Current Federal Tax Developments

Week of March 2, 2020

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ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
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Kaplan Financial Education

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SECTION: FBAR REPORTING
TAXPAYER GETS HIT WITH WILLFUL FAILURE TO FILE FBAR PENALTIES AFTER VOLUNTARILY WITHDRAWING FROM OVDI PROGRAM

Citation: United States v. Ott, US DC SD Michigan, Case No. 2:18-cv-12174, 2/26/20

A taxpayer's decision to voluntarily withdraw from the IRS's Offshore Voluntary Disclosure Initiative (OVDI) program and instead argue a reasonable cause defense for the failure to file Foreign Bank Account Reporting forms did not end well. In the case of *United States v. Ott*, US DC SD Michigan, Case No. 2:18-cv-12174 the taxpayer ended up with almost $1 million in penalties when the Court determined that he had acted willfully in failing to file annual FBAR reports on his Canadian accounts.

The Court describes the history of his Canadian accounts as follows:

> In 1993, Defendant opened two brokerage accounts with McDermid St. Lawrence Ltd. ("McDermid"), a Canadian financial institution, and deposited $50,000 into those accounts.
>
> In 1994, Ott's Canadian financial advisor, Donna Balaski ("Balaski"), moved brokerage firms from McDermid to Thomson Kernaghan & Co. Ltd. ("Thomson"), a Canadian financial institution. Following his broker, Ott closed his accounts with McDermid and transferred the contents of those accounts into the Thomson accounts.
>
> Between 1993 and 1998, Defendant made additional deposits into the foreign accounts. The additional deposits totaled $71,478.
>
> Balaski moved her employment again to Desjardins Securities ("Desjardins"), a Canadian financial institution. On May 2, 2002, Defendant subsequently transferred the contents of his accounts with Thomson to Desjardins, following Balaski.
>
> On or about July 3, 2003, Ott opened two bank accounts with TD Canada Trust, a Canadian financial institution.
>
> On July 1, 2006, Ott opened two financial accounts with Octagon Capital Corporation ("Octagon") in Toronto, Ontario, with account numbers ending in 589-E and 589-F (the "Canadian Accounts"), and transferred the contents of the accounts with Desjardins to the Octagon accounts.

> Ott has a sister with a Canadian home address. Soon after the Octagon accounts were opened, Ott listed his sister's home address for receipt of mailings and correspondence from the Octagon firm. At all relevant times, the address associated with the Canadian Accounts was Ott's sister's Canadian address.
>
> Octagon sent mail to the address listed on Ott's account, his sister's Canadian address, which included information regarding potential income tax obligations with respect to the Octagon accounts.
>
> With rare exception, Ott's sister did not transmit mailings from the Octagon firm to Ott.
>
> Ott had regular contact with his securities broker at Octagon throughout the years 2007 to 2009.
>
> During the 2007, 2008, and 2009 calendar years, the balance of the Canadian Accounts exceeded $10,000.
>
> The highest aggregate balance of the Canadian Accounts in 2007 was $1,903,477. The highest aggregate balance of the Canadian Accounts in 2008 was at least $770,000. The highest aggregate balance of the Canadian Accounts in 2009 was $1,766,129.

Mr. Ott had a CPA prepare his returns for the years before the Court. The CPA did not inquire regarding whether Mr. Ott had bank accounts outside the United States. While the CPA did not actually make an entry in his tax software regarding whether Mr. Ott did or did not have a foreign bank account, his software defaulted to checking the boxes "No" on Schedule B.

In 2010 Mr. Ott transferred his accounts to a different Canadian banking institution. When he transferred and liquidated the accounts, he disclosed them to his CPA. The CPA referred him to a tax attorney.

Initially, the attorney recommended that Mr. Ott enter the OVDI program and voluntarily disclose his accounts. In doing so he provided the IRS with

- Copies of his original and amended individual income tax returns;
- Statements for his Canadian accounts; and
- Copies of his FBAR reports he was filing late.

