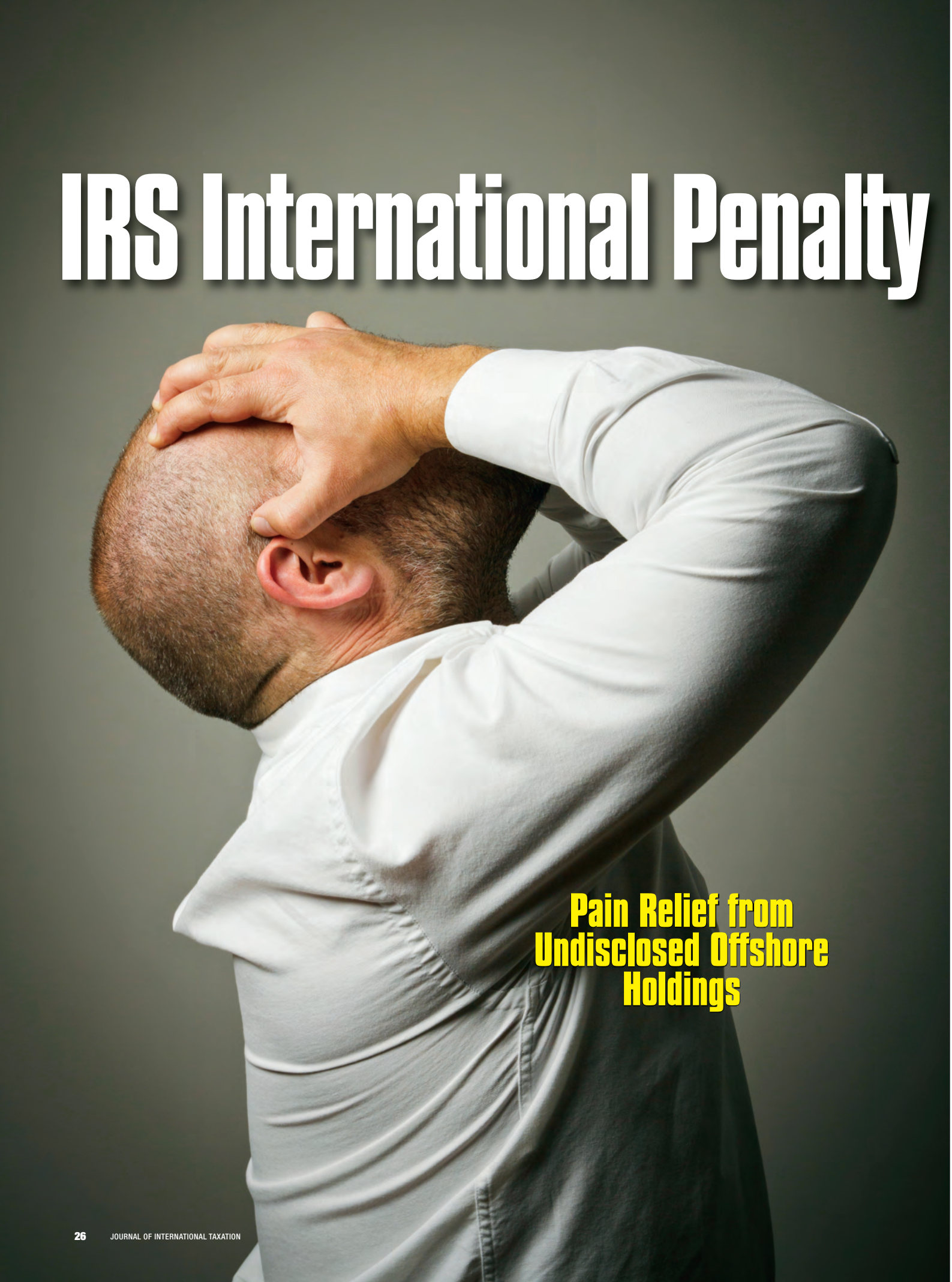
IRS International Penalty



Pain Relief from Undisclosed Offshore Holdings

PAUL MARCOTTE, JR.

