Office of Chief Counsel
Internal Revenue Service
memorandum

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date: May 05, 2021

to: Manager, Eastern Compliance Practice Area Team 1485
(Large Business & International)

from: W. Carl Hankla
(Large Business & International)

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subject:

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether the Service should assess a penalty under Section 6694(b)[1] against for advising its client to take the return position that a reserve for estimated liabilities may be excluded from income.

CONCLUSION

The Service should assess a penalty under Section 6694(b) against for advising its client to take the return position that a reserve for estimated liabilities may be excluded from income.

FACTS

Introduction. was incorporated in as part of a reorganization of became the parent of a consolidated group including the owners of a partnership for tax purposes. experienced a technical termination under

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[1] "Section" references are to the Internal Revenue Code.

Section 708(b)(1)(B) in connection with the reorganization, apparently because

took the place of as the majority owner. Protest, p. 2. continued in business after the technical termination as it had for approximately , according to website.

The IRS examined tax years through . The main issue was whether method of accounting for income items complied with Section 451 of the Code, "General rule for taxable year of inclusion," and Section 461, "General rule for taxable year of deduction." The accounting methods were adopted in the tax year based on advice given by . prepared the returns for and following years accordingly.

The examination team ("Exam") rejected the accounting method. In its view, improperly offset certain liabilities against its accounts receivable before including the remainder into gross income. Those liabilities were (i) estimated early-payment discounts and (ii) estimated write-offs for disputed billing or shipping charges.

Exam concluded that could not exclude or deduct those liabilities because they were estimates based on historical data instead of fixed, actual liabilities in existence and identifiable at year end. Accordingly, Exam proposed the following adjustments to income as reflected on the consolidated returns:

	$	$	$
		[2]	
			$

protested. Exam filed a reply. The Appeals Office agreed fully with Exam in a memo dated .[3] then conceded, although its representative,

[2] discontinued its reserve for estimated discounts as of .

[3] The Appeals memo makes it clear that no concession was made, even though the word "settlement" appears:

SUMMARY AND RECOMMENDATION

, persuaded Appeals to consolidate and move all of the adjustments to tax year so that its client would not have to file amended state tax returns. (Before agreeing, Appeals satisfied itself that this would not generate any tax benefits.) This resolved all of the issues raised in the examination.[4] Assessments were made.

Subsequently, Exam requested guidance as to whether return preparer penalties should be asserted against . This memorandum is in response to that request.

<u>Background.</u> For financial statement purposes during the years at issue, practice was to recognize revenue when it was “realized” or “realizable and earned,” generally when: 1) there was evidence of an arrangement (e.g. a sales agreement or a signed contract with clearly defined term and conditions of the parties), 2) delivery or substantial performance of the obligation had occurred, 3) the price was fixed or determinable, and 4) collection of the revenue was reasonably assured. This revenue reflected the full amount of invoiced price.

also accounted for certain anticipated customer claims, such as early-payment discounts customer disputes, by offsetting its reported revenue by the estimated amount of these claims and recording a reserve account titled “Allowance for Customer Claims” account (“Contra Account”). The Contra Account represented the difference between amounts included on sales invoices and what was likely to collect after reductions for estimated customer claims, which were based on percentages, computed from historical loss data, for each category of claim. The Contra Account was offset against accounts receivable at the end of the year, with the net amount being carried over into gross income for tax purposes.

Under generally accepted financial accounting principles during the years at issue,

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> Is the taxpayer entitled to an amount for customer deposits and unearned discounts?
>
> No, In Full: The taxpayer utilized statistics to record the expense for the two items. The courts held that statistics were not a valid method to record the amounts. The taxpayer did not provide any documentation to substantiate any actual expenses. As a settlement, the amounts for all years in question were placed on the return to minimize the burden on the taxpayer of amended returns.

Later in the memo, the Appeals officer explained why an acceptance of “offer” did not cost the government anything:

> The effect of the offer is that taxpayer wants to move all amounts [for the tax years under examination] related to the issues to the tax year to minimize the amended [state] returns which need to be prepared by the [parent] corporation. Per inspection of all the returns involved, the placing of the amount on the one year does not trigger any credits or net operating losses.
>
> The issue is agreed.

[4] No penalties were asserted against because of its claim that it reasonably relied on advice in the Memo discussed below.

accounting for anticipated liabilities using reserve accounts provided a conservative measure of the economic performance of the business.

