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Duty of Consistency Limited: 'Belmont Interests v. Commissioner'

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From time to time a corporation or its advisers will consider taking a position on an income tax return which is advantageous in the year for which returns are being prepared but inconsistent with a position taken on a return for a prior year, perhaps a year with respect to which the statute of limitations period for assessment of additional tax has run. Even where it is reasonably clear that the earlier position was erroneous, the IRS has a powerful argument against the inconsistent position in the later year, namely, the so-called "duty of consistency."

The duty of consistency is described in the recent Tax Court decision of *Belmont Interests, Inc. v. Commissioner* (TC Memo 2022-60), discussed below, as an equitable doctrine, also sometimes referred to as quasi-estoppel, that "prevents taxpayers from benefiting from their own prior errors or omissions. In particular, '[t]he duty of consistency doctrine prevents a taxpayer from taking one position one year and a contrary position in a later year after the limitations period has run on the first year'" (citation omitted).

However, under cases cited in *Belmont Interests*, the duty of consistency does not apply where the treatment of an item in a prior, closed year reflects a mutual mistake of law by the taxpayer and the Commissioner. The importance of this exception is illustrated by the *Belmont Interests* decision.

Facts in *Belmont Interests*

Belmont Interests, Inc. ("Belmont") was the parent corporation of a consolidated group. Seven lower-tier subsidiaries of Belmont that were also members of the group (the "Loss Subsidiaries") owed indebtedness under notes (the "Notes") evidencing prior debt on which the subsidiaries had defaulted. The Notes required annual payments of interest from 1993 onward and matured in 2007. The Loss Subsidiaries made no payments with respect to the Notes through 2012 but deducted the accrued interest each year, and uniformly reported losses from 1995 through 2013.

The balance sheet included in the consolidated return of Belmont and its subsidiaries for 2011 showed the assets of one of the Loss Subsidiaries as consisting solely of investments in subsidiaries, and the other Loss Subsidiaries as having no assets.

The Loss Subsidiaries were not included in the consolidated return of Belmont in 2012 or 2013 (the two years before the court), but Belmont's counsel acknowledged that the Loss Subsidiaries nonetheless remained members of the consolidated group throughout those years. For 2013, each of the Loss

Subsidiaries filed a return reflecting a full discharge of the indebtedness. The amount of discharged debt was excluded from gross income and applied to reduce net operating losses, as shown on an IRS Form 982 (Reduction of Tax Attributes) included in each return.

Cancellation of debt (COD) income that would normally result from the discharge of debt without payment may be excluded from the debtor's income under Internal Revenue Code section 108(a) to the extent of the debtor's insolvency, and the use of Form 982 suggests that the COD income was excluded from each Loss Subsidiary's gross income on this basis.

Under consolidated return regulations, losses of subsidiaries that are taken into account in computing consolidated taxable income generally result in downward adjustments to the bases of other members of the group in the Loss Subsidiaries' stock, with an excess loss account (ELA) being created to the extent those losses exceed stock basis. The amount of the ELA (which can be analogized to negative basis) with respect to a subsidiary's stock must be included in the income of the group upon various events, including a disposition of the subsidiary's stock outside the group and other events listed in Reg. section 1.1502-19(c)(1)(iii) under the heading of "worthlessness."

The Belmont group was audited by the IRS for various years, including 2007 through 2009 (but not for 2010 or 2011). In response to an information document request from the IRS during the examination for years 2007-09, Belmont provided in March 2011 a document that summarized the interest deducted with respect to the Notes from 1992 through 2008 and related COD income. The document included the following statement: "Installments [sic] payments not made are considered COD income after six years." That treatment was apparently based on an understanding that, under applicable state (Texas) law, the obligation to pay each installment ceased to be enforceable six years after the installment was due. The IRS apparently did not challenge this approach to determining COD income with respect to the Notes.