Procedure and Strategy

Taxpayers, as well as many tax practitioners, would be hard-pressed to find other areas of the tax law that are more complex than the special tax regimes and reporting obligations applicable to U.S. persons with foreign holdings or activities. In addition to sheer complexity, the level of penalties for noncompliance with international information return **reporting requirements can be quite steep, if not draconian.** In some instances, especially when unreported foreign bank accounts are involved or the government asserts that a compliance failure is willful, the total level of penalties that can be imposed can be well in excess of the value of the unreported accounts or assets. This article focuses on helping clients seek relief from these civil penalties and, specifically, when reasonable cause will justify this relief.[1]

When can reasonable cause justify penalty relief?

International Civil Penalties for Late Filings

A detailed discussion of the reporting requirements for U.S. persons with foreign accounts or activities and related penalties for noncompliance is beyond the scope of this article. However, it is helpful to have a basic understanding of some of the more significant penalties that can arise in this area in terms of their potential sting from a financial perspective. Before looking at income tax-type civil penalties, a brief review of the penalty structure for non-criminal violations of the foreign bank account reporting (FBAR) rules is in order since FBAR violations occur quite frequently in tandem with tax noncompliance related to offshore holdings.[2]

The FBAR information is submitted on Treasury Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts) and is due June 30 of each year with no provision for an extension.[3] Penalties for noncompliance with the FBAR requirements are quite severe. Prior to the American Jobs Creation Act of 2004 (AJCA), there was no civil penalty for an innocent or non-willful failure to file an FBAR.[4] This means that as to FBAR filings for 2003 and earlier years, no civil penalty applied under pre-AJCA law absent a showing of willfulness. After the AJCA, for FBARs due after June 29, 2005, a non-willful violation can result in a penalty not exceeding $10,000 per violation, subject to a reasonable cause exception discussed below.[5] Multiple years of noncompliance can result in total penalties that can easily consume or exceed the entire account balance.[6]

Distributions from, and transfers to, a foreign trust are reported on IRS Form 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts), which is also used to report the receipt of large gifts from non-U.S. persons. The initial penalty for failure to file this return for a distribution from a foreign trust or transfer to a foreign trust is the greater of $10,000 or 35% of the amount of the distribution or transfer, with further escalating penalties if noncompliance continues after notice from the IRS.[7] For a failure to report receipt of a large foreign gift, the penalty is 5% of the amount of the foreign gift for each month that a reporting failure continues up to a maximum of 25%.[8] Form 3520-A (Annual Information Return of Foreign Trust with a U.S. Owner) is used by a foreign trust with one or more U.S. persons as deemed owners under the foreign grantor trust rules to satisfy the reporting requirements under Section 6048(b). If such a foreign trust fails to timely file this return or it is incomplete, any U.S. person that is a deemed owner is subject to a penalty of the greater of $10,000 or 5% of the value of the trust assets (before any liabilities) deemed owned by that U.S. person, determined as of the end of the tax year.[9] These penalties can be waived or avoided if the compliance failure is shown to be due to reasonable cause and not willful neglect.[10]

The Chief Counsel has indicated that when an individual taxpayer is delinquent in making these types of foreign trust filings and dies, the decedent's estate steps into the shoes of the decedent, with the result that the estate becomes responsible for the penalties.[11] The Chief Counsel does distinguish between the "initial" penalties under Sections 6677 (failure to file information with respect to certain foreign trusts), which carry over automatically from the decedent to the estate, and the "additional" penalties that arise when the executor is late in filing the delinquent Form 3520 or 3520-A. In the latter situation, a case for reasonable cause may be established if, for example, the executor can show that the fiduciary discovered the foreign trust only recently.