However, federal tax rules generally prohibit using reserves to offset gross revenue, instead requiring liabilities to be "fixed" before becoming deductible under Section 461's "all events" test.

Advice. In a -page, single-spaced memorandum to dated with the subject line " " ("Memo") provided the following advice:

- could net its Contra Account against accounts receivable for tax purposes as well as financial purposes.
- This would be proper under Section 451's all-events test because the estimated discounts and disputes in the Contra Account reflected conditions precedent to recognition of the invoiced amounts in full.
- Although this would be a new practice, did not need to notify the IRS of a change in accounting method under Section 446 because, having gone through a "technical termination" in , it was a new taxpayer.
- Since would be treating the Contra Account the same way for both financial and tax purposes, no Schedule M adjustment on return would be necessary.

The Memo did not analyze whether the estimated amounts in the Contra Account would be deductible under Section 461.

employed a number of individuals who created the Memo. The documents produced in response to Exam's penalty IDRs indicate that was the tax partner with overall responsibility for the Memo. did a substantial amount of the drafting of the Memo, and , a , reviewed and approved the Memo.

Examination. The Service selected returns for examination. Exam discovered the Contra Account issue when it noticed that Schedule L to the return showed a year-end reserve for bad debts that was millions of dollars higher than the same item on the return. When Exam expressed doubt about the propriety of netting the Contra Account against accounts receivable, produced a copy of the Memo. Interview with RA , .

Exam disagreed with position on the ground that estimated liabilities are not deductible under Section 461's all-events test. On or about , Exam issued a notice of proposed adjustment to income totaling $

for estimated customer disputes and for estimated customer discounts). Related adjustments were proposed for years .

Protest. On , , on behalf of , filed a protest ("Protest").

The Protest argued that Exam erred by relying on Section 461. "This is not a deduction issue but an income accrual issue." Protest, n. 23 on p. 13. "The Taxpayer excludes from income (it does not deduct) an amount for customer disputes by year end, and the amount of the early payment discount." *Id*. at 7 (underlining in original).

The Protest asserted at page 21 that "customer claims are a statistical certainty," making them excludable: "such disputes are accurately estimated using historical and statistical analysis."

The Protest attempted to distinguish the Service's authorities, including *General Dynamics Corp. v. United States*, 481 U.S. 239 (1987). *General Dynamics* held that, except for insurance companies, taxpayers could not use the reserve method for income tax accounting: "A reserve based on the proposition that a particular set of facts is likely in the future may be an appropriate conservative accounting measure, but it does not warrant a tax deduction." 481 U.S. at 245.

Appeal. The Appeals Office issued a detailed memorandum rebutting position ("Appeals Memo"). The Appeals Memo concluded that the Contra Account contained estimated, contingent liabilities that could not properly be used to reduce accounts receivable. Appeals Memo, pp. 27-28. later conceded in full, although it requested that the adjustments for the years in examination be consolidated into the final year, , to avoid having to prepare and file amended state returns. Appeals agreed to this after determining that the government would not be adversely affected. The proposed adjustments were consolidated into the year and assessed.

LAW AND ANALYSIS

Summary. The position that , a non-signing tax return preparer, advised to take—that Contra Account reserve for estimated liabilities could be excluded from income—was contrary to well-settled law applicable to the facts and circumstances. thus should be subject to a penalty under Section 6694(b).

General principles.

Gross income is broadly construed to include "all income from whatever source derived." Section 61(a). Exclusions from gross income, on the other hand, are narrowly construed. *Commissioner v. Schleier*, 515 U.S. 323, 328 (1995). Deductions from income under Section 162 are a matter of legislative grace, and taxpayers bear the burden of proving their entitlement thereto. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992).

Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis on which taxpayer regularly computes his income in keeping his books and records. Section 1.446-1(a) provides further that the term “method of accounting” includes not only the overall method of accounting of a taxpayer but also the accounting treatment of any material item.

Under Section 446(b), taxable income is to be computed under the accounting method regularly used by the taxpayer for keeping its books and records unless the method used “does not clearly reflect income.”

Section 451 provides the rules for determining the taxable year of inclusion for items of gross income. Treas. Reg. §§ 1.446-1(c)(1)(ii)(A) and 1.451-1(a) provide that under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive the income and the amount thereof can be determined with reasonable accuracy. All such events occur when (1) performance takes place, (2) payment is due, or (3) payment is made, whichever occurs first. *Schlude v. Commissioner*, 372 U.S. 128, 133 (1963); Rev. Rul. 2003-10; Rev. Rul. 84-31; Rev. Rul. 80-308.

