Current Federal Tax Developments

Week of July 12, 2021

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WEEK OF JULY 12, 2021

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SECTION: PPP LOAN
JOURNAL OF ACCOUNTANCY REPORTS SBA HAS FORMALLY NOTIFIED LENDERS IT IS ENDING PRE-FORGIVENESS LOAN NECESSITY REVIEWS

Citation: Jeff Drew, "SBA officially drops PPP Loan Necessity Questionnaire requirement," Journal of Accountancy, 7/12/21

The *Journal of Accountancy* reported that the SBA informed lenders in a July 9 letter that it will no longer request the completion of a loan necessity questionnaire for borrowers with PPP loans of more than $2 million and will not perform an additional necessity review.[1]

The article states:

> In a notice sent July 9, the SBA said it would no longer request either version of the Loan Necessity Questionnaire: SBA Form 3509 for for-profit borrowers and SBA Form 3510 for not-for-profit borrowers. In addition, Loan Necessity Questionnaires previously requested by the SBA are no longer required to be submitted.
>
> For PPP loans with an open request for additional information related to the Loan Necessity Questionnaire, the SBA advised lenders to close the request in the PPP computer platform and submit the loan back to the SBA.
>
> The changes are effective immediately, but the SBA said it would release an FAQ shortly with more details.[2]

We reported on June 28 on a statement from the Associated General Contractors of America stating that the questionnaires would be withdrawn to settle a lawsuit the AGCA had brought on the matter late in 2020.[3]

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[1] Jeff Drew, "SBA officially drops PPP Loan Necessity Questionnaire requirement," *Journal of Accountancy* website, July 12, 2021, https://www.journalofaccountancy.com/news/2021/jul/sba-drops-ppp-loan-necessity-questionnaire-requirement.html (retrieved July 13, 2021)

[2] Jeff Drew, "SBA officially drops PPP Loan Necessity Questionnaire requirement," *Journal of Accountancy* website, July 12, 2021

[3] Edward Zollars, "SBA Reported to Be Withdrawing Loan Necessity Questionnaires for PPP Loan Program," *Current Federal Tax Developments* website, June 28, 2021, https://www.currentfederaltaxdevelopments.com/blog/2021/6/28/sba-reported-to-be-withdrawing-loan-necessity-questionnaires-for-ppp-loan-program (retrieved July 13, 2021)

Although the *Journal of Accountancy* article did not contain a link to a copy of the letter in question, a similar report was found in an article on *Inc.'s* website.[4]

While it appears the SBA has "given up" on attempting to determine the necessity of the loan at this point before the initial grant of forgiveness, they could still review particular loans at a later time. Thus, the promised revised FAQ may give affected borrowers more information on what plans the agency might have to attempt to review the issue at a later date.

SECTION: 6061
DIGITAL SIGNATURE ON 2014 AND 2015 AMENDED RETURNS WAS NOT A VALID SIGNATURE

Citation: Mills v. United States, United States Court of Federal Claims, 7/14/21

During the COVID-19 pandemic, many people turned to digital signatures to avoid meeting face to face. And, as we've noted in prior posts, the IRS also authorized the use of electronic signatures for many purposes.[5] If you search Google for "digital signatures legally binding" you are likely to get links to articles from many digital signature providers with headlines stating that such signatures are legally binding.

But if you read behind the headlines you will find caveats and exceptions. In the case of *Mills v. United States*,[6] the taxpayer discovered that signatures on tax documents are subject to specific requirements and his use of a digital signature did not count, costing him the chance to pursue his claim for refund.

The taxpayer in question was a U.S. citizen living in Australia working for a defense contractor. His path to this case dealing with electronic signatures began when he had a tax consulting firm look at his tax returns.

> In 2018, the plaintiff hired a tax-consulting firm, Castro & Co., LLC, to review his tax returns and to prepare amended returns. (Id. ¶ 45.) Castro & Co. determined that the plaintiff was entitled both to an FEIE[7] and to a tax exclusion for employer-provided lodging. (Id. ¶ 46.) The plaintiff had not claimed either exclusion on his original 2015

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[4] Diana Ranson, "SBA to Drop Its Review of PPP Loans of $2 Million and Above," *Inc.* website, July 9, 2021, https://www.inc.com/diana-ransom/small-business-administration-ppp-loan-necessity-questionnaire.html (retrieved July 13, 2021)

[5] See Edward Zollars, "IRS Extends and Expands Temporary Deviation Allowing Some Forms to Be Signed Electronically or Digitally," *Current Federal Tax Developments* website, April 23, 2021, https://www.currentfederaltaxdevelopments.com/blog/2021/4/23/irs-extends-and-expands-temporary-deviation-allowing-some-forms-to-be-signed-electronically-or-digitally (retrieved July 15, 2021)

[6] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/%27digital-marks%27-on-amended-returns-spell-end-of-refund-suit/76vwb (retrieved July 15, 2021)

