DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Charles P. Besecky
Branch Chief CC:INTL:BR4

SUBJECT:

This Field Service Advice responds to your memorandum dated November 27, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Parent =

CorpA	=
CorpB	=
CorpC	=
Shareholder1	=
Shareholder2	=
Tax Adviser	=
CPA Tax Adviser	=
BusinessA	=
BusinessB	=
BusinessC	=
CountryA	=
YearX-2	=
YearX-1	=
YearX	=
YearX+1	=
YearX+2	=
Date1	=
Date2	=
Date3	=
Date4	=
Date5	=
a	=

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

m =

n =

p =

q =

ISSUE

What are the standards for determining whether the reasonable cause exception of § 6038B(b)(2) should excuse Parent from the penalty for failure to report a transfer of property to a foreign corporation in an exchange described in § 367(a)?

CONCLUSIONS

Parent, a domestic corporation, was subject to the § 6038B reporting requirements because Parent made a transfer subject to § 367(a) in the Date5, YearX reorganization. Parent would have reasonable cause for failing to file timely the required information if Parent exercised ordinary business care and prudence but was still unable to comply with its obligations because of circumstances beyond its control. All the facts and circumstances should be considered in determining whether Parent exercised ordinary business care and prudence. It appears that Parent did not have reasonable cause for failing to file the Form 926. Parent has the burden of proving that it had reasonable cause for failing to file timely.

FACTS

We understand that the facts developed as of the date of the submission are as follows:

A. General Facts and Date5 YearX Reorganization

Parent is the parent of an affiliated group of corporations that files consolidated federal income tax returns with a May 31, taxable year end. Parent has been in existence since Date1 for over a years. Parent is engaged in several types of businesses, including BusinessA and BusinessA holdings, BusinessB, and BusinessC. Parent is a privately held company that had assets between $i million and $j million for taxable years YearX-2 through Year X+1, and gross receipts between $k million and $m million for taxable years YearX-2 through Year X+1. Shareholder1, an individual, owns a g% majority interest in Parent, and Shareholder2 owns a h% interest in Parent. Shareholder1 was a shareholder of both Parent and CorpA prior to the Date5 YearX reorganization. Shareholder1 is the President of Parent and was the former President, Chief Executive Officer, and Chairman of the Board of Directors of CorpA. On Date2 YearX-1, Shareholder1 resigned from his position as Chairman of CorpA, and on Date3 YearX-1, Shareholder1 resigned from his Board of Directors position of CorpA. Parent has only q employees.

Prior to the Date5 YearX reorganization, Parent owned shares in CorpA, a publicly traded domestic corporation engaged in BusinessA. To implement a reorganization plan, CorpA organized CorpB, as a wholly owned CountryA corporation, and CorpB organized CorpC as a wholly owned domestic subsidiary. On Date5 YearX, CorpC merged with and into CorpA (with CorpA remaining as the surviving corporation) and the shareholders of CorpA transferred their shares of CorpA stock to CorpB (a CountryA corporation) in exchange for equal shares of CorpB stock. As a result of the Date5 YearX reorganization, CorpB (a CountryA corporation) became the parent holding company of CorpA (a domestic corporation).

On Date5 YearX, Parent owned b shares of CorpA common stock, valued at $c per share, which it exchanged for an equal number of CorpB stock. Parent's basis in the CorpA stock was $e, Parent's amount realized on the exchange was $d, and Parent's gain was $f from the Date5 YearX reorganization.

B. Information about the Date5 YearX Reorganization

On Date4 YearX, CorpA introduced a plan to reorganize into a CountryA corporation. CorpA sent a letter dated Date4 YearX to all its shareholders (including Parent) seeking approval of the Date5 YearX reorganization. The letter dated Date4 YearX included a proxy statement and prospectus for the reorganization and information about the tax implications of the proposed Date5 YearX reorganization (which collectively will be referred to as the "Date4 YearX letter"). The Date4 YearX letter provided that individual shareholders could be taxed on the exchange in the proposed Date5 YearX reorganization at the relevant capital gains rate. In addition, the Date4 YearX letter provided an alternative for those shareholders wishing to have a portion of the reorganization treated as a non-taxable exchange, by allowing shareholders to elect to subscribe to and receive non-taxable equity in exchange for CorpA stock. Parent did not make an election to receive non-taxable equity.