Section 461 prescribes the taxable year in which a liability is incurred and generally taken into account for Federal income tax purposes. Under an accrual method of accounting, a liability is incurred and taken into account in the taxable year in which all events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Treas. Reg. § 1.461-1(a)(2); § 1.446-1(c)(1)(ii)(B); § 461(h). A liability includes any item allowable as a deduction, cost, or expense for Federal income tax purposes. See Treas. Reg. § 1.446-1(c)(1)(ii)(B).

Generally, for purposes of determining whether an accrual basis taxpayer can treat the amount of any liability as incurred, the all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability. Treas. Reg. § 1.461-4(a)(1).

Memo opines that properly could employ the reserve method of accounting, the same method it used for financial accounting purposes, and include income items net of the estimated cost of its anticipated discounts and disputed claims.

A taxpayer’s conformity with its accrual method used for financial accounting purposes does not create a presumption that its tax accrual method clearly reflects income. *See Thor Power Tool Company v. Commissioner*, 439 U.S. 522, 541 (1979). Nor do the tax laws permit taxpayers to use reserves or reserve accounting except as expressly authorized by statute. *See Lucas v. American Code Co*., 280 U.S. 415, 452 (1930) (footnote omitted). Accord, *Brown v. Helvering*, 291 U.S. 193, 201-02 (1934).

Based on the facts provided, rendered its complete performance due under a contract when it shipped the goods. Thus, at that point, the Section 451 all events test was satisfied, for had a fixed right to receive income equal to the full invoice price no later than the shipment date. *See* Rev. Rul. 2003-10; and Rev. Rul. 84-31. Memo correctly reaches this conclusion, stating that had, for purposes of applying the all events test of Section 451, had a “fixed right to income when the goods shipped” and that contractual terms are relevant in determining when a taxpayer’s right to income or obligation is fixed for purposes of applying the all events test. *See Decision, Inc. v. Commissioner*, 47 T.C. 58 (1966).

Notwithstanding the above, Memo circumscribes the reach of this conclusion, by opining that did not have a fixed right to income with respect to amounts anticipated to equal the discounts to be granted and customer claims to be settled in a subsequent tax year. When applying the all events test, courts have distinguished between conditions precedent, which must occur before the right to income arises, and conditions subsequent, the occurrence of which will terminate an existing right to income, but which do not preclude accrual of income. *Charles Schwab Corp. & Subs. v. Commissioner,* 107 T.C. 282, 293 (1996), aff'd, 161 F.3d 1231 (9th Cir. 1998).

Memo seeks to characterize the uncertainties surrounding the amounts anticipated to be owed in the future as conditions precedent but fails to identify how these uncertainties are the result of any contractual conditions existing before the shipment date. The contingencies on which Memo relies would not prevent from accruing the income if the all events test were otherwise satisfied. Instead, we find that the contingencies herein are in the nature of conditions precedent to future *obligation* to its customers (e.g. its obligation to honor a discount or settle a dispute) rather than conditions precedent to fix contractual right to income resulting from the sale of goods, as asserted by .

Consideration from a contract is includable in gross income notwithstanding the taxpayer may incur or create a reserve for future expenses. *See Bell Electric Co. v. Commissioner*, 45 T.C. 158 (1965), acq.,1966-2 C.B. 4. Accordingly, the contingencies do not preclude income inclusion.

Memo also relies, in part, on a line of authorities that stand for the general proposition that in certain circumstances an accrual basis taxpayer need not accrue unpaid income if the obligor *actually* disputes the validity of the claim. It is not disputed that there are instances in which significant controversy may preclude income accrual in some instances. Nonetheless, advice fails to offer any evidence of actual disputes between and a customer, only probabilities of such disputes. Thus, the authorities cited are distinguishable.
The correct rubric under which to view the anticipated discounts and disputed claims are the timing rules of Section 461(a) and (h). It is fundamental to the all events test

that, although expenses may be deductible before they have become due and payable, the liability must first be firmly established. *See* Treas. Reg. § 1.461-1(a)(2)(i).

