Volume 56
Issue 2 *Dickinson Law Review - Volume 56, 1951-1952*

1-1-1952

Are Taxpayers Safe in Relying Upon the Advice of their Accountants and Attorneys in Federal Tax Cases

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ARE TAXPAYERS SAFE IN RELYING UPON THE ADVICE OF THEIR ACCOUNTANTS AND ATTORNEYS IN FEDERAL TAX CASES

By

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It can be stated as a general proposition that taxpayers are justified in relying upon the advice of reputable counsel, and in cases where they rely upon such advice, they cannot be found guilty of fraud and be subjected to penalties. The following cases bear out the courts' finding to that effect.

1. The Circuit Court of Appeals, Third Circuit, in the case of *Hatfried, Inc. et al.* v. *Com. of Internal Revenue*[1] held: "Where a taxpayer made full disclosure of all facts operating to establish its status as a personal holding company, and the tax return was prepared by a certified public accountant who was its regular accountant and who personally took care of all its records and that the only possible conclusion was that the statements in its return that it was not a personal holding company was made on the accountant's advice, the Tax Court's finding that there was no reasonable cause for failure to file a personal holding company return and that it was not liable for penalty was not sustained by substantial evidence."

2. "That in the application of penalties, all questions in doubt must be resolved in favor of those from whom penalty is sought."

3. "Taxpayer's failure to file personal holding company return on advice of its regular certified public accountant, was due to 'reasonable cause' and not to 'willful neglect,' and therefore was not liable for penalties."

In another case the United States Court of Appeals for the District of Columbia in *Orient Investment and Finance Co. Inc.* v. *Com. of Internal Revenue*[2] held as follows:

1. " 'Reasonable cause' within statutory provision imposing penalty for failure to file personal holding company return unless failure is due to reasonable cause, means nothing more than the exercise of ordinary business care and prudence."[3]

2. "Where neither president of two corporate taxpayers nor his wife and daughter, who were the only other stockholders, had any knowledge on the sub-

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1 162 F.2d 628.
2 166 F.2d 601.
3 26 U.S.C.A. Int. Rev. Code sec. 291(a).

ject of form of income tax returns to be filed and those matters were placed in the hands of certified accountants to whom facts were fully disclosed, failure to file personal holding company returns was due to 'reasonable cause', so that the corporate taxpayer would not be held liable for penalties, especially where the Commissioner's own agents examined the books of the corporate taxpayer and made a report on the theory that personal holding company returns were not required."

The United States District Court (W. D. Kentucky, Louisville Division) in *Walnut Street Co.* v. *Glenn, Collector of Internal Revenue,*[4] held as follows:

1. "Rent which constituted virtually all of the corporation's income and was received for use of a building leased to a partnership comprised of owners of more than 90% of the outstanding capital stock in the corporation was 'personal holding company income' taxable as such."[5]

2. "Penalty for failure to file personal holding company surtax returns should not be assessed unless failure to file was due to willful neglect and was without 'reasonable cause.' "[6]

3. "The statute providing penalty for failure to file income tax returns, unless failure to file was due to 'reasonable cause' and not 'willful' neglect, 'reasonable care' means exercise of ordinary business care and prudence and 'willful' means intentional or knowing or voluntary."[7]

4. "Belief in good faith on advice of reputable tax accountant that corporation was not a personal holding company taxable as such constituted 'reasonable cause' for failure to file personal holding company surtax returns, and corporation was not subject to penalty assessable for failure due to 'willful' neglect to file required returns."[8]

The very fact that taxpayers seek and obtain advice of counsel indicates that they acted in good faith and that they availed themselves of the best means at their command to determine fairly and honestly their liability.

