

Financial Planner's Participation in US Tax Court Decisions

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Abstract

A preliminary survey of US Tax court cases indicates that the majority of tax court decisions involving the participation of financial planners deal with negligence. This paper presents the findings of a mixed qualitative/quantitative descriptive research study. The study reviewed and analyzed 114 US Tax Court Cases involving financial planners between 1970 and 2013. The conclusions suggest specific sections of the US tax code with which financial planners need to focus on in order to avoid exposure and provide sound tax advice. These code sections deal primarily with negligence. The analysis also shows 21% of the time the financial planner acts as a plaintiff. The results of this study will help financial planners identify those areas of the federal tax law they need to understand in order to minimize liability for themselves and their clients.

Introduction

One of the components of a financial plan is tax planning. A typical objective of a financial plan is to minimize taxes throughout the client's life. Financial planners and tax advisors must understand the tax code to avoid recommending their clients schemes that result in tax evasion. Tax minimization strategies must be within the restrictions set forth by the tax code.

The importance of financial planners in their role as tax planning advisors is a growing concern (Givner, 2008). Taxpayers increasingly consult their financial planner for income tax advice. This paper presents the result of a survey of US tax court cases in which the case transcript refers to financial planners in some capacity. In some cases the financial planner participated as witness or provided financial and tax advice to the complainant.

The survey, which collected case transcripts from the WestlawNext™ database, identified 114 US tax court cases involving financial planners between 1970 and 2013. The study followed a qualitative exploratory research approach combined with a basic descriptive quantitative analysis. The original goal of the study was to explore the impact of financial planning participation in federal tax court cases.

The increasing role of financial planners in tax planning and the need to better understand the exposure and responsibility of the planner as a tax advisor motivated the study. This paper presents a summary of the methodology used to analyze the 114 court cases identified and the results of the qualitative and quantitative analysis.

Research Method

Qualitative research examines human behavior in social, political, and cultural contexts (Salkind, 2003). This study intended to examine the impact of financial planner participation in tax court cases. Quantitative research, on the other hand, involves studies that deal with numerical data and cause-effect relationships (Christensen, 2014). Surveying 114 court cases resulted in a fair amount of quantitative data. In addition, the study also intended to determine if a potential effect of the participation of financial planners in the results of a court case

Using a mixed of qualitative and quantitative research methods addressed the goals of the research. A qualitative exploratory approach helped to identify the role financial planners played in the tax court trials. A quantitative descriptive approach helped to quantify the data collected. Quantification of the data resulted in the identification of themes prevalent in the cases. NVivo 10 software from QSR International was used to conduct the qualitative data analysis. Microsoft Excel provided the tools used to complete the quantitative descriptive analysis.

Data Analysis

The NVivo 10 software helped to build the word cloud shown in figure 1. This word cloud displays the words most commonly found in the 114 cases surveyed. To focus on the research subject words that were not relevant and which frequently appear in case records were eliminated prior to generating the cloud. Examples of such words include “petitioner”, “tax”, “return”, and “attorney” as well as many adjectives were. The cloud led to the establishment of themes.

Theme Analysis

Qualitative analysis involves the discovery of themes (Maxwell, 1996). Typical research projects use interview data to do qualitative and thematic analysis. This study used transcripts of Federal tax court cases as the source of data. These transcripts are comparable to interviews in the sense that they capture the interaction and arguments presented by the parties in a case. Court transcripts are also comparable to observation as they reflect the dialog that took place during the trial.

The following paragraphs describe the main themes identified in the qualitative exploratory analysis of the 114 case records. Of particular interest was the identification of specific sections of the tax code as themes that constantly appear in the cases. The sections identified are those that financial planners and tax advisors may need to be more literate on. The fact that the Commissioner of Internal Revenue (i.e. the IRS) is the defendant in all 114 cases is relevant. Therefore, taxpayers are the plaintiffs or petitioners in all cases. Taxpayers sue the IRS to avoid penalties or to recover penalties assessed by the IRS.

