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My Tax Adviser Made Me Do It

By Robert W. Wood

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Many clients assume that relying on their tax professional means they'll never pay penalties. Wood examines that assumption in light of the Ninth Circuit's decision in *Knappe v. United States*.

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When can you rely on your tax adviser? Shouldn't you always be able to? What happens if your tax lawyer or accountant is wrong and additional taxes are due? What if your tax adviser was correct about the amount of tax, but wrong about when it was due so you incur penalties and interest you shouldn't have faced?

It will probably be no surprise that no matter what your tax adviser says, if the IRS is right and your adviser is wrong, you will have to pay the taxes. Interest, too, is usually inevitable. But penalties are another matter. Penalties, as many a tax adviser will tell you, are often up for grabs in all but the most serious tax cases.

In light of this practical reality, as well as the equities of getting bum advice, surely you should be able to avoid paying penalties if you were just relying on your tax adviser. For any damages you suffer and even for out-of-pocket costs such as attorney's fees, you may have a separate claim against your tax adviser for what turned out to be bad advice. If you would owe the taxes regardless of what your tax adviser said, you presumably can't charge the adviser for the tax.

But penalties are another matter. Rather than quibbling with your tax adviser over who should pay penalties to the IRS, it seems to make sense to assert reliance on a professional as a defense. But must the IRS let you off the penalty hook because you relied on your tax man or tax woman?

The answer is an annoying, ''It depends.'' Not only that, but whether the tax advice you obtained was substantive or procedural can make a big difference. Substance would include points like whether something is deductible. Procedural would include whether your return and payment are due April 15 or March 15. But sometimes, as we shall see, this dichotomy is not so clear-cut.

Due Dates and Other Mishaps

Sometimes in the tax world it can seem that no matter how hard you try, something is bound to go wrong. Peter Knappe probably thinks so.[1] He was asked to be the executor of an estate, which meant filing an estate tax return. He hired an accountant and asked him to apply for an extension. So far, so good.

The accountant assured Knappe that the deadline had been extended one year, but it was actually extended only six months. Acting on the bad advice, Knappe filed the tax return late, and the IRS assessed penalties (nearly $200,000) against the estate. When the penalty fight went to court, the court agreed with the IRS that Knappe had not shown reasonable cause to excuse the penalty.

But hadn't he hired a CPA and wasn't that enough? You might think so. Knappe hired CPA Francis Burns, who said the deadline was nine months from the date of death. Extensions of the filing deadline are granted automatically for six months. Extensions of the payment deadline are discretionary, and the IRS may grant them for up to a year.

The CPA filed Form 4768, applying for a six-month automatic filing extension and a one-year discretionary payment extension. The IRS approved the extension, but somehow the CPA misread it. He thought the return was not due for a year. Knappe received a copy, but he also didn't understand it.

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[1]*See Knappe v. United States*, No. 10-56904 (9th Cir. 2013).

The CPA helped Knappe file (four months late as it turned out), but the IRS assessed a 20 percent late-filing penalty. That $200,000 penalty was later reduced to $150,000, but with interest it was back up to $185,000. By then, the CPA realized his mistake, and Knappe asked the IRS to remove the penalty, because it was "due to reasonable cause and not due to willful neglect."[2] After all, he had hired a CPA and relied on him.

The IRS disagreed and the district court granted summary judgment for the IRS. The district court found Knappe's reliance on the CPA's advice insufficient, so Knappe appealed to the Ninth Circuit. To establish reasonable cause, one must prove that he "exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time."[3]

Relying on a CPA is just what a business person would do, claimed Knappe. Yet the Ninth Circuit divided the situations involving reliance on a professional into two categories. In the first column were cases involving taxpayers who delegate the task of filing a return to an expert agent, only to have the agent file the return late or not at all. The leading case is *United States v. Boyle*.[4] In *Boyle*, the executor of his mother's estate hired an attorney who advised him an estate tax return was due but did not mention when it was due.

