Where Does the Buck Stop? Recent Case Condones Nonfiling of Forms 1065 and Schedules K-1

By Hale E. Sheppard

Hale E. Sheppard examines where the buck stops when a partnership fails to file Forms 1065 and Schedules K-1.

I. Introduction

As the world becomes more complex and globalized, we become more interdependent. The actions or inactions of one party often affect others, in some manner, at some point, to some degree. We see this regularly in the world of tax. It is particularly apparent in situations involving multi-tier structures, like a series of partnerships, where the failure by one partnership to file a timely, accurate Form 1065 (*U.S. Return of Partnership Income*) with the IRS and its failure to issue timely, accurate Schedules K-1 (Partner's Share of Income, Deductions, Credits, *etc.*) to the partners negatively impacts all parties further up the chain. Indeed, taxpayers deprived of tax-related data are incapable of completing their own tax returns appropriately, and the IRS cannot effectively administer the tax system. In an effort to avoid these problems, Congress enacted significant penalties, which the IRS can waive under certain circumstances. The focus of this article, using a recent bankruptcy court case (*In re Refco Public Commodity Pool, LP*) as a guide, is which parties are to blame and which situations warrant penalty mitigation.[1] In other words, where does the buck stop?

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II. Summary of the Relevant Law

A. Duty to File Forms 1065 and Schedules K-1

Generally, any person (including individuals and entities) liable for any tax must file a complete return or statement according to the forms and regulations issued by the IRS.[2] When it comes to domestic partnerships, they must file Forms 1065.[3] Foreign partnerships must file Forms 1065, too, but only if they have either gross income that is effectively connected with a U.S. trade or business or gross income derived from other U.S. sources.[4]

In addition to filing Forms 1065, partnerships generally must furnish Schedules K-1 to their partners, such that the partners have the information necessary to complete their own tax returns.[5] Each Schedule K-1 must show the partner's distributive share of income, gain, loss, deduction and/or credit from the partnership, along with any additional data required by the U.S. tax code or IRS instructions.[6]

B. Penalties Related to Forms 1065

There are civil penalties, of course, if a partnership violates its filing duties. If the partnership neglects to file a timely, accurate, complete Form 1065, then the IRS can assert a penalty under Code Sec. 6698(a). The penalty currently is calculated in the following manner: $195, multiplied by the number of partners in the partnership at any time during the relevant year, multiplied by the number of months (not to exceed 12) that the violation continues.[7] Importantly, the IRS may not impose a penalty regarding missing or problematic Forms 1065 if the partnership can demonstrate that the violations were due to "reasonable cause."[8]

C. Penalties Related to Schedules K-1

The IRS generally may assert penalties under Code Sec. 6722 when a taxpayer, including a partnership, files late, incomplete or incorrect "payee statements."[9] For these purposes, Schedules K-1 are considered "payee statements."[10] Ordinarily, any person that violates the filing requirements for "payee statements" must pay a penalty of $250 for each violation, with a maximum of $3 million per year.[11] This penalty increases to $500 per violation, with no cap, when violations are attributable to "intentional disregard" by the taxpayer.[12] The rules regarding reduction or waiver of penalties for "payee statements" are unique and specific to violations for certain types of information returns.[13] The special rules, found in Code Sec. 6724 and the corresponding regulations, are examined below.

1. Lower Penalties

The IRS may not assert penalties where the violation (i) is due to "reasonable cause," as this term is defined for purposes of Code Sec. 6721 through Code Sec. 6724 *and* (ii) is not due to "willful neglect."[14] These standards are discussed in the following portion of this article.

a. The Violation Was Due to "Reasonable Cause." Penalties will be waived for "reasonable cause" if *either* (i) there are significant mitigating factors with respect to the violation, *or* (ii) the violation arose from events beyond the filer's control.[15] In addition to meeting one of these two standards, the taxpayer must also show that it acted in a "responsible manner," both before and after the violation.[16]

i. Significant Mitigating Factors. The regulations contain a nonexhaustive list of significant mitigating factors. Three are worth noting here. First, mitigation exists where the taxpayer was not previously required to file the particular type of return with respect to which the violation occurred.[17]