The sections below present the qualitative descriptive analysis of these themes: trusts, benefits, financial planner, partnerships, negligence, real estate, insurance, real estate certified financial planner®, and the sections 6621, 6653, 6661, 6662, 6664, and 7491 of the US Tax code.



Figure 1 Word Cloud

Theme 1: Trusts

Black Law's dictionary defines trust as "An equitable or beneficial right or title to land or other property, held for the beneficiary by another person, in whom resides the legal title or ownership, recognized and enforced by courts of chancery" (Garner, 2014). The review of the 114 cases found 175 references to trusts in 15 different cases. Revocable, irrevocable, estate, and insurance trusts are examples of the types of trusts mentioned. The word cloud (figure 1) suggests this theme is significant. However, the quantitative analysis identified only 15 cases that make reference to trusts. This fact highlights the benefit of using a mixed qualitative/quantitative research approach. While the theme of trusts is important, it is not at the top of the list. A further analysis of these 15 cases indicated that the plaintiffs used a variety of trusts with multiple purposes. There is not a prevalent type of trust used to shelter taxes. Instead, the transcripts suggest that taxpayers used a wide variety of trusts as tax shelters.

Theme 2: Benefits

There are 163 references to benefits in 55 cases. The initial thought was that this theme referred to employee benefits. Interestingly, however, after reviewing the cases that contained the word benefits the study found that the theme refers to economic benefits. The IRS considered many business transactions that taxpayers deducted for tax purposes as having "lacked economic benefits". Section 7701(0) of the US code states that a

transaction shall be treated as having economic substance only if (i) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (ii) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the transaction" (U.S. Code § 7701).

Employee benefits are hardly mentioned in the 55 cases that have references to benefits. Instead, there is an emphasis on the IRS' wanting to obtain a justification of economic benefits on expenses claimed as deductible.

Theme 3: Tax Code Section 6662

Section 6662 of the US Tax code, titled "Imposition of accuracy-related penalty on underpayments," applies to "any portion of an underpayment of tax required to be shown on a return" (U.S. Code § 6662). The penalty, a 20% of the underpayment, is imposed when a taxpayer exhibits negligence or disregard of rules and regulations or submits a substantial understatement of income tax. Negligence, another theme identified, is closely related to section 6662. The hefty 20% penalty should raise a flag and make taxpayers and tax advisors aware of their exposure. Figure 2 presents a partial view of a word tree generated by the NVivo 10 software. The tree shows some of the statements that include section 6662. The tree reveals how negligence and penalties prevail in this theme.