[7] Foreign Earned Income Exclusion

> and 2016 tax returns. (Id.) Based on this assessment, the plaintiff sought to amend his returns.[8]

Mr. Mills initially tried to file amended returns by having an associate of the tax consulting firm sign the amended returns on his behalf:

> On November 29, 2018, the plaintiff filed Form 1040X, U.S. Amended Income Tax Returns, for both tax years 2015 and 2016 ("first amended returns"), claiming a refund of $10,950.00 and $1,764.00, respectively. (Id. ¶ 47; see also ECF 24-2, Ex. 5; ECF 24-3, Ex. 7.) Because he was living in Australia when he filed his first amended returns, the plaintiff did not sign them. (Mills Decl. ¶ 5; see also ECF 24-2, Ex. 5 at A-083; ECF 24-3, Ex. 7 at A-179.) Instead, Tiffany Michelle Hunt, an associate of Castro & Co., signed her name on both the 2015 and 2016 amended returns on each return's line designated for the taxpayer's sworn signature in the jurat. (See ECF 24-2, Ex. 5 at A-083; ECF 24-3, Ex. 7 at A-179.) The name "John Anthony Castro," of Castro & Co., was typed on the line designated for the preparer's signature. (See ECF 24-2, Ex. 5 at A-083; ECF 24-3, Ex. 7 at A-179.) The plaintiff did not include a power of attorney with these first amended returns. (See ECF 24-2, Ex. 5; ECF 24-3, Ex. 7.)
>
> Several months after filing the first amended returns, the plaintiff filed a Form 2848, Power of Attorney and Declaration of Representative, that he signed on January 31, 2019. (Mills Decl. ¶ 6; see also ECF 24-3, Ex. 9.) On his Form 2848, the plaintiff indicated his authorization for John Anthony Castro, Tiffany Michelle Hunt, and Kasondra Kay Humphreys to represent him before the IRS. (Mills Decl. ¶ 6; see also ECF 24-3, Ex. 9.) Although the plaintiff gave these three representatives authority to act on his behalf for income-tax matters, he did not check the box in Part 5a of Form 2848 providing them with the authority to "[s]ign a return." (ECF 24-3, Ex. 9 at A-276.) The plaintiff signed the power of attorney form with his handwritten signature. (See id. at A-277.)[9]

Eventually the IRS noticed that the taxpayer had not himself signed the returns in question:

> In a letter dated August 20, 2019, the IRS advised the plaintiff that the first amended returns did "not appear to have your signatures" and that it did "not appear that you have authorized a representative to sign a return on your behalf." (ECF 24-3, Ex. 11 at A-280.) The IRS requested the plaintiff submit 1040X forms bearing original signatures. (Id.)

[8] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

[9] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

By this time, the taxpayer was now on assignment in Afghanistan, facing the request that he hand sign the forms:

> In response to the IRS's request, on August 27, 2019, the plaintiff again filed Form 1040X, U.S. Amended Income Tax Returns, for tax years 2015 and 2016 ("second amended returns"). (ECF 1, ¶ 47; see also ECF 24-3, Exs. 6 & 8.) At the time of filing, the plaintiff was deployed by his employer to Afghanistan without an easily accessible unclassified printer to print, sign by hand, and scan the documents. (Mills Decl. ¶¶ 9-11.) Instead of signing the forms by hand, the plaintiff attests that he electronically "signed" each Form 1040X with his initials, "KJM." (Id. ¶ 11; see also ECF 24-3, Ex. 6 at A-176, Ex. 8 at A-275.) He attests that he intended the digital markings to be his signature and to bind him to the second amended returns. (Mills Decl. ¶ 11.)[10]

Mr. Mills filed suit in the Court of Federal Claims attempting to get the refunds he claimed were due to him on the amended returns. But the IRS argued that Mr. Mills had failed to take the steps necessary to bring this matter before the United States Court of Federal Claims:

IRC §7422(a) provides:

> No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Secretary, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof.[11]

The IRS pointed out that the regulations required written verification under penalty of perjury, and that such a claim must be signed properly.[12] The IRS position was that such a digital signature was not an authorized method of signing this return at the time it was filed in August of 2019.

The Court noted that the IRS has provided little guidance on what is necessary for a signature, not defining the words *sign* or *signature*.[13]

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[10] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

[11] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

[12] Treasury Reg. §301-6402-2

[13] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

Congress did direct the IRS to develop measures to accept electronic signatures in 1998, adding IRC §6061(b)(1) which provides:

> (b) Electronic signatures. —
>
> > (1) In general. — The Secretary shall develop procedures for the acceptance of signatures in digital or other electronic form. Until such time as such procedures are in place, the Secretary may —
> >
> > > (A) waive the requirement of a signature for; or
> > >
> > > (B) provide for alternative methods of signing or subscribing,
> >
> > a particular type or class of return, declaration, statement, or other document required or permitted to be made or written under internal revenue laws and regulations.[14]