Second, mitigation exists where the taxpayer has a history of complying with the information-reporting requirement at issue.[18] In considering a taxpayer's compliance history, the IRS gives particular consideration to whether the taxpayer has incurred prior penalties under Code Sec. 6721 (covering certain "statements," "returns" and "other items"), Code Sec. 6722 (covering "payee statements") and/or Code Sec. 6723 (covering other "specified information reporting requirements"). If the taxpayer has been penalized before, then the IRS analyzes the taxpayer's level of success in reducing the error rate.[19] The IRS, to put it colloquially, looks to see if the taxpayer has gotten its act together.

Finally, another mitigating factor is reasonable reliance on a qualified tax advisor.[20]

ii. Events Beyond the Taxpayer's Control. The regulations also contain a partial list of events that the IRS considers to be beyond the filer's control. Among the uncontrollable events are (i) unavailability of the relevant business records; (ii) actions by the taxpayer's agent, after the taxpayer exercised reasonable business judgment in contracting with the agent to file timely and accurate returns; and (iii) failure by the payee or another person to provide information to the taxpayer.[21]

(a) Unavailability of Relevant Business Records. With respect to unavailability of relevant business records, the regulations indicate that the IRS will abate penalties when two criteria have been met. First, the taxpayer's business records were unavailable under such conditions, in such

manner, and for such period as to prevent the taxpayer from timely complying with the information-reporting requirement.[22] Second, the unavailability of the relevant business records was caused by a "supervening event," including, but not limited to, (i) a statutory or regulatory change that has a direct impact on data-processing by the taxpayer and that occurred so close to the deadline for filing the information return that "for all practical purposes" the taxpayer cannot comply with the change in a timely manner, (ii) a fire or other casualty that damages the business records or the filer's system for processing and filing such records and (iii) the unavoidable absence (*e.g.*, because of death or serious illness) of the person with the sole responsibility for filing a return or furnishing a payee statement.[23]

(b) Reasonable Reliance by Taxpayer on Agents. The regulations concerning reliance by the taxpayer on the actions or inactions of its agents indicate that the IRS will abate penalties when two circumstances exist. First, the taxpayer demonstrates that it exercised reasonable business judgment in contracting with the agent to file timely and accurate information returns, which includes providing the proper information to the agent sufficiently in advance of the filing deadline.[24]

Second, the agent on whom the taxpayer relied had reasonable cause, as this concept is uniquely defined under Code Sec. 6724.[25] The regulations and IRS guidance refer to this notion as "imputed reasonable cause," that is, the reasonable cause of the taxpayer's agent is imputed/extended to the taxpayer itself.[26]

Like the regulations, the Internal Revenue Manual expressly recognizes penalty abatement in situations involving "imputed reasonable cause." It indicates that penalties are inappropriate where (i) the taxpayer exercised reasonable business judgment in hiring an agent to file information returns, (ii) the taxpayer supplied the agent with the proper information well in advance of the due date of the relevant information returns and (iii) there was a significant mitigating factor for the agent, or there was an event beyond the agent's control.[27] The Internal Revenue Manual goes on to clarify that a taxpayer who hired an agent, yet cannot meet the "imputed reasonable cause" standards, might still be able to demonstrate reasonable cause on its own merit by having a history of compliance and otherwise acting in a responsible manner.[28] The Internal Revenue Manual provides more details:

> This criteria is considered met if the partnership exercised reasonable business judgment in contracting with an agent to prepare and e-file the partnership return, and the agent failed to deliver on its contract. The partnership must have contracted with a qualified agent, and provided the agent with all documentation required in order for the agent to be able to prepare and e-file the return in a timely manner. Reasonable business judgment rises above ordinary business care and prudence, as it requires research on the part of the partnership in the process of selecting a reliable agent with whom to contract, and who is able to provide the required service.[29]

