'Flat Sum' Settlements

An 'End Run' Around New York's Reporting Requirements?

By Garrett L. Brodeur

In computing a state resident's adjusted gross income for personal income tax purposes, New York, like many states, starts with the individual's federal adjusted gross income and makes certain additions or subtractions to arrive at the individual's state taxable income [N.Y. Tax Law sections 607(a), 612(a)]. This federal-state conformity simplifies tax administration and makes compliance easier for taxpayers. It also benefits state taxing authorities by allowing them to track federal audit adjustments and "take a bite of the apple" when state residents are assessed additional federal taxable income. To facilitate this tracking, New York Tax Law section 659 requires state taxpayers to report certain adjustments to their federal taxable income to the New York State Department of Taxation and Finance (DTF).

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Some settlement agreements between taxpayers and the IRS—even those that appear to adjust federal taxable income—may not be subject to New York's reporting requirement. For certain flat sum settlements, a 2015 administrative decision by the New York Division of Tax Appeals (DTA) may offer a plausible argument that taxpayers are not required to file a report or an amended return with the DTF to reflect particular adjustments to their federal taxable income.

New York Law and Regulations

Generally, the DTF must assess additional personal income taxes within three years after a state income tax return is filed (N.Y. Tax Law section 683).

But there is an exception to this rule. If, for any taxable year, the IRS (or other competent authority) changes or corrects the amount of a taxpayer's federal taxable income, the total taxable amount or ordinary income portion of a lump sum distribution, or the includible gain of a trust reported on the taxpayer's federal income tax return, the taxpayer must report the change or correction to the DTF within 90 days after the final determination of the change or correction (N.Y. Tax Law section 659; see 20 CRR-NY section 159.5 for the definition of "final determination"). The same rule applies if a taxpayer's claim for credit or refund of federal income tax is disallowed in whole or in part—in that case, the taxpayer must report the disallowance within 90 days after the final determination of the disallowance (N.Y. Tax Law section 659).

The New York Code of Regulations provides additional guidance on the reporting requirement. Under the regulations, taxpayers must report a change or correction, or file an amended New York State income tax return, to reflect the following federal adjustments:

(1) a Federal change or correction or an amended Federal income tax return increasing the taxpayer's Federal taxable income, Federal items of tax preference, or total taxable amount or ordinary income portion of a lump sum distribution;
(2) a Federal change or correction which is treated in the same manner as if it were a deficiency for Federal income tax purposes;
(3) a Federal change or correction decreasing the taxpayer's Federal credit for employment-related expenses;
(4) a Federal change or correction or amended Federal return of income tax withheld increasing the amount required to be deducted and withheld from wages for

Federal income tax purposes; or (5) the disallowance, in whole or in part, of a taxpayer's claim for credit or refund of Federal income tax. [20 CRR-NY section 159.6(a)(1–5)]

New York State residents must report federal adjustments regardless of whether they believe those adjustments will require modification of their state income tax liability [20 CRR-NY section 159.2(a)]. Different rules apply for nonresidents.

If a taxpayer fails to report or file an amended return within 90 days after the final determination of an adjustment, the statute of limitations on assessment remains open indefinitely, and the DTF may make an assessment of New York State income tax at any time [20 CRR-NY section 159.6(a)]. On the other hand, if the taxpayer properly and timely reports or files an amended return, the DTF must make any assessment within two years after the taxpayer files the report or amended New York State income tax return [20 CRR-NY section 159.6(b)].

Most settlements with the IRS involve routine adjustments to federal taxable income (e.g., an increase or decrease in taxable income, a decrease in a federal credit for employment-related expenses, or an increase in the amount required to be deducted or withheld from wages for federal income tax purposes). These adjustments clearly fall within the types of changes listed in the regulations and must be reported. But certain settlements—particularly those involving large-scale, global resolutions of multiple liabilities attributable to different years—might involve adjustments that do not fall squarely within the regulations or combine multiple adjustments into a single settlement amount. For taxpayers or practitioners negotiating these types of settlements, it is reasonable to ask whether this settlement would give rise to a reportable federal change under New York State law.

In 2015, a decision by the New York DTA suggested a possible "end run" around New York State's reporting requirements under specific circumstances.