Reporting of interests in, or transactions with, a foreign corporation, including a controlled foreign corporation (CFC), is usually made on IRS Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations), and for a transfer of property to a foreign corporation, on Form 926 (Return by a U.S. Transferor of Property to a Foreign Corporation). As an example of the steep penalty structure for noncompliance with these corporate information returns, the failure to file Form 5471, or just filing an incomplete form, results in an initial $10,000 penalty. Subsequent failure to file a complete form more than 90 days after IRS notice generates an additional $10,000 penalty each 30 days up to $50,000.[12] A penalty of 10% of the value of property transferred to a foreign corporation not reported timely on Form 926 is imposed up to a maximum of $100,000 (there is no maximum for an intentional disregard of the filing requirement).[13] Reasonable cause is an excuse for avoiding or abating both of these penalties.[14] The penalties, like many others involving international information returns, may be imposed even if no income tax liability is due with respect to the particular holding that triggers a reporting obligation, when a form is filed but is incomplete, or even when the subject entity is inactive.[15]

In addition to taxpayers with interests in foreign corporations, reporting may be required when interests are held in foreign entities treated as partnerships for U.S. tax purposes (see IRS Form 8865 (Return of U.S. Persons With Respect to Certain Foreign Partnerships)), as well as when an interest is held in a single-member foreign entity, such as an LLC equivalent that elects to be treated as a disregarded entity for U.S. tax purposes (IRS Form 8858 (Information Return of U.S. Persons With Respect to Foreign Disregarded Entities)). These international information return filing requirements continue to expand.[16]

Assessment Procedures; Taxpayer Ability to Challenge Penalty Before Payment

Typically, the penalties for late-filed or incomplete information-type returns, as well as FBARs, will turn up in the context of an examination of the taxpayer's basic income tax return (Form 1040 (U.S. Individual Income Tax Return) or

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1120 (U.S. Corporation Income Tax Return)) and be proposed by the revenue agent handling the examination. However, IRS service centers can and do issue computer-generated penalty notices when certain types of these filings arrive after the due date.[17]

Many international tax-type penalties are "assessable penalties" because they are not subject to deficiency procedures that typically apply to income tax returns, so that payment is required before judicial redress is available.[18] As a result, a major concern until relatively recently was that a taxpayer did not have the right or ability to challenge an assessment of one of these international penalties prior to actually paying it. The IRS now provides for formal prepayment review of international penalties by its Appeals Office under rules that were added to the Internal Revenue Manual (IRM) in 2010.[19] For Category 1 taxpayers (those with assets of $100 million or more), Appeals is required to render a decision within 120 days of receiving the case under accelerated procedures for large taxpayers.[20] If a taxpayer is unsuccessful at the administrative level (IRS Appeals), there is no right to further contest the penalty in court before payment is made.

As discussed above, enforcement authority of penalties for FBAR violations has been delegated to the Service. The IRS has established procedures for pre-assessment consideration of FBAR penalties by the Appeals office, which are also in the IRM.[21] These rules also provide that Appeals can consider cases post-assessment.

IRS Position/Guidance—Reasonable Cause Exception

The IRS includes the basic rules and underlying policies for when the IRS will assert penalties. The basic IRS policy and procedure behind the imposition of penalties are reflected in Policy Statement 20-1.[22] The IRM says that "[p]enalties exist to encourage voluntary compliance by supporting the standards of behavior expected by the Internal Revenue Code."[23] The IRM also says that "[p]enalties advance the mission of the Service when they

1 This article does not discuss criminal sanctions or a filing failure that may be considered willful so that a different mitigation strategy may be advisable. That strategy might entail advising a client to make a valid and timely disclosure under the ongoing IRS offshore voluntary disclosure initiative (OVDI).

2 Although the FBAR reporting requirements arise under a nontax statute (see note 3, *infra*), under a current delegation order by the Financial Crimes Enforcement Network (FinCEN), IRS administers FBAR enforcement.

3 The Currency and Foreign Transactions Reporting Act (originally the Bank Secrecy Act), 31 U.S.C. section 5314 and related implementing regulation 31 C.F.R. section 1010.350, require that U.S. persons make an annual report separate from their tax return disclosing the existence of foreign accounts. Reporting is required for a financial interest in or signature authority over a foreign account if the aggregate balance of all such accounts at any time during the year exceeds $10,000. See also 31 C.F.R. section 1010.306(c).

4 P.L. 108-357, October 22, 2004.

5 31 U.S.C. section 5321(a)(5), as amended by P.L. 108-357. If the taxpayer intentionally fails to file an FBAR, the civil penalty is the greater of $100,000 or one-half the account balance for each year's violation, in addition to any criminal sanction.