Following the Date5 YearX reorganization, CorpB sent a letter dated January 3, YearX+1 to all its shareholders about the Date5 YearX reorganization. The January 3, YearX+1 letter explained to shareholders that under § 367(a) most CorpA shareholders were required to recognize gain on the Date5 YearX reorganization. In addition, the January 3, YearX+1 letter explicitly informed the shareholders of the requirement to file Form 926 (Return by a U.S. Transferor of Property to a Foreign Corporation, Foreign Estate or Trust or Foreign Partnership) with their tax returns that included the date of the Date5 YearX reorganization, and warned shareholders about the penalty under § 6038B for failure to file the required form. CorpB attached with the January 3, YearX+1 letter information, including a partially completed Form 926, to allow the shareholders to determine and report the correct amount of gain from the exchange. Parent received CorpB's letter (including the partially completed Form 926) on January 15, YearX+1.

C. <u>Filing of Tax Returns Related to the Date5 YearX Reorganization</u>

Parent's tax return for its tax year ended May 31, YearX, with extensions, was due on February 15, Year X+1, and filed on February 14, YearX+1. Parent asserts that it was not until June of YearX+1 that it determined that the Date5 YearX reorganization was taxable. We understand that Parent did not file an amended tax return for its YearX tax year to take into account the taxable gain on the exchange, nor did Parent file a Form 926 with its YearX tax return to disclose the Date5 YearX reorganization.

In February YearX+2, Parent filed its tax return for the year ended May 31, YearX+1, and included as long-term capital gain, the $<u>f</u> gain on the exchange of the CorpA stock from the Date5 YearX reorganization. Parent also had a YearX+1 long-term capital loss of $<u>n</u> that it used to offset a substantial portion of the gain from the Date5 YearX reorganization. Parent included a completed Form 926 with the YearX+1 tax return, and the Form 926 correctly stated that the $<u>f</u> gain arose from a Date5 YearX reorganization. Parent's YearX+1 tax return was prepared by CPA Tax Adviser.

Shareholder1, as an individual shareholder of CorpA, was also required to report the gain from the Date5 YearX reorganization on a Form 926 filed with his YearX tax year. Shareholder1 filed his YearX tax return in August of YearX+1, included in income in his YearX tax return the gain from the Date5 YearX reorganization, and attached a Form 926.

D. IRS Audit

The IRS examined CorpA's income tax return for YearX, and in YearX+2, the IRS examined Parent as a shareholder of CorpA and as a result of its examination of CorpA's YearX tax return. The IRS questioned Parent on its failure to timely file the Form 926 and report the Date5 YearX reorganization. Parent responded that it had filed the Form 926 reporting the Date5 YearX reorganization and reported the gain in its YearX+1 tax return.

LAW AND ANALYSIS

A. Statute and Regulations

For transfers made on or before August 5, 1997, § 6038B(a), as then in effect, required that each person transferring property to a foreign corporation in an exchange described in § 332, 351, 354, 355, 356, or 361 or making a § 336 distribution to a foreign person, furnish certain information regarding the transfer to the IRS. Under § 6038B(b), a taxpayer who fails to furnish the information required must pay a penalty equal to 25 percent of the gain realized on the exchange or distribution, unless the taxpayer's failure to comply is due to reasonable cause and not willful neglect.

Under § 6038B, as then in effect, any U.S. person making certain transfers described in § 367(a) or § 367(d) was required to report certain prescribed information related to the transfer on a Form 926 and was required to file the Form 926 with its federal income tax return for the year which included the date of the transfer. Temp. Treas. Reg. § 1.6038B-1T(b) and (c). Regulations describe the consequences of a failure to comply with the § 6038B reporting requirements and provide that a failure to comply with the § 6038B reporting requirements includes the failure to report at the proper time and in the proper manner any material information required to be reported under the rules. Temp. Treas. Reg. § 1.6038B-1T(f). The general consequences resulting from a failure to comply do not apply when the taxpayer's failure is due to reasonable cause and not willful neglect. Temp. Treas. Reg. § 1.6038B-1T(f)(3).

