WHEN IT COMES TO PENALTY ABATEMENT, IS THE I.R.S. OFFSIDE?

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INTRODUCTION

The tax press often champions the value of tax transparency. However, as tax information reporting obligations grow, many taxpayers find that the penalties for inadvertent errors can exceed the tax, even where a taxpayer has reasonable cause for not fully complying with his or her obligations.

Using Treas. Reg. §301.6651-1(c)(1) as guidance, a taxpayer who wishes to avoid the assertion of a penalty for failure to file a tax return must make an affirmative showing of all facts alleged as a reasonable cause for the failure to file such return. If the taxpayer exercised ordinary business care and prudence but was nevertheless unable to file the return within the prescribed time, then the delay is due to reasonable cause.

This article addresses how the foregoing standard is applied. One man's reasonable cause might not be reasonable cause for someone else.

REASONABLE CAUSE

The I.R.S. website[1] states the following with regard to the Delinquent International Information Return Submission Procedures:

> Taxpayers who have identified the need to file delinquent international information returns who are not under a civil examination or a criminal investigation by the IRS and have not already been contacted by the IRS about the delinquent information returns should file the delinquent information returns through normal filing procedures.
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> Penalties may be assessed in accordance with existing procedures.
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> - All delinquent Forms 3520 and 3520-A should be filed according to the applicable instructions for those forms.
> - Taxpayers may attach a reasonable cause statement to each delinquent information return filed for which reasonable cause is being asserted. During processing of the delinquent information return, penalties may be assessed without considering the attached reasonable cause statement. It may be necessary for taxpayers to respond to specific correspondence and submit or resubmit reasonable cause information.

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1 See here.

In practice, the system has proven difficult to administer. Much of the confusion and disagreement have centered on what it means to be reasonable, and the I.R.S. seems to interpret the term counterintuitively. Training material prepared by the I.R.S., consisting of internal guidance and slides, indicate that the I.R.S. has raised the bar that must be met before relief can be granted in many circumstances.[2]

One level of complication is that tax compliance is not a do-it-yourself exercise for people with ordinary jobs. It requires the work of tax professionals, including advisers in regard to front-end planning and tax return preparers when filing season rolls around. The technical nature of tax law means that it can be difficult for a taxpayer to accurately navigate the ins and outs of proper compliance. If filing obligations are not met, who is at fault? An accountant may make a mistake, perhaps a taxpayer did not provide sufficient information to his or her tax preparer, or there may simply have been a breakdown in information flow. Does the assertion of automatic penalties actually promote compliance when a taxpayer other than an investment banker or rocket scientist finds that the professional she engage made an error in compliance? The I.R.S. seems to favor such an approach.

U.S. V. BOYLE

In deciding whether to reduce a taxpayer's penalty, the I.R.S. considers the hazards of litigation, or the potential risk of losing at trial. If the I.R.S. is confident that it will win, concessions to the taxpayer are not likely to be made. Moreover, reports in the tax press suggest the existence of a view that the I.R.S. is allowing mitigation of tax penalties too liberally.

This view is justified under a Supreme Court case, *U.S. v. Boyle*,[3] which addressed a failure to comply due to a tax preparer's error. In *Boyle*, an executor of an estate filed an estate-tax return three months late due to his attorney's administrative error. The executor repeatedly requested updates regarding the preparation of the estate tax return, but did not realize that the deadline had passed. The Supreme Court unanimously rejected the executor's argument that reasonable cause for late filing existed. The executor knew that a return was required and need to be filed within a specified time period beginning as of the date of death of the decedent. A reasonable person would have checked the deadline.

The case seems to provide guidance for cases involving taxpayers who were aware of a filing obligation but did not verify basic details. But when your only guidance is *Boyle*, every problem starts to look unreasonable. Some advisers that the I.R.S. overuses *Boyle* in disputes involving international information return penalties like Form 5471 (Information Return of U.S. Persons With Respect To Certain Foreign Corporations) or Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts).