6 This is possible because the penalty is applied per account that is not reported, and the statute of limitations for assessing civil FBAR penalties is six years under 31 U.S.C. section 5321(b)(1). Thus, if an FBAR is not timely filed for several years, and more than one account is not disclosed in each year, the penalty will be applied to each account for each year, subject to mitigation guidelines discussed below. Exposure is greater when the nondisclosure is willful.

7 Section 6677(a).

8 Section 6039F(c). IRS is also permitted to determine whether the gift is taxable for income tax purposes.

9 Sections 6677(b) and (c)(2). See also Notice 97-34, 1997-1 CB 422, as to statements that a trustee of a foreign trust is required to give to a U.S. beneficiary.

10 Sections 6677(d) and 6039F(c)(2).

11 CCA 201208028.

12 Sections 6038(b) and 6679(a). As an additional penalty, foreign tax credits can be reduced. See Section 6038(c).

13 Section 6038B(c).

14 Sections 6038(c)(4)(B) and 6679(a)(1). See also Reg. 1.6038-2(k)(3)(ii) on reasonable cause for Form 5471 purposes. This Regulation also discusses when substantial compliance may excuse a penalty for a return that is missing information or otherwise deemed incomplete.

encourage voluntary compliance.... [C]ompliance is achieved when a taxpayer makes a good faith effort to meet the tax obligations [and reporting requirements] defined by the Code."[24]

As discussed, many of the Code provisions authorizing the imposition of penalties for late or delinquent international-type filings recognize that a compliance failure "due to reasonable cause and not due to willful neglect" is an excuse to avoid assessment or to permit penalties to be abated. Section 6677(d) says that the penalty for failure to file information returns such as Form 3520 (used to report distributions from a foreign trust or receipt of large foreign gifts) will not be imposed when the filing failure is due to reasonable cause and not willful neglect. Reg. 1.6038-2(k)(3) allows reasonable cause as a ground to avoid penalties for failure to timely furnish information returns related to foreign corporations or partnerships, such as Form 5471, or when the filings are deemed incomplete. Section 6038D(g) provides a similar reasonable cause exception for the late filing of Form 8938 (Statement of Specified Foreign Financial Assets).[25]

The Regulations indicate what the IRS generally deems "reasonable cause" under late-filing and payment penalty provisions:

> (c) Showing of reasonable cause.
>
> (1).... If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause. A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship (as described in [Reg.] 1.6161-1(b)] if he paid on the due date. In determining whether the taxpayer was unable to pay the tax in spite of the exercise of ordinary business care and prudence in providing for payment of his tax liability, consideration will be given to all the facts and circumstances of the taxpayer's financial situation.[26]

The IRM says that "[t]he ordinary business care and prudence standard requires that taxpayers make reasonable efforts to determine their tax obligations.... Reasonable cause may be established if the taxpayer shows ignorance of the law in conjunction with other facts and circumstances."[27] The IRM says that the level of complexity of a tax or compliance issue is a factor that should be considered in evaluating reasonable cause based on ignorance of the law.[28] The IRM lists circumstances that may give rise to reasonable cause to excuse the imposition of penalties, such as death or serious illness, natural disasters, and undue hardship.[29]

The Chief Counsel has stated that the same criteria used to evaluate whether penalties under Section 6651 for a late-filed corporate return (Form 1120) should be excused for reasonable cause also generally apply to the Section 6038 penalty for a late-filed related international tax information return used to report an interest in a foreign corporation (Form 5471), since the Code penalty provisions use similar language and should be construed consistently.[30] The same rationale should extend to penalties under other Code provisions relating to late filing of international information returns by individuals.