Importantly, the IRS has made it clear that it is not necessary for the taxpayer to follow-up on the agent's actions or inactions in order to have "imputed reasonable cause." The preamble to the regulations indicates the following in this regard:

> [A]n event beyond the filer's control can arise from the filer's contracting with an agent to perform the filing of information returns or the furnishing of the payee statements. The temporary regulations require that the filer establish that it contracted sufficiently in advance of the required filing date to permit timely filing; that it monitored the agent's efforts to perform; and that the agent can demonstrate that an event beyond the agent's control prevented timely correct filing. Commentators asked that the requirement that filers monitor their agents be deleted because it is not consistent with ordinary business practices. The final regulations adopt this suggestion, and require instead that the filer exercise reasonable business judgment in selecting its agent.[30]

In the context of late-filing of tax and information returns, the courts and the IRS often take the position that timely filing is a "non-delegable duty," such that taxpayers *cannot* establish reasonable cause by relying on tax advisors who failed to meet their commitment to timely file items on behalf of their clients/taxpayers.[31] However, this position does not apply with respect to cases where the IRS is asserting penalties under Code Sec. 6721, Code Sec. 6722 or Code Sec. 6723, and the taxpayer is requesting penalty waiver under Code Sec. 6724. This is evident from the specific tax regulations and Internal Revenue Manual entries cited above, which discuss and define the concept of "imputed reasonable cause." It is also evident from an appellate case, where the court explained that "we do not believe that *Boyle's* definition [of 'due to reasonable cause and not to willful neglect'] applies to Section 6724's waiver provision."[32]

(c) Failure by Person to Provide Information. Regarding failure by the payee or another person to provide

information to the taxpayer, the regulations indicate that the IRS will abate penalties when *either* of the following two criteria has been met. First, the violation resulted from the failure of the payee "or any other person" to provide the information necessary for the taxpayer to comply with the information-reporting requirements.[33] Second, the violation resulted from incorrect information provided by the payee or any other person upon which the taxpayer relied in good faith.[34]

iii. The Taxpayer Acted in a Responsible Manner. Acting in a "responsible manner" means that (i) the taxpayer exercised reasonable care, which is the standard of care that a prudent person would use under the circumstances in the course of its business in determining its filing obligations, and (ii) the taxpayer undertook significant steps to avoid or mitigate the failure, including requesting filing extensions where practicable, attempting to prevent any foreseeable impediment or failure, acting to remove an impediment or the cause of the failure after it occurred and rectifying the failure as promptly as possible once the impediment was removed or the failure was discovered.[35]

2. Higher Penalties for Filing Violations

The IRS may assert a higher penalty in situations where the noncompliance was due to "intentional disregard;," that is, where a taxpayer "knowingly" and "willfully" failed to comply.[36] In making this determination, the IRS must examine "all the facts and circumstances" in a particular case.[37] These include, but are not limited to, (i) whether the noncompliance is part of a pattern of conduct, which means the taxpayer repeatedly failed to file proper returns; (ii) whether the taxpayer corrected the situation upon discovering the noncompliance; (iii) whether the taxpayer filed corrected returns within 30 days of a written request by the IRS to do so; and (iv) whether the amount of the penalties is less than the cost of complying with the rules, such that the taxpayer views the penalties as simply a cost of doing business.[38] The regulations contain several examples of "intentional disregard" by a taxpayer, some of which are set forth below in abbreviated fashion.[39]

> **Example 1.** Automobile Dealer receives $55,000 from an individual for the purchase of an automobile in a transaction subject to certain reporting requirements. The individual presents documents to Automobile Dealer that identify him as "John Doe." However, Automobile Dealer completes the Form 8300 (relating to cash received in a trade or business) and reflects the name of a cartoon character as the payor. Because Automobile Dealer knew at the time of filing the Form 8300 that the payor's name was not the name of the cartoon character, he willfully failed to include correct information. Therefore, the higher penalty is imposed for the intentional disregard of the requirement to include correct information.