Although § 6724 does not explicitly address information reporting required by § 6038B, § 6724 provides that any penalties imposed for failure to furnish certain information returns may be waived if "such failure is shown to be due to reasonable cause and not to willful neglect." Treas. Reg. § 301.6724-1(a)(2)(1991) provides that reasonable cause is present if the filer establishes that either: (1) there are significant mitigating factors for the failure, or (2) the failure arose from events beyond the filer's control. The filer must also establish that it acted in a responsible manner both before and after the failure occurred. Treas. Reg. § 301.6724-1(a)(2) (1991).

Under § 301.6724-1(b) (1991), significant mitigating factors include, but are not limited to, the following: (1) the filer is a first-time filer of the particular type of return, or (2) the filer has an established history of compliance with the information reporting requirements for which the failure occurs. The regulations specifically provide that if the filer establishes that there are significant mitigating factors for a failure but the filer is unable to establish that it acted in a responsible manner, the mitigating factors will not be sufficient for the filer to obtain a waiver of the penalty. Treas. Reg. § 301.6724-1(a)(2) (1991). Similarly, if the filer establishes that a failure arose from an impediment but is unable to establish that it acted in a responsible manner, the impediment will not be sufficient for the filer to obtain a waiver of the penalty. Treas. Reg. § 301.6724-1(a)(2) (1991).

Unavailability of relevant business records may be considered in determining whether the taxpayer's failure to file was due to events beyond the taxpayer's control. Treas. Reg. § 301.6724-1(c)(1) (1991). To establish reasonable cause because of the unavailability of business records, the filer must show that its business records were unavailable under such conditions, in such manner, and for such period as to prevent timely compliance. Treas. Reg. § 301.6724-1(c)(1) (1991). Ordinarily the taxpayer should have the relevant business records for at least a 2-week period prior to the due date, with extensions, of the required return. Treas. Reg. § 301.6724-1(c)(1) (1991).

B. Taxpayer's Position

Parent asserts that it had reasonable cause for its failure to file timely with its Year X tax return a Form 926, reporting the Date5 YearX reorganization. First, based on CorpA's oral and written assurances that the shareholders had a non-taxable equity alternative available to them, Parent contends that it believed that the Date5 YearX reorganization was non-taxable to it even though Parent did not elect the non-taxable equity alternative. Tax Adviser also believed that the Date5 YearX reorganization was non-taxable to Parent. It was not until the receipt of the January 3, YearX+1 letter from CorpB that Parent had any reason to question the availability of the non-taxable equity alternative or the taxability of the Date5 YearX reorganization. Parent contends that there was inadequate time to make an informed judgment on the information received from CorpB between January 15, YearX+1, when Parent received the letter dated January 3, YearX+1 from CorpB, and February 15, YearX+1, when Parent's tax return and Form 926 for the year ending May 31, YearX was due.

The second reason that Parent contends that it had reasonable cause for failing to file timely a Form 926 with its YearX tax return is that in January YearX, Tax Adviser, Parent's financial officer and accountant, contracted a very painful and debilitating illness, and as a result Parent's financial reporting matters were not given the same attention that they would have received had Tax Adviser been well.

The third reasonable cause reason that Parent asserts that it had for not filing timely the Form 926 with its YearX tax return, is that not only was there initial confusion about whether the transaction was taxable to Parent, but because Parent has a May 31 tax year end, there was also confusion about the appropriate year to report the Date5 YearX reorganization. Moreover, Parent reported the Date5 YearX reorganization before the IRS ever approached Parent about auditing its YearX tax return. In particular, Parent reported the Date5 YearX reorganization and filed a Form 926 with its YearX+1 tax return. Parent contends that the amount placed at risk to the IRS by Parent reporting the gain in the wrong year was an interest amount for the period from the date the tax should have been paid until the date it was paid. Parent has paid the tax related to the Date5 YearX reorganization, as well an amount for interest.