Penalties for international information returns may be imposed **even if no income tax is due** for the holding that triggers a reporting obligation

FBAR Reasonable Cause Standards and Mitigation Guidelines

The requirement to file an FBAR reporting foreign accounts originates under a federal statute other than the Internal Revenue Code, so the question is whether the same reasonable cause standards that apply to income tax also apply to FBAR-related penalties for non-willful violations. The FBAR statute says in relevant part that no penalty will be imposed for non-willful violations when (1) reasonable cause exists, and (2) the "amount of the transaction or balance in the account at the time of the transaction was properly reported."[31] The second part of the statute requiring proper reporting leaves some room for interpretation, but the IRS appears flexible in stating that the account balance is considered "properly reported" if it is ultimately reported on a delinquent FBAR filed with an examiner.[32]

The IRS has indicated that general negligence principles apply in determining whether FBAR penalties for non-willful violations should be imposed, including the standards applicable under Reg. 1.6664-4. Although this is an income tax Regulation, the IRS says that these rules may be helpful in determining whether an FBAR violation was due to reasonable cause.[33]

Since the statutory FBAR penalties are maximums, the IRS has developed guidelines for agents conducting FBAR examinations, as they are to exercise discretion and not apply the statutory maximum automatically whenever a non-willful violation occurs.[34] The guidelines for violations occurring after October 22, 2004, apply when (1) the taxpayer has no prior history of criminal tax or FBAR violations; (2) all funds in the foreign accounts are from legal-source income; (3) the taxpayer has cooperated; and (4) the civil fraud penalty has not been asserted with respect to any income tax underreporting associated with the accounts. When a reporting failure is non-willful, if the maximum aggregate balance in all accounts not properly disclosed does

[15] For a simplified filing procedure for dormant foreign corporations, see Rev. Proc. 92-70, 1992-2 CB 435.

[16] See Marcotte, "Update on FBARs, OVDI, FATCA, and Emerging Trends in Cross-Border Tax Enforcement," 24 JOIT 40 (November 2013), which discusses the recent FATCA reporting requirements for individuals in IRS Form 8938 (Statement of Specified Foreign Financial Assets) and related penalties for noncompliance.

[17] In fall 2008, the IRS announced in a notice on its website that penalties for late or incomplete 5471 filings would be assessed automatically beginning January 1, 2009.

[18] See Section 6677(e) on the penalty for late-filed Forms 5471 and CCA 201226028 on the penalty for late-filed Forms 8938 as to unavailability of deficiency procedures. See also CCA 201150029, which indicates that penalties under Section 6677 are not a "divisible" tax, with the result that the entire penalty must be paid before a judicial challenge can be undertaken. Penalties related to FBARs do not arise under the Internal Revenue Code and so are not subject to income tax deficiency procedures. See *Williams*, 131 TC 54 (2008).

[19] IRM section 8.11.5.1.

[20] IRM section 8.11.5.2. The accelerated procedures also apply to other taxpayers that are designated Category 1 by mutual decision of IRS Compliance and Appeals.

[21] IRM section 8.11.6.

[22] IRM section 1.2.20.11.

[23] IRM section 20.1.1.2(1), which is the beginning of the "IRS Penalty Handbook" that serves as a compilation of official guidance to IRS personnel on imposition of penalties.

[24] IRM sections 20.1.1.2.1(5) and (6).

[25] The last sentence of Section 6038D(g) says that reasonable cause does not exist when the reason for a compliance failure is that a foreign jurisdiction would impose a penalty (including criminal sanctions) for disclosing information required by the Code.

[26] Regs. 301.6651-1(c)(1) and 301.6656-1.

[27] IRM section 20.1.1.3.2.2.6.

[28] IRM section 20.1.1.3.2.2.6(2)(e).

[29] IRM section 20.1.1.3.2.2.1 *et seq.*

[30] CCA 200748006.

[31] 31 U.S.C. section 5321(ii).

[32] IRM section 4.26.16.4.4(2).

[33] IRM section 4.26.16.4.3.1(3).

[34] See "Normal FBAR Penalty Mitigation Guidelines for Violations Occurring After October 22, 2004," IRM section 4.26.16.4, Exhibit 4.26.16-2.

[35] See Baker & McKenzie Voluntary Disclosure Steering Committee, "IRS Preliminary Guidance for Post-September 9, 2011, Voluntary Disclosures: OVDI 2011+?," 23 JOIT 59 (March 2012).

not exceed $50,000 (Level I—NW), the guideline penalty is $500 for each unreported account, not to exceed a total penalty of $5,000 for all violations. An intermediate guideline penalty (Level II—NW), when maximum balances exceed $50,000 but not $250,000, is $5,000 for each unreported account, not to exceed 10% of the maximum account balance during the year. If the monetary account thresholds under these initial guideline levels are exceeded (Level III—NW), the guidelines indicate that the recommended penalty is the statutory maximum.