Mr. Ott also voluntarily paid the tax due on income that had not been previously reported.

After he entered the program, the IRS offered participants the option to voluntarily withdraw from the program if they believed the penalties they would face for their

failures would be less than that under the OVDI program Mr. Ott had entered. That would generally be true if Mr. Ott could show that his failures to file were not willful. His attorney counseled to withdraw and instead submit evidence to show he had not willfully failed to file. Mr. Ott followed his counsel's advice and withdrew from the program. He submitted the required statement of reasonable cause defenses to the FBAR penalties to the government.

The IRS audited Mr. Ott's returns for the years in question and they did not accept his reasonable cause defenses, asserting willful failure to file penalties.

The IRS position was that Mr. Ott was constructively aware of his FBAR reporting obligations by signing the return with the Schedule B questions referring to FBAR as part of the form. As well, his use of his sister's address represented evidence of an attempt to conceal the accounts. And the balances in the account meant the income from these accounts were a huge proportion of Mr. Ott's income for the years in question, showing a reckless disregard for his reporting responsibilities.

The District Court sided with the IRS. First, the Court found that failing to read the return was not a valid reason for not filing the FBAR form, noting:

> Here, the Defendant stated in both his deposition and trial testimony that he did not review the substance of his tax returns beyond "the bottom line," meaning "what [he] owed or received back" for each year in question. ECF No. 45, PageID.550-555. Ott further testified that no interest, dividends, or capital gains from the foreign Canadian accounts were reflected in his tax returns during this time. Id. at PageID.554-555. In *Mohney*, the Sixth Circuit upheld the defendant's conviction for willfully filing false returns, affirming that a taxpayer's "signature is prima facie evidence that the signer knows the contents of the return." 949 F. 2d at 1407 (finding that "knowledge may be inferred from the signature along with the surrounding facts and circumstances. . .").
>
> A sister district court undertook a thorough analysis of the constructive knowledge doctrine, agreeing with the Sixth Circuit and refusing "to excuse [the defendant's] liability and knowledge of a plainly evident duty because he failed to read what he was signing." *McBride*, 908 F. Supp. 2d at 1207 (D. Utah 2012). Given that McBride was not shielded from liability for failure to read the content of his tax returns, Ott should not be able to claim protection here under that same argument. Ott signed a return each year, under penalty of perjury — regardless of whether he actually read the return — certifying that he did not have an interest in foreign accounts. Accordingly, constructive knowledge of the requirement to file the FBAR is imputed to Ott, supporting a finding of willfulness here. See id. at 1208.

He also could not rely on the fact that his accountant hadn't asked him about foreign accounts—it's not reasonable to think it never occurred to him that it *might* be relevant. At best, he was attempting to remain willfully ignorant of any reporting responsibilities:

> The Defendant's failure to discuss his foreign investments with his long-time accountant Weide, for example, indicates "a conscious effort to avoid learning about reporting requirements." Id. at 529 (citing *U.S. v. Williams*, 489 Fed. Appx. 655, 658 (4th Cir. 2012)). Ott's lack of experience in tax accounting suggests that he knew, or should have known, that relying solely on advice he received as a young adult, without consulting his accountant, was reckless conduct in disregard of potential reporting requirements. At the very least, Ott's failure to disclose hundreds of thousands of dollars in a foreign Canadian account to his tax preparer demonstrates that he should have known there was a risk of noncompliance, and yet he failed to take any investigative or corrective action. *McBride*, 908 F. Supp. 2d at 1209. Therefore, Ott's claim that he relied on his own beliefs as to his legal reporting obligations, without verifying those beliefs with his long-time tax preparer, supports a finding of recklessness here.

