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Ellen S. Brody and Michael J. Miller of Roberts & Holland, who represented the taxpayer in *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner*, write that the Tax Court correctly rejected penalties and additions to tax in the case based on their client's reliance on a tax professional. The court rejected an IRS argument that the company should have conducted a deeper investigation of its long-time adviser's competency.

Reliance on a CPA as Reasonable Cause: 'Neonatology' Lives on After 'Grecian Magnesite Mining'

BY ELLEN S. BRODY AND MICHAEL J. MILLER

The Tax Court on July 13 issued its long awaited decision in *Grecian Magnesite Mining, Indus. & Shipping Co., SA v. Commissioner*. The main issue in the case was whether the capital gain recognized by the taxpayer, Grecian Magnesite Mining, Industrial & Shipping Co., SA (GMM), a Greek corporation, upon the redemption of its interest in a U.S. limited liability company classified as a partnership, is taxable as income effectively connected with the conduct of a trade or business in the U.S.

The Tax Court held that such gain wasn't effectively connected, and thus firmly rejected Revenue Ruling 91-32, 1991-1 C.B. 107, which held otherwise on similar facts. *Grecian Magnesite Mining, Indus. & Shipping Co., SA v. Commissioner*, 2017 BL 243353, 149 T.C. No. 3, No. 19215-12, 7/13/2017.

Prior to the trial, GMM agreed that a portion of the gain on the redemption should be subject to tax under the ''FIRPTA'' rules of Internal Revenue Code Section 897(g) to the extent that it was attributable to U.S. real property held by the limited liability company. (FIRPTA is a shorthand reference to the Foreign Investment in Real Property Tax Act of 1980 enacted as Subtitle C of Title XI of the Omnibus Reconciliation Act of 1980, Pub. L. No. 96-499, 94 Stat. 2599, 2682 (Dec. 5, 1980).) GMM had filed a Form 1120-F, U.S. Income Tax Return of a Foreign Corporation, in 2008 reporting its share of the limited liability company's income, but no gain from the redemption.

Ellen S. Brody and Michael J. Miller are partners at Roberts & Holland LLP in New York. They represented Grecian Magnesite Mining, Industrial & Shipping Co. in the Tax Court litigation discussed here.

The parties agreed that GMM would cease being a partner as of Dec. 31, 2008, but the second installment of the redemption proceeds wasn't received until January 2009. GMM didn't file any Form 1120-F for 2009 as it had no income attributed to it from the limited liability company, and it didn't believe that it had to report any gain on the redemption of its interest.

The Internal Revenue Service asserted additions to tax under Section 6651(a) for failure to file and failure to pay with respect to 2009, and an accuracy-related penalty under Section 6662(a) with respect to 2008.

Section 6662 imposes an accuracy-related penalty of 20 percent of the portion of the underpayment of tax that is attributable to, among other things, the taxpayer's negligence or disregard of rules or regulations or that is attributable to any substantial understatement of income tax. Section 6662(a), (b)(1) and (2). Negligence is defined as ''any failure to make a reasonable attempt to comply with the provisions of this title, and the term 'disregard' includes any careless, reckless, or intentional disregard.'' Section 6662(c). An understatement of a corporation's income tax is substantial if it exceeds the greater of 10 percent of the tax required to be shown on the return and $10,000. Section 6662(d)(1)(B).

Section 6651(a)(1) imposes an addition to tax for failure to file a timely return and Section 6651(a)(2) provides an addition to tax for failure to timely pay the

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amount shown as tax on any return specified in paragraph (1), unless there was reasonable cause for such failures. As GMM failed to report any of the capital gain attributable to the disposition of the U.S. property interests, it is clear that the Section 6662 penalties would apply for 2008 and the Section 6651 penalties would apply for 2009, absent an exception to the general rules.

Reasonable Cause Defenses

The Tax Court chose to bypass the numerous arguments made by GMM as to why it wasn't negligent, and went straight to the reasonable cause defenses. Both the Section 6662(a) accuracy-related penalties and the additions to tax pursuant to Section 6651(a)(1) and (2) provide for an exception based on ''reasonable cause.'' As the Tax Court noted, ''The defenses arise from distinct statutory sources, but where a taxpayer asserts reasonable cause as a defense from liability for all three because he relied on the advice of a competent adviser, the defenses overlap significantly.'' Thus, the Tax Court chose to address the defenses jointly, rather than approach each one separately, as had been done in the briefs filed by GMM and the government.

Treasury Regulations Section 1.6664-4(a) provides that ''no penalty may be imposed under section 6662 with respect to any portion of an underpayment upon a showing by the taxpayer that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion.'' The regulations emphasize that the determination of whether a taxpayer acted with good faith must be made on a case-by-case basis, and all pertinent facts and circumstances must be duly considered. Among the relevant circumstances specifically enumerated in the regulations are the experience, knowledge, and education of the taxpayer, and whether the taxpayer relied on the advice of a professional tax adviser.

The Supreme Court held in *United States v. Boyle*, 469 U.S. 241 (1985), that reliance on a professional tax adviser can also constitute reasonable cause for failure to file a tax return. The Supreme Court clearly stated:

> When an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a ''second opinion,'' or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. . . . ''Ordinary business care and prudence'' do not demand such actions.