Taxpayers with unreported offshore accounts or other holdings may consider penalty relief under the current IRS offshore voluntary disclosure initiative (OVDI), which was reopened in January 2012 with no set deadline.[35] The OVDI program *(Continued on page 61)*

(Continued from page 31) may give taxpayers more certainty as to the overall level of penalties and possibly a lower level than otherwise would be available.[36] Alternatively, a taxpayer may want to come in under OVDI to reduce the risk of more severe consequences, such as criminal prosecution, but "opt out" of the offered penalty framework and assert reasonable cause, so that no (or very little) penalties should apply.

Judicial Authorities—Reasonable Cause Based on Complexity of the Law

While ignorance of the law is usually not an excuse in most areas of the law, it can give rise to reasonable cause under the tax law where other factors that the IRM and the courts recognize are present.[37] As a relatively recent example, at least regarding international tax filings, *Congdon* is instructive.[38] The individual taxpayer owned (directly and indirectly) offshore entities engaged in helping clients set up offshore trusts or other entities. As a result of an audit of his personal return, the IRS determined that the original Form 5471 included with his return was substantially incomplete. The government sued the taxpayer seeking to reduce the penalties to judgment. In denying the government's motion for summary judgment, the court held that there was a genuine dispute as to whether there was reasonable cause to excuse assessment of penalties for filing an incomplete Form 5471.

The taxpayer alleged that he misunderstood his filing category status and that including information as to the subject holdings on his Form 1040 (as opposed to reflecting them on Form 5471) was sufficient and he did not omit any income on his return. He also indicated that he spent approximately 200 hours trying to fill out these forms. The court said:

> The IRS gives some examples of what might be considered reasonable cause…. Ignorance of the law, in and of itself, does not constitute reasonable cause…. However, reasonable cause may be established if the taxpayer shows ignorance of the law in conjunction with other facts and circumstances. Some factors to be considered include the following: the taxpayer's education, if the taxpayer has been previously subject to the tax, if the taxpayer has been penalized before, if there were recent changes in the tax forms or law which a taxpayer could not reasonably be expected to know, and the level of complexity of a tax or compliance issue.
>
> The Court finds that there is a genuine dispute regarding whether Plaintiff acted with ordinary business care and prudence. Although ignorance of the law alone is not sufficient to constitute reasonable cause, Plaintiff also alleges other factors such as his inexperience in tax matters, and the complexity of the area of law. Combined, those factors could be found by the finder of fact to constitute reasonable cause. Although Plaintiff has obtained his Master's in Business Administration, he had little to no instruction in the area of accounting, tax law, or finances…. Plaintiff had never been penalized for a violation of section 6038 prior to this occasion. Finally, Plaintiff paid the correct amount of tax and disclosed all the information, albeit on the wrong form…. These facts illustrate that a genuine issue of fact exists regarding whether Plaintiff acted with ordinary business care and prudence, and therefore, whether Plaintiff had reasonable cause for his failure to file a substantially complete Form 5471.

A similar result can arise when a taxpayer's situation or facts are complex. *Dillin,* 56 TC 228 (1971), involved a former U.S. citizen and his wife who had been living in Texas and domiciled there prior to the tax years in question. In 1958, the taxpayer rendered services locally there and was to receive payment over three years beginning in 1963. Shortly before receiving the first payment, the taxpayer renounced his U.S. citizenship and he and his wife took up residence in the Bahamas, with the wife retaining her U.S. citizenship. The taxpayer husband erroneously believed that by becoming a nonresident alien (NRA) and using the cash method of accounting, his receipt of the deferred compensation payments would not be taxable. The Tax Court found that the payments to the husband were taxable on receipt, since they were considered U.S. source. In addition, the taxpayer's wife was held subject to tax on half of that income under Texas community property rules. However, the court refused to uphold the imposition of failure-to-file and negligence penalties due to the complexity of questions of law and fact.

