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19-P-141 Appeals Court

DAVID J. POGORELC vs. COMMISSIONER OF REVENUE.

No. 19-P-141.

Suffolk. April 15, 2020. - July 15, 2020.

Present: Green, C.J., Henry, & Sacks, JJ.

Taxation, Abatement, Income tax, Capital gain. Estoppel.

Appeal from a decision of the Appellate Tax Board.

The case was submitted on briefs.
David J. Pogorelc, pro se.
Maura Healey, Attorney General, Kevin W. Brown, Special Assistant Attorney General, & Brett M. Goldberg for Commissioner of Revenue.

GREEN, C.J. The taxpayer, David J. Pogorelc, appeals from the denial of his tax abatement application in which he sought a refund of over $300,000 in personal income tax for the 2011 tax year. In 2007, Pogorelc and his business partner refinanced a residential rental property that they owned through a limited liability company (LLC). As part of the refinancing, they transferred fifty percent ownership of the LLC to a third party,

in exchange for the third party's assumption of one-half of the debt associated with the residential rental property. Pogorelc reported the transaction as a "deemed sale," generating a capital loss of $4.2 million on his 2007 tax filings. Pogorelc realized the benefit of the $4.2 million capital loss by offsetting unrelated capital gains generated in 2007 and 2008, reducing his tax liability in those years by a total of over $200,000. In 2011, the LLC sold the residential rental property, generating a capital gain of $7.5 million for Pogorelc, on which he was taxed $365,078 in 2011 as personal income tax. Pogorelc now seeks the abatement and refund of a majority of that $365,078.

Pogorelc contends that the treatment of the 2007 transaction as a "deemed sale" in his 2007 return was erroneous under Massachusetts tax law, with the result that he paid excess tax in 2011. The Commissioner of Revenue (commissioner) denied Pogorelc's application for abatement. On appeal to the Appellate Tax Board (board), the board ruled for the commissioner, finding that the 2007 transaction was properly treated as a "deemed sale." Adopting the Federal rule of the "duty of consistency," we affirm the board's decision.

Background. 1. Initial ownership structure. In January 2006, Pogorelc and his business partner formed Heaven at Seven, LLC (Heaven). Pogorelc owned seventy-five percent of Heaven and

his business partner owned the other twenty-five percent. Heaven was in turn the sole member, or owner, of another LLC named 7 Seaport, LLC (Seaport LLC). Because Seaport LLC was owned solely by Heaven, Seaport LLC was not treated as a separate taxable entity from Heaven. In February 2006, Seaport LLC purchased a residential rental property in Quincy (Seaport property), financed through a mortgage.

2. The 2007 transaction. In October 2007, as part of a refinance of the Seaport property, Heaven transferred one-half of its ownership interest in Seaport LLC to Meadows at Marina Bay, LLC (Meadows), a third party. In return, Meadows legally assumed one-half of Seaport LLC's liabilities, which included one-half of the debt associated with the Seaport property. (We refer hereafter to this transfer of ownership interest and assumption of debt as the 2007 transaction.) Though no cash exchanged hands, in line with the guidance provided by the Internal Revenue Service's Revenue Ruling 99-5, the 2007 transaction was treated as (or "deemed") a sale of one-half of the Seaport property from Heaven to Meadows. See Rev. Rul. 99-5, 1999-1 C.B. 434. We summarize Revenue Ruling 99-5 and its application to the 2007 transaction in the margin.[1]

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[1] Revenue Ruling 99-5 is an Internal Revenue Service ruling that describes the tax consequences of two possible situations in which a single-member LLC is converted into a multiple-member LLC, and the tax consequences of each. Revenue Ruling 99-5

As a "deemed sale," the 2007 transaction was a transaction upon which Heaven could realize a capital gain or loss. Indeed, Heaven realized a $5.6 million capital loss from this transaction,[2] and as seventy-five percent owner of Heaven, Pogorelc realized a $4.2 million capital loss from this transaction. Pogorelc used the $4.2 million of capital loss to offset unrelated capital gains in 2007 and 2008, reducing his tax liability in those years by a total of over $200,000. Pogorelc filed his 2007 and 2008 tax returns on or before October 15, 2008, and October 15, 2009, respectively.

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applied because the 2007 transaction converted Seaport LLC from a single-member LLC to a multiple-member LLC.