Finally, Parent contends that even if it had no reasonable cause for failing to file timely the Form 926, because Parent filed the Form 926 prior to notification of the IRS audit, a consistent application of the IRS' Penalty Policy Statement (P-1-18) would constrain the IRS to forgive the penalty in this case. Parent contends that in view of its good faith payment and filings, the imposition of the penalty under § 6038B(b)(1) is excessively punitive and unreasonable.

C. Applicability of § 6038B to Date5 YearX Reorganization

Each U.S. person that makes certain transfers described in § 367(a) or (d) is required to file a Form 926. Temp. Treas. Reg. § 1.6038B-1T(b)(2)(i). Parent is a U.S. person, and based on the information included in the letter dated January 3, YearX+2 from CorpB, Parent transferred property in a transfer described in § 367(a) in the Date5 YearX reorganization. Thus, Parent generally would be subject to the § 6038B penalty for failure to report the transfer of property in the Date5 YearX reorganization if Parent's transfer of property in the Date5 YearX reorganization is described in § 367(a).

D. Applicability of § 6038B(b)(2) Reasonable Cause Exception

Section 6038B and the related regulations do not define the terms "reasonable cause" and "willful neglect." Courts have, however, developed definitions of these terms for purposes of delinquency related penalties and other information reporting provisions. In addition, the regulations under § 6724 provide guidance on when a taxpayer's failure to file certain information returns is due to reasonable cause and not willful neglect. Finally, the IRS has developed internal policies for determining when penalties should be imposed and for determining if a taxpayer's failure to file is due to reasonable cause and not willful neglect.

Based on case law, Parent would have reasonable cause for failing to file timely a Form 926 with its YearX tax return if Parent exercised ordinary business care and prudence but was still unable to comply with its obligations because of circumstances beyond its control. See U.S. v. Boyle, 469 U.S. 241 (1985); Stevens Bros. Foundation Inc. v. Commissioner, 39 T.C. 93 (1962), *aff'd in part, rev'd in part and rem'd in part, on other grounds*, 324 F.2d 633 (8th Cir. 1963). Although Parent has the burden of proving that it had reasonable cause for failing to file timely the Form 926 with its YearX tax return, all the facts and circumstances should be considered in determining whether Parent exercised ordinary business care and prudence in filing the Form 926. Id.

Below we provide our initial thoughts about the applicability of the reasonable cause exception to Parent's failure to file timely the Form 926 with its YearX tax return. IRM Handbook No. 120.1.3 should be used in considering what additional facts should be considered in making a final determination.

Parent contends that based on CorpA's oral and written assurances that the shareholders had a non-taxable equity alternative, both Parent and Tax Adviser believed that the Date5 YearX reorganization was non-taxable to Parent. Moreover, Parent contends that it was not until the receipt of the January 3, YearX+1 letter from CorpB that Parent had any reason to question the availability of the non-taxable equity alternative or the taxability of the Date5 YearX reorganization. According to Parent, there was inadequate time to make an informed judgment on the information received from CorpB between January 15, YearX+1, when Parent received the CorpB package, and February 15, YearX+1 when Parent's tax return and Form 926 for the year ending May 31, YearX was due. Section 6038B reporting, however, is not conditioned upon an exchange being taxable, and thus Parent would have been responsible for reporting under § 6038B even if the Date5 YearX reorganization were non-taxable. See generally, I.R.C. § 6038B(a)(1) and Temp. Treas. Reg. 1.6038B-1T(a) - (c). In addition, the Date4 YearX letter specifically noted that the proposed Date5 YearX reorganization could be taxable to CorpA shareholders.