The Court noted that over those more than twenty years the IRS had not, until recently, developed any procedures to accept electronic signatures on amended returns. The Court also notes that while the IRS instructions for the original Forms 1040 for the years in question provide for accepting electronic signatures with a personal identification number, the instructions for amended returns had no comments on accepting electronic signatures.[15]

The taxpayer argued that his electronic signature should count as a signing of the amended return:

> The plaintiff argues that he did sign the second amended returns under penalty of perjury, as required by Treasury Regulation § 301.6402-2(b). He relies on the definition of "signature" found at 1 U.S.C. § 1: "'signature' or 'subscription' includes a mark when the person making the same intended it as such." 1 U.S.C. § 1.9 At the time that he filed his second amended returns, the plaintiff was working in Afghanistan. (Mills Decl. ¶ 9.) Without an easily accessible unclassified printer to print, sign by hand, and scan the documents, the plaintiff attests that he electronically signed the form with his initials, "KJM," and intended those digital markings to be his signature and to bind him to the second amended returns. (Id. ¶¶ 9-11; see also ECF 24-3, Ex. 6 at A-176, Ex. 8 at A-275.) Although the plaintiff argues that, as a matter of policy, he should be allowed to submit an electronic signature in his unique situation, he cannot point to any source of law authorizing him to do so.
>
> The plaintiff also relies on the definition of electronic signature in the Government Paperwork Elimination Act ("GPEA"), Pub. L. No. 105-277, §§ 1701-10, 112 Stat. 2681 (1998). The GPEA provides that "[t]he

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[14] IRC §6061(b)(1)

[15] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

> term 'electronic signature' means a method of signing an electronic message that — (A) identifies and authenticates a particular person as the source of the electronic message; and (B) indicates such person's approval of the information contained in the electronic message." GPEA § 1710. The plaintiff cites a 2016 IRS Chief Counsel Advisory that provided that digital signatures are legally sufficient under the GPEA and I.R.C. § 6061(b)(1), the provision directing the Secretary to develop procedures for accepting signatures in digital or other electronic form. Electronic Signatures & Form 2678, IRS CCA 201650019 (Dec. 9, 2016).

But the Court did not accept either justification. First, it notes that the law, by itself, did not allow for the taxpayer's digital signature.

> The Court, however, finds that I.R.C. § 6061(b)(1) does not, on its own, authorize the plaintiff's digital markings as a signature. Until the Secretary establishes procedures for digital or electronic signing, the Secretary *may*, but is not required to, waive the signature requirement or provide alternative methods of signing. I.R.C. § 6061(b)(1). The plaintiff has not pointed to any waiver or alternative method authorizing him to sign his second amended returns with digital markings as a signature. Similarly, 1 U.S.C. § 1 does not determine the meaning of signature in I.R.C. § 6061. The definition of "signature" in 1 U.S.C. § 1 applies "unless the context indicates otherwise." 1 U.S.C. § 1. Context indicates otherwise here; in fact, I.R.C. § 6061(b)(1) expressly governs electronic signatures on tax returns. See *First Nationwide Bank v. United States*, 431 F.3d 1342, 1348 (Fed. Cir. 2005) ("As a principle of statutory interpretation, a specific provision prevails against broader or more general provisions, absent clear contrary intent."). Under I.R.C. § 6061(b)(1), the plaintiff cannot digitally mark a tax return as a signature without a waiver or prescribed alternative method of signing.[16]

The Court also rejected the taxpayer's attempt to rely on the GPEA and a Chief Counsel Advisory, noting:

> The plaintiff's reliance on the GPEA and the Chief Counsel Advisory is likewise misplaced. As the plaintiff admits, the GPEA does not apply to the IRS. See GPEA § 1709 (providing explicitly that the GPEA does not apply to the Department of the Treasury or the IRS). As for the Chief Counsel Advisory, it "may not be used or cited as precedent." IRS CCA 201650019; see I.R.C. § 6110(k)(3) ("Unless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent.").
>
> Not only may the Chief Counsel Advisory not be relied on as precedent, but it also did not consider the question of electronic signatures on tax returns. *See generally* IRS CCA 201650019. The Advisory examined "whether the Service may accept a Form 2678,

[16] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

> *Employer/Payer Appointment of Agent*, that displays an electronic signature." Id. (italics in original). Its conclusion cuts against the plaintiff's argument. The Advisory concluded that the IRS should not accept electronic signatures without published guidance:
>
> > It is our view that an electronic signature should only be accepted by the Service when there are published guidance or [Internal Revenue Manual ("IRM")] provisions that specifically authorize use of an electronic signature for the specific form involved. Since there is no guidance or IRM provisions authorizing the use of an electronic signature on Forms 2678, we recommend that the Service not accept Forms 2678 signed electronically until the Service authorizes its use for Forms 2678 either in published guidance or in the IRM.
> >
> > Id.[17]

The opinion notes that the taxpayer has not provided any example of a provision providing for such authorization to use the digital signature in the amended return situation:

