REASONABLE CAUSE FOR INTERNATIONAL INFORMATION RETURN PENALTIES—WHAT IS THE STANDARD?

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The Internal Revenue Code ("IRC") requires the filing of a number of different information returns with respect to foreign entities or transactions. These "international information returns" include Form 5471 (for US persons who own shares in certain foreign corporations), Form 5472 (for U.S. corporations that are 25% owned by foreign persons), Form 8865 (for U.S. persons who are partners in certain foreign partnerships), Form 3520 (for transactions with foreign trusts and for the receipt of certain foreign gifts) and Form 8938 (for foreign assets generally). For each, there is a significant penalty for failing to timely and correctly file the form. But the penalty does not apply if the failure was due to reasonable cause (sometimes with the additional condition that the failure was not due to willful disregard). But what is "reasonable cause?"

REASONABLE CAUSE FOR DELINQUENCY AND ACCURACY-RELATED PENALTIES

Reasonable cause is a defense to both delinquency penalties (IRC section 6651) and accuracy-related penalties (IRC sections 6662 and 6662A). Because the penalties are for different behavior, however, Treasury Regulations define reasonable cause slightly differently for each. For a delinquency penalty, "if the taxpayer exercised ordinary business care and prudence and was nevertheless unable" to file the return or pay the tax, the taxpayer has reasonable cause and the penalty will not be assessed. For an accuracy-related penalty, the regulations provide that whether the taxpayer acted with reasonable cause is determined on a case-by-case basis, with the most important factor being "the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." Each reasonable cause determination requires analysis of the specific facts and circumstances, but in the case of a failure to file or pay, the independent standard is explicit: "ordinary business care and prudence." While this standard may be implied in the case of an accuracy-related penalty, the regulations give more room to argue reasonable cause on the basis of the taxpayer's training and knowledge or lack thereof.

GUIDANCE FOR INTERNATIONAL INFORMATION RETURN PENALTIES

Treasury Regulations for international information returns generally recite that penalties for failure to file the returns are not to be imposed if the filer had reasonable cause. Only one regulation (section 301.6679-1(a)(3), applicable to failures to file Forms 5471 or 8865 to report the acquisition of shares of a foreign corporation or an interest in a foreign partnership), however, states that if the taxpayer exercises "ordinary business care and prudence," the failure to furnish a required item of information is due to reasonable cause. On the other hand, one other regulation, section 1.6038A-4(b)(iii), recites the same circumstances indicating reasonable cause as the regulations for accuracy-related penalties. The remaining regulations either give no additional description of reasonable cause or state that

the determination is to be made on the basis of all the facts and circumstances.

The Internal Revenue Manual ("IRM") discusses reasonable cause relief for failure to file international information returns and provides an overall standard as follows:

Reasonable cause applies to most, but not all, of the penalties. However, taxpayers who conduct business or transactions offshore or in foreign countries have a responsibility to exercise ordinary business care and prudence in determining their filing obligations and other requirements. It is not reasonable or prudent for taxpayers to have no knowledge of, or to solely rely on others for, the tax treatment of international transactions. IRM 20.1.9.1.1 (4) (October 24, 2013).

This language sets a strict standard: business care and prudence is required, and a taxpayer cannot claim either lack of knowledge or exclusive reliance on professional advisers. This is close to the standard for filing income tax returns that the Supreme Court explained in U.S. v. Boyle, 469 U.S. 241 (1985): "[O]ne does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due. In short, tax returns imply deadlines. Reliance by a lay person on a lawyer is of course common; but that reliance cannot function as a substitute for compliance with an unambiguous statute." The IRM therefore appears to take the position that U.S. taxpayers who conduct international business or transactions are expected to have the same knowledge of filing international information returns as of filing Form 1040.

REASONABLE CAUSE AS SEEN BY THE COURTS

In a series of recent cases, courts have taken a more lenient view of a taxpayer's responsibilities. These cases—involving Form 5471, Form 3520, and Form 3520-A—look at the facts and circumstances and consider the taxpayer's sophistication and representation.

Congdon v. U.S., 108 AFTR 2d 2011-6343 (E.D. Texas, 2011)

The taxpayer in this case operated a partnership that formed offshore entities for other businesses. The partnership also owned a controlled foreign corporation ("CFC"), and Congdon filed Form 5471 reporting that CFC with his Form 1040. Unfortunately, he reported the income from the CFC on his Form 1040 and not Form 5471, while including little information on the Form 5471 itself. The IRS assessed a $10,000 penalty against Congdon for filing a substantially incomplete Form 5471.