Practice note. For individuals who have recently emigrated to the United States and obtained permanent resident status, or who have been naturalized citizens for just a short time, the potential for compliance failures is not unusual if they continue to maintain holdings in their home country or elsewhere outside the United States. This is quite common when these persons come from countries that do not tax their citizens on a worldwide basis. In these instances, when the IRS asserts penalties for late-filed information returns or FBARs, practitioners should consider whether reasonable cause can be asserted based on ignorance of these rather specialized tax rules by quite innocent newcomers to the United States.

Judicial Authorities—When Is Reliance on Professional Advisors "Reasonable Cause"?

In the seminal penalty case of *Boyle*, 469 U.S. 241 (1985), the Supreme Court made the following observation as to the IRS official guidance and in particular when penalties can be excused where a taxpayer relies on a professional advisor:

> The administrative regulations and practices exempt late filings from the penalty when the tardiness results from postal delays, illness, and other factors largely beyond the taxpayer's control…. The principle underlying the IRS regulations and practices—that a taxpayer should not be penalized for circumstances beyond his control—already recognizes a range

of exceptions which there is no reason for us to pass on today. *This principle might well cover a filing default by a taxpayer who relied on an attorney or accountant because the taxpayer was, for some reason, incapable by objective standards of meeting the criteria of "ordinary business care and prudence."* [Internal citations omitted, emphasis added.]

The Supreme Court's decision in *Boyle* has been cited in numerous cases for the proposition that reliance on an advisor constitutes reasonable cause even though, under the facts in *Boyle,* the Court concluded that an executor could not rely on his counsel for failure to meet an estate tax filing deadline since no special training was required to ascertain when a return was due.[39] In *Neonatology Associates, P.A.*, 115 TC 43 (2000), *aff'd* 299 F.3d 221 (CA-3, 2002), the Tax Court indicated that to qualify for relief based on reliance on a tax advisor, the taxpayer must show that (1) the advisor was a competent professional; (2) the advisor was provided with all necessary information; and (3) the taxpayer reasonably relied on the advisor in good faith.

Some courts continue to distinguish between a professional advising a client as to a deadline for a tax filing, which is viewed as not requiring any specialized knowledge, and the more basic issue as to whether a return is due in the first place, although the judicial decisions are not uniform.[40] Also, the IRS, in Regulations under Section 6664(c) (the reasonable cause exception for accuracy related penalties), as well as recent judicial authorities, require the tax advisor to be independent and not a promoter or otherwise conflicted.[41] At the same time, a taxpayer is generally not required to challenge or second-guess advice from a competent advisor.[42]

As discussed above, a consistent line of cases has refused to impose penalties when there has been good faith reliance on a professional tax advisor or expert. A good example of how reasonable cause based on reliance of a professional adviser applies in this area is a recent federal district court decision, *James*, 110 AFTR2d 2012-5587 (DC FL, 2012) (unpublished), denying the government summary judgment.

The taxpayer was a physician who set up an offshore trust for quite legitimate non-tax-avoidance purposes (i.e., asset protection against possible future malpractice claims). He failed to file Form 3520 reporting the trust for several years and was assessed over $500,000 in late-filing penalties, which he paid and filed a refund action against the government to recover. As grounds for the refund, he asserted reasonable cause based on his accountant's failure to advise him of the filing requirement. The facts in the opinion indicate that the accountant was fully familiar with the trust, had seen the trust documentation, and had discussed the trust from time to time with Dr. James. The district court highlighted that in preparing Dr. James' personal return, the accountant answered "no" to the ques-

[36] See note 16, *supra*.

[37] See IRM section 20.1.1.3.2.2.6.

[38] 108 AFTR2d 2011-6340 (DC Tex., 2011), *report and recommendation adopted* 108 AFTR2d 2011-6343 (DC TX., 2011).

[39] See *Estate of La Meres*, 98 TC 294 (1992); *Sim-Air U.S.A Ltd.*, 98 TC 187 (1992); *Colton*, TCM 1995-275.