> The plaintiff here has not cited any provision, in the IRM or otherwise, that authorized the use of an electronic signature on Form 1040X amended returns at the time he filed his second amended returns. That the plaintiff is unable to do so is not surprising. Electronic signatures are required for documents that may be submitted in electronic format; forms that have traditionally been filed in paper format must always have a handwritten signature.[18]

Thus, the Court finds the taxpayer has not submitted a signature with his amended return and therefore the return is not treated as filed:

> The IRS had not established procedures for accepting electronic signatures on hard-copy amended returns, had not waived the signature requirement, and had not prescribed an alternative method of signing at the time the plaintiff filed his amended returns. Accordingly, the plaintiff's digital markings on his second amended returns do not meet the requirement that his returns "be signed" and, as a refund claim, "be verified by a written declaration that it is made under the penalties of perjury." I.R.C. § 6061(a); Treas. Reg. § 301.6402-2(b).[19]

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[17] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

[18] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

[19] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

SECTION: 6651
NO REASONABLE CAUSE FOR LATE FILING AND PAYMENT EVEN THOUGH ATTORNEY EMBEZZLED FUNDS MEANT TO PAY THE TAX FROM THE CLIENT AND DID NOT FILE THE RETURNS

Citation: Lindsay v. United States, CA 5, Case No. 20-50994, 7/9/21

The Fifth Circuit Court of Appeals upheld a lower court ruling that a taxpayer did not have reasonable cause for late filing of his tax returns when the attorney he had hired to handle such affairs while the taxpayer was incarcerated had embezzled the funds meant to be used to pay the taxes and had not filed the returns in question.[20] The case illustrates just how difficult it is for a taxpayer to escape such penalties by claiming reliance on a tax professional, even when that professional has intentionally misled the taxpayer about having filed the returns in question.

Embezzlement and Request for Reasonable Cause Relief

The opinion outlines the facts of the situation as follows:

> Lindsay was incarcerated from April 2013 to June 2015. In May 2013, he executed a Universal Power of Attorney ("POA") appointing Keith Bertelson as his attorney in fact. According to the terms of the POA, Bertelson had complete control of Lindsay's bank accounts and retained full authority to "manage [his] affairs." While incarcerated, Lindsay directed Bertelson to file his tax returns and pay his taxes. Although Bertelson assured Lindsay that he was filing his returns and paying his taxes, he was actually embezzling hundreds of thousands of dollars from him. Lindsay's tax returns for 2012 through 2015 were not timely filed, nor were his taxes or estimated quarterly taxes timely paid. While still incarcerated, Lindsay discovered Bertelson's malfeasance and revoked the POA in April 2014. Lindsay then sued Bertelson for embezzlement and after a jury trial in 2015, he was awarded $705,414.61 in actual damages and $1 million in punitive damages.[21]

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[20] *Lindsay v. United States*, CA 5, Case No. 20-50994, July 9, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/individual-has-no-defense-to-late-filing%2c-late-payment-penalties/76vdj (retrieved July 13, 2021)

[21] *Lindsay v. United States*, CA 5, Case No. 20-50994, July 9, 2021

After his release from incarceration, Mr. Lindsay filed all of the delinquent returns and paid all of the taxes, interest and penalties due on the returns. He then filed a claim for refund which the IRS denied, after which he brought suit to recover the penalties:

> In his complaint, Lindsay argued that his failure to file his tax returns and pay his taxes was due to reasonable cause and not willful neglect. He alleged that his incarceration qualified as a "disability" and that, considering his unusual circumstances, penalizing him for late filing and payments would go against equity and good conscience.[22]

The IRS moved to dismiss the case, relying on the US Supreme Court case of *United States v. Boyle*, 469 US 241 (1985). Generally, *Boyle* holds that a taxpayer is not due reasonable cause relief for a late filing if the taxpayer relies upon an agent to timely file the returns in question, and the taxpayer could have determined the proper date for filing (thus he/she is not relying on the professional expertise of the agent).[23]

While the magistrate judge hearing the matter recommended against granting this motion, the District Court disagreed and dismissed the case:

> In its order, the district court explained that while it was sympathetic to Lindsay's specific circumstances, the "weight of authority indicates he has failed to state a claim upon which relief can be granted." Beginning with Boyle, 469 U.S. at 245, the district court navigated the relevant caselaw and concluded that Lindsay was not entitled to assert the reasonable cause defense under I.R.C. § 6651(a)(1)–(2) or § 6654(a).[24]

Late Filing/Payment and Reasonable Cause

IRC §6651(a)(1) and (2) provide for penalties to apply for late filing of returns and the late payment of the related taxes, but subject to a *reasonable cause* exception:

> (a) **Addition to the tax.** In case of failure—
>
> > (1) to file any return required under authority of subchapter A of chapter 61 (other than part III thereof), subchapter A of chapter 51 (relating to distilled spirits, wines, and beer), or of subchapter A of chapter 52 (relating to tobacco, cigars, cigarettes, and cigarette papers and tubes), or of subchapter A of chapter 53 (relating to machine guns and certain other firearms), on the date prescribed therefor (determined with regard to any extension of time for filing), *unless it is shown that such failure is due to reasonable cause and not due to willful neglect*, there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 5 percent for each additional month or fraction thereof during