> **Example 2.** Individual contacts Agent to act as his intermediary in the purchase of an automobile. Individual gives Agent $20,000 and asks Agent to purchase the automobile in Individual's name. Agent does so. Agent prepares the required Form 8300, but in the area designated for the name of the payor, Agent writes "confidential." Because Agent knew at the time the return was filed that it contained incomplete information, the higher penalty is imposed for the intentional disregard of the requirement to include correct information.

> **Example 3.** Corporation deliberately does not include $5,000 of dividends on a Form 1099-DIV on which a total of $200,000 (including the $5,000 dividends) is required to be reported. Because the failure was deliberate, Corporation's failure is due to intentional disregard of the requirement to include correct information.

Importantly, the IRS's own pronouncements indicate that the higher penalty should only be asserted in extraordinary, outrageous situations:

> Congress intended the failure to file penalty to be applied in most cases; it is only the "flagrant abuses of the tax system" that result in penalties based upon intentional disregard of tax laws. Indeed, the examples under the regulations demonstrate that the higher penalty is applied when there is an "obviously flagrant disregard by the taxpayer for its reporting responsibilities."[40]

> In our opinion, the Section 6721(e) penalty should be reserved for particularly egregious factual situations … The intentional disregard penalty for failure to file information returns or provide correct information was added to the Code … to prevent situations where "parties knowingly attempt to subvert the reporting requirements that are crucial to the functioning of our tax system."[41]

III. Analysis of the Case

The penalty issues were addressed separately by the bankruptcy court in *In re Refco Public Commodity Pool, LP.*

In an effort to clarify the issues and avoid the procedural complexities, the penalty analysis has been divided into six phases in this article.

A. Phase One—Proof of Claim by the IRS

Refco Public Commodity Pool, LP (f/k/a S & P Managed Futures Index Fund, LP) ("Fund") filed bankruptcy. As part of this procedure, the IRS filed a Proof of Claim in October 2014 showing penalties for 2005, 2006, 2007 and 2008 totaling a mere $2,000. A month later, in November 2014, the IRS filed an Amended Proof of Claim, increasing the penalties to about $4.1 million. Which specific penalties applied, and the manner in which the IRS calculated them, was unclear from the Amended Proof of Claim; it merely indicated that there were various "miscellaneous penalties," "partnership penalties" and "employment withholding tax issues" that were either "pending examination" or "unassessed liabilities." Later in the litigation, the IRS (i) clarified that it was asserting penalties under Code Sec. 6698 for unfiled Forms 1065 and under Code Sec. 6722 for unfiled Schedules K-1, (ii) acknowledged that the supposed liabilities related to employment taxes were erroneous because the Fund had no employees during the relevant years and (iii) dropped the penalties for 2005 when it discovered that the Fund had filed a timely Form 1065 and Schedules K-1 for that year.

B. Phase Two—Objection by Fund to Proof of Claim[42]

In January 2015, the Fund made a filing with the bankruptcy court, objecting to the Amended Proof of Claim filed by the IRS and requesting that the bankruptcy court determine that the Fund owed no federal taxes and no penalties.

According to the documents filed by the Fund, it is a domestic partnership, formed in Delaware in 2003, for purposes of investing essentially all its assets in the Sphinx Managed Futures Fund, SPC (SMFF). For its part, SMFF is a segregated portfolio company, based in the Cayman Islands, that is part of a group of affiliated companies called SPhinX Group ("SPhinX").