One I.R.S. training slide gives the hypothetical of an information return that is submitted late because of a software error. The accountant tells the taxpayer that it has been properly filed because he or she has not been notified that the software

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[2] "IRS Appeals Training Materials on Reasonable Cause Worry Practitioners," *Tax Notes*, October 10, 2022; "FOIA Materials Show Appeals' View on Approval of Penalties," Tax Notes, October 10, 2022.

[3] 469 U.S. 241 (1985).

malfunctioned. The slide concludes that *Boyle* removes any hazards of litigation, because of the I.R.S.'s interpretation of *Boyle* as the proposition that taxpayers cannot rely on others to file for them. But *Boyle* relied on the fact that "it requires no special training or effort to ascertain a deadline." Ascertaining whether software malfunctioned might similarly require only common sense, or it might require some level of expertise. But it does not have an obvious answer, which is how the I.R.S. treats the scenario.

The I.R.S. Manuel addresses Hazards of Litigation in the context of penalty abatement as follows:

Hazards of Litigation

1. Penalties may be settled based on hazards of litigation. Unlike Compliance, Appeals may consider the hazards of litigation in attempting to reach a settlement. The proper use of this settlement authority given to Appeals is critical in fulfilling its mission

2. The settlement process is based on the ATE's[4] experience and judgment after considering the facts and the law.

3. ATEs must evaluate the facts pertinent to the issue under consideration, the applicable law, and the potential outcome in the event the case is litigated.

4. The hazards of litigation are the uncertainties of the outcome of the court's decision in the event of a trial.

5. Litigating hazards generally fall into three categories: factual, legal and evidentiary.

Note: Lack of case law should not be considered a hazard of litigation.

6. Appeals may weigh these factors and determine an appropriate settlement range for the issue and obtain a realistic settlement.

WHERE CASES FIND REASONABLE CAUSE

Courts have held that reliance on a qualified adviser may demonstrate reasonable cause and good faith if the evidence shows that the taxpayer relied on a competent tax adviser and provided the adviser with all necessary and relevant information.[5] To conclude otherwise, would nullify the very purpose of seeking the advice of a presumed expert in the first place.[6] Even *Boyle*[7] acknowledged that when a taxpayer selects a competent tax adviser and supplies him or her with all relevant information, it is consistent with ordinary business care and prudence to rely upon his or her professional judgment as to the taxpayer's tax obligations.

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[4] Appeals Technical Employee's.

[5] *Tebarco Mechanical Corp. v. Commr.,* T.C. Memo 1997-311, at p. 35 (citations omitted).

[6] *Longoria v. Commissioner,* T.C. Memo 2009-162, at p. 37.

[7] 469 U.S. 241,at 250-251 (1985).

In *Neonatology v. Commr.*,[8] the Tax Court framed the inquiry into whether reliance on an outside advisor constitutes reasonable cause in the following manner:

1. Was the advisor a competent professional who had sufficient expertise to justify reliance?

2. Did the taxpayer provide necessary and accurate information to the advisor?

3. Did the taxpayer actually rely in good faith on the advisor's judgment?

The Tax Court further addressed the taxpayer's burden that must be met when demonstrating reliance. It held that a taxpayer must prove by a preponderance of the evidence that each of the above requirements has been met.

Kelly v. Commr.,[9] is a case involving complex facts resulting, in part, in the assertion of penalties for the failure to file timely Forms 5471 with regard to several C.F.C.'s owned by the taxpayer. The taxpayer asserted the three-prong test of *Neontology v. Commr*., and the court accepted the assertion that he reasonably relied on a firm of accountants even though the firm failed to identify the Form 5471 filing requirement.