Subsequently, the IRS ultimately asserted income tax deficiencies for 2012 and 2013 against the consolidated group of which Belmont was the common parent, and Belmont filed a petition for review in the Tax Court. Various rationales for the deficiencies were expressed in the Commissioner's original and amended answers to the petition. Ultimately, with respect to 2013, the Commissioner argued that the pre-2013 tax returns of Belmont effectively represented that the Notes did not become worthless until 2013, in which year the Notes' worthlessness caused the Loss Subsidiaries to meet the worthlessness condition in the ELA regulation, thereby causing the ELA amounts to be includible in income. The Commissioner further asserted that the duty of consistency precluded Belmont from taking a position inconsistent with those representations.

With respect to 2012, the Commissioner apparently asserted (as an alternative position) that Belmont's reporting through 2011 effectively represented that the Loss Subsidiaries did not become worthless within the meaning of the ELA regulation before 2012, that there was a "worthlessness" event with respect to each of the Loss Subsidiaries in that year, and that the duty of consistency precluded Belmont from taking an inconsistent position for 2012.

Belmont filed a motion for summary judgment requesting a ruling that the duty of consistency was not applicable for 2012 or 2013. The main thrust of Belmont's argument was apparently that applicable state law provided for different periods of limitation after which debt would cease to be enforceable depending on characteristics of the debt, with the relevant period being six years if the indebtedness was negotiable and four years if it was not negotiable (although Belmont also acknowledged that the running of the period of limitation with respect to a debt is not necessarily controlling as to when the debt is considered to cease to exist for tax purposes).

Belmont further asserted that the Notes were subject to the four-year limitation period and therefore ceased to be enforceable by 2011, and that the facts as to enforceability were available to the IRS as well as Belmont. Therefore, Belmont argued, the failure to take income attributable to the discharge of debt into account in the correct year (that is, by 2011) was attributable to a mutual mistake in law, and (on the basis of cases discussed in the decision) an error attributable to a mutual mistake in law does not support the application of the duty of consistency.

Discussion

In a closely reasoned decision, the court agreed in part with Belmont. In particular, the court concluded that the Commissioner failed to demonstrate that there was any fact relevant to the time at which the indebtedness evidenced by the Notes was canceled for tax purposes that the IRS did not have while Belmont's 2011 taxable year remained open for the assessment of additional tax. Therefore, the acceptance by the IRS without challenge of Belmont's positions as to enforceability showed a mutual mistake of law, and the duty of consistency did not bind Belmont to its representations in the earlier returns and audits indicating that the Notes should not be considered to have been canceled for federal tax purposes until 2013.

The Commissioner's alternative argument, in support of the asserted deficiency for 2012, survived the motion for summary judgment. The consolidated return regulation relating to excess loss accounts (Reg. section 1.1502-19) provides in part that an ELA with respect to stock of a subsidiary must be taken into account at the time that all of the subsidiary's assets are treated as having been disposed of, abandoned or destroyed for federal tax purposes. Further, the preamble to the regulation as proposed in 2007, as discussed at length in the opinion, indicates that a subsidiary should not be treated as having disposed of all of its assets until it had recognized all items of income, gain, deduction and loss attributable to its assets and operations -- which arguably did not occur before 2012.

Belmont asserted that both it and the IRS ignored the implications of this rule. However, the government argued that the circumstance that the balance sheet included in the 2011 consolidated return did not provide sufficient information to be determinative as to the timing of a worthlessness event. For example, there could have been valuable assets not required to be shown on the balance sheet.

The court concluded that it did not have sufficient information to conclude that Belmont's returns for 2011 and prior years provided the government with all the facts needed to reach a determination as to whether the ELAs were triggered in 2011, and, therefore, that further proceedings would be necessary to determine whether there was a deficiency for 2012. The opinion further states, however, that, in order for the Commissioner to prevail on its alternative argument, the Commissioner will have to establish that the ELAs were not required to be included in income in 2011 or an earlier year by reason of the deemed cancellation of the Notes (taking into account, presumably, applicable state law).

Observations

The *Belmont Properties* decision did not reach a final determination as to one of the two tax years before the court, and it remains uncertain whether the government will file an appeal. Further, in all events the duty of consistency will remain an important tool of the government. Notwithstanding the above, this decision is an important reminder that the consistency rule may not be applicable where, for example, the government has been informed of the relevant facts and accepted the taxpayer's erroneous treatment without challenge in an earlier audit, in the context of a mutual mistake of law.

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