Boyle contacted his attorney repeatedly and was assured the return would be timely filed. Eventually, the attorney admitted that he filed it three months late. The IRS assessed a penalty, which Boyle paid but then sued to recover. The Supreme Court held that Boyle's reliance on his attorney was not reasonable cause for the delay. Given the importance of clear deadlines, the Court said, few situations excuse missing one. Executors have an unambiguous duty to file the return within nine months, and that was that.

Substantive Tax Advice?

The second category delineated by the Ninth Circuit constitutes cases in which a taxpayer relies on an agent's erroneous advice that *no* return is due. This is different from a deadline glitch, and courts have held that reliance on that kind of advice does constitute reasonable cause for delay. Even the *Boyle* Court appeared to endorse penalty relief:

> 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.[5]

Cases in this category say that whether a return is due is a matter of substantive tax law.[6] But when it's clear that a return must be filed, the taxpayer has a personal, non-delegable duty to file it on time.

Put differently, filing deadlines may be one thing, but figuring out what you owe is something else. Whether the taxpayer owes taxes (and if so, how much) is a substantive question of tax law, which often only an expert can answer. Relying on an expert is an exercise of ordinary business care and prudence. How did Knappe's case stack up to these two categories?

The Ninth Circuit said it didn't fit squarely into either category. Knappe didn't delegate the filing to a neglectful agent. At the same time, he didn't receive mistaken advice that no taxes were due. Instead, he personally filed the return after the deadline, but within the time period that his CPA had told him (incorrectly) he had to file.

In *Boyle*, the Supreme Court didn't reach that question. But some courts have, and with mixed results. In *Estate of Kerber v. United States*,[7] the Eighth Circuit refused to find reasonable cause where an executrix's attorney correctly advised that a return was due, but erroneously believed it was due one year (not nine months) after the decedent's death.

However, in *Estate of Bradley v. Commissioner*,[8] the Tax Court held the petitioner appropriately relied on an accountant's advice concerning the due date of the estate tax return. Then, in *Fleming v. United States*,[9] the Seventh Circuit refused to absolve a late-filing taxpayer whose attorney failed to submit an extension application after the taxpayer asked him to do so. The Third Circuit in *Sanderling Inc. v. Commissioner*[10] went even further, holding that reliance on an accountant's misrepresentations about the due date of returns was reasonable when the due date was not readily determinable. Besides,

[2]Section 6651(a)(1).
[3]Reg. section 301.6651-1(c)(1).
[4]469 U.S. 241 (1985).
[5]*Id.* at 250-251.
[6]*See, e.g.*, *United States v. Kroll*, 547 F.2d 393, 396 (7th Cir. 1977).
[7]717 F.2d 454, 455-456 (8th Cir. 1983) (per curiam).
[8]T.C. Memo. 1974-17, *aff'd*, 511 F.2d 527 (6th Cir. 1975).
[9]648 F.2d 1122, 1125-1127 (7th Cir. 1981).
[10]571 F.2d 174, 178-179 (3d Cir. 1978).

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said the court, even the IRS was uncertain at trial about the correct due date.

Knappe's case seems to fall in the first category — a taxpayer's reliance on an accountant to timely file, but the return is filed late or not at all. To distinguish between substantive and non-substantive tax advice, the Ninth Circuit cited its decision in *Baccei v. United States*.[11] The court concluded that if an extension has been obtained to file an estate tax return, when the return is due is not a substantive question. You can read the grant of the extension, and that's hardly substantive.

For that reason, Knappe did not exercise ordinary business care and prudence when he relied on the CPA's advice about the extended deadline. Knappe unreasonably abdicated his duty to ascertain the filing deadline and comply with it, said the court.

Expert Hiring?

Shouldn't a taxpayer who hires a qualified professional and supplies the professional with all the needed detail be protected? It sure seems that way. Indeed, the Ninth Circuit recognized that our tax laws are famously labyrinthine. One might well assume that hiring a tax expert would be the quintessence of ordinary business care and prudence. You hire a tax expert precisely so you don't have to deal with any of it.