The Fund had nearly 1,600 partners, whose total investment in SMFF was approximately $39 million. SMFF traded futures and related financial instruments through Refco, LLC and maintained its excess margin at Refco Capital Markets, LLC (RCM). RCM and certain affiliates filed for bankruptcy in New York in October 2005 ("Refco Bankruptcy"). The committee of unsecured creditors filed a proceeding in bankruptcy court seeking to invalidate and recover approximately $312 million in transfers that RCM made to SMFF shortly before the Refco Bankruptcy, on the theory that such transfers constituted improper preferential payments ("Preference Action"). The bankruptcy court froze SMFF's assets in 2006 in connection with the Preference Action.

The Fund attempted to redeem all its investment in SMFF soon after the Preference Action began. SMFF did not honor this request. Instead, it issued to the Fund so-called S shares in an attempt to satisfy its redemption obligation to the Fund. The S shares were illiquid at all relevant times.

In June 2006, SPhinX was placed into liquidation in the Cayman Islands, and joint official liquidators (JOLs) were appointed. The JOLs then started a proceeding seeking recognition with the U.S. bankruptcy court, which was granted.

The Fund's sole material asset was its investment in SMFF. Therefore, the Fund had always been reliant on SMFF to file Forms 1065, attaching Schedules K-1, in order to allow the Fund, in turn, to file its own Form 1065 and Schedules K-1. Before the bankruptcy in 2005, SMFF met its filing requirements, and the Fund did the same. However, after the appointment of the JOLs in the Cayman Islands in 2006, SMFF stopped filing. Consequently, after 2005, the Fund did not file Forms 1065 or issue Schedules K-1 to its 1,600 partners.

Since the JOLs were appointed in 2006, investors in SMFF, including the Fund, tried to get the JOLs to provide the necessary tax and financial data. The JOLs did not. Instead, from 2006 to 2010, they issued various reports indicating that they were working with a "Big 4" accounting firm, PriceWaterhouseCoopers (PWC), and taking other measures to prepare and file Forms 1065 for the relevant years.

By 2011, the JOLs had still not filed Forms 1065 for 2006 forward. The JOLs filed a motion in the U.S. bankruptcy proceeding seeking a determination that they were not liable for any amounts (such as taxes, penalties and interest) associated with not filing Forms 1065 or issuing Schedules K-1 to its investors, like the Fund.[43] The JOLs stated that preparing the Forms 1065 and Schedules K-1 would require "monumental effort and cost," ranging from $5 million to $7 million. The JOLs also explained that the problems stemmed from fact that (i) PWC had resigned before completing the audit and return preparation, (ii) PWC found that the former administrator for SMFF had failed to properly perform certain duties and (iii) the JOLs hired a new accounting firm, but such firm refused to complete the items because it lacked sufficient records/substantiation to acknowledge to the IRS, under penalties of perjury, that they were true, accurate and complete.

In response to this motion by the JOLs, the IRS executed a Stipulation in June 2014. The Stipulation indicated that it would refrain from taking further actions against the JOLs and SMFF for failures to file Forms 1065 and Schedules K-1 in exchange for a payment of $100,000. In light of the Stipulation in June 2014, the JOLs had no obligation to provide investors, like the Fund, any returns regarding SMFF. Nevertheless, three months later, in October 2014, the IRS filed the Proof of Claim and then the Amended Proof of Claim seeking approximately $4.1 from the Fund (whose assets were essentially all invested in SMFF) for not filing Forms 1065 and Schedules K-1.

Indeed, taxpayers deprived of tax-related data are incapable of completing their own tax returns appropriately, and the IRS cannot effectively administer the tax system.