> [The accounting firm] has prepared Mr. Kelly's personal returns since 2000, including Schedules C for his affiliated companies. [The accounting firm] prepared approximately 700 tax returns per year. Mr. Scott was the primary contact for the preparation of Mr. Kelly's returns. Mr. Scott is a C.P.A. with no history of adverse disciplinary actions or IRS preparer penalties. He had decades of experience with Federal tax return preparation but had no prior knowledge of Form 5471 in 2009. It was reasonable for Mr. Kelly to rely on Mr. Scott. [The accounting firm] was adequately advised that Mr. Kelly owned a Cayman Islands entity. Mr. Kelly's staff pointed out that there might be a different reporting. Conversely, in Flume, the taxpayer failed to provide his tax return preparer all the necessary information.
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> Respondent contends that it was not enough for Mr. Kelly to inform [the accounting firm] that KY&C was a foreign entity, and he implies that Mr. Kelly should have advised Mr. Scott that Form 5471 was required. The failure to file the Forms 5471 does not present an obvious tax obligation which was negligently omitted from information that a taxpayer provided to the return preparer. Mr. Kelly, through his staff, provided the necessary information to [the accounting firm], identified KY&C as a foreign corporation, and stated that he was unsure of the reporting requirements. Having done this, Mr. Kelly reasonably relied on [the accounting firm] to prepare his returns properly. While it could be argued that [the accounting firm] should have done more to ascertain Mr. Kelly's filing obligations, it was reasonable for Mr. Kelly to rely on [the accounting firm] do so. A taxpayer need not question the advice provided, obtain a second opinion, or monitor the advice received from the professional. *Boyle*, 469 U.S. at 251.

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8 *Neonatology Assocs. v. Comm.*, 115 T.C. 43 (2000).

9 T.C. Memo. 2021-76.

WRZESINSKI V. U.S.

Wrzesinski v. U.S.,[10] a case that was docketed earlier this, involves the late filing of a Form 3520. There, the taxpayer's Polish mother won the lottery and sent her son $830,000 across two years. The amount of the gifts and the foreign identity of the giver triggered an obligation for the taxpayer to file Form 3520 for both years. The taxpayer twice asked a U.S.-based tax accountant whether any filing obligations existed in relation to the receipt of the gift. The tax accountant was an enrolled agent authorized to practice before the I.R.S.[11] Both times, the taxpayer was told that no such obligation existed. The taxpayer had no reason to suspect that the advice was erroneous.

"The approach of the I.R.S. in Wrzesinski v. U.S., under which it would only mitigate the amount of the penalty, but would not abate it completely, raises a more serious question."

Seven years later, the taxpayer wished to make a gift to his godson. He suspected that, as a U.S. person sending a gift abroad, he might have compliance requirements and conducted some research on the internet. He discovered his missed Form 3520 obligations, which he confirmed with an attorney. The taxpayer filed the required Form 3520 for each year. A reasonable-cause statement was attached, indicating that the compliance failure was due to erroneous advice of the Enrolled Agent. Shortly after filing the forms, the taxpayer received Form CP15 Notices of Penalty Charge in the aggregate amount of $87,500 and $207,500. The Notices stated that ignorance of the tax laws was not a basis for penalty abatement under the "reasonable cause" standard and that ordinary business care and prudence require that taxpayers be aware of their tax obligations and file or deposit accordingly. In response, the taxpayer filed a protest letter with the I.R.S. The letter was lost in the I.R.S. system. With the intervention of the Taxpayer Advocate's Office of the I.R.S., the appeal ultimately proceeded. Based on hazards of litigation, not on the proper application of law to the facts, the I.R.S. offered to mitigate but not abate the penalty. This left the taxpayer with a bill for $41,500. The taxpayer paid the penalty, filed a claim for refund, and brought legal action when the claim was denied. The case has not yet been heard.

TOLL CHARGE TO OBTAIN RELIEF

The approach of the I.R.S. in *Wrzesinski v. U.S.*,[12] under which it would only mitigate the amount of the penalty, but would not abate it completely, raises a more serious question. If a taxpayer is correct in principle, should the I.R.S. be allowed to demand a reduced penalty simply as a toll charge for settling the case? Those tax advisers having a controversy practice involving significant amounts of tax at stake in an I.R.S. challenge to a highly structured transaction likely would confirm that "horse trading" is part of the resolution process. Principle is principle, but a good settlement is in the interest of the I.R.S. and the taxpayer.