[22] *Lindsay v. United States*, CA 5, Case No. 20-50994, July 9, 2021

[23] *Lindsay v. United States*, CA 5, Case No. 20-50994, July 9, 2021

[24] *Lindsay v. United States*, CA 5, Case No. 20-50994, July 9, 2021

> which such failure continues, not exceeding 25 percent in the aggregate;
>
> (2) to pay the amount shown as tax on any return specified in paragraph (1) on or before the date prescribed for payment of such tax (determined with regard to any extension of time for payment), *unless it is shown that such failure is due to reasonable cause and not due to willful neglect*, there shall be added to the amount shown as tax on such return 0.5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 0.5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate;...

The court notes that the Treasury provides some guidance on reasonable cause in Reg. §301.6651-1(c)(1) which provides, in part:

> If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause. A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship . . . if he paid on the due date.[25]

The panel stated that this means there are two questions to be resolved in the taxpayer's favor for reasonable cause relief to be granted:

- Did the taxpayer use ordinary business care and prudence in attempting to comply with the law's requirements? and
- Was the taxpayer nevertheless unable to pay the tax?[26]

Exercise of Ordinary Business Care and Prudence

The taxpayer argued that the facts show he had exercised ordinary business care and prudence:

> Lindsay claims that he exercised ordinary business care and diligence by giving Bertelson his power of attorney and by directing Bertelson to file his income tax returns and to pay his taxes. Lindsay routinely asked Bertelson whether he was handling Lindsay's tax obligations, and Bertelson said that he was. In Lindsay's view, he has a reasonable cause for late filings and delayed payments because he used ordinary business care and prudence but was nevertheless unable to file his

[25] *Lindsay v. United States*, CA 5, Case No. 20-50994, July 9, 2021

[26] *Lindsay v. United States*, CA 5, Case No. 20-50994, July 9, 2021

> returns and pay his income taxes due to circumstances beyond his control, i.e., Bertelson's malfeasance.[27]

However, the panel found that the Supreme Court had rejected this delegation of the duty to file and pay the tax in *Boyle*:

> *Boyle* established that taxpayers have a non-delegable duty to promptly file and pay their taxes. 469 U.S. at 249–50. Unlike cases where taxpayers seek and detrimentally rely on tax advice from experts, "one does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due." *Id.* at 251.[28]

Mr. Lindsay would have known (or could easily have determined) the dates upon which the returns must be filed and could have filed them himself to assure that the act took place. But he decided to rely upon his attorney to take care of these acts.

IRS Audit Technique Manual and the Unavoidable Absence

Mr. Lindsay claimed that the IRS *Audit Technique Manual for Estate Tax Examiners* provides for eight reasons the agency considers to constitute reasonable cause for late filing which the taxpayer argues should apply to his failures as well. One of those exceptions involves the taxpayer's unavoidable absence, which Mr. Lindsay claimed should apply to his incarceration.

However, the panel did not accept this position, noting:

> Lindsay points to his incarceration as an example of an unavoidable absence, but "the mere fact that [Lindsay] was incarcerated when his return was due is not reasonable cause for his failure to file timely." *George v. Comm'r*, T.C. Memo 2019-128, 2019 WL 4686285, at *3 (collecting cases)). "Nor is the unavailability of records generally reasonable cause for failure to file a timely return." *Id.*[29]

Not Physically Capable of Complying

Finally, Lindsay argues that *Boyle* does not apply when a taxpayer is not "physically and mentally capable of knowing, remembering, and complying with a filing deadline…" citing the concurring opinion in *Boyle* penned by Justice Breyer. He also cites a U.S. District Court decision in the *Brown* case:

> He argues that his incarceration rendered him incapable of complying with his filing deadline, and he relies on *Brown v. United States*, 630 F. Supp. 57 (M.D. Tenn. 1985). In *Brown*, the district court concluded that *Boyle* did not govern the § 6651(a)(1) analysis where an elderly man entrusted his tax responsibilities to an attorney, the attorney became ill and filed the return late, and the elderly man was "incapable of

[27] *Lindsay v. United States*, CA 5, Case No. 20-50994, July 9, 2021

[28] *Lindsay v. United States*, CA 5, Case No. 20-50994, July 9, 2021

[29] *Lindsay v. United States*, CA 5, Case No. 20-50994, July 9, 2021

> meeting the criteria of ordinary business care and prudence" given his age, health, and lack of experience. Id. at 58, 60.[30]

But the panel found that the facts indicated that Mr. Lindsay was able to conduct other activities while incarcerated, thus he was not like the elderly man in *Brown*:

