TaxNewsFlash

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Eleventh Circuit: Substantial understatement penalty reversed

The U.S. Court of Appeals for the Eleventh Circuit today affirmed the Tax Court's findings that the taxpayers were liable for a tax deficiency of approximately $1.78 million due to the improper characterization of income from the sale of real property as capital gain, rather than as ordinary business income.

However, the Eleventh Circuit reversed the Tax Court's imposition of a 20% penalty for substantial understatement of income tax under section 6662. The Eleventh Circuit found that the Tax Court erred in determining that the taxpayers had failed to establish that they had acted with reasonable cause and that the return had been prepared in good faith.

The case is: *Boree v. Commissioner,* No. 14-15149 (11th Cir. September 12, 2016). Read the Eleventh Circuit's **decision** [PDF 142 KB]

Summary

The taxpayers, a married couple, purchased in 2002 about 1,900 acres of vacant land in Florida. The taxpayers then engaged in some development activities. The county adopted certain land use restrictions in 2005, and the taxpayers encountered resistance from the county's commissioners concerning their proposed use of their land. During this period, some lots were sold to individuals (the taxpayers asserted eight lots, but the Tax Court found that 17 lots had been sold).

Eventually, the taxpayers learned that a successful Miami developer was planning a large-scale development on adjoining property, and in 2006, the taxpayers negotiated a real estate purchase agreement with the developer to buy nearly all of the remaining unsold property. The sale was closed in early 2007, with some 1,067 acres selling for about $9.6 million. The taxpayers reported this amount as long-term capital gain, and not as ordinary income.

The IRS determined a tax deficiency of $1.78 million and imposed a substantial understatement penalty exceeding $356,000 on a finding the taxpayers should have characterized the income from the sale as ordinary income, rather than capital gain.

At trial before the Tax Court, the taxpayers asserted that they had purchased the property primarily to hold as an investment and that the lots that had been sold were simply sold to allow them to make payments on the debt that was incurred to purchase the property in the first place. The Tax Court, however, found that the true intent of the taxpayers was to develop the property for sale in the ordinary course of business. The Tax Court also found that the taxpayers were liable for the 20% penalty because they had not established reasonable cause for the underpayment or that the return was prepared in good faith.

On appeal, the Eleventh Circuit affirmed the deficiency determination. However, the appeals court noted that the taxpayers (the husband was a former logger) were untrained in tax matters and had relied in good faith on the return filed by the accounting firm. The Eleventh Circuit concluded that the Tax Court did not elaborate on why it found that the taxpayers did not establish reasonable cause or that their tax return was prepared in good faith, and that the record did not support the Tax Court's conclusion.

Thus, the Eleventh Circuit concluded that the Tax Court had clearly erred in finding that the taxpayers did not establish reasonable cause and that the return was prepared in good faith.