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10 E.D. Pennsylvania, Docket No. 2:22-CV-03568 (September 7, 2022).

11 According to the I.R.S. website, an enrolled agent is a person who has earned the privilege of representing taxpayers before the I.R.S. by either passing a three-part comprehensive I.R.S. test covering individual and business tax returns, or through experience as a former I.R.S. employee. Enrolled agent status is the highest credential the I.R.S. awards. Individuals who obtain this elite status must adhere to ethical standards and complete 72 hours of continuing education courses every three years. Licensed C.P.A.'s and attorneys admitted to practice in a State are not required to become enrolled agents.

12 E.D. Pennsylvania, Docket No. 2:22-CV-03568 (September 7, 2022).

However, the two fact patterns are not identical, and the standards for finding reasonable cause are not identical. One involves a deliberate decision to structure a transaction in a certain way to obtain a favorable tax result based on advice from sophisticated advisers. Here, the examination risk is addressed in deciding to go through with the transaction – does the tax result deserve a "will" opinion, a "should" opinion, or a "more likely than not" opinion? The other involves a taxpayer seeking advice on information reporting obligations by a taxpayer who passively receives a gift or an inheritance and clearly attempts to comply, but finds to his or her dismay that there was a compliance failure. Importantly, the taxpayer took steps to redress the shortfall in a voluntary, prompt, and appropriate way. In the second fact pattern, the threat of severe penalties would seem to be counterproductive because it is not proportional to the error.

In *Chai v. Commr.*,[13] the issue raised was whether the assessment of a penalty requires an independent determination by an I.R.S. employee as to whether the penalty should be imposed prior to its assessment. The case involved an accuracy penalty[14] and whether it could be reviewed by the U.S. Tax Court.[15] In holding that the penalty assessed by the I.R.S. was subject to the review of the U.S. Tax Court, the 2nd Circuit Court of Appeals looked to a comment in the legislative history indicating that Congress thought penalties should be issued when and as appropriate and not as a bargaining chip.

> The report from the Senate Finance Committee on § 6751(b) states clearly the purpose of the provision and thus Congress's intent: "The Committee believes that penalties should only be imposed where appropriate and not as a bargaining chip." S. Rep. No. 105-174, at 65 (1998). The statute was meant to prevent IRS agents from threatening unjustified penalties to encourage taxpayers to settle. IRS Restructuring: Hearings on H.R. 2676 Before the S. Comm. on Finance, 105th Cong. 92 (1998) (statement of Stefan F. Tucker, Chair-Elect, Section of Taxation, American Bar Association) ("[T]he IRS will often say, if you don't settle, we are going to assert the penalties.").

CONCLUSION

While *Chai* involved the jurisdiction of the U.S. Tax Court to review the assertion of a penalty, the principle has wider application. Taxpayers who passively receive a gift or an inheritance, seek advice as to their obligations, and are misadvised should not be held to the high-stakes poker approach that Mr. Wrzesinski encountered when

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13 851 F.3d 190 (2d Cir. 2017).

14 Code §6751(b)(1).

15 Penalties that are imposed automatically by electronic means are exempt from the requirement for an independent determination by an I.R.S. employee as to whether the penalty should be assessed. In the case, the Notice of Deficiency issued by the I.R.S. indicated that determinations were made by the Technical Services Territory Manager of the I.R.S. or a revenue agent acting under her authority. No indication existed that it was made electronically through the IMF Automated Underreporter Program, a computerized system that uses information return matching to identify potentially underreported tax returns.

seeking to correct the error on a voluntary basis. The goal for the I.R.S. is to encourage voluntary reporting. Taxpayers who seek to correct an error in what remains an esoteric area of the law for most individual taxpayers should not be forced to consider the amount of a toll charge when faced with a difficult choice.