> Even if we read *Boyle* and *Brown* as creating an exception to the reasonable cause rule, Lindsay was not incapable of meeting the filing and payment deadlines. Lindsay could have used ordinary business care and prudence to assure that his taxes were filed and paid, much like he conducted business and employed a CPA while incarcerated. Lindsay failed to act with such care, and we affirm the district court's dismissal accordingly.[31]

The Court also found that the fact the attorney was embezzling from him did not incapacitate him:

> Lindsay also contends that his agent's embezzlement incapacitated him, and he should be exempted from the reasonable cause standard under *Matter of American Biomaterials Corporation*, 954 F.2d 919 (3rd Cir. 1992). That case is distinguishable because unlike the company in *American Biomaterials*, Lindsay could have controlled his agent.[32]

Fundamentally, it appears the panel's view is that the problem was that had Mr. Lindsay taken steps to handle this matter directly without relying upon an agent, he would not have been disadvantaged at all by the attorney's deceit and embezzlement.

Impact of the Case

While this case specifically deals with a professional that was clearly violating his professional duty to his client, it points out that taxpayers will not be able normally to get relief if, for whatever reason, the professional fails to timely file the return or extension, or fails to submit a payment timely. This means that professionals who simply make a mistake and fail to submit documents timely aren't likely to find the IRS willing to forgive the mistake and not pursue the penalty from the client.

This also means that, generally, a request for reasonable cause relief from penalties should not spend time arguing for failures on the part of the professional to perform such mundane tasks as filing the document on time, since *Boyle* indicates such reasons won't count. Rather, only errors that relate to tax advice the taxpayer needed to obtain from the professional will normally be deemed relevant.

But just because federal law doesn't treat such a failure to timely file a document or make a payment as excusable for the taxpayer due to the professional's error, that does not mean the client won't be able to pursue and be awarded reimbursement from the professional in a separate action in state court.

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[30] *Lindsay v. United States*, CA 5, Case No. 20-50994, July 9, 2021

[31] *Lindsay v. United States*, CA 5, Case No. 20-50994, July 9, 2021

[32] *Lindsay v. United States*, CA 5, Case No. 20-50994, July 9, 2021

SECTION: 7430
IRS POSITION NOT SUBSTANTIALLY JUSTIFIED WITH REGARD TO TAXPAYER BASIS COMPUTATION AND OVERALL METHOD OF ACCOUNTING

Citation: Morreale v. Commissioner, TC Memo 2021-90, 7/15/21

In the case of *Morreale v. Commissioner*[33] the Tax Court found that the IRS position in his case was not substantially justified, awarding the taxpayer attorney's fees for the costs incurred on this matter—but this matter alone, and only at the statutory rate.

The taxpayer is a hotelier and restaurateur who operated in Denver. He failed to file income tax returns for 2011 and 2012 and in 2013 filed for bankruptcy. The IRS bankruptcy specialists referred the case to the Examination Division to assist in the preparation of substitutes for returns for 2011 and 2012.[34]

The taxpayer agreed to prepare the delinquent income tax returns. After the returns were submitted to the Revenue Agent, the RA proposed adjustments based on two primary issues:

- The taxpayer had not substantiated basis in Sketch, LLC which operated two restaurants[35] and
- The taxpayer had improperly reported income on the accrual basis of accounting, so that accrued but unpaid expenses were disallowed.[36]

Basis Issue

While the opinion does not tell us exactly what the impact of the failure to show basis in Sketch was on the returns, the most likely impacts would be to disallow any loss deductions claimed from the entity and/or taxation of any distributions received from the entity. The burden is on the taxpayer to prove sufficient basis exists to claim any losses, as well as to show that any distributions represented a nontaxable return of basis, so adjustments would likely be appropriate if a taxpayer was unable to document his/her basis.

[33] *Morreale v. Commissioner,* TC Memo 2021-90, July 15, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/court-awards-business-owner-fraction-of-claimed-litigation-costs/76vyp (retrieved July 16, 2021)

[34] *Morreale v. Commissioner,* TC Memo 2021-90, July 15, 2021

[35] Note that the opinion does not tell us what tax entity type Sketch LLC had opted to be treated as, though it seems likely it was either an S corporation or a partnership.

[36] *Morreale v. Commissioner,* TC Memo 2021-90, July 15, 2021

But in this case the taxpayer did respond to the proposed adjustment by providing such information:

> To attempt to substantiate his basis in Sketch, petitioner had his accountant email a "full basis calculation for Sketch LLC from the opening of the restaurant" to RA Taurchini on July 13, 2016. Petitioner's accountant attached a spreadsheet, which provided a detailed summary of petitioner's basis in Sketch for tax years 2006 through 2010. The record does not indicate that RA Taurchini responded to this email or considered the calculations set out in the attached spreadsheet.[37]

Cash Basis of Accounting

The RA's assertion that the taxpayer should be on the cash basis of accounting likely surprises some readers—the IRS has a well known preference for taxpayers to file on the accrual basis, and under Reg. §1.446-1(c)(2)(i) businesses where *inventory* (which really means goods of some sort) are a material income producing factor must use the overall accrual basis of accounting for tax—the basis this taxpayer was using as food served in a restaurant is a material income producing factor.