The Court also found the use of his sister's address was an act of concealment of the account, further evidence of willfulness:

> Here, instead of receiving the mail associated with his foreign accounts at his Michigan address, Ott provided the bank with his sister's Canadian address. During the 2011 Offshore Voluntary Disclosure Program process, Ott stated under penalty of perjury that: ". . . I opened a bank account at TD Canada Trust . . . I used my name and address but also used my sister's address in Toronto for ease of mailing statements." Gov't Trial Ex. 3, Page 5. During his trial testimony, however, Ott stated that he had no part in the address change and his broker, by herself, changed the mailing address to Ott's sister's address in Canada. ECF No. 44, PageID.439.
>
> Considering the eight-year difference between Ott's conflicting statements as well as the arguments during trial, the Court finds it improbable and lacking in credibility that the Defendant took no part in changing his mailing address to a foreign Canadian address. Using an address that matched the country of the foreign bank accounts suggests that Ott sought to avoid the detection of his account ownership. Further, sending everything to his sister allowed Ott to avoid seeing any statements concerning reporting responsibilities, including the language: "These transactions are to be reported on your annual return of income." ECF No. 44, PageID.459. This failure to review any of the mail sent to his sister from the brokerages constitutes an act of concealment and "conduct marked by careless disregard

> whether or not one has the right so to act," therefore meeting the civil recklessness standard. *Safeco Ins.*, 551 U.S. at 57.

The opinion also noted that he spoke with the broker frequently about the account, making clear he was very aware of the accounts' existence—this was not a "little account" that he simply failed to recall. And that's because it was clearly not insignificant. The opinion notes:

> …Ott consistently monitored his foreign account balances online during the years in question. He testified that he looked at the account statements online "maybe monthly" so that he "could see the value of my account." ECF No. 44, PageID.458, 460. In other words, Ott had online access to monitor his accounts with balances at or exceeding a million dollars at their highest aggregate points. This is in stark contrast to the income amounts Ott provided on his tax returns, which ranged between twenty and forty thousand dollars for the years in question. See Gov't Trial Ex. 13-15. The amounts on Ott's tax returns are significantly disproportionate to the foreign accounts' million-dollar balances. Further, bank records and Ott's answers to the Government's interrogatories indicate that in-person cash withdrawals and numerous checks were written on the Canadian accounts. See Gov't Ex. 28, Page 1, Gov't Ex. 44, Page 5. These amounts totaled thousands of dollars in withdrawals and checks. Id. At trial, the Defendant was largely unable to remember when those withdrawals occurred or what the money was spent on. ECF No. 44, PageID.515. This Court agrees with the Government that it is neither credible nor believable that Ott, who claimed an income level near the poverty line, would be unable to recall taking out thousands of dollars from his Canadian accounts.

The opinion concludes by noting "[t]he Government has met its burden by a preponderance of the evidence that Ott acted recklessly and with willful blindness by failing to report his foreign accounts."

SECTION: 6699
ILLNESSES OF CORPORATE OFFICERS DID NOT PROVIDE REASONABLE CAUSE FOR LATE FILING OF S CORPORATION RETURNS

Citation: Hunter Maintenance and Leasing Corp. Inc. v. United States, US District Court ND Ill., Case No. 1:18-cv-06585, 2/27/20

An S corporation argued that it had reasonable cause for late filing its Forms 1120S for multiple years due to both its CEO and CFO having serious illnesses that in both cases led to their deaths. However, the corporation was not successful in the case of *Hunter Maintenance and Leasing Corp. Inc. v. United States*, US District Court ND Ill., Case No. 1:18-cv-06585 in obtaining an abatement of the penalties.

Victor Cacciatore had founded the company, along with a number of others, and was treated as CEO and Chairman of the Board of the Company, controlling and exercising final decision-making authority over all financial and tax matters.

