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Penalty Avoidance: When Can Taxpayers Rely on Their Advisors?

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The IRC imposes various penalties on taxpayers who fail to comply with the obligations it sets forth for them. However, taxpayers can often avoid penalties if they can prove that their failure was due to reasonable cause and that they acted in good faith [IRC section 6664(c)(1)]. Reasonable cause is determined on a case-by-case basis, taking into account all the facts and circumstances [Treasury Regulations section 1.6664-4(b)(1)]. Courts will look to see if a taxpayer had an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, taking into account the taxpayer's experience, knowledge, and education.

One important method of establishing reasonable cause is to demonstrate that the taxpayer relied in good faith on the advice of an independent professional, such as a tax advisor, lawyer, or accountant. This standard was recognized by the Supreme Court in *United States v. Boyle*. The question of whether adequate reliance exists in any given fact pattern has been litigated many times, and courts have summarized the three basic requirements for establishing reasonable reliance on professional advice as follows (*Neonatology Assocs., P.A. v. Commissioner*):

- The professional is a competent tax advisor with sufficient expertise to justify reliance.
- The taxpayer provided necessary and accurate information to the advisor.
- The taxpayer actually relied in good faith on the advisor's judgment.

In the most recent case to address this issue, *Rivera v. Commissioner* (decided earlier this year), the taxpayers hired an advisor whom they believed was a former IRS revenue agent. The advisor told the taxpayers they could deduct their daughter's college tuition by funneling it through an S corporation. Noting that this tax position might be "'too good to be true' in other circumstances," the court nevertheless found that the taxpayers acted reasonably and in good faith, because the taxpayers, who faced a significant language barrier, had no training in taxation or accounting, and believed the advisor was a tax expert. To understand the *Rivera* court's reasoning, it is necessary to consider the three prongs of the *Neonatology* test in detail.

Tax Professional

The regulations make it clear that it is not reasonable to rely on the advice of someone the taxpayer knows, or should know, lacks knowledge in the relevant aspects of federal tax law [see Treasury Regulations section 1.6664-4(b)(2), Examples 1–2; *G. Kierstead Family Holdings Trust v. Commissioner*). A taxpayer's education, sophistication, and business experience are all relevant to the determination of whether the taxpayer acted with reasonable reliance on an advisor and in good faith. In analyzing these factors, courts have looked closely at both the qualifications of the purported professional as well as the background and sophistication of the taxpayer to determine whether the taxpayer's faith in the advisor was justified.

In *CNT Investors, LLC v. Commissioner*, the court held that a taxpayer reasonably relied on a lawyer who had no particular expertise in tax matters, in light of the taxpayer's long-term relationship with the lawyer and the taxpayer's unfamiliarity with tax concepts in general, and the specifics of the transaction at issue in particular.

In contrast, the court in *Curtis Inv. Co. v. Commissioner* faulted the taxpayers for relying on what they should have known was insufficient due diligence on the part of their advisors. The court in *Curtis* distinguished the facts in that case from those in *CNT Investors, LLC,* in part by contrasting the educational background and sophistication of the taxpayers: In *CNT*, the taxpayer held a near 50-year-old degree in mortuary science, and held most of his savings in cash; whereas in *Curtis,* one of the taxpayers had a business degree, and both had experience working in finance.

In *Grecian Magnesite Mining*, the IRS argued that the taxpayer, a foreign corporation that had limited business dealings in the United States, was at fault for relying on a referral from its attorney for a U.S. tax return preparer rather than conducting its own investigation into the preparer's background and experience in tax return preparation, as well as for failing to hire an expert in international taxation or an attorney with an LLM degree.

The court rejected the IRS's argument on both points, noting—

- that the taxpayer's unfamiliarity with the U.S. tax system meant that any investigation into the qualifications of its U.S. advisor was unlikely to be productive, and
- that a high level of expertise on the part of an advisor is not a requirement for a reasonable cause defense.

Similarly in *Rivera*, the court held that the coworker’s recommendation that the tax advisor was a former IRS revenue agent was enough for the taxpayer to reasonably believe that he was a competent tax advisor, particularly in light of the taxpayers' own lack of sophistication.