The taxpayer pointed this out in their response:

> In response to RA Taurchini's contention that petitioner's businesses should have reported on a cash basis, petitioner's counsel provided financial statements that purported to show petitioner's consistent use of the accrual method. Additionally, petitioner's counsel argued that petitioner's businesses must use the accrual method by operation of section 1.446-1(c)(2)(i), Income Tax Regs., which requires businesses that carry inventory to use the accrual method of accounting.[38]

However if the taxpayer had been previously reporting on the overall cash basis of accounting, under IRC §446(e) the taxpayer could not change to the overall accrual basis of accounting without getting the IRS's permission. While such permission would be automatically granted by the IRS, that only applies if the taxpayer follows the proper procedures outlined in Rev. Proc. 2015-13 (as clarified and modified by Rev. Proc. 2015-33, and as modified by Rev. Proc. 2017-59, and by Section 17.02 of Rev. Proc. 2016-1). That requires filing a Form 3115 with a timely filed tax return. As these returns were not timely filed, the automatic permission rules were off the table and, as the returns were under exam, the special rules for changes in accounting methods for returns in exam would have applied instead.

The RA's position was that, in fact, the taxpayer had previously been reporting on the overall cash basis of accounting.

> RA Taurchini rejected these arguments and, instead, determined that petitioner should have used the cash basis method of accounting. He based this determination on a single third-party contact discussion

[37] *Morreale v. Commissioner,* TC Memo 2021-90, July 15, 2021

[38] *Morreale v. Commissioner,* TC Memo 2021-90, July 15, 2021

> with petitioner's former return preparer who stated that he recalled preparing petitioner's returns on the cash basis.[39]

However, the Court notes that despite this position, the RA made adjustments to beginning and ending inventories, arguably something that should not have existed on a pure cash basis reporting entity:

> Notably, however, in his lead sheets and eventually in his report, RA Taurchini adjusted petitioner's beginning and ending inventories relating to Sketch for the tax years at issue "according to * * * [petitioner's] balance sheets at 12/31/2011 and 12/31/2012."

However, under Revenue Procedures in place at that time, certain taxpayers were allowed to use the cash basis of accounting so long as they treated amounts that would have been in inventory as supplies. And, even if the business did not qualify for such treatments, it's still possible the taxpayers recorded inventory but otherwise were on the overall cash basis.

Fundamentally, though, the RA's position rested on his conclusion regarding the evidence related to the methods that the taxpayer had previously been using. He claimed this was the overall cash basis of accounting based on a single contact with a former return preparer.

Tax Court Filing and Trip to Appeals

A Notice of Deficiency was issued on September 7, 2017 based primarily on the original adjustments proposed by the RA. The taxpayer chose to take the matter to Tax Court rather than having the matter disposed of in the bankruptcy proceeding.

After adopting the same position outlined in the Notice of Deficiency in its answer to the taxpayer's petition to the Tax Court, the IRS referred the case to the Appeals Office.

The Appeals Office was not very impressed with the IRS's case. As the opinion notes:

> The Appeals Office assigned petitioner's case to Appeals Officer Rodney Largent (AO Largent). AO Largent noted in his case activity record that a critical issue in this examination was "the legal and professional adjustments disallowed for only the accrual issues". After a 10-month review, AO Largent prepared a schedule of adjustments, which addressed seven substantive adjustments as well as the additions to tax for failure to file for tax years 2011 and 2012 and the accuracy-related penalty for tax year 2012 proposed by RA Taurchini. Of the seven substantive adjustments, four involved the method of accounting dispute. For these, AO Largent concluded that "[t]here isn't sufficient evidence to establish the taxpayer ever used the cash method of accounting" and that "the accrual books appear to clearly reflect income and expenses." With respect to petitioner's basis in Sketch, AO Largent considered the July 13, 2016, email sent by

[39] *Morreale v. Commissioner,* TC Memo 2021-90, July 15, 2021

> petitioner's accountant and concluded that "[t]he taxpayer provided a basis computation * * * [that] was sufficient to substantiate basis." AO Largent also concluded that the additions to tax for both years and the accuracy-related penalty for tax year 2012 should be "conceded in full".
>
> On the basis of the Appeals Office's conclusions, the parties filed a stipulation of settled issues on January 30, 2019. In the stipulation the parties agreed that petitioner owed deficiencies of only $1,367 and $30,639 for tax years 2011 and 2012 and that no addition to tax or penalty was owed for either year. The stipulation of settled issues ended the substantive dispute between the parties.[40]

Was the IRS Position Substantially Justified?

Under IRC §7430, in certain situations, a prevailing taxpayer may receive an award of reasonable costs related to a proceeding if the IRS position was not substantially justified.