Events such as the customer paying promptly or disputing an invoice were necessary to fix liabilities under the Section 461 all events test. Mere estimates of those anticipated liabilities, based on events that had not occurred before the close of the taxable year, were not sufficient to fix liabilities for this purpose.

Memo relies on speculation, reasonable as it may be, rather than the actual occurrence of the necessary events. In so doing, disregards black letter law holding that a taxpayer may not deduct a liability that is contingent, see *Lucas v. American Code Co.,* 280 U.S. 445, 452 (1930), or contested, *see Security Flour Mills Co. v. Commissioner*, 321 U.S. 281, 284 (1944).

Nor may a taxpayer deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year. *Brown v. Helvering*, 291 U.S. 193, 201, 54 S.Ct. 356, 360, 78 L.Ed. 725 (1934); cf. *American Automobile Assn. v. United States*, 367 U.S. 687, 693, 81 S.Ct. 1727, 1730, 6 L.Ed.2d 1109 (1961). On this point, advice specifically disregards the seminal case of *United States v. General Dynamics Corp*., 481 U.S. 239 (1987), in which an accrual-method taxpayer self-insured its medical-reimbursement liability for its employees and established a reserve at the end of the year equal to its anticipated obligation to reimburse employees for medical care already received by the employees from third parties, but for which reimbursement claims had not yet been filed. The taxpayer deducted, at the end of the tax year as an accrued liability, the amount of it was anticipated to owe in the future. The Supreme Court observed that some of the taxpayer's employees might not file a claim for reimbursement for a variety of personal reasons and reasoned that the filing of a claim, not the provision of medical services, "[was] the true condition precedent to liability on the part of the taxpayer." *Id*. at 243-44 & n.5. "A liability cannot be fixed if is subject to some event that must occur for a liability to become due." *Id*. at 244. The Court further held that the near probability of the anticipated expense does not change that outcome, stating that the taxpayer could not "deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year." 481 U.S. at 246.[5]

The Court of Appeals for the Third Circuit, in *Giant Eagle, Inc. v. Commissioner*, 822 F.3d 666 (3d Cir. 2016), *nonacq.*, 2016-40 I.R.B. 424, took a different view of when a

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[5] *See New York Life Ins. Co. v. United States*, 724 F.3d 256 (2d Cir. 2013), the Court of Appeals for the Second Circuit (discussing the rationales of *General Dynamics* and *Hughes Properties* and stressing that expenses cannot be deducted before they are actually incurred, "however high" the chance that they will be incurred); *see also Hallmark Cards, Inc. v. Commissioner*, 90 T.C. 26, 34 (1988) ("The all events test is based on the existence or nonexistence of legal rights or obligations at the close of a particular accounting period, not on the probability—or even absolute certainty—that such right or obligation will arise at some point in the future."); *ABKCO Industries v. Commissioner*, 482 F.2d 150, 151 (3d Cir. 1973) ("a taxpayer using the accrual method of accounting may not deduct any liability until the contingencies relating to such liability are removed").

liability fixes for purposes of the Section 461 all events test. In *Giant Eagle*, the taxpayer, a grocery store chain, was permitted to claim a deduction for unexpired and unredeemed discount-gas points in the taxable year in which customers made the related purchases, because at that point the taxpayer's liability, according to the Third Circuit's reasoning, became fixed under the all events test. The Service has declined to follow *Giant Eagle* outside of the Third Circuit.

[redacted] we find the holding in *General Dynamics* to be controlling and the facts in *Giant Eagle* distinguishable.

At year end, did not and could not know whether any customers would pay promptly and claim the discounts or whether they would dispute their invoices. Under the reasoning of *General Dynamics*, the events necessary to fix obligations to grant the discount or settle customer disputes did not occur by year end. Thus, the fixed prong of the Section 461 all events test was not satisfied.

Giant Eagle still would not save the reasoning in advice. Even if , arguably, were in the jurisdiction of the Third Circuit, could not satisfy the economic performance requirement of Section 461(h). Unlike , the taxpayer in *Giant Eagle* had timely adopted the recurring-item exception, allowing the taxpayer to treat economic performance as occurring in the same tax year in which gas purchases were made. *See* Treas. Reg. § 1.461-5.[6]

Outside the purview of the recurring-item exception, the timing of when economic performance is considered to occur depends on the nature of the liability. For example, economic performance occurs for a refund liability when the refund is paid (whether paid in property, money, or a reduction in the price of goods or services to be provided in the future). Treas. Reg. § 1.461-4(g)(3). This rule generally applies to refund liabilities regardless of whether they are characterized as deductions from gross income, or adjustments. *See* Id.; *see also* Rev. Proc. 2011-17, 2011-5 I.R.B. 441. Thus, refunds reducing gross receipts generally are incurred when paid. Treas. Reg. §§ 1.61-3(a) and 1.446-1(c)(1)(ii)(B).