The other party involved was described by the Court as follows:

> In 1996 George Tapling, a certified public accountant, was hired by Jos. Cacciatore & Co. According to plaintiff, Tapling "functioned as, possessed and exercised the responsibilities of Chief Financial Officer ("CFO")" for all the Cacciatore companies, including plaintiff, until his death in May 2016. Despite being called plaintiff's "de facto" CFO, Tapling was never an employee, officer, or director on the books and records of plaintiff, or any company other than Jos. Cacciatore & Co.
>
> Nonetheless, it is undisputed that Tapling was solely responsible for preparing and filing the federal and state income tax returns for all the Cacciatore companies, as well as preparing and issuing the Schedule K-1s to the shareholders. All IRS notices and correspondence issued to any of the companies were given directly to Tapling unopened.
>
> Tapling directly reported to and was supervised by Victor until Victor's death in 2013. After Victor's death, Tapling reported to and was supervised by Peter Cacciatore, President of Jos. Cacciatore & Co.

Both officers had issues with cancers that would prove fatal. The condition of Victor was described as follows:

> Sometime in 2008 or 2009 Victor was diagnosed with myelodysplastic syndrome ("MDS"), a cancer affecting the bone marrow. He became

> increasingly ill over the ensuing years, later being diagnosed with bladder cancer and an aggressive fast growing tumor that could not be treated through surgery because of the MDS. According to plaintiff, by 2010 through his death in 2013, Victor was incapacitated by his illness, which prevented him from exercising his responsibilities.

The CFO also had medical issues, as the Court noted:

> In 2010, Tapling himself became ill with melanoma skin cancer. He ultimately died from the disease in 2016 after it metastasized. Despite his illness, he remained in his position with Jos. Cacciatore & Co., and continued to act as the "de facto" CFO of the companies. He did not outwardly exhibit any behavior or symptoms that would lead anyone to question his abilities until shortly before his death. Unbeknownst to the companies, however, beginning in 2010 Tapling failed to file the income tax returns for plaintiff and some of the tax returns for some of the other companies. He did in fact prepare plaintiff's returns, and issued the Schedule K-1s, but failed to file the 1120S forms and other returns for 2010 through 2013.

The problems were uncovered following the CFO's passing. As the opinion continues:

> After Tapling's death, unopened IRS notices were found in his desk. The companies hired an outside firm to review the income tax filing compliance for all of the companies. It found that Tapling had prepared plaintiff's tax returns but failed to file them. In March 2017 that firm filed the delinquent returns for plaintiff.

The corporation clearly faced significant late filing penalties under IRC §6699. The corporation argued that the penalties should be abated for reasonable cause, as the corporation was disabled due to the incapacity of its CEO and CFO.

The opinion notes that reasonable cause is not defined in IRC §6699 and the IRS has not issued any regulations in that area. But the court found the regulations under §6651(a)(1) which deal with failure to file other returns to be appropriate to consult. The opinion notes:

> Under that standard a taxpayer demonstrates "reasonable cause" if it can show that it "exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time period. 26 C.F.R. § 301.665-1(c)(1); *ATL & Sons Holdings, Inc. v. Commissioner* of Internal Rev,, 2019 WL 1220942 *6 (T.C. 2019)(holding the same standard applies to penalties imposed under § 6699).

The opinion begins its analysis by noting that a taxpayer bears a heavy burden when arguing for reasonable cause for late filing:

> In *Boyle*,[1] the seminal case discussing reasonable cause, an executor of an estate hired an attorney to prepare and file the federal estate tax return. The attorney filed a return three months late, resulting in a penalty. The estate argued that the penalty should be waived for reasonable cause, arguing that the executor had in good faith relied on the attorney to timely file their returns. The Court rejected this argument, holding that the taxpayer could not demonstrate reasonable cause because Congress placed the burden of prompt filing on the taxpayer, not on an agent or employee of the taxpayer. The Court articulated a bright line rule that reliance could not "function as a substitute for compliance with an unambiguous statute." Id. at 252. "The failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not 'reasonable cause' for late filing under [§ 6699]." id.
>
> Defendant argues that *Boyle* is directly on point, and that plaintiff's failure to timely file was due solely to its reliance on its agent Tapling, who was supposed to file their returns but failed to do so. Tapling, according to defendant, was simply an agent of plaintiff, and under *Boyle*, reliance on an agent does not constitute reasonable cause excusing a late filer from penalties.

