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Client Alert

Fifth Circuit Faults IRS Attempt To Impose Intermediate Sanctions On Owners Of Home Health Care Agencies

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The U.S. Court of Appeals for the Fifth Circuit has criticized errors made by the Internal Revenue Service ("IRS") and Tax Court in a case involving the "intermediate sanctions" provided under section 4958 of the Internal Revenue Code. *Caracci v. Commissioner*, ___ F.3d ___ (5th Cir. July 11, 2006), rev'g 118 T.C. 379 (2002). Because of these errors, the appeals court decided that the taxpayers were not liable for the taxes the IRS sought to impose.

This case involved the conversion of certain tax-exempt organizations (the "Sta-Home" entities) from non-profit to for-profit status. The conversion was accomplished by transferring the assets and liabilities of the Sta-Home entities, which provided home health care services to Medicare and Medicaid clients in rural Mississippi, to S corporations controlled by the Caraccis, who also operated the Sta-Home entities. In making the conversion, the Caraccis retained attorneys and accountants who concluded that the liabilities of the Sta-Home entities, which had a history of losses, exceeded their assets. Consequently, no value was transferred to the Sta-Home entities in the conversion transaction other than the assumption of their liabilities. Upon audit, however, the IRS concluded that the Sta-Home entities did have value in excess of liabilities and sought to impose intermediate sanctions, income taxes and penalties on the Caraccis.

According to the appeals court, a "cascade of errors" began when the IRS issued a notice determining more than $250,000,000 of excise taxes and over $8,000,000 of income tax deficiencies and penalties (plus interest) based on a "brief, intermediate internal analysis." The IRS did not concede that the determination was excessive until the opening of the trial. The appeals court found that this concession established that the determination was arbitrary and excessive, and that the Tax Court should have shifted the burden of proof to the IRS at that point.

Furthermore, the appeals court found significant flaws in the valuation evidence presented by the IRS and accepted by the Tax Court, noting that the IRS expert and the Tax Court used the wrong method to value the entities, relying on an "invested capital" method rather than an asset valuation method. The IRS expert and the Tax Court also relied on data for companies that were not comparable to the Sta-Home entities to value the invested capital. The appeals court noted other errors in the Tax Court's opinion that led the trial court to mistakenly conclude that the Sta-Home entities had a net positive value. The appeals court also noted that there was no dispute that the value of the Sta-Home entities' tangible assets was substantially less than their liabilities, as determined by the Caraccis' expert witness, and that there was no basis for finding that the value of any intangible assets held by the Sta-Home entities exceeded their net liabilities. The appeals court accordingly rendered judgment in favor of the Caraccis.

This case demonstrates the importance of valuation issues in intermediate sanctions controversies. There was essentially no dispute as to whether intermediate sanctions would apply to the Caraccis if the Sta-Home entities had a net positive value. Rather, the case revolved around the appropriate approach to the valuation of the Sta-Home entities. The taxpayers were able, with the appropriate expert assistance, to demonstrate that the conversion of the Sta-Home entities afforded them no unwarranted benefits and relieved them of liability for a massive amount of taxes and penalties. Other taxpayers contemplating transactions that might be subject to intermediate sanctions would be well advised to secure appropriate professional assistance in planning and executing such transactions. The case may also serve as a warning to the IRS against employing overly aggressive valuation tactics.

Circular 230 Disclaimer

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