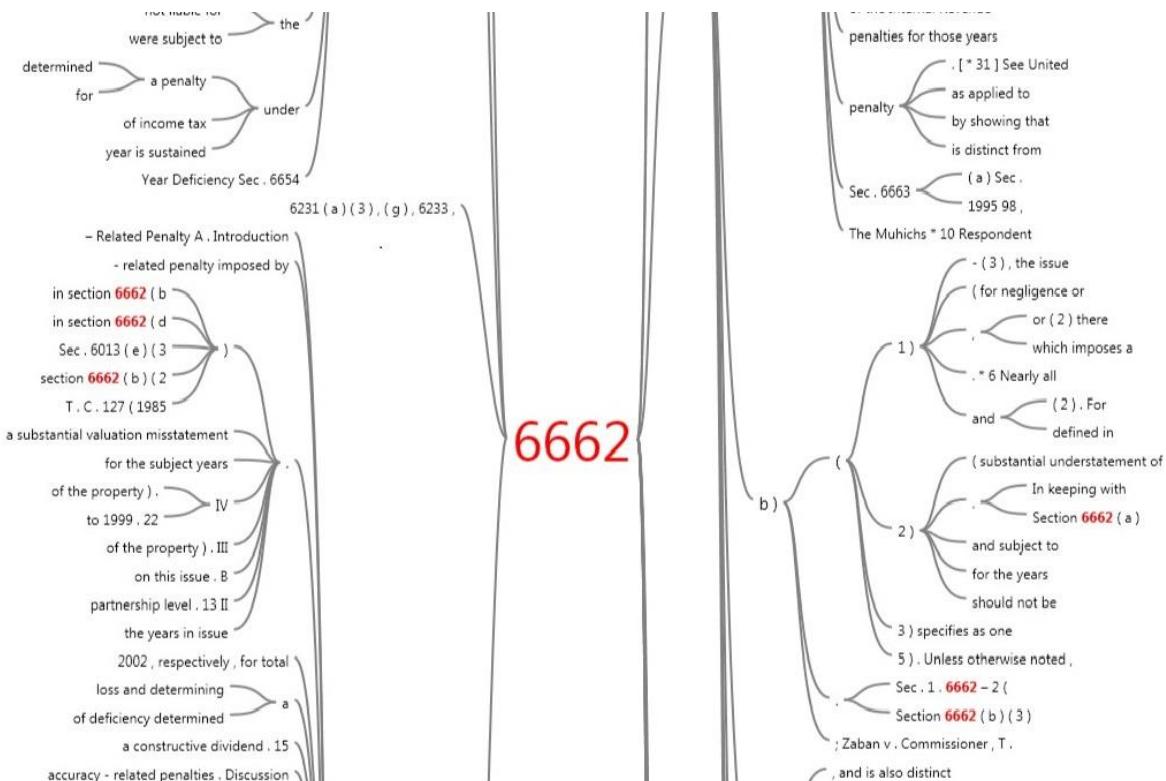


Figure 2 US Tax Code Section 6662 Tree Map

Theme 4: Tax Code Section 6653

Section 6653, titled “Failure to pay stamp tax”, applies to the failure to pay taxes due by stamp, coupons, tickets, or books. A stamp tax is one in which “flat or ad valorem tax placed on legal transactions like property transfer” (Garner, 2014). The penalty assessed is 50% of the underpayment. Unlike Section 6662, this section explicitly applies when the failure to pay is “willful.” The fact that penalties under this section are even stiffer than under section 6662 should be a concern of taxpayers. Tax advisors and financial planners need to be aware of the financial impact and consequence of willfully evading taxes and must discourage clients from doing so. Figure 3 displays a partial tree map illustrating the content of this theme.

Theme 5: Financial Planner

Financial planner was the key term used in the search of tax court cases on the WestLaw™ database. It is not surprisingly therefore to find 124 references to financial planners in the 114 cases. Financial planners acted both as plaintiffs and as providers of support for plaintiffs. It is important to remember that in all court cases the defendant was the IRS. All cases emerged after the imposition of penalties on taxpayers who brought the case to court to recover or eliminate those penalties. The advice offered by planners generally involved investments on what the IRS considered to be tax shelters. Both independent financial planners and employees of major brokerage houses participated as plaintiffs or advisers to the plaintiffs. The analysis didn’t provide evidence of any impact on the court’s final decision when a financial planner plays a role in the case.

Table 1 - Sample References to Financial Planner

This investment was proposed to petitioners by Doug Coleman (Coleman), a business associate of Mrs. Davis. Coleman, a financial planner and president of a finance company, had for several years arranged financing for telecommunications customers of Mrs. Davis.
Petitioner worked for Prudential Insurance Company in Houston during 1987 as a financial planner.
Petitioner was hired by IDS Financial Services, Inc. (IDS), as a financial planner in 1983.
Eventually one of Merrill Lynch’s account representatives referred petitioners to Al Davino, a certified financial planner (CFP) for advice.
At trial, petitioner presented testimony and submitted a written report from Dr. Shannon P. Pratt as to the value of the stock and the trust units. Dr. Pratt holds a doctorate of finance, is a member of the American Society of Appraisers, and is a certified financial planner.
In support thereof, petitioner argues: (1) He relied on advice from an independent financial planner.