Courts have generally held that reliance on an advisor is not reasonable if the advisor has a conflict of interest in providing the advice that the taxpayer knows or should know about, such as a tax shelter promoter who has a financial stake in the transaction (see, for example, *Blum v. Commissioner; Neonatology*). On the other hand, the mere fact that an advisor receives compensation for services relating to a transaction does not necessarily mean the advisor has a conflict (*Am. Boat Co. LLC v. United States*).

Advice Based on Information Provided

As a threshold matter, a reliance defense generally applies only to professional advice—not to acts or omissions. Therefore, reliance on an accountant to actually file a return or pay a tax on behalf of a taxpayer will not exempt the taxpayer from penalties if the accountant fails to do so. Courts are split, however, on whether a professional's erroneous advice that a taxpayer is not required to file a return, or regarding the due date for filing, will suffice to establish reasonable cause.

The regulations provide that a professional's advice must consist of, *inter alia*, a "communication [from] a person other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly" [Treasury Regulations section 1.664-4(c)(2)].

There are several important details to note here. The regulation requires that the advice come from someone other than the taxpayer. Thus, in *Seven Enters., Inc. v. Commissioner*, the tax court held that while a corporation could avoid penalties with respect to a tax year in which it relied on the advice of an individual it hired as an outside tax consultant, it could not avoid penalties with respect to subsequent years in which it relied on advice from the same individual after hiring him as the company's vice president of taxes. In addition, the regulation seems to require that the advice be intended for the taxpayer—second-hand advice will not suffice.

Beyond these requirements, the advice does not need to be in any particular form. However, the case law indicates that the mere review and signing of a tax return does not constitute advice.

The advice itself must be based on all of the facts and circumstances. The taxpayer will have the burden to prove to a court that she provided all relevant information to her tax advisor. In *Archer v. Commissioner*, the court found that the taxpayers did not establish reliance, in part because while they testified in general terms that they had described the substance of the transaction to their return preparer, they did not prove that they provided him with complete and accurate information. Similarly in *Rivera,* while the erroneous advice regarding the deductibility of their daughter's tuition was based on complete information, the taxpayers did not show that they gave the tax advisor all the relevant information with respect to other income and expense items. Therefore, they were liable for accuracy penalties on all adjustments other than the ones relating to the outside services deduction.

When is Reliance Reasonable?

Treasury Regulations section 1.6664-4(c)(1) provides that in order for a taxpayer to reasonably rely on advice received from a competent professional, the advice must not be based on any unreasonable assumptions or representations. Additionally, the taxpayer must in fact rely upon the advice. The fact that a professional may have written a memorandum supporting the taxpayer's position will not help if the taxpayer never received it or if there is other evidence demonstrating that the taxpayer did not in fact rely on it (see *McNeill v. Commissioner*).

In order for taxpayers to rely on professional advice, it must be provided with an appropriate level of confidence by the professional. For example, a position described in an accountant's memorandum as merely having a "realistic possibility of success" (which previously was the standard for a return preparer to avoid penalties) was not necessarily sufficient to constitute advice on which the taxpayer could rely. Under the current regime, a return preparer can avoid penalties if there is "substantial authority" for a position or, if required disclosures are made, merely a "reasonable basis" [IRC section 6694(a)(2)]. This is the same standard that allows a taxpayer to avoid penalties under IRC section 6662(d)(d)(B).

Assuming the taxpayer has disclosed all relevant information and the advisor is a qualified professional, the taxpayer generally has no duty to second-guess the advice that is provided by the advisor. As the Court noted in *Boyle*, "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."

But some courts have suggested that when the advice provided is "too good to be true," the taxpayer may have a heightened duty to confirm the advisor's competence (see *Stobie Creek Invs. LLC v. United States*). Once again, however, the taxpayer's sophistication is likely to be a significant factor. As noted above, while the advice that the *Rivera* taxpayers received regarding the deductibility of their daughter's college tuition was "too good to be true," the court held that the taxpayers acted reasonably and in good faith, given their lack of relevant education and training, and their difficulty with the English language.

Best Practices

As in any standard that is so fact-and-circumstances dependent, in order to preserve a possible reasonable cause defense, taxpayers and their advisors should endeavor to communicate clearly about what the advisor is and is not advising, the facts and assumptions on which the advice is based, and the level of confidence of the advisor in the position. Sophisticated and institutional taxpayers should also give some thought to the qualifications of their advisors and be prepared to defend their choice of advisor if necessary. This way, even if a tax position doesn’t hold up in court, the taxpayer will stand a better chance of avoiding penalties.

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