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Correlative Adjustments Denied: 'FAB Holdings v. Commissioner'

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Where a deduction for a payment (such as for services) is denied on audit, a single amount may be taxed more than once. Taxpayers in such situations may seek a correlative adjustment to the tax treatment of the payment by the recipient so as to avoid or mitigate duplicative income inclusions. Unfortunately, such correlative adjustments are commonly denied when the change in the payor's tax treatment does not clearly justify a change in treatment of the payee. In *FAB Holdings, LLC v. Commissioner* (TC Memo 2021-135), circumstances indicated an attempt to obtain more favorable tax treatment through a tax-motivated structure, and the petitioners were unable to obtain any correlative adjustment. The decision underscores the potential for such structures to backfire.

Facts in *FAB Holdings*

FAB Holdings, LLC (FAB), a limited liability company that had elected to be taxed as a corporation, was one of three petitioners before the Tax Court in this recent memorandum decision. The owners of FAB from the time of its formation in 2010 through 2013 (the years at issue) were Frank and Dana Berritto. Ms. Berritto died in 2015, and the other two petitioners were her estate and Mr. Berritto, who worked in the financial industry. He started work for Merrill Lynch in 2010 and continued to work there for the other years at issue.

In 2010 the Berrittos engaged a tax planning firm to develop a plan which involved the organization of Berritto Enterprises, LLC ("Enterprises"), owned by the Berrittos and classified as a partnership for tax purposes, and FAB. The Berrittos contributed securities to Enterprises, and the interest and dividend income and capital gains of Enterprises were passed through to the Berrittos as its members.

Under a management agreement between Enterprises and FAB, Enterprises paid management fees to FAB, and those fees were in turn used by FAB to pay salaries and director fees, to fund an employee benefit program, and to pay for legal and professional services, license fees, taxes, and other expenses. Mr. Berritto was the managing member of Enterprises and the president of FAB. Enterprises reflected the payment of management fees on its returns as expenses resulting in losses flowing through to its members, and FAB reported the fees as income and its salary payments and other expenses as offsetting deductions.

So far as appears from the opinion, no one other than the Berrittos and their professional advisers was employed by, or otherwise provided services to FAB, and FAB did not purport to provide services to any person other than Enterprises.

The returns of Enterprises, FAB, and the Berrittos for the years at issue were prepared and filed by a principal of the firm that created this plan. That individual also consented, on behalf of Mr. Berritto and the estate of Ms. Berritto (collectively "Berritto"), to extensions of time to assess tax that were apparently requested by the IRS in the ensuing audit. The audit resulted in notices of deficiency to Berritto and FAB. The tax deficiencies were premised on: denial of the deductions claimed by Enterprises for management fees; denial of deductions claimed by FAB for salary payments, legal and professional fees, its employee benefit program, director fees, and other expenditures; and increases in the Berrittos' taxable income by reason of expenditures by FAB for the benefit of the Berrittos, which were characterized by the examining agent as constructive dividends to them.

The IRS rationale for the adjustments to the income of Enterprises and FAB does not appear in the opinion, but the circumstances suggest that the agent may have concluded that Enterprises held the securities as investments, but was not engaged in a "trade or business," and that FAB was not engaged in a trade or business either. A footnote in the opinion (note 23) states that IRC section 482, generally relating to adjustments of income and expense arising between businesses under common control, "was not argued by the parties" and was not at issue in the case.

Issues Discussed in Opinion

The petitioners first argued that the extensions of time to assess tax signed by the tax planner were not valid (and therefore that the period of time in which tax could be assessed for most of the years at issue had lapsed before the notices of deficiency were issued), because the tax planner who signed most of the extensions, as the promoter of the structure, had an inherent conflict of interest preventing him from having authority to act as representative of the Berrittos or FAB.

The court found, however, that the cases cited by the petitioners as classifying tax advisers in certain other contexts as promoters did not support this argument. The Berrittos' adviser, by providing tax planning services and acting as a paid tax return preparer, was not viewed as having a conflict that would preclude him from acting as the representative of the Berrittos and FAB, at least absent special circumstances, such as evidence (not present here) that the planner/preparer was under criminal investigation by the federal tax authorities.

With respect to the adjustments relating to Enterprises, Berritto did not dispute the denial of deductions for the purported management fees, but asserted that there should be a correlative adjustment to the income of FAB, reducing its income by the amount of the management fees for which deductions were denied. Berritto might have argued that these payments should be viewed as, instead, distributions by Enterprises directly to its members (who were also the owners of FAB), but that is not stated in the opinion. The petitioners did argue that, without a correlative adjustment, Berritto would otherwise be "double taxed" -- that is, on the income of Enterprises as passed through to them without offset by deductions for these fees, and also on the further payments made by FAB to its owners through use of the funds received from Enterprises.

The petitioners cited, in support of such an adjustment, *Alondra Industries, Ltd. v. Commissioner* (TC Memo 1996-32), in which the Tax Court had expressed reluctance to deny deductions to partners of a partnership (all corporations) for payments by them to the partnership for management services. There deductions claimed by the partnership were being denied for amounts paid as compensation to the individual who (with his daughter) owned the partners. The court in *Alondra* was troubled by the circumstance that that those same payments, included in the income of the ultimate owner, would also be included in the income of the partnership without offset for the payments by the partnership to the individual, and suggested that the partnership should instead be viewed as a mere conduit.

The court in *FAB Holdings* found *Alondra* to be distinguishable, primarily on the basis that the payments in *FAB Holdings* were made to a separate entity that was a C corporation not owned by the payor. The court also asserted that FAB had "significant other transactions that affected third parties" (although a footnote observed that "[o]ne such transaction was a funded profit-sharing plan that benefited the Berrittos," and did not describe any other transactions).

The court further observed (citing various cases) that there were benefits associated with doing business through a corporation (or an entity classified as a corporation) and that, along with those potential benefits, the petitioners must accept the consequences -- which included the possibility that fees paid to FAB would retain their character as income taxable to it, notwithstanding the denial of deductions for such expenditures made by Enterprises.

The court also upheld the government's treatment of payments made by FAB for salary, legal and professional fees, long-term care insurance, employee benefit programs, director fees, and taxes and license fees, as constructive dividends to the owners of FAB (without elaboration as to why all of these expenditures were considered to be personal expenses).

Berritto argued that, given the denial of deductions to Enterprises for management fees, FAB was entitled to a correlative adjustment to exclude those fees from its earnings and profits. Because corporate distributions are treated as dividends for tax purposes only to the extent made from the corporation's earnings and profits, such an exclusion might in turn have reduced the constructive distributions that would be characterized as dividends under IRC section 301.

Once again, however, the court was unpersuaded by the correlative adjustment argument, effectively holding FAB to the form of the transaction as the recipient of management fees with the resulting earnings and profits, notwithstanding the apparent expectation that all the funds received by FAB would be paid to or otherwise applied for the benefit of its owners.

As an extremely modest victory for Berritto, however, the court determined that the amounts paid by FAB to the Berrittos as director fees, which had already been included in their incomes as such, could not be included in their incomes a second time as constructive distributions.

Observations

Another court might have responded to the petitioners' arguments by adopting a different characterization of at least some of the payments, for example by characterizing the payments by Enterprises to FAB as distributions from Enterprises to its members (which also owned FAB), in a manner that would have

reduced the tax deficiencies. However, it is unsurprising that this court, in this context, involving an effort by the Berrittos to use a complicated structure to claim tax benefits not ordinarily available, held the Berrittos and FAB to their form and sustained IRS determinations made on that basis.

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