In "Situation 1," the original member of the LLC (i.e., Heaven) sells part of its ownership interest in the LLC to a new member (i.e., Meadows). Because the 2007 transaction was properly categorized as a "Situation 1," the tax consequence according to Revenue Ruling 99-5 is that the 2007 transaction "is <u>treated</u> as [Meadows's] purchase of a 50% interest in each of [Seaport LLC's] assets [i.e., the Seaport property], which are treated as <u>held directly by [Heaven] for federal tax purposes</u>" (emphasis added). Rev. Rul. 99-5, 1999-1 C.B. 434.

To fall under "Situation 2," the new member (i.e., Meadows) would contribute assets directly to the LLC (i.e., Seaport LLC) in exchange for an ownership interest. Had the parties chosen to structure the 2007 transaction this way, there would be no deemed sale and Heaven would not have realized any capital gains or losses from the 2007 transaction. See Rev. Rul. 99-5, 1999-1 C.B. 434.

[2] Heaven realized a $5.6 million capital loss when it transferred one-half of Seaport LLC's assets ($16.7 million) to Meadows in exchange for Meadows's assumption of one-half of Seaport LLC's liabilities ($11.1 million).

Immediately after the 2007 transaction, Heaven transferred its interest in Seaport LLC to DB Member, LLC (DB Member). As with Heaven, Pogorelc owned seventy-five percent of DB Member. The same business partner who previously owned twenty-five percent of Heaven owned the other twenty-five percent of DB Member. DB Member and Meadows each held one-half of the ownership interest in Seaport LLC.

3. The 2011 sale. In January 2011, Seaport LLC sold the Seaport property for approximately $35.5 million. As a result of the 2007 transaction's treatment as a deemed sale in the 2007 return, Seaport LLC's adjusted tax basis in the Seaport property was approximately $22 million.[3] From the 2011 sale, Seaport LLC realized a capital gain of approximately $13.5 million, and for reasons specific to the operating agreement of Seaport LLC, $10.1 million of that was distributed to DB Member. As seventy-five percent owner of DB Member, Pogorelc realized and reported a $7.56 million capital gain from the sale of the Seaport

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[3] A tax basis is a value used to calculate the capital gain or capital loss that a property owner realizes when he sells a property. A tax basis is adjusted to account for tax benefits already realized on the asset. See https://www.irs.gov/publications/p551, Publication 551 (12/2018), Basis of Assets [https://perma.cc/SN6V-ZXJ2].

An owner realizes a capital gain equal to the difference between the amount realized from the sale of a property and the adjusted tax basis. Thus, when the tax basis of an asset is adjusted lower, the capital gain from a sale of that asset is higher, and the corresponding tax liability is higher.

property. After offsetting other capital losses, Pogorelc's net capital gain in 2011 was $6.89 million.[4] Accordingly, Pogorelc paid a Massachusetts personal income tax of $365,078 (i.e., 5.3 percent of $6.89 million) on the capital gains realized from the sale of the Seaport property.

Procedural posture. On or before October 15, 2012, Pogorelc filed his Massachusetts income tax return for the 2011 tax year, listing the $6.89 million capital gain and the corresponding $365,078 tax. In December 2012, Pogorelc filed an abatement application seeking a refund of the entire $365,078. Thereafter, he filed two other abatement applications regarding the 2011 tax year, but raising different issues. The commissioner denied the first abatement application, took no action on the second, and granted the third. Pogorelc received a refund of $3,975 upon the grant of the third abatement application.

Pogorelc appealed to the board regarding the first abatement application for the remaining $361,103. Specifically, Pogorelc contended, as he does now, that Massachusetts does not follow the tax consequences prescribed by Revenue Ruling 99-5

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[4] For Federal tax purposes, Pogorelc was able to offset $6.8 million of capital gains through net operating loss carryovers from 2007-2010, substantially reducing his Federal tax liability from the Seaport property sale. However, Massachusetts income tax law does not allow such carryovers. See G. L. c. 62, § 2 (d) (1) (C).

because Massachusetts does not tax "fictional" gains or losses from deemed sales. Therefore, Pogorelc argued, his Massachusetts tax basis on the Seaport property should not have been adjusted downward after the 2007 transaction, which was not a "real" sale but merely a "deemed" sale. Accordingly, his argument continued, because the tax basis of the Seaport property was adjusted downward based on his 2007 return, Pogorelc recorded an erroneously high capital gain after the 2011 sale and was overtaxed in 2011. See note 3, supra. The board ruled in favor of the commissioner, and Pogorelc appealed the board's decision pursuant to G. L. c. 58A, § 13.

