

Call us today at **1.800.442.2477 x 1** or log on at www.clientwhyscpe.com and see what thousands of Enrolled Agents like you have already experienced.

ClientWhys®

Build your knowledge. Build your practice.

deficiency because the notice of deficiency may not have given him credit for business deductions or other items affecting taxable income. Consequently, the issue of whether he is entitled to his claimed deductions was not a new matter but the original and only matter he asked the court to decide.

With the procedural matters settled, the first substantive issue the Tax Court had to determine was the correct amount of the 2002 income. Because the petitioner reported his income on a signed tax return, the Tax Court treated his return as an admission and determined that the correct income was \$578,997.

The next issue the Tax Court tackled was the amount of substantiated deductions claimed on the 2002 tax return. The court

because it only had two members in 2002, the commissioner classified it as a partnership in the absence of any election to be taxed as a corporation. The default rule for small partnerships allowed the commissioner to audit it at the individual partner level and therefore the petitioner could not rely on the K-1 he received but instead had to prove its accuracy.

The Tax Court then noted that while a taxpayer has a duty to report his losses and deductions from S Corporations consistent with the corporate tax returns, individual S Corp shareholders are answerable for all the issues on the corporation's tax return. Therefore, the introduction of the K-1 he received from Blue World as proof of his deductions was insufficient. Because the petitioner introduced only old tax returns and K-1s

With respect to Guardian Enterprises, LLC...the commissioner classified it as a partnership in the absence of any election to be taxed as a corporation.

determined that there were two classes of deductions claimed by petitioner, those he tried to substantiate with old tax returns and those he tried to substantiate with more persuasive documentation.

For the deductions the petitioner tried to support with old tax returns, other than capital loss carryovers, the court relied on precedent in which it has repeatedly held that a taxpayer's returns do not substantiate deductions or losses because they are nothing more than a statement of claims.³ Additionally, in *Halle v. Commissioner*,⁴ the Tax Court held that a taxpayer cannot use old tax returns as substantiation of deductions or losses without records or credible testimony with respect to those items. In *Lerch v. Commissioner*⁵ the Tax Court also held that a taxpayer cannot successfully substantiate his old tax returns by arguing that the commissioner is estopped from challenging them because the commissioner failed to challenge them in earlier years.

The Tax Court also held the same line of reasoning to the K-1 forms that the petitioner offered to substantiate his deductions from his passthrough businesses, as they were only statements of claim and not proof of them. With respect to Guardian Enterprises, LLC,

to verify his claim for deductions, the Tax Court determined he failed to substantiate almost all his claims.

However, with respect to his claim of a short-term capital loss carryover, the petitioner had 1099s dating back to 1996, and the Court found those documents persuasive to show he had a loss in 1996. The petitioner, however, had to prove that those losses were not used up from 1997 through 2001, and because he had only old tax returns to offer to prove the intervening years, the Court found he failed to substantiate the capital loss he wanted to carry into 2002.

In conclusion, the Tax Court found that petitioner admitted to income of \$578,997 but only offered old tax returns and K-1 forms to substantiate his deductions, which did not carry any weight. Because the amount in issue at trial was only the original tax deficiency of \$47,692 and because the commissioner conceded many of petitioner's other deductions, the liability of \$47,692 may be reduced pending recalculation of the amounts conceded by the commissioner. **EA**

³ *Wilkens v. Commissioner*, 71 T.C. 633; *Roberts v. Commissioner*, T.C. 834

⁴ 7 T.C. 245 (1946)

⁵ 877 F.2d 624, affg T.C. Memo 1987-295

NAEA's
National Tax
Practice Institute
(NTPI®)
&
37th Annual
Meeting

August
9-12, 2009
Baltimore, MD

More Details
to Come!