In *Dayton Bronze Bearing Co.* v. *Gilligan, Internal Rev. Collector,*[9] the Circuit Court of Appeals held:

1. "Where a corporation, believing in good faith, on reasonable grounds, and after taking advice of reputable counsel that it was not liable for munitions tax, made no return within the time prescribed by statute, but later, on advice of the collector, made a voluntary return without prejudice, the imposition of the

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4 83 F. Supp. 945.
5 26 U.S.C.A. secs. 500(a)(1, 2); 502(f, g).
6 26 U.S.C.A. secs. 291; 500(a)(1, 2).
7 26 U.S.C.A sec. 291.
8 26 U.S.C.A. secs. 291; 500(a)(1, 2); 501(a)(1, 2); 502 (f, g).
9 28 Fed. Rep. 709.

penalty for failure to make timely return, prescribed by Rev. St. sec. 3176, not authorized."

The above case was cited in the *Hatfried Inc.* case, *supra,* and in *Hayseed Lumber Mining Co.* v. *Com. of Internal Revenue*[10] in which the U. S. Court of Appeals, Second Circuit held:

1. "Where corporate taxpayer's officer consulted a competent certified accountant to prepare proper corporate tax returns and disclosed all necessary information and accountant knew that taxpayer was a personal holding company but did not inform officer thereof and officer filed on behalf of the corporation only the ordinary returns prepared by the accountant, corporate taxpayer exercised 'ordinary business care and prudence' and was not subject to penalty for failure to file personal holding company's surtax returns."[11]

2. "The fact that taxpayer delegated to an agent all responsibility for preparing tax returns does not require that he should be held to accept agent's efforts with all the burdens and be chargeable with the agent's negligence in preparing the returns."

The Tax Court held that "we do not think it improper for these petitioners to employ and rely upon those whom they believe to be competent to prepare their returns."[12]

If the advice of counsel is relied upon by the taxpayer, the advice must be on the point involved and not on some extraneous point,[13] and taxpayer must furnish complete information to his counsel.[14] Reliance on an accountant does not justify false statements.[15]

Taxpayers have often successfully offered the defense of relying upon attorney's advice in criminal prosecutions.[16]

Additional information returns are required to be filed by any attorney, accountant, fiduciary, bank, trust company, financial institution, or any other person who aids, assists, counsels or advises with respect to the organization or reorganization of any foreign corporation.[17] Conviction for violating this section subjects the parties above mentioned to a fine of not more than $2000 or imprisonment for not more than one year or both.

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10 178 F.2d 769.
11 26 U.S.C.A. sec. 291.
12 J. B. Arnold, 14 BTA 954; William E. Mitchell, 40 BTA 424 rev'd and remanded 118 F.2d 308; 161 F.2d 898; 185 F.2d 266.
13 Louis Ginsburg, 13 BTA 417, appeal dismissed 48 F.2d 1074; Paul Plunkett & Co. Inc., 42 BTA 464; Emily L. Buck, BTA. Memo. Op. Dkt. 98859, September 10, 1940.
14 E. M. Green, 11 BTA 278.
15 Grover C. Blumer, 23 BTA 1045; Harry Feldman, 34 BTA 517.
16 U. S. v. La Fontaine, 54 F.2d 371; Hargrove v. U. S., 67 F.2d 280.
17 Sec. 1177(g) I.R.C.

If an attorney, accountant, fiduciary, bank, trust company, financial organization or other person counselled, aided, assisted or advised any person with regard to the formation, organization or reorganization, of any foreign corporation after the enactment of the Revenue Act of 1937, he must file a return with the Commissioner within 30 days. The 1939 Revenue Act relieves attorneys-at-law from filing a return with respect to any advice given or information obtained by virtue of the attorney and client relationship.[18]

The return must contain the information as required by law and as summarized in *Merteas Law of Federal Income Taxes,* vol. 9 p. 649.

The courts have decided in innumerable cases that any and all information given by taxpayers to attorneys-at-law in criminal and civil tax fraud cases in privileged information and the attorneys cannot be compelled to divulge it. Accountants are not put in the same position by the courts; information furnished to them by clients is not privileged and even though some states have attempted by legislation to give accountants the same privilege as that had by attorneys-at-law, the courts have held that privilege cannot be legislated or created by statute but exists and was establised by the common law. The courts have considered all such legislation unconstitutional and of no avail.