The corporation argued that the appropriate question was whether the corporation had the ability to perform the action in question, not just its reliance on Tapling. The opinion continues:

> There can be no dispute that an individual taxpayer's illness and severe health problems can constitute reasonable cause to file late. See e.g., *Meyer v. Comm.*, T.C. Memo 2003-12 (2003). Whether a corporation can be incapable of timely filing based on incapacity of a corporate officer is another matter. Plaintiff relies on *In Re American Biomaterials Corp.*, 954 F.2d 919 (3d Cir. 1992), in which the corporation's CEO and chairman of the board and its CFO and Treasurer were embezzling funds. The court affirmed a lower court's decision that these officers' actions "incapacitated the corporation" and rendered it unable to comply with the IRC. The court noted that these officers were the "only two corporate officers with responsibility for [the corporation's] tax filing. Id. at 922.

But the Court notes that while such cases exist where the conduct of an officer may make the corporation unable to complete its filing, such cases are rare—and this isn't one of them.

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[1] *U.S. v. Boyle*, 469 U.S. 241 (1985)

The opinion concludes:

> Despite the number of cases cited in plaintiff's briefs, only American Biomaterials concluded that the corporation was incapable of timely filing, and that was based on its officers' criminal activity. All the other cases equated the officers' activity to that of the attorney in Boyle. In the instant case, plaintiff relied on Tapling. And regardless of whether Tapling was its agent or its employee, plaintiff cannot simply rely on his illness to demonstrate the corporation's inability to file. The corporation had a president and board members independent from Tapling and Victor, all of whom had responsibility to ensure that the corporation carried out its statutory duties. Nor has plaintiff presented any evidence of any ordinary business controls to ensure that it met its responsibility. Indeed, it admits that it ceded all responsibility to Tapling without any oversight. This does not demonstrate ordinary and prudent business practice. Consequently, the court grants defendant's motion for summary judgment and denies plaintiff's motion for summary judgment.

The Court also refused to take into account the taxpayer's argument that the IRS had abated penalties for related companies also controlled by Victor noting in a footnote:

> Plaintiff points out that the government abated late filing penalties for some of the other Cacciatore companies "some of which" were based on the same reasonable cause arguments made by plaintiff in the instant case. Even if this is true, and the court has no evidence to demonstrate the reasoning of those decisions, they are irrelevant to the instant decision, which must be based solely on the facts presented to the court. Nor does the court have any evidence as to the corporate structures of the other companies or whether those companies can or did demonstrate ordinary and prudent business practices.

SECTION: 7502
SUPREME COURT DECLINES TO HEAR CASE REGARDING MAILBOX RULE TO PROVE TIMELY FILING

Citation: United State Supreme Court Orders List, Denial of Petition for Certiorari, 2/24/20

The U.S. Supreme Court has decided not to hear the appeal from the Ninth Circuit in the case of Baldwin v. United States, Case No. 19-402.[2] The denial leaves standing the Ninth Circuit's ruling that Reg. §301.7502-1(e)(2) rendered irrelevant a prior Ninth Circuit decision in the case of *Anderson v. United States*, 966 F.2d 487 (9th Cir. 1992).

We previously wrote about this case when it was first decided by the Ninth Circuit in April 2019.[3]

The issue involved whether a taxpayer could only show timely mailing of their document by producing a certified or registered mail receipt stamped by a U.S. Postal Service employee or whether they could resort to other evidence showing the document had been timely mailed. In 1992 the Ninth Circuit had ruled that other evidence could be considered in the Anderson case. Other circuits had held that provisions Congress enacted in IRC §7502 for proof of timely filing of documents were meant to be the sole method of proving such timely mailing.