However, the study found a very interesting fact: in 21% of all court cases reviewed the petitioner or plaintiff was a financial planner. To avoid getting involved in tax litigation financial planners need to understand well the tax implications of their own investments. Financial planners tend to be sophisticated investors and may invest in sophisticated investments. These types of investments may have complex tax implications the planner must clearly understand, especially when the planner recommend those investments to clients. Table 1 lists examples of references made to the role of financial planners in specific court cases. This is a very small sample but illustrates how many financial planners were petitioners themselves.

Theme 6: Partnerships

There are 117 references in 27 cases to partnerships. This theme emerges many of the plaintiffs/petitioners are partners in a partnership to which the IRS has disallowed some deduction. In many of the cases the IRS claims that these partnerships had not the goal of making a profit but of becoming tax shelters. Financial planners and tax advisors need to ensure that their clients are aware of the implications of forming partnerships with no business purpose.

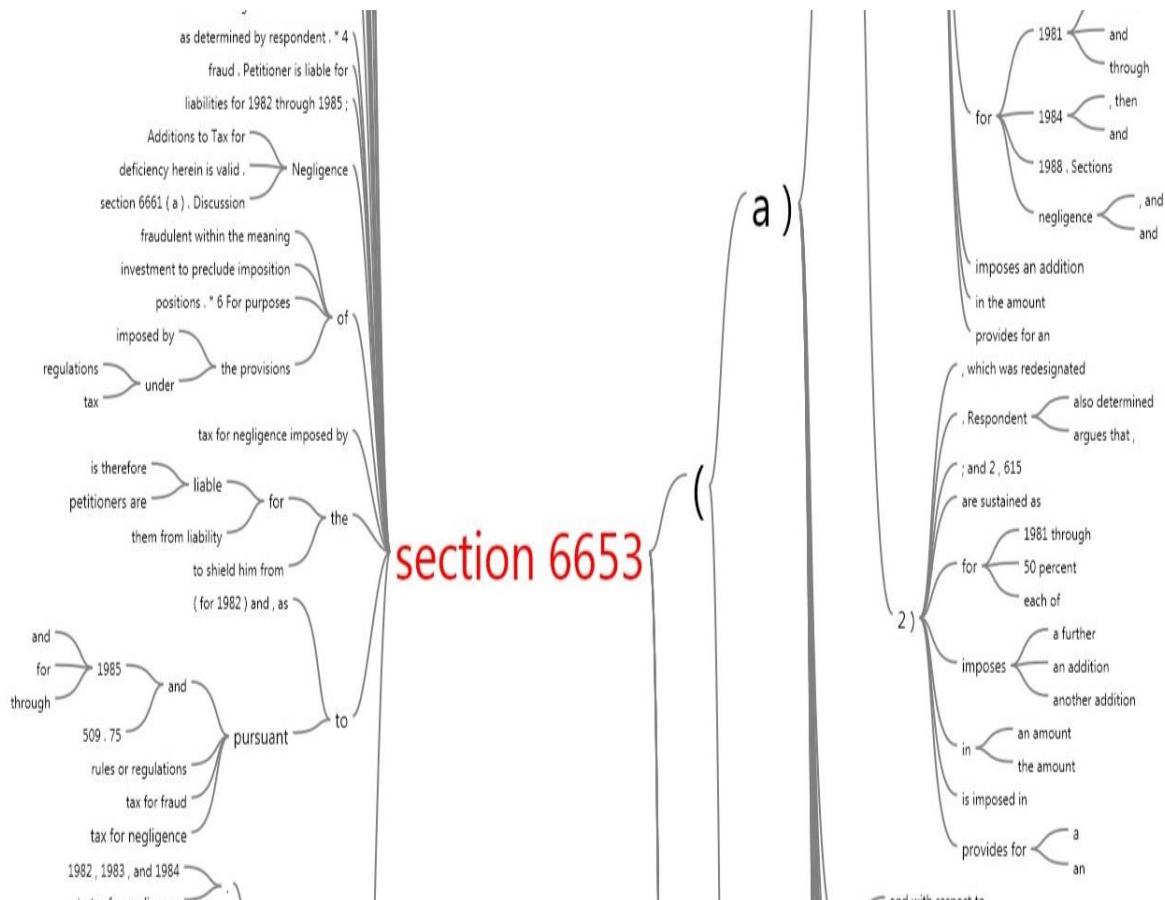


Figure 3 US Code Section 6653 Tree map

Theme 7: Negligence

In the common law negligence is “the omission to do something which a reasonable man, guided by those considerations which ordinarily regulate the conduct of human affairs, would do, or doing something which a prudent and reasonable man would not do” (Garner, 2014). This theme is prevalent with 94 references. A frequent IRS claim is that a taxpayer had “negligence and intentional disregard for the rules”. Negligence is also an element that appears in some of the tax code themes such as section 6662 and section 6665.

Theme 8: Tax Code Section 6661

This section, which applied to substantial understatements of liability, was repealed as of December 31st, 1989.

Theme 9: Real Estate

This theme, with 89 references, deals with a variety of elements related to real estate. These elements include real estate transactions (purchase and sale), real estate agents, real estate interests, real estate contracts, and commercial real estate mortgages. Most cases make reference to the fact that the plaintiff owned some real estate.