It is no excuse for taxpayer's late filing of his return or the non-filing of one that he was relying on his accountant to do so, where the law is clear and the accountant had no reasonable grounds to believe that a filing of return was unnecessary.[19] Taxpayer was also not excused in the *Terox Corporation* case[20] where he relied on both his accountant and attorney in not filing a personal holding company return, where the law was clear on the subject requiring the filing of it. The taxpayer was not excused where his accountant was under the belief that a fiscal year return was due instead of what was actually due, a calendar year return.[21]

Relying on an accountant ignorant of the law is no excuse. Full disclosure and reliance on an attorney or accountant is considered a reasonable cause for failure to file a return only where there is doubt in the law as to whether a return is actually due to be filed.[22]

The Tax Court of the United States has upheld the imposition of penalties

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18 Sec. 3604 I.R.C. as amended by 1939 Act, sec. 404.
19 Malcolm Clifton Davenport, 6 T.C. 22(A); Bro-Jeff Theatres, Inc., T.C. Memo. Dkt. 4008. December 29, 1945, apps. dism'd (CCA-2) October 21, 1946; Hatfried, Inc., T.C. Memo. Dkt. 6711. February 8, 1946.
20 6 T. C. 35.
21 Eagle Piece Dye Works, 10 BTA 1360.
22 Three States Lumber Co., T.C. Memo. Dkt. 5588. October 11, 1945, rev'd on other grounds, 158 F.2d. 61.

in the following cases for failure to file returns even though taxpayers were under mistaken belief that no returns were necessary.[23]

A taxpayer who fails to file a return because he is under a misapprehension is not guilty of a crime.[24] If he acts honestly by advice of counsel or if an incorrect return is prepared by a certified public accountant who has full knowledge of the facts he cannot be held guilty of criminal intent.[25] Advice of attorney and accountant considered valid in the following cases.[26]

Legal expenses incurred in successfully defending criminal charges arising out of the lawful operation of a business are usually deductible as an ordinary and necessary business expense.[27] It is important that we show in these cases that the act with which the taxpayer was charged was actually connected with his business.[28] Deductions for legal expenses can be had by clients if the charge is dismissed against them during the trial for want of prosecution or by *nolle pros* after the jury disagreed in the case.[29] Expenses incurred in defending civil fraud case were allowed by the Tax Court in the case of *Charles Goodman et al*[30] even though the court upheld the fraud penalty on the ground that "a deduction will only be denied if it would frustrate the sharply defined policies of the statute which has been violated." Fees paid for accounting and bookkeeping work incurred in the operating of taxpayer's business are deductible as business expenses.[31] Installation of accounting systems are held by the courts as deductible as operating expenses of the business.[32]

Expenses incurred in connection with cases involving federal income tax liability are deductible usually as business or non-business expenses.[33] Expenses paid in determining one's liability for income taxes are deductible as non-business expenses.[34] Therefore the cost of preparing returns, obtaining refunds or resist-

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23 Heatbath Corp, 14 T.C. 332, app. on other issues dism'd, (CCA-1) December 11, 1950; Palm Beach Trust Co., 9 T.C. 1060; Miresta Corp., 8 T.C. 987. The Court of Appeals took a more lenient view in Palm Beach Trust Co. v. Com., 174 F.2d 527, cert. denied 94 L.Ed. 43; Economy Savings & Loan Co. v. Com., 158 F.2d 4721, and the District Court of Texas in Newhoff Bros. v. U. S. has also taken the liberal view on June 21, 1950.