Boyle, 469 U.S. at 251.

Later case law sets forth the following three requirements for a taxpayer in order to use reliance on a tax professional in avoiding liability for a Section 6662(a) penalty: ''(1) The adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment.'' *Neonatology Assocs., P.A. v. Commissioner*, 115 T.C. 43, 99 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

It was undisputed that GMM's adviser had all necessary and accurate information to prepare its tax returns. Thus, it was up to the Tax Court to decide if the adviser was a competent professional with sufficient expertise and if GMM actually relied in good faith on the adviser's judgment.

LLC Interest the Only U.S. Tie

GMM was a family-owned Greek corporation whose interest in the limited liability company was its only involvement in the U.S. and the only investment that gave rise to any U.S. filing obligations. Although the government argued that the taxpayer was a sophisticated international corporation, a long-standing leader in the magnesite industry with investments in many countries, the Tax Court agreed that this didn't equate to GMM holding any special knowledge, or deemed knowledge, of the U.S. tax system in general, let alone the specific tax rules that apply to foreign investments in U.S. partnerships.

GMM asked its U.S. lawyer for a referral of an accountant to prepare its U.S. tax returns. The lawyer recommended a certified public accountant who had a bachelor's degree from Columbia College, a master of business administration degree from Columbia University Graduate School of Business, and a juris doctorate from St. John's University School of Law. The accountant held himself out to be qualified to prepare whatever returns would be required of GMM with respect to its investment in the limited liability company.

In fact, for years the accountant prepared Forms 1120-F for GMM that went unchallenged by the Service. Those returns were simple. He didn't need any special expertise to take the information from the Schedule K-1 that GMM was provided and to use that to prepare the Form 1120-F. The only thing that changed in 2008 was that GMM decided to sell its interest in the limited liability company. GMM had no reason to suspect that there would be complicated tax issues arising from its disposition of the membership interest.

The accountant determined that GMM didn't have to report any of its gain on the redemption of its membership interest on its 2008 return, and didn't have to file a 2009 tax return, as he determined that such gain was foreign source. The accountant admitted that he didn't consider the FIRPTA implications and hadn't focused on the fact that the limited liability company owned real property. To expect GMM to know of the esoteric FIRPTA rules when a certified public accountant didn't know them would be ludicrous. As noted above in the quoted language from *Boyle*, to require GMM to challenge the accountant's decision ''would nullify the very purpose of seeking the advice of a presumed expert in the first place.''

IRS Seeks to Narrow 'Neonatology'

The government tried to limit the application of *Neonatology*, and argued that GMM couldn't in good faith have relied on the accountant because GMM didn't conduct an investigation into the accountant's background and experience in tax return preparation prior to retaining him. In rejecting this argument, the Tax Court noted that: ''Given what little GMM knew about the U.S. system of taxation, we cannot imagine GMM would have known how to conduct such an investigation, let alone what value such uninformed inquiries would have added. GMM acted reasonably, given its admitted inexperience.''

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The government also tried to narrow the application of the *Neonatology* test by arguing that the accountant wasn't competent as he didn't specialize in international tax law or have a master of laws degree. The Tax Court again rejected the government's arguments, noting that these requirements weren't part of the standard for the reasonable cause defense, but rather the focus was on whether ''[t]he adviser was a competent professional who had sufficient expertise to justify reliance.'' *Neonatology* at 99. The Tax Court found that the accountant's 40 years of preparing income tax returns were ''sufficient credentials to justify GMM's reliance,'' and no higher degrees specializing in international taxation were required,

This case didn't involve tax shelters or other schemes to avoid the payment of tax. GMM simply invested in a limited liability company, held its interest for many years, and then sold its interest. The limited liability company was a real operating entity that generated economic profits and losses. Until the disposition of the membership interest, the accountant was fully competent to prepare GMM's U.S. tax returns. GMM paid tax in Greece on the gain it realized on the sale. From GMM's point of view it wasn't escaping any taxation and it didn't have any malicious motives in failing to file a tax return for 2009, it simply was following the advice of its tax adviser.

Competency Investigation An Impossible Burden

The Tax Court correctly held that no penalties or additions to tax should be applied to GMM's tax underpayments. To do otherwise would have put impossible burdens on taxpayers (both foreign and domestic) to investigate the competency of their trusted professionals. While a simple inquiry into a professional's previous experience might be prudent, reliance on a referral is often how people hire all forms of professionals, be it an accountant, a doctor, or a plumber. The whole point of relying on a professional is to have them do a job that you aren't personally qualified to do yourself. And if you lack the knowledge and expertise to do it yourself, how could you possibly be expected to thoroughly interview the professionals as to their skills and capability?

The Tax Court understood that expecting a taxpayer who is relatively ignorant as to the U.S. tax laws to smoke out a possible shortcoming in the qualifications of the accountant recommended to it by a trusted adviser is unrealistic to the point of absurdity. Following *Grecian*, we can only hope that the IRS will be more realistic in the future.