Theme 10: Insurance

A total of 88 references appear on the records of 12 court cases. This fact suggests that while the theme of insurance is relevant, it is not of significant throughout the cases. The theme of insurance refers in most instances to the fact that financial planners or insurance agents were employed or appointed with specific insurance companies. The theme refers primarily to the insurance companies and specific insurance products don't seem relevant.

Theme 11: Tax Code Section 6621

Section 6621, titled “Determination of rate of interest”, relates to the methods used to determine the rates of interest that apply on penalties for underpayment of taxes due. This theme emerges because this section of the code applies whenever a taxpayer owes a penalty.

Theme 12: Tax Code Section 7491

The title of section 7491 is “Burden of proof.” This section describes the cases where the burden of proof shifts from the taxpayer to the Secretary of the Treasury or his/her representative and applies to taxes imposed under subtitles A and B of the Code. Subtitle A deals with income taxes, while subtitle B deals with estate and gift taxes. The cases where this theme emerges refer to whether the Commissioner provided the necessary evidence and whether the evidence was credible.

Theme 13: Tax Code Section 6664

This section, “Definitions and Special Rules”, provides definitions of relevant terms such as underpayment, penalties, exceptions, and others.

Theme 14: Certified Financial Planner

There are a total of 46 references to certified financial planners in the 114 cases. This fact suggests that nearly 50% of all financial planners involved in these court cases were CFP® certificants. Certification was used primarily to demonstrate the credentials and credibility of

the planner. Multiple references are made to the education certified financial planners receive in order to get certified. Just like with financial planners in general the study didn't find specific evidence that the participation of a CFP® practitioner affected the court's final decision. Figure 4 presents the complete tree map resulting from the presence of the term CFP or Certified Financial Planner in the 114 case transcripts.