In court, Congdon acknowledged that he had filed a substantially incomplete Form 5471, but argued that he had reasonable cause. He claimed that he had reported all the relevant income from the CFC on his 1040. Noting that he was not a tax expert, Congdon alleged that he misunderstood the instructions for Form 5471. The government argued that neither ignorance of the law nor complexity of the tax laws constituted reasonable cause.

The court decided that Congdon's arguments, if proven, would show reasonable cause; that is, that he acted with ordinary business care and prudence. Although ignorance of the law alone is not sufficient to constitute reasonable cause, inexperience in tax matters, the complexity of the area of law, and a track record of compliance can show reasonable cause. The court also stated that the correct amount of tax had been paid and the required information disclosed, although in the wrong place. Congdon therefore acknowledges the complexity and relative obscurity of international information returns as factors in supporting reasonable cause.

James v. U.S., 110 AFTR 2d 2012-5587 (M.D. Florida, 2013)

This case involved the penalties for failing to file Forms 3520 and 3520-A. James was a doctor who set up an offshore trust to protect his assets against possible malpractice claims. He transferred more than $1.5 million to the trust over a period of three years, but did not file Form 3520 or cause the trust to file Form 3520-A. The IRS assessed penalties, and James sued for refund of those penalties.

James argued that he reasonably relied on his long-time accountant. He alleged that he provided the accountant with all appropriate trust documents and information and that, in effect, the accountant advised him he did not need to file Form 3520 by not including it in the returns prepared. The IRS argued that James did not have reasonable cause because he had been put on notice of the requirement to file Form 3520 and his reliance on the accountant could not constitute reasonable cause.

The court ruled that if James could show that his accountant had advised him that he did not need to

file Form 3520 and that he reasonably relied on that advice, he would have reasonable cause. In particular, the court allowed the possibility that the accountant's checking "no" to the question posed on Schedule B of James's tax return ("Did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If 'yes,' you may have to file Form 3520") could be construed as the accountant advising James that he did not have to file a Form 3520. In effect, the court held that a taxpayer can rely exclusively on his tax adviser concerning whether to file Form 3520, as long as the taxpayer provided all necessary information and the reliance was reasonable.

Nance v Comm'r, 111 AFTR 2d 2013-1616 (W.D. Tenn. 2013)

The taxpayer in this case formed offshore companies and set up an offshore trust under advice from a tax lawyer (Bly). Nance received a letter from the IRS that he was under examination and offered him the opportunity to participate in a voluntary compliance initiative. Having retained a new tax lawyer (Carney), Nance entered the initiative, part of which was a requirement that he file delinquent international information returns, for which no penalty would be imposed. Carney and the revenue agent reviewing Nance's returns discussed which returns should be filed, and the revenue agent asked for all international information returns through 2004, including Form 3520-A. Nance submitted all the international information returns and signed a closing agreement, which required substantial penalties for civil fraud and FBARs (Reports of Foreign Bank and Financial Accounts), but no separate international information return penalties.

After Nance signed the closing agreement and paid the penalties, the IRS imposed a large additional penalty under IRC section 6677 for late filing of Form 3520-A for 2003, reasoning that the closing agreement covered only the years 1999 through 2002. Nance paid the penalty and sued for refund.

Citing Boyle, the court stated that reasonable cause requires a taxpayer to demonstrate that he exercised ordinary business care and prudence but nevertheless was unable to file within the prescribed time. The court then stitched together a possible route by which Nance could show reasonable cause: that he first relied on Bly's advice that no returns need be filed, then relied either on Carney's further erroneous advice that he did not need to file the 3520-A immediately or on the revenue agent's erroneous advice, gleaned from discussions with Carney, that he would not be penalized for filing the 2003 Form 3520-A together with the other information returns. In other words, despite Nance's involvement in a scheme that used offshore trusts and companies with the specific purpose of reducing his taxes, he could reasonably rely on the advice of others to show reasonable cause.

PATH TO A REASONABLE CAUSE DEFENSE

These three cases illustrate that a taxpayer can claim lack of knowledge (Congdon) or complete reliance on a professional (James and Nance) to help establish a reasonable cause defense to international return penalties. These stategies run counter to the IRS position taken in the Internal Revenue Manual. The courts gauge the taxpayer's efforts to comply with the requirements of the IRC as an important factor. Therefore, when advising someone who has not filed an international information return, it is critical for CPAs to document the taxpayer's efforts to understand and comply with the IRC's requirements.