It appears that a taxpayer such as Parent, an established company in existence over a years, exercising ordinary business care and prudence would have considered its tax obligations independently of general statements made by CorpA, especially since Parent did not elect the non-taxable equity alternative. Also, Shareholder1, a key officer of Parent and recent key officer of CorpA, correctly filed his Form 926 with his YearX tax return. The IRS, in determining whether a taxpayer exercised ordinary business care and prudence but was unable to file a return timely because of lack of knowledge about the information reporting requirements, may consider, among other factors, a taxpayer's education and exposure to the type of tax and reporting requirements, the complexity of the compliance issue, and changes in tax forms or law. See IRM Handbook No. 120.1.3.1 (1998). That tax obligations are complex does not necessarily make noncompliance reasonable. See Stevens Bros. v. Commissioner, 39 T.C. 93 (1962). Generally, reasonable cause should never be presumed even where ignorance of the law is claimed. See Stevens Bros. v. Commissioner, 39 T.C. 93 (1962), and IRM Handbook No. 120.1.3.1 (1998). It appears that Parent and Shareholder1, an officer of Parent and the majority shareholder, have been exposed to complex tax and compliance issues, and presumably Parent, because it has been in existence for over a years and engaged in various businesses, has experience with various complex tax reporting rules and forms. Thus, it appears that Parent should have researched its tax reporting obligations and should have been aware of its reporting obligations so as to file the Form 926 in a timely manner.

Parent has noted that in January YearX, Tax Adviser, Parent's financial officer and accountant, contracted a very painful and debilitating illness, and as a result Parent's financial reporting matters were not given the same attention that they would have received had Tax Adviser been well. Courts have held that the duty to file a return is non-delegable, and, if that responsibility is shifted to an agent, the taxpayer must accept the consequences of shortcomings in the performance of that duty by an agent. ASAT, Inc. v. Commissioner, 108 T.C .147 (1997); Estate of Maltaman v. Commissioner, 73 T.C.M. (CCH) 100 (1997). In conjunction with all other facts and circumstances, including the length of time to comply and whether the taxpayer is a corporation, a tax adviser's illness may be considered in determining whether a taxpayer exercised ordinary business care and prudence but was still unable to comply with its reporting obligations. See IRM Handbook No. 120.1.3.1 (1998). It appears that Parent, as an established corporation in existence for over a years and exercising ordinary business care and prudence, should have been aware that it had potential tax reporting obligations when Parent received the Date4 YearX letter from CorpA about the proposed Date5 YearX reorganization, and should have determined its tax obligations and filing requirements regardless of Tax Adviser's illness. Parent and its majority shareholder, Shareholder1, have been involved in many different types of complex businesses and transactions. Parent could have hired another tax adviser to determine its tax obligations related to the Date5 YearX reorganization. CPA Tax Adviser signed Parent's YearX+1 tax return.

The third reasonable cause reason that Parent asserts that it had for not filing timely the Form 926 with its YearX tax return, is that not only was there initial confusion about whether the transaction was taxable to Parent, but because Parent has a May 31 tax year end, there was also confusion about the appropriate tax year in which to report the Date5 YearX reorganization. Generally, that a mistake was made is not consistent with the ordinary business care and prudence standard and does not provide a basis for reasonable cause. See IRM Handbook No. 120.1.3.1 (1998). Parent, however, contends that it reported the Date5 YearX reorganization and filed a Form 926 with its YearX+1 tax return, and before the IRS ever approached Parent about auditing its YearX tax return. According to Parent, the amount placed at risk to the IRS by it reporting the gain in the wrong year was an interest amount for the period from the date the tax should have been paid until the date it was paid. Parent has paid the tax related to the Date5 YearX reorganization, as well as an amount for interest. It appears that if Parent had exercised ordinary business care and prudence, Parent would have been able to determine the correct tax year for including the Date5 YearX reorganization. Parent has been in existence for over a years and engaged in multiple businesses. In addition, the United States Supreme Court in Boyle, 469 U.S. 241, 105 S. Ct. 687 (1985), specifically emphasized the importance of filing dates by noting that deadlines are inherently arbitrary, but fixed dates are often essential to accomplish necessary results. The Court further noted that the Government has millions of taxpayers to monitor, and that the federal income tax system of self-assessment, in the initial calculation of a tax simply cannot work on any basis other than one of strict filing standards; any less rigid standard would risk encouraging a lax attitude toward filing dates. U.S. v. Boyle, 469 U.S. 241 (1985).