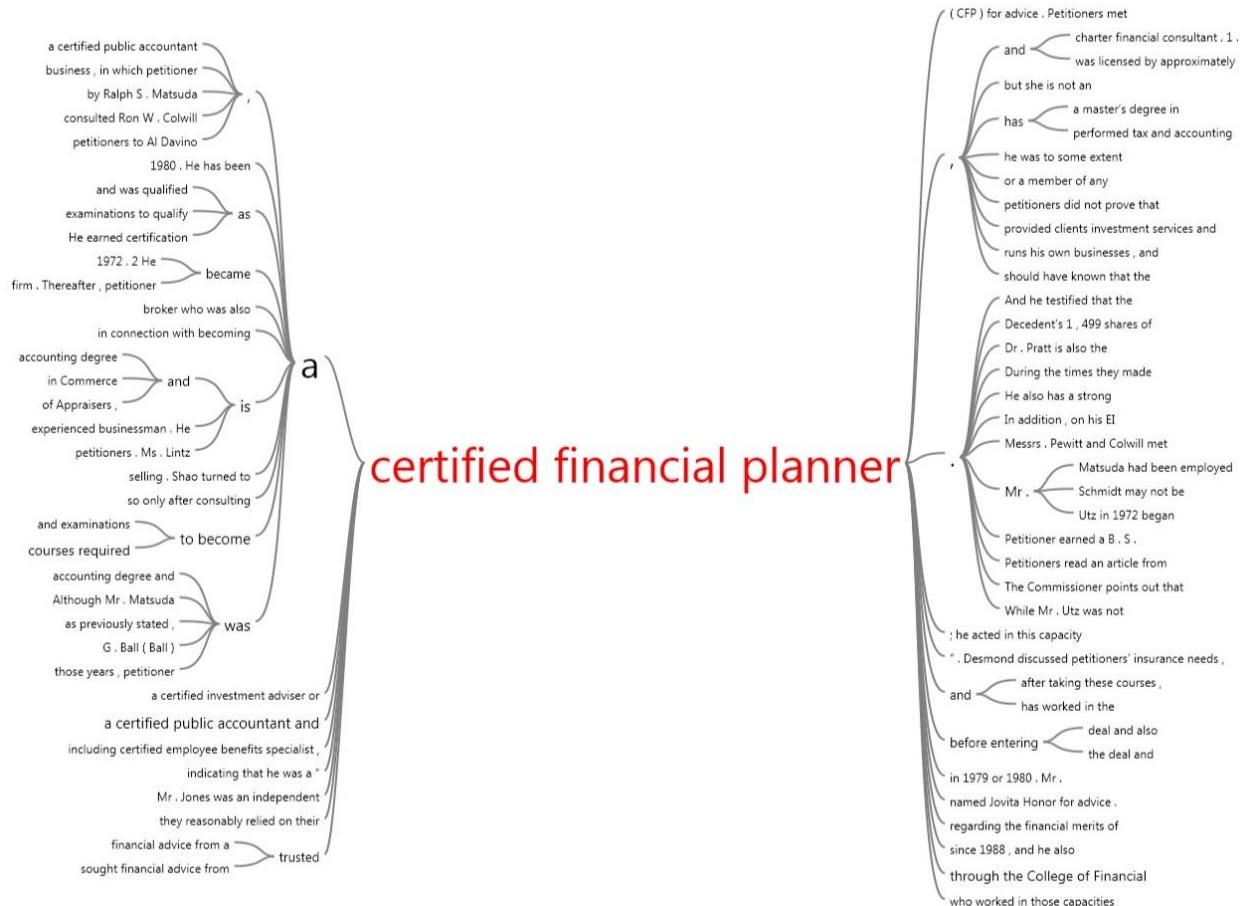


Figure 4 - CFP Tree Map

Conclusions

The results of the analysis are inconclusive in regard to the question of whether the participation of financial planners, whether certified or not, had an effect on a tax court decision. However, the analysis yielded interesting results and information of value to financial planners, tax advisors and taxpayers in general.

The majority of tax cases that involved financial planners dealt with claims of negligence on the part of the taxpayer which resulted, according to the IRS, in underpayment of taxes.

This result is not surprising as the majority of cases going to the tax courts involve a taxpayer that the IRS claims owe taxes and; therefore, an under penalty.

Financial planners and tax advisors need to be aware of the consequences of negligence and ensure that their clients aren't negligent when preparing their income tax returns or providing input to their tax preparers. There are six sections of the US Tax Code with which financial planners should be familiar. These sections are 6662, 6653, 6621, 7491, and 6664. Financial planners and tax advisors must also be familiar with the tax implications of real estate investments and different types of trusts to properly advise their clients. The Certified Financial Planner® designation has significance in tax courts and provides credibility to CFP® holders.

