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From:
Sent: Wednesday, February 18, 2009 4:04:41 PM
To:
Cc:
Subject: Reasonable Cause Defense to Penalty

I am following up on our conversation of a few weeks ago regarding your questions about reasonable cause where an employee has committed acts that possibly inhibited an entity from properly filing or reporting their correct tax liability.

To determine what test a court might apply in this case, there are several cases that address the standard for reasonable cause in the employment tax area which are analogous to your facts and from which we can extrapolate a standard. In nearly all of the case I looked at an employee or outside accountant hired by the entity had embezzled money or had taken some action so that the company had not timely paid their employment taxes and the IRS asserted that a penalty was due under sections 6651(a) and 6656. See e.g., Pediatric Affiliates, P.A. v. United States, 2006 WL 454374 (D.N.J. 2006)(reliance on outside accounting service did not render taxpayer unable to fulfill its tax obligations); Classic Printing v. United States, 2001 WL 283799 (M.D. Pa. 2001)(taxpayer failed to exercise ordinary care and prudence by failing to insure its tax obligations were met and putting in place controls to oversee employee handling these obligations); Conklin Brothers of Santa Rosa, Inc. v. United States, 986 F.2d 315 (9th Cir. 1993)(employee's concealment of failure to timely file and pay employment taxes did not create a disability that prevented the use of ordinary business care and prudence as the employee was subject to supervision by the company's president). In none of these cases did the court find the facts supported a finding of reasonable cause.

The Supreme Court established a bright line rule in United States v. Boyle, 469 U.S. 241 that a taxpayer's reliance on an agent to file a timely return when the due date of the return was ascertainable by the taxpayer does not constitute reasonable cause excusing the taxpayer from the statutory penalties for late filing. The Supreme Court went on to state that to be excused from the failure to timely pay taxes owed a taxpayer must be able to show that the failure (1) did not result from willful neglect, and (2) was due to reasonable cause. Id. at 244. Willful neglect is a "conscious, intentional failure or reckless indifference." Id. at 245. Reasonable cause exists if the taxpayer exercised "ordinary business care and prudence, but nevertheless was unable to file the return within the prescribed time." Id. at 246. Your facts do not suggest that there is any willful neglect, leaving only the issue of reasonable cause to be resolved.

What elements constitute reasonable cause is a question of law and whether those elements exist is a question of fact. Id. at 249. Because the duty to file and pay taxes has been imposed by Congress on the entity, the entity cannot rely solely on its agent to comply with the tax laws to avoid its obligations. The cases referenced above made clear that an entity has a obligation to exercise ordinary business care and prudence and must, therefore, properly oversee its employees. As I recall, there were facts in your case that suggested that a CFO oversaw the employees maintaining the books and records and, the CFO, while not a tax specialist should have know there were at least some accounting irregularities. Under the cases referenced above, these facts suggest reasonable cause may not be established by the taxpayer.

One case did distinguish between an entity's misplaced reliance on an agent versus a taxpayer's disability to comply with its tax obligations. The court in In the Matter of American Biomaterials Corp., 954 F.2d 919 (3rd Cir. 1992) found that the criminal acts of the CFO and CEO, which caused the company's failure to fulfill its tax obligations, did not automatically make the company liable for the penalties resulting from the failure to pay taxes. The government had argued that the malfeasance of its agents should be imputed onto the entity and, therefore, no reasonable cause could exist as a matter of law. The court, however, did not address the issue of whether the corporation had adequate internal controls in place so as to establish ordinary business case. Cf. Janice Leather Imports, Ltd. v. United States, 391 Supp. 1235 (S.D.N.Y. 1974).

Ultimately it is the agent's determination based on this legal standard to determine whether there are sufficient facts to support a finding a reasonable cause. These cases did not address whether the taxpayer came forward regarding their tax obligations. The forthright nature of the taxpayer may be a fact that appeals, or other fact finder, may consider and, therefore, represents a potential litigation hazard. But, at the exam level the decision is whether the facts support a penalty or not.

Please let me know if you have any further questions.