In absence of a timely election, could not rely on the recurring-item exception to satisfy the economic performance requirement by year end. Rather, economic performance and, thus, the Section 461 all events test with respect to the contingent

[6] Treas. Reg. § 1.461-5(b)(1) provides a recurring item exception to the general rule of economic performance. Under this exception, a liability generally is treated as incurred for a taxable year if: (i) at the end of the taxable year, all events have occurred that establish the fact of the liability and the amount can be determined with reasonable accuracy; (ii) economic performance occurs on or before the earlier of (a) the date that the taxpayer files a return (including extensions) for the taxable year, or (b) the 15th day of the ninth calendar month after the close of the taxable year; (iii) the liability is recurring in nature; and (iv) either the amount of the liability is not material or accrual of the liability in the taxable year results in better matching of the liability against the income to which it relates than would result from accrual of the liability in the taxable year in which economic performance occurs. *See* Rev. Rul. 2007-3.

liabilities would not be met any earlier than when the amounts are paid or credited to a customer’s account. *See* Treas. Reg. § 1.461-4(a)(1).

[redacted].[7] It appears, however, that advice directly contradicts Rev. Rul. 70-78, which concludes that an accrual-method taxpayer may not deduct an addition to its reserve for customers' cash discounts, based on its customers' outstanding accounts receivable at the end of its accounting period, in anticipation of the allowance of cash discounts on those accounts in the following year.

potential liability for preparer penalty.

1. was a “nonsigning tax return preparer” because it advised to take a position that constituted a substantial portion of the return(s).

denies that it was a nonsigning tax return preparer. This position is meritless. The advice it gave to in the Memo met the definitions in the Code and regulations. The Memo directly led to an understatement of income on return of , which was a substantial portion of the return.

Section 7701(36)(A) defines a “return preparer” as

> [A]ny person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by this title or any claim for refund of tax imposed by this title. For purposes of the preceding sentence, the preparation of a substantial portion of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund.

did not sign returns. It can still be a return preparer, however. The regulations under Section 7701 make a distinction between a “signing tax return preparer” and a “nonsigning tax return preparer.” “A signing tax return preparer is the individual tax return preparer who has the primary responsibility for the overall substantive accuracy of the preparation of such return or claim for refund.” Treas. Reg. § 301.7701-15(b)(1). “A nonsigning tax return preparer is any tax return preparer who is not a signing tax return preparer but who prepares all or a substantial portion of a return or claim for refund within the meaning of paragraph (b)(3) of this section with respect to events that have occurred at the time the advice is rendered.” *Id*. at (b)(2). “Examples of nonsigning tax return preparers are tax return preparers who provide advice (written or

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7 [redacted]

oral) to a taxpayer (or to another tax return preparer) when that advice leads to a position or entry that constitutes a substantial portion of the return." *Ibid.* provided written advice to in the form of the Memo, and that advice was followed by the actual return preparer when computing the taxable income.

A firm that employs a tax return preparer subject to a penalty under Section 6694(b) is also subject to a penalty if: (1) one or more members of the principal management (or principal officers) of the firm or a branch office participated in or knew of the conduct proscribed by Section 6694(b); (2) the corporation, partnership, or other firm entity failed to provide reasonable and appropriate procedures for review of the position for which the penalty is imposed; or (3) the corporation, partnership ,or other firm entity disregarded its reasonable and appropriate review procedures through willfulness, recklessness, or gross indifference in the formulation of the advice, or the preparation of the return or claim for refund, that included the position for which the penalty is imposed. Treas. Reg. § 1.6694-3(a)(2); *see also* CCA 201825028.

meets the test for firm liability. The itemized billing statement for the Revenue Recognition engagement, produced on in response to IDR 4, shows that multiple partners or principals participated in the matter. was the billing partner who signed the engagement letter and reviewed the work, and , another senior executive, reviewed and approved the Memo. This knowledge on their part satisfies one of the disjunctive criteria for employer liability for the preparer penalty.