Regardless of how sympathetic the Ninth Circuit sounded to this view, that's not the rule, it said. In *Boyle*, the court drew a sharp distinction between substantive tax advice, on which executors may reasonably rely, and non-substantive advice, on which executors may not. Determining the filing date of a tax return is non-substantive. You don't have to be a tax expert to know returns and payments have due dates.

Another Ninth Circuit case, *Baccei*, involved an executor who retained a CPA to prepare and file an estate tax return. The CPA said he requested an extension of both payment and filing deadlines, but actually had only requested an extension of the filing deadline. He forgot to check a box on the Form 4768. Baccei paid the taxes late and incurred a penalty. Baccei sought relief from the penalty but failed because he had received no substantive advice regarding a debatable tax position.

Knappe claimed that this situation was different from his. After all, the accountant in *Baccei* failed to request an extension at all, while Knappe's CPA had muffed the extension he filed. To the Ninth Circuit, however, this was a distinction without a difference. Both cases involved agents who wrongly informed their principals that the filing and payment deadlines had been extended to a particular date. Both agents erred.

Taken together, *Boyle* and *Baccei* suggest that an executor's late filing will be excused only if he relied on substantive advice about an issue of tax law. So was Knappe's reliance on his CPA concerning a substantive tax question? Knappe said it was, based on *Estate of La Meres v. Commissioner*.[12]

In *La Meres*, the estate's representative understood the correct filing deadline for the estate tax return but needed more time. After one extension, the lawyer wrongly advised her that a second six-month extension of the filing deadline was available by filing a new extension application. The IRS denied this second request but failed to notify the estate's representative, and the estate eventually incurred penalties. The *La Meres* court held that the estate's representative had shown reasonable cause because she reasonably relied on her attorney's advice that a second six-month extension was available.

Thus, the court treated the question of whether multiple filing extensions were available as substantive. Knappe's issue — about a single extension — still was not, said the Ninth Circuit. The instructions were clear, and so was the tax code. His CPA fouled up on a non-substantive tax question. For that reason, Knappe failed to show reasonable cause to excuse his late filing.

Executors have it rough, the court seemed to acknowledge. However, this burden is necessary in light of the government's substantial interest in ensuring that returns are timely filed.[13] It was Knappe's duty to ascertain the correct extended filing deadline. By relying on his accountant's advice about that non-substantive matter, he failed to exercise ordinary business care and prudence.

Conclusion

The glibbest answer to this kind of dilemma is to always be correct and not to have to rely on the ''he told me to do it that way'' defense. Still, as a practical matter, it seems likely that many penalties have been waived or compromised that were decidedly in the non-substantive category. Where the IRS can collect the tax due and interest, the penalty is a natural point of compromise. That is as it should be.

Besides, the nature of the tax advice, particularly to revenue agents, appeals officers, and tax advisers in the trenches, may not be so clear. Despite the bright line the courts have tried to draw between

[11] 632 F.3d 1140, 1148-1149 (9th Cir. 2011).

[12] 98 T.C. 294 (1992).

[13] *See Boyle*, 469 U.S. at 249.

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substantive and non-substantive tax advice, it may not be as clear even to someone who is aware of the distinction and trying to discern the difference. The distinction may be most observed in cases very much like *Knappe*, involving estate tax returns and filing dates. The extension and payment date rules across the universe of different types of taxpayers and taxes may perhaps be less confusing.

The Ninth Circuit in *Knappe* focused especially on estates, noting that its decision was necessary to avoid collusion between culpable executors and their agents. Lawyers and accountants, the court speculated, would be encouraged to claim that they gave erroneous advice to the executor even if they did not. The court even went on to say that:

> Even in cases in which executors and their agents did not actively collude to propound a contrived misrepresentation defense, negligent agents would be unilaterally incentivized to persist in giving erroneous advice to their clients, even if they realized their error.

This observation sounds a bit like Judge Richard A. Posner, economics lion of the Seventh Circuit. But in any case, being right is surely the best defense.

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