24 U. S. v. Harry Murdock, 290 U. S. 389.

25 D.W. Kuhn v. U. S., 42 F.2d 786, cert. denied 287 U. S. 611.

26 Adelaide Park Land, 25 BTA 211; C. R. Lindback Foundation, 4 T.C. 652, aff'd. 150 F.2d 986; Keokuk & Hamilton Bridge Inc., 12 T.C. 249 as amended by T.C. Memo. Dkt. 10559, May 19, 1949 rev'd on other grounds 180 F.2d 56; Agricultural Securities Corporation, 39 BTA 1103, aff'd on other issue 116 F.2d 800; Safety Tube Corp., 8 T.C. 757 aff'd on other issues 158 F.2d 787; Cristinade Burbon Patine, 13 T.C. 816, aff'd on other issues (CCA-4) December 30, 1950; Adelaide McCalgan, 19 BTA 958.

27 Citron-Byer Co., 21 BTA 380; Hal Price Headley et ux, 37 BTA 738(A).

28 John Stephens, 2 BTA 724; G. L. Rickard, 12 BTA 836; I.T. 3551, CB1942-1, 42.

29 Hal Price Headley, see n. 27; Morgan S. Kaufman, 12 T.C. 114(a).

30 T.C. Memo Dkt. 14238, September 12, 1950.

31 I.T. 2819, CB. XIII-2, 1934; North Star Granite Corp., 21 BTA 222; Fred G. Richardson, T.C. Memo Dkt. 108228, January 19, 1943.

32 A.R. 998. C.B.I. -2, 195, 1922; Schlosser Bros. Inc., 2 BTA 137.

33 T. Kissel, 15 BTA 270 and sec. 29.23(a)-15.

34 Sec. 29.23(a)-15.

ing additional taxes are considered at present as expenses connected with the conservation or maintenance of property held for the production of income and is an expense connected with the management of one's business. The courts have widened the sphere of deductibility in the following cases.[35] These expenses, accounting and legal, incurred in determining liability for income taxes are retroactively deductible for all the open years. Therefore, it is advisable to check past returns in order to determine whether we should file claims for refunds. Transferee can deduct expenses incurred where he would otherwise be liable on non-contest.[36]

In *Plastic Parts Development Corp.*,[37] the Tax Court in this case held that where a "competent tax expert", overlooked the fact that taxpayer was a personal holding company, where it had all the facts and knew of the personal holding company requirements, and had given client a negative answer to the return question on personal company status, the court refused to impose a penalty. The firm was a certified public accounting firm that had 60 employees many of whom were Certified Public Accountants, the returns were prepared by juniors, checked by seniors and finally by partner responsible for the client. On these facts the court found that "the firm was one upon which the petitioner could, in the exercise of ordinary prudence and business care, rely to prepare the necessary return".

In the case of *C. W. Gardner et al.* v. *James L. Conway,* the Minnesota Supreme Court held on July 6, 1951 that an accountant is illegally practicing law if in the course of preparing an income tax return he passes on difficult or doubtful legal questions. The facts were a non-certified public accountant in preparing a return had to determine whether (1) taxpayer was a partner with his "common law" wife, (2) whether she could be claimed as an exemption, (3) whether taxpayer had to file a separate return, (4) whether farm expenses and losses were deductible? The court held that in deciding these questions the accountant was illegally practicing law. This court's test is stricter than the test applied by our Appellate Division and the Court of Appeals in New York state in the *Bercu case,* which held that an accountant is not practicing law if he decided tax questions in connection with his regular accounting work for the taxpayer including preparing of the tax return. The court merely held in the *Bercu case* that a person who is not a lawyer could not hold himself out to the public as a tax consultant or tax expert.

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[35] Herbert Marshall, 5 T.C. 1032 (A) and Louis E. Stoddard Jr. v. Com., 152 F.2d 445; William Heyman, 6 T.C. 799.
[36] Benjamin P. O'Neal, 18 BTA 1036; F. E. Cloyd, 19 BTA 966, aff'd on other issues 63 F.2d 649, cert. denied 290 U. S. 635; Fred T. Ley, 21 BTA 216(N); W. D. Haden Co. Can., 165 F.2d 588.
[37] T.C. Memo Dkt. 26686.