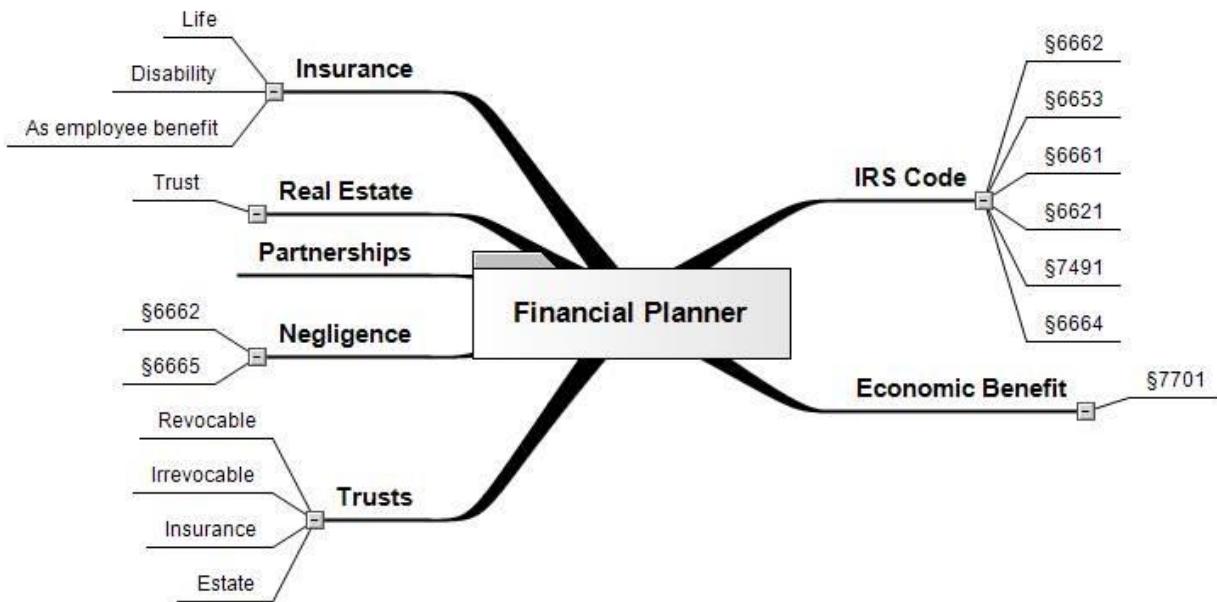


Figure 5 - Financial Planner – Tax Court Model

Perhaps, the most surprising conclusion is that of the 114 cases, in 25 of them the petitioner (plaintiff) was a financial planner. This represents 21% of the cases and a significant amount. As professionals in the investment industry, financial planners are active investors and are attracted to sophisticated investments. Sophisticated investments have complex tax implications and the financial planner must be very knowledgeable of them. Furthermore, a financial planner that recommends an alternative or sophisticated investment must educate well the client on the tax implications of the same.

Figure 5 presents a visualization of the result of this analysis. Financial planners, including certified planners acting as tax advisors need to know and understand specific sections of the US tax code. These sections must be kept in mind when advising clients on tax matters. These tax code sections deal primarily with negligence and willful misrepresentation of facts in the preparation of federal income tax returns.

Recommendations for Further Research

Additional analysis may provide a better picture of whether financial planners have an effect on the outcome of federal tax court cases. Supplementary descriptive and qualitative analysis will determine the number of cases where the petitioner won in tax court. Classifying the cases according to the role played by the financial planner, petitioner, witness, petitioner advisor, etc., will provide more insights on the impact of the planner's involvement in the court case.

Another subject of interest will be determining the outcomes of the cases were the petitioner was a financial planner and the types of penalties imposed by the tax court. A very useful analysis will be the weigh the court gave to the fact the petitioner was a financial professional and what impact this had on the court's decisions.

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