Finally, Parent contends that even if it had no reasonable cause for failing to file timely the Form 926, because Parent paid taxes related to the Date5 YearX reorganization and filed the Form 926 prior to notification of the IRS audit, a consistent application of the IRS' Penalty Policy Statement (P-1-18) would constrain the IRS to forgive the penalty in this case. Parent contends that in view of its good faith payment and filings, the imposition of the penalty under § 6038B(b)(1) is excessively punitive and unreasonable.

The IRS' Penalty Policy Statement (P-1-18) provides in part as follows:

> (1) Penalties are used to enhance voluntary compliance: Penalties constitute one important tool of the [IRS] in pursuing its mission of collecting the proper amount of tax revenue at the least cost. Penalties support the [IRS'] mission only if penalties enhance voluntary compliance. Even though other results such as raising of revenue, punishment, or reimbursement of the costs of enforcement may also arise when penalties are asserted, the [IRS] will design, administer and evaluate penalty programs solely on the basis of whether they do the best possible job of encouraging compliant conduct.
>
> (2) In the interest of an effective tax system, the [IRS] uses penalties to encourage voluntary compliance by: (1) helping taxpayers understand that compliant conduct is appropriate and that noncompliant conduct is not; (2) deterring noncompliance by imposing costs on it; and (3) establishing the fairness of the tax system by justly penalizing the noncompliant taxpayer.

As we previously stated, it appears that Parent had no reasonable cause for failing to file with its YearX tax return, a Form 926 reporting the Date5 Year X reorganization. Although Parent included the gain from the Date5 YearX reorganization and filed a Form 926 with its YearX+1 tax return, Parent had losses in YearX+1 to offset partially such gain. As the Supreme Court noted in U.S. v. Boyle, 469 U.S. 241 (1985), the Government has millions of taxpayers to monitor, and the federal income tax system of self-assessment in the initial calculation of a tax simply cannot work on any basis other than one of strict filing standards. Any less rigid standard would risk encouraging a lax attitude toward filing dates. U.S. v. Boyle, 469 U.S. 241 (1985). It appears that Parent's failure to file timely the Form 926 is a type of situation for which penalties should be imposed. Parent appears to have a lax attitude about properly following the information reporting and income reporting tax rules. Our federal income tax system should not and cannot tolerate such a lax attitude. Parent apparently never attempted to comply with the reporting requirements specifically provided under Temp. Treas. Reg. 1.6038B-1T(a) - (c), but instead reported as it chose and now contends that its manner of reporting was sufficient.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

For transfers made after August 5, 1997, Congress amended § 6038B to provide that for failures to report, taxpayers will pay a penalty equal to 10 percent of the fair market value of the property at the time of the exchange. Parent is subject to a penalty equal to 25 percent of the amount of the gain realized on the Date5 YearX reorganization. For transfer made after August 5, 1997, the amount of the penalty may not exceed $100,000. Parent's penalty is equal to $p. A court could infer from the amendments made to § 6038B that Congress viewed the 25 percent penalty as excessive. On the other hand, a court could also infer that Congress initially imposed the 25 percent penalty because of concerns about the extent of abuses and the IRS' ability to obtain the information required under § 6038B and the related regulations. Congress did make the amendments applicable to exchanges made after August 5, 1997, and not before.

Also, as Parent's representatives noted in PLR 9244004, the IRS determined that because the taxpayer voluntarily complied with the gift tax laws prior to notice by the IRS of an examination, under § 6662 the taxpayer should not be required to pay a 20 percent negligence penalty for underpayment of tax. The IRS in that letter ruling noted that its determination was consistent with the IRS' Penalty Policy Statement (P-1-18), as penalties should be used to enhance voluntary compliance. It appears that Parent never fully complied with § 6038B, and Parent's penalty results from a failure to report certain basic information related to the Date5 YearX reorganization, not from an understatement of an amount. Parent, however, did file a Form 926 and did pay taxes and interest related to the Date5 YearX reorganization. [redacted]

Please call Camille Evans (202) 622-3860 if you have any further questions.

CHARLES P. BESECKY
Branch Chief

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