Discussion. Observing that Massachusetts follows Federal tax classifications and consequences unless they explicitly conflict with Massachusetts law, the board concluded that the tax consequence prescribed by Revenue Ruling 99-5 was correctly applied to the 2007 transaction for Massachusetts tax purposes. See 830 Code Mass. Regs. § 63.30.3(4)(a) (2009) ("To the extent rules or principles are not otherwise described in [this regulation], the Massachusetts tax consequences of . . . deemed transactions . . . will generally be determined by applying federal rules and principles . . ."). See also General Mills, Inc. v. Commissioner of Revenue, 440 Mass. 154, 170-171 (2003), cert. denied, 541 U.S. 973 (2004). The board also found that the 2007 transaction was not a "fiction" but rather produced

real economic changes, such as a change in the ownership structure of Seaport LLC and a discharge of $11.1 million of debt for Heaven. See Bill DeLuca Enters., Inc. v. Commissioner of Revenue, 431 Mass. 314, 322-323 (2000).

While the board's analysis appears to be "based on both substantial evidence and a correct application of the law," Boston Professional Hockey Ass'n v. Commissioner of Revenue, 443 Mass. 276, 285 (2005), we need not resolve the case on its merits to affirm the board's decision. We hold that Pogorelc is estopped from raising his challenge by the duty of consistency.

The duty of consistency prevents a taxpayer who has already benefited from taking a certain position on a tax issue from later taking an inconsistent position on the same issue in order to further his benefit. See Beltzer v. United States, 495 F.2d 211, 212 (8th Cir. 1974). The duty of consistency arises when (1) the taxpayer made a representation for tax purposes in one year, (2) the commissioner has acquiesced in or relied on that representation for that year, and (3) now, after the statute of limitations bars correction of that representation, the taxpayer attempts to change the representation or recharacterize the situation in such a way that harms the commissioner. See Eagan v. United States, 80 F.3d 13, 17 (1st Cir. 1996). "When these requirements are met, 'the [c]ommissioner may act as if the previous representation, on which he relied, continued to be

true, even if it is not. The taxpayer is estopped to assert the contrary.'" Id., quoting Herrington v. Commissioner of Internal Revenue, 854 F.2d 755, 758 (5th Cir. 1988), cert. denied, 490 U.S. 1065 (1989).

Though this is the first time that we apply this doctrine in Massachusetts law, the duty of consistency is hardly new. It is a well-established doctrine in Federal tax law. See Johnson, The Taxpayer's Duty of Consistency, 46 Tax L. Rev. 537, 538 (Summer 1991). Moreover, none of the doctrine's underlying principles are novel; the duty of consistency is merely an application of traditional equitable principles to tax law.[5] See R.H. Stearns Co. v. United States, 291 U.S. 54, 61-62 (1934). In R.H. Stearns Co., a taxpayer overpaid taxes in 1918 and requested that the overpayment be credited to his unpaid taxes from 1917. Id. at 57-58. The tax authority acquiesced in this request. Id. at 58. Almost six years later, the taxpayer attempted to reclaim the overpayment from 1918, claiming that the application of the 1918 overpayment to 1917 taxes was

[5] For an example of another occasion on which we have adopted an estoppel theory developed in Federal tax cases for application to similar circumstances under Massachusetts law, see Tenneco Inc. v. Commissioner of Revenue, 57 Mass. App. Ct. 42, 46 (2003), citing Romano v. Weiss, 26 Mass. App. Ct. 162, 171 (1988) (taxpayer obligated to pay taxes arising from its choice to organize affairs in a certain form). Though the commissioner also raises the form disavowal theory in the present case, our disposition of the case obviates any need for us to consider it.

prohibited because the tax authority had not timely signed a waiver of the statute of limitations for the 1917 and 1918 taxes. Id. at 58-59. The Court rejected the taxpayer's claim, stating that "[t]he applicable principle is fundamental and unquestioned. . . . [N]o one shall be permitted to found any claim upon his own inequity or take advantage of his own wrong." Id. at 61-62.