The Tax Court notes that traditionally the Court normally used an item-by-item analysis, but as this case is subject to appeal to the Tenth Circuit Court of Appeals, the Court instead must use a test established by the Tenth Circuit in *United States v. Johnson*, 920 F.3d 639. The opinion describes this test as follows:

> In *Johnson*, the Court of Appeals addressed the proper scope of inquiry with regard to whether the "position of the United States" was substantially justified under section 7430. In its analysis, the Court of Appeals drew heavily on caselaw interpreting the Equal Access to Justice Act (EAJA), 28 U.S.C. sec. 2412. The EAJA, using wording similar, though not identical, to that found in section 7430, provides that a court "shall award [fees and other expenses] to a prevailing party" in any case "brought by or against the United States * * *, unless the court finds that the position of the United States was substantially justified". 28 U.S.C. 2412(d)(1)(A).
>
> Given this linguistic similarity, the Court of Appeals looked to caselaw interpreting the meaning of the "position of the United States" under the EAJA to guide its analysis under section 7430. To start, the Court of Appeals relied on the Supreme Court's statements in *Commissioner, INS v. Jean*, 496 U.S. 154, 161-162 (1990), that the structure of "the EAJA — like other fee-shifting statutes — favors treating a case as an inclusive whole" when defining the word "position". The Court of Appeals also relied heavily on the analysis in *Roanoke River Basin Ass'n v. Hudson (Roanoke)*, 991 F.2d 132, 139 (4th Cir. 1993), where the U.S. Court of Appeals for the Fourth Circuit first held that the "position of the United States" should be understood as a singular, holistic position rather than multiple itemized contentions. The Court of Appeals in

[40] *Morreale v. Commissioner,* TC Memo 2021-90, July 15, 2021

> *Johnson*, 920 F.3d at 649, considered *Roanoke's* "in-depth analysis of th[is] issue * * * [to be] persuasive" and adopted its approach.[41]

The panel found that the IRS position was not substantially justified for either the issue of lack of basis or the issue of the overall method of accounting—matters that were crucial to the case as a whole.

With regard to basis, the Court noted:

> With regard to the basis dispute, after respondent filed his answer, which he concedes is "essentially the same" as the position taken by the Examination Division, the Appeals Office concluded that petitioner had "provided a basis computation along with prior year workpapers, schedules, and books * * * [that] was sufficient to substantiate basis." The Appeals Office based its conclusion on the July 13, 2016, email from petitioner's accountant to which the revenue agent did not respond. Because this email provided documentation sufficient to substantiate petitioner's basis a month before the issuance of the 30-day letter but was not properly considered in forming the basis substantiation contention reflected in the notice and the answer in this case, we conclude that this contention lacked a reasonable basis in fact.[42]

As well, the Court found the IRS position wholly wanting with regard to the overall basis of accounting for tax purposes.

> With regard to the method of accounting dispute, section 1.446-1©(2)(i), Income Tax Regs., provides, in relevant part, that "[i]n any case in which it is necessary to use an inventory, the accrual method of accounting must be used with regard to purchases and sales". Petitioner's restaurant businesses carried inventory during the years at issue, and the notice lists an adjustment to "Sch C1 — Beginning Inventory" that "allow[s] an additional deduction for purchases." Finally, the Appeals Office concluded that "[t]here isn't sufficient evidence to * * * [support] the examiner's determination that in the prior years the taxpayer used the cash method of accounting." Taking these circumstances into consideration, we can find no reasonable legal or factual basis for respondent's determination relating to the proposed change in method of accounting determined in the notice and adopted in the answer. Moreover, we conclude that this contention "did not follow * * * applicable published guidance", specifically section 1.446-1(c)(2)(i), Income Tax Regs. See sec. 7430(c)(4)(B)(ii), (iv)(I). Therefore we are compelled to presume that the overall position of the United States was not substantially justified.[43]

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[41] *Morreale v. Commissioner,* TC Memo 2021-90, July 15, 2021

[42] *Morreale v. Commissioner,* TC Memo 2021-90, July 15, 2021

[43] *Morreale v. Commissioner,* TC Memo 2021-90, July 15, 2021

The Court notes that while a case can be entirely conceded and yet the position could still be substantially justified, that was clearly not so in this case:

> Of course, it is true that conceding a case — even in full — does not, on its own, mean that the position of the United States was not substantially justified. *Maggie Mgmt. Co. v. Commissioner*, 108 T.C. at 443. But this case does not involve a mere concession in respondent's answer; respondent's concessions here came after filing his answer and were made because the Appeals Office concluded that the determination reflected in his answer lacked a basis in fact and law — a conclusion with which we agree. In the light of all the facts of this examination and litigation, we cannot say that the position of the United States was "justified * * * in the main". *Underwood*, 487 U.S. at 565. Rather, these determinations were contrary to applicable guidance and were lacking in a factual basis, and they tainted the Government's position in the entire case. See *Roanoke*, 991 F.2d at 139.[44]

[44] *Morreale v. Commissioner,* TC Memo 2021-90, July 15, 2021