In re Petition of Bentley Blum

In re Bentley Blum [DTA 825455 (N.Y. Div. Tax App., Apr. 16, 2015)] dealt with the consequences of a disallowed tax shelter transaction and held that an individual taxpayer's flat sum settlement of his federal tax liabilities with the IRS did not constitute a change in federal taxable income that was required to be reported to New York State under Tax Law section 659. In deciding *In re Bentley Blum,* the administrative law judge (ALJ) took a narrow view of the federal change reporting requirement of Tax Law section 659, essentially looking past the adjustments proposed in the initial IRS revenue agent's report and emphasizing the fact that the parties' final settlement did not explicitly reflect a change in federal taxable income.

Blum and the tax shelter arrangement. The petitioner, Bentley Blum, was involved in a tax shelter arrangement through which he controlled a variety of corporations engaged in the promotion, sale, and operation of oil and gas drilling interests during the tax years 1994 through 1996. Blum created several TEFRA partnerships to contract with the corporations for the exploration, drilling, and completion of oil and gas wells. [TEFRA refers to the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248, section 402(a), 96 Stat. at 648), which established a unified procedure for determining the tax treatment of partnership items at the partnership level.] Blum sold interests in the partnerships to U.S. investors, who submitted cash payments equal to roughly 15% of their total investments and signed long-term promissory notes for the balance. After the partnerships transferred these investment funds to the various corporations and promoters,

they claimed substantial losses for drilling and operational costs during the years at issue, which passed through to the individual investors.

IRS audit and examination report. After the IRS conducted an examination of the partnerships, it determined that the losses they claimed should be disallowed because, among other issues, the partnerships were merely tax shelters without a business purpose or profit motive. The IRS also recharacterized certain intercompany transfers as taxable income to the promoters (including Blum) as either gross receipts or constructive dividends. After the examination, the IRS issued a revenue agent's report that proposed adjustments to Blum's taxable income based partly on the receipt of constructive dividends and a reduction of net operating loss carryover for the tax years 1994 through 1997.

Flat sum settlement and deficiency notice. The ALJ's findings of fact indicate that the parties reached a settlement following months of continued negotiations after the IRS concluded its examination in February 2000 *(In re Bentley Blum,* DTA 825455, p. 4). The IRS first settled the partnership cases by allowing the investors' claimed losses in an amount equal to their initial cash investment plus 50% of the face amount of their promissory notes. Then the IRS used a global approach to reach a flat sum settlement with the remaining parties, including the corporations and promoters. At the corporate level, the IRS agreed to a settlement of $2.2 million with an entity related to Blum for the entity's 1997 tax year. In addition, the IRS agreed to a settlement with Blum (as a promoter) of $510,000 for the 1996 tax year in resolution of Blum's liabilities for the tax years 1994 through 1996. The parties also agreed to a 50% reduction of the net operating loss carry forward that Blum had reported for 1997.

Blum timely filed a New York State personal income tax return for tax year 1996; thus, at the time of the settlement with the IRS in the summer of 2000, the general three-year statute of limitations for assessment already had expired (N.Y. Tax Law section 683).

In May 2012, the DTF issued a notice of deficiency, assessing a deficiency in New York State and New York City personal income tax of $159,561 plus interest for a total balance due of $473,209. The notice explained that the deficiency was based on Blum's failure to report a federal change in his income tax liabilities for tax year 1996. Blum then filed a petition for a redetermination of the deficiency or alternatively for a refund of New York State and New York City personal income taxes for 1996.

Litigation and ALJ decision. Blum argued that Tax Law section 659 did not require him to report the flat sum settlement with the IRS because it was not a change to his adjusted gross income or taxable income for tax year 1996. Accordingly, he was compliant with New York State's reporting requirements and the DTF's assessment of the deficiency was time-barred by the state's general three-year limitations period (N.Y. Tax Law section 683).

The DTF countered that Blum failed to properly report pursuant to Tax Law section 659, and therefore the limitations period on assessment remained open indefinitely. Pointing to the proposed adjustments to Blum's federal taxable income in the IRS's initial revenue agent's report, the DTF argued that the flat sum settlement figure reached by the parties under the global resolution was "simply an extrapolation of the changes made by the IRS" (*In re Bentley Blum,* DTA 825455, p. 6). According to the DTF, the parties' agreed settlement amount of $510,000 "was tax that [Blum] paid on behalf of his investors that would have otherwise been assessed but was deemed [Blum's] tax" (DTA 825455, p. 3).