Likewise, the United States Court of Appeals for the Ninth Circuit has noted that the duty of consistency "is not unlike the . . . more familiar doctrine of judicial estoppel" and "not only reflects basic fairness, but also shows a proper regard for the administration of justice and the dignity of the law." Estate of Ashman v. Commissioner of Internal Revenue, 231 F.3d 541, 543-544 (9th Cir. 2000).

The doctrine is based on the sensibility that a "fact fixed for one year ought to remain fixed in all its consequences," Alamo Nat'l Bank of San Antonio v. Commissioner of Internal Revenue, 95 F.2d 622, 623 (5th Cir.), cert. denied, 304 U.S. 577 (1938), or that "truth should not change with the calendar," Johnson, The Taxpayer's Duty of Consistency, 46 Tax L. Rev. at 538. In Eagan, 80 F.3d at 14-15, for example, the taxpayer was held to the tax consequences of representing that he was a statutory employee of a company when, years later, he tried to repudiate that representation. Starting in 1981, Eagan

represented that he was a statutory employee of his company, so taxes on contributions to Eagan's 401(k) retirement plan were deferred until those funds were to be withdrawn. Id. at 15. But when Eagan withdrew the funds in 1989 and was taxed, he contended that starting in 1987 he was no longer a statutory employee, and therefore was not subject to taxes on the withdrawal of funds in 1989. Id. at 16. The United States Court of Appeals for the First Circuit rejected Eagan's contention based on the duty of consistency: "Conveniently for Eagan, the applicable statute of limitations now bars the assessment of tax on most of the contributions to the plan. Thus, if Eagan's argument is accepted, he would have the best of both worlds: the ability to avoid tax on most of the original contributions and on the subsequent withdrawals. . . . We hold that the duty of consistency bars Eagan from taking a position in one year to his advantage, and then later, after correction is barred by the statute of limitations, taking a contrary position to his further advantage." Id. at 14-15.

Similarly, in the present case, should we accept Pogorelc's argument, he too would have "the best of both worlds." He would benefit from the reduction of over $200,000 in tax liability in 2007 and 2008 and avoid the contested levy in 2011. Thus, the duty of consistency requires the denial of Pogorelc's abatement application.

The elements of the duty of consistency are met here. First, Pogorelc reported on his 2007 tax filings that he realized a $4.2 million capital loss on the 2007 transaction by choosing to treat the 2007 transaction as a "deemed sale" consistent with Revenue Ruling 99-5.

Second, the commissioner acquiesced in the representation by accepting Pogorelc's tax returns for 2007 and 2008 as filed, allowing Pogorelc to apply the $4.2 million capital loss to reduce his tax liability in those years by over $200,000, and allowing the statute of limitations to run. See Eagan, 80 F.3d at 17.

Third, Pogorelc now attempts to repudiate the representation made on his 2007 tax filings in order to avoid the levy of taxes in 2011. Specifically, Pogorelc now contends that Massachusetts does not tax "fictional" gains or losses from deemed sales, and that Revenue Ruling 99-5 should not apply in the calculation of Massachusetts taxes. Yet Pogorelc never suggested that the economic substance of the 2007 transaction was "fictional," nor disputed the application of Revenue Ruling 99-5 to it, until he filed his first abatement application in December 2012.[6] By then, the statute of limitations already

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[6] We note that Federal cases have suggested that "the duty of consistency does not apply when the inconsistency concerns a pure question of law and both the taxpayer and the Commissioner had equal access to the facts," but that the duty does apply to

barred the correction of filings regarding the 2007 and 2008 tax years. See G. L. c. 62C, § 37, first par.

With all the elements met, we conclude that the duty of consistency estops Pogorelc from now contending that the 2007 transaction was incorrectly treated as a "deemed sale." As that contention formed the basis of his abatement application, Pogorelc's application for a refund was properly denied. The decision of the Appellate Tax Board is affirmed.

So ordered.

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a "mixed question of fact and law." Herrington, 854 F.2d at 758. Pogorelc raises no challenge in his briefs on appeal to the commissioner's argument based on the duty of consistency, and any defense based on the contention that the treatment of the 2007 transaction in his 2007 tax return was a pure question of law is therefore waived. See G. L. c. 58A, § 13, third par.

In any event, like the court in Herrington we consider there to be "a question of fact, or at best a mixed question of fact and law, concerning which the taxpayers had more information than the [c]ommissioner at the time the initial representations were made." Herrington, 854 F.2d at 758. After all, the ultimate inconsistency in this case is whether or not the 2007 transaction had economic substance.