This split in the circuits eventually led the IRS in 2011 to issue revised regulations under §7502, taking the side of the circuits that held that the section was meant to be the sole method of proving timely mailing of the document. The relevant provision at §301.7502-1(e)(2) now reads:

> (i)Registered and certified mail. In the case of a document (but not a payment) sent by registered or certified mail, proof that the document was properly registered or that a postmarked certified mail sender's receipt was properly issued and that the envelope was properly addressed to the agency, officer, or office constitutes prima facie

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[2] United States Supreme Court Orders List, February 24, 2020, https://www.supremecourt.gov/orders/courtorders/022420zor_mjo1.pdf, p. 49

[3] Ed Zollars, "Ninth Circuit Panel Holds Taxpayers Cannot Rely on Common Law Mailbox Rule to Prove Timely Filing of Documents," Current Federal Tax Developments website, https://www.currentfederaltaxdevelopments.com/blog/2019/4/17/ninth-circuit-panel-holds-taxpayers-cannot-rely-on-common-law-mailbox-rule-to-prove-timely-filing-of-documents, retrieved February 26, 2020

> evidence that the document was delivered to the agency, officer, or office. Other than direct proof of actual delivery, proof of proper use of registered or certified mail, and proof of proper use of a duly designated PDS as provided for by paragraph (e)(2)(ii) of this section, are the exclusive means to establish prima facie evidence of delivery of a document to the agency, officer, or office with which the document is required to be filed. *No other evidence of a postmark or of mailing will be prima facie evidence of delivery or raise a presumption that the document was delivered.* (emphasis added)

The Ninth Circuit found that prior Supreme Court precedent, found in National Cable & Telecommunications Association v. Brand X Internet Services, 545 U.S. 967, 982 (2005), required the Court to accept the IRS's view of the law so long as the law itself did not clearly speak to the issue of whether other ways of proving timely mailing are allowed and the IRS regulation is a reasonable interpretation of the law. The Ninth Circuit noted:

> We did not hold in Anderson that our interpretation of the statute was the only reasonable interpretation. In fact, our analysis made clear that our decision filled a statutory gap. Under Brand X, the Treasury Department was free to fill that gap by adopting its own reasonable interpretation of the governing statute.[4]

The Supreme Court determination not to hear this case does not necessarily mean the Court agrees that the case was properly decided, but it can reasonably be read to imply the members of the Court who decided not to hear the case either do agree it was properly decided or simply believe the issue isn't important enough at this time to take up the Court's time. As a practical matter, it means that taxpayers should assume that any proof of mailing other than that provided for in the regulation is not likely to hold up if the IRS decides to challenge the issue. Certainly, in the Ninth Circuit that result now is virtually assured unless a party can persuade the Supreme Court to hear a later case on the matter coming up via that Circuit.

The case has garnered attention outside the tax world due to the possibility the Court might have used this case as a vehicle to reconsider the Brand X decision. While the majority of the Court is not ready to do that, the author of the very decision in question, Justice Thomas, now is ready to reconsider the matter. Justice Thomas authored a dissent on the petition for certiorari. As Justice Thomas wrote:

> Although I authored Brand X, "it is never too late to 'surrende[r] former views to a better considered position.'" South Dakota v. Wayfair, Inc., 585 U. S. ___, ___ (2018) (THOMAS, J., concurring)

[4] *Howard L. Baldwin et ux. v. United States*, CA9, No. 17-55115; No. 17-55354; 921 F.3d 836, April 16, 2019

> (slip op., at 1) (quoting McGrath v. Kristensen, 340 U. S. 162, 178 (1950) (Jackson, J., concurring)). Brand X appears to be inconsistent with the Constitution, the Administrative Procedure Act (APA), and traditional tools of statutory interpretation. Because I would revisit Brand X, I respectfully dissent from the denial of certiorari.[5]

As Justice Thomas' citation of Wayfair suggests, this is not the first time recently the Justice has decided he erred in the past—while not the author, he had been part of the majority in the Quill decision which was overturned by the Wayfair decision, with Justice Thomas also being part of the majority in that more recent case.

[5] United States Supreme Court Orders List, February 24, 2020, https://www.supremecourt.gov/orders/courtorders/022420zor_mjo1.pdf, p. 50