The ALJ determined that the IRS settlement of $510,000 in taxes due for 1996 was a "'flat sum settlement' that constituted an agreed-upon sum in satisfaction of the liability of petitioner and other parties" and "was not a change in petitioner's taxable income" (DTA 825455, p. 7). The ALJ further noted that "a careful reading of Tax Law section

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659 shows that a taxpayer is directed to report certain specific changes to New York" and "a flat sum settlement is not one of the changes listed." Accordingly, "there was no federal change mentioned by Tax Law section 659 that petitioner was required to report and … the Notice of Deficiency was barred by the statute of limitations" (DTA 825455, p. 4).

Practical Insights

It seems clear (and the DTF argued as such) that Blum would not have owed additional tax if there had not been some sort of adjustment made to his federal taxable income. Nevertheless, the ALJ did not consider the proposed adjustments in the IRS's initial revenue agent's report; instead, the ALJ focused on the fact that the parties' final settlement agreement did not explicitly reflect a change in federal taxable income. To this author's knowledge, *In re Bentley Blum* remains the last decision (by an ALJ or otherwise) to address a taxpayer's reporting obligations under Tax Law section 659 with respect to a flat sum settlement. The DTF did not appeal to the Tax Appeals Tribunal (20 CRR-NY section 3000.17) and the only subsequent history in the matter was a denial of Blum's application for litigation costs [2015 WL 5927529, DTA 825455 (N.Y. Div. Tax App. Oct. 1, 2015)].

In light of *In re Bentley Blum,* taxpayers and preparers in New York State should be mindful when negotiating with the IRS that certain types of settlement arrangements may not give rise to a reportable federal change for purposes of Tax Law section 659. If it can be demonstrated that a settlement combines several adjustments to federal taxable income into a global, flat sum amount resolving liabilities attributable to different taxable years or different taxpayers, there may be a plausible argument that the settlement does not require the filing of a report or an amended return with the DTF. (The New York Code of Regulations specifies certain types of federal adjustments that must be reported. If any of the adjustments referenced therein are explicitly reflected or documented in a settlement agreement, an argument relying on the decision in *In re Bentley Blum* would likely prove unavailing.) Though plausible, this position remains tenuous given the nonprecedential nature of ALJ decisions. [See 20 CRR-NY section 3000.15(e)(2) ("determinations of administrative law judges are not considered precedent, nor are they given any force or effect in other proceedings in the division of tax appeals").]

Aside from its immediate holding, *In re Bentley Blum* also highlights several practical considerations for New York taxpayers. First, the interest rate on tax in New York State is relatively high (usually 7–8%, compounding daily), so taxpayers who fail to file an amended return could face substantial interest charges on any deficiency assessed by the DTF. For example, if Blum's legal argument had failed, he would have owed roughly $313,648 in interest at the time of assessment—nearly twice the amount of his tax liability. Second, New York State provides a very liberal voluntary disclosure program. (See NY State Dept. of Taxation and Finance—Voluntary Disclosure and Compliance Program, https://on.ny.gov/3CA5nht.) Eligible taxpayers who choose to participate in the program and voluntarily file amended returns (before the IRS reports an adjustment) can avoid monetary penalties and possible criminal charges by securing a closing agreement from New York State.

In considering the issues discussed above, CPAs should follow all applicable ethics requirements, including those found in the AICPA Code of Professional Conduct, the AICPA's Statements on Standards for Tax Services, and New York State's tax preparer regulations (20 CRR-NY section 2600-4, "Duties and Responsibilities of Tax Return Preparers"). In addition, legal counsel should follow the New York Rules of Professional Conduct (Rule 1.4 and related comments) in negotiating with federal authorities or offering legal advice concerning the issues raised by *In re Bentley Blum*. As a safeguard against a potential claim of malpractice, counsel should also document any client discussions regarding a decision not to file or report, particularly given the nonprecedential nature of *In re Bentley Blum.* ■

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