Further, the taxable income item constituted a substantial portion of return. Generally, "substantial portion of a return or claim for refund" means "a substantial portion of the tax required to be shown on a return or claim for refund." Treas. Reg. § 301.7701-15(b)(3). A single entry on a tax return can have such an economic impact on the tax liability of the taxpayer so as to be a "substantial portion" of the tax return itself. *Goulding v. United States*, 717 F. Supp. 545, 551 (N.D. Ill. 1989), *aff'd*, 957 F.2d 1420 (7th Cir. 1992). That was the case here. The understatement of taxable income on return was , and the correct tax due for that year was . See Form 4549-A for . The tax as reported on the return was . Because of the Memo, there was a understatement of tax.[8] As a result, is properly considered a "nonsigning tax return preparer."

2. Because the position resulted in an understatement of tax, is liable for a penalty under Section 6694(b).

[8] Treas. Reg. § 7701-15(b)(3)(i) states that a factor to consider is "the size of the understatement attributable to the item compared to the taxpayer's reported tax liability." Subsection (b)(3)(ii)(A) contains a *de minimis* rule that items involving (i) less than $10,000 or (ii) less than $400,000 and less than 20 percent of gross income will not constitute a "substantial portion" of the return.

Section 6694 has two tiers of return preparer penalties. [redacted]

The first tier, under subsection (a), is for understatements due to an unreasonable position that the preparer knew or reasonably should have known about. The amount of the penalty is the greater of $1,000 or 50 percent of the compensation. Several defenses are available:

- a “substantial authority” defense under subsection (a)(2)(A).
- a “reasonable basis” defense under subsection (a)(2)(B), if the position was disclosed on the return.
- a reasonable-to-believe-that-the-position-would-more-likely-than-not-be-sustained-on-the-merits defense under subsection (a)(2)(C), in the case of a tax shelter or reportable transaction.
- a reasonable-cause-and-good-faith defense under subsection (a)(3).
- a statute-of-limitations defense under Section 6696(d)(1).

[redacted] The relevant return is the one for ; as a result of Memo, an understatement occurred constituting a substantial portion of the return. The return was filed with an extension in . [redacted].[9]

The second tier penalty, under subsection (b), may be assessed “at any time” under Section 6696(d)(1). [redacted]

Section 6694(b) penalizes an understatement due to “willful or reckless conduct.” For returns prepared for tax years ending before December 18, 2015, the amount of the penalty is the greater of $5,000 or 50 percent of the preparer’s income with respect to the return.[10]

In Section 6694(b)(2), willful or reckless conduct is defined as:

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[9] [redacted]

[10] For returns prepared for tax years after December 18, 2015, the maximum penalty was increased to 75 percent pursuant to the Protecting Americans from Tax Hikes Act of 2015 (P.L. 114-113).

(A) a willful attempt in any manner to understate the liability for tax on the return or claim, or

(B) a reckless or intentional disregard of rules or regulations.

The subsection (b) penalty does not provide substantive defenses as under [the] subsection (a) penalty.

A preparer is considered to have willfully attempted to understate liability if the preparer disregards, in an attempt wrongfully to reduce the tax liability of the taxpayer, information furnished by the taxpayer or other persons. Treas. Reg. § 1.6694-3(b).

A preparer is considered to have recklessly or intentionally disregarded a rule or regulation if the preparer takes a position that is contrary to a rule or regulation and the preparer knows of, or is reckless in not knowing of, the rule or regulation in question. Treas. Reg. § 1.6694-3(c). A rule or regulation includes the provisions of the Internal Revenue Code, temporary or final Treasury regulations issued under the Code, and revenue rulings or notices issued by the IRS. Treas. Reg. § 1.6694-3(e).

The preparer has the burden of proof as to the issue of reckless or intentional disregard of a rule or regulation. Treas. Reg. § 1.6694-3(h)(1). The government has the burden of proof as to whether the preparer willfully attempted to understate the liability for tax. Section 7427; Treas. Reg. § 1.6694-3(h).

3. Support for the subsection (b) penalty against .

As discussed above, the return position as set forth in the advice was contrary to established law under Section 461.