[40] See *Knappe*, 713 F.3d 1164 (CA-9, 2013) (executor of estate relied on erroneous advice of CPA that a 12-month extension of due date for estate tax return was possible; court distinguished Supreme Court's holding in *Boyle*—tax filing deadlines are not substantive issues under the tax law where a taxpayer can rely on advice of a professional, since obligation to file a return is not delegable); see also *Baccei*, 632 F.3d 1140 (CA-9, 2011) (taxpayer could not rely on CPA's erroneous advice as to extension to pay estate tax). *Cf. Estate of Lee*, TCM 2009-84 (reasonable cause found where executor relied on attorney's advice that a second six-month extension to file an estate tax return could be granted).

[41] See Reg. 1.6664-4(c); *Canal Corp.*, 135 TC 199 (2010); *Paschall*, 137 TC 8 (2011).

[42] See *Boyle*, discussed above. The rationale is that to require otherwise would defeat the purpose of seeking tax advice in the first place.

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tion on Form 1040, Schedule B (Interest and Ordinary Dividends)—"did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust?" The form says that if the answer is "yes," "you may have to file Form 3520." The court indicated that in answering "no" to this question, the accountant, by preparing the return, could be construed as advising Dr. James that Form 3520 was not required.

The government argued that Dr. James (1) did not rely reasonably rely on the accountant's advice, and (2) had improperly delegated the responsibility to file Form 3520 to his accountant. The court never reached the merits of these arguments, instead denying the government's motion for summary judgment and holding that there was a genuine issue of material fact as to what advice the accountant provided and whether Dr. James had reasonably relied on that advice.

An earlier Tax Court decision, *Hudson*, TCM 1992-91, involved a Canadian national who obtained permanent resident status in the United States, but failed to withhold under Section 1441 on alimony payments to two former NRA spouses and interest paid on a loan from a Canadian lender that had not claimed exemption from withholding. Although the Tax Court upheld the tax withholding assessment, it refused to allow penalties for negligence and failure to file and make tax deposits because the taxpayer was a relative newcomer not familiar with the U.S. tax system and, more importantly, because the taxpayer's accountant testified in open court that he was aware of the payments, but did not advise the taxpayer that any withholding was required.

To assert a claim of reliance on an advisor, the taxpayer must prove that it actually received advice on a substantive tax issue and relied on that advice in the first place. *New York Guangdong Finance, Inc.,* TCM 2008-62, *aff'd* 588 F.3d 889 (CA-5, 2009), is a case where that was not shown. Penalties were imposed for late filing of Form 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons) to report withholding tax on interest paid under cross-border loans with Chinese government-controlled foreign affiliates of the U.S. taxpayer. The taxpayer claimed that it relied on advice of a former officer (also a CPA) that the interest payments were exempt by treaty, but the officer appears to have given no specific advice that Form 1042 did not need to be filed. It did not help that the relevant Regulations required Form 1042 to be filed even when payments are exempt from withholding.

In CCA 200645023, the IRS indicated that there was no reasonable cause to excuse a corporate parent's late-filed Form 5741 for its subsidiaries when the parent failed to follow the advice of its own professional advisor that the form was required.

Practice note. The Service routinely scrutinizes claims for penalty relief related to delinquent international information returns when reliance on a tax advisor is asserted as the ground for reasonable cause. In particular, the Service demands proof that the advisor knew of the undisclosed account or activity for which a return was not filed timely. This often results in the taxpayer blaming the advisor or return preparer, with the advisor/preparer in turn claiming that the taxpayer never disclosed the account or holding in the first place. In many situations, the advisor or preparer will not cooperate with the taxpayer in providing an affidavit to the Service to establish reasonable cause absent prior indemnification or an agreement not to sue from the taxpayer.

Conclusion

Penalties for noncompliance regarding international income tax filings and FBARs can be significant, if not staggering, but relief can be obtained provided that reasonable cause can be established to the satisfaction of the IRS. At the same time, and given ongoing efforts by the government to combat offshore tax evasion, when it comes to asserting reasonable cause based on reliance on a professional advisor, the IRS requires strong proof of the claim and quite frequently is willing to litigate these cases. ●