Memo improperly provided that was entitled to take into account, e.g. offset its gross income, by the amount of its anticipated liabilities before the amounts were considered incurred. *See* Treas. Reg. § 1.461-1(a)(2)(i). Specifically, the advice failed to consider whether all events necessary to fix liabilities, e.g. prompt payment by customers or settlement with its customers of disputed amounts, had occurred for purposes of the all events test. In the absence of these events by year end, the fixed prong of the Section 461 all-events test, as described in *General Dynamics* and Treas. Reg. § 1.461-2(a)(i), was not satisfied. Nor did the advice consider whether economic performance had occurred with respect to the anticipated liabilities during the applicable tax years. *See* Treas. Reg. § 461(h) and § 1.461-4(g); *see also* Rev. Rul. 70-78.

had to have been aware of Section 461 and the regulations thereof when writing the Memo, so it knew that could not use book accounting to exclude or deduct estimated liabilities for tax reporting.[11] Yet the Memo advised that should do just that. almost certainly intentionally disregarded the rules and regulations.

Memo is also likely a willful disregard or distortion of facts provided by or failure to make appropriate inquiries as to how Contra Account system worked. *See* Treas. Reg. § 1.6694-1(e); § 1.6694-3(b). The Memo focused on the premise that discounts and disputes were conditions precedent that precluded recognition of income, stressing that kept close track of those items in the Contra Account. The Memo downplayed the reality that the Contra Account was based on estimated liabilities in estimated amounts; the Contra Account was a running total of discounts and write-offs that were likely to occur based on historical data, not those that had actually occurred. To claim that the reductions in the Contra Account were “statistically certain to occur” does not change the fact that they were estimated. *See New York Life, supra*, 724 F.3d at 263 (“a liability is not established, by a statistical probability—however high—that the taxpayer will ultimately pay the expense”).

[redacted] However, in *Judisch v. United States*, 755 F.2d 823 (11th Cir. 1985), the Section 6694(b) penalty was upheld because the preparer was aware of requirements for home office deduction but intentionally disregarded them, claiming the deduction for clients without attempting to find out whether they actually met the requirements. In *United States v. Ernst & Whinney*, 735 F.2d 1296 (11th Cir. 1984), a preparer injunction case under Section 7407, the court concluded that the conduct of an accounting firm in advising clients to make unjustified tax credit claims by means of deceptive terminology, including referring to a door, which was nonqualified property, as a “movable partition,” was so linked to the goal of understating tax liability that it came within definition of penalty conduct under Section 6694(b). *See also* IRS NSAR 20032601F, 2003 WL 22205990 (advising that Section 6694(a) and (b) penalties could be asserted against return preparer claiming an impermissible election for a Section 280C research credit).

[redacted]

11

[redacted]

[redacted] focused on potential liability in her individual capacity as a return preparer and tacitly assumed that its liability as her employer would be limited to that amount.[12] But is potentially subject to a penalty in its own right. The statute and regulations do not limit the firm's penalty amount to the employee's penalty amount. To the contrary, Treas. Reg. § 1.6694-1(f) provides that the firm's liability may be based on "all compensation the firm receives or expects to receive with respect to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position(s) taken on the return or claim for refund that gave rise to the understatement." If both an individual within a firm and a firm that employs the individual are subject to a penalty under Section 6694(b), the amount of penalties assessed against the individual and the firm shall not exceed 50 percent of the income derived (or to be derived) by the firm from the engagement of providing tax advice with respect to the position taken on the return that gave rise to the understatement. Treas. Reg. § 1.6694-1(f)(3). The amount of the penalty against would be the greater of $5,000 or 50 percent of the compensation it received with respect to the Memo.[13] Section 6694(b)(1)(B) (as applicable to returns prepared for tax years ending before 12-18-2015). In its response to IDR 4, claims that it invoiced and received for the "Revenue Recognition" engagement. The facts indicate that the actual compensation may have been greater.[14] If the figure is accepted, the penalty would be 50 percent, or .

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[12] Even this contention is inaccurate. [redacted]

[13] As previously noted, acknowledges that the Memo led to a position taken on return but points out that no assessment was made for a deficiency as to that year. That fact does not negate the direct link between the advice in the Memo and the understatement of in taxable income and corresponding understatement of in tax for .

[14] The letter explains that had multiple "engagements" with in . This resulted in total billings of Only related to the Revenue Recognition engagement, claims [redacted]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

None other than those discussed above.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (313) 234-1723 if you have any further questions.

By:

W. Carl Hankla
Attorney
LB&I

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