In objecting to the Amended Proof of Claim filed by the IRS, the Fund argued that penalties could not be sustained under the relevant tax provisions and regulations because there were significant mitigating factors and the violations resulted from events beyond the Fund's control. Then, going outside the established penalty-mitigation standards, the Fund contended that penalties were improper because they were inequitable: "Not only is disallowance [of the IRS's Amended Proof of Claim] legally appropriate, it is equitable."[44] The Fund also maintained that penalties would constitute an excessive punishment in violation of the eighth amendment to the U.S. constitution because they are not linked to the size of any tax harm to the IRS. In what might have been an effort to confuse the bankruptcy court about the difference between a tax return and an information return, the Fund stated that a partnership is not a taxable entity and thus the failure to file Forms 1065 (with the IRS) and Schedules K-1 (with the IRS and the partners) for multiple years did not generate any tax harm. Expanding on this without producing any proof, the Fund then tried to cast the IRS as either the bad actor or the beneficiary here: "Thus, the real effect of the Fund's failure to file partnership returns was likely a benefit to the IRS. It has likely enjoyed years of extra funds because investors have not taken losses."[45]

C. Phase Three—DOJ's Response to Objection by Fund[46]

Despite the complexity of the facts and legal issues, despite the fact that late Form 1065 and late Schedule K-1 issues are pervasive problems for the IRS, and despite the large penalty of about $4.1 million facing the Fund, the DOJ filed a mere four-page response to the Fund's objection to proposed penalties. The DOJ, without getting into the details about the legal standards under Code Sec. 6698 (related to Forms 1065) and/or Code Secs. 6721–6724 (related to Schedules K-1), summarized its positions as follows: (i) the failure of a third-party, like SMFF, to provide a Schedule K-1 to the Fund does not, alone, establish reasonable cause for the Fund not to file its own Form 1065 and Schedules K-1; (ii) the Fund must also demonstrate that it pursued other means to try to prepare the necessary returns; (iii) the Fund took no steps to obtain the necessary financial data directly from either SMFF or the JOLs; and (iv) if the Fund had made a reasonable effort, like the DOJ did, it would have been able to prepare Forms 1065 and Schedules K-1 for its own partners because the JOLs gave a series of spreadsheets and pointed the DOJ to other relevant, public information in response to a simple request. From the DOJ's perspective, "[f]ar from being impossible, the record shows that the [Fund] could have prepared a partnership return had it merely tried."[47]

D. Phase Four—Brief by the Fund in Support of Objection[48]

The Fund later filed a brief in support of its objection to the Amended Proof of Claim, which contained various counterarguments to the DOJ's position that the Fund could have easily prepared timely Forms 1065 and Schedules K-1 had it made appropriate efforts. The main counterarguments were as follows: (i) The data available from the JOLs (that the DOJ said the Fund should have used) were unreliable and inaccurate, as the JOLs and others expressly warned investors and the courts; (ii) Substantial uncertainties existed regarding the Fund's investment in SMFF, as evidenced by the 23 liquidation-related issues/disputes identified by the JOLs that had to be resolved before making any distributions to investors; (iii) These uncertainties made things particularly complicated for an accrual-basis taxpayer, like the Fund, which does not recognize income until all the events related to the right to receive income and the amount have been determined with reasonable accuracy; (iv) The Fund made reasonable efforts to get the necessary data, particularly in light of fact that nearly all its financial resources were controlled by the JOLs; and

(v) Filing Forms 1065 and Schedules K-1 based on estimates/guesses would have been irresponsible with 1,600 partners because doing so might later trigger thousands of amended returns, penalties, abatement requests, *etc*.

As it did earlier, the Fund also raised the equity argument with the bankruptcy court: "The IRS claim is without substantive merit. The Fund had reasonable cause for its failure to file and no penalties can be imposed. What is more, there is no equitable patina on which it can be supported. To the contrary, equity favors the Fund and its investors. The IRS claim should therefore be denied in its entirety."[49]

E. Phase Five—Oral Arguments[50]

Oral argument, as one would expect, was not the forum to raise new points. Rather, the parties elaborated on positions already identified for the bankruptcy court through written submissions, and the court took the opportunity to clarify the essence of the main contentions. Some noteworthy aspects of the oral arguments are noted below.

Counsel for the Fund again attempted to humanize the issue, emphasizing that the notion of equity lobbies against economically penalizing the 1,600 partners, who likely lost all or a portion of their investment in the Fund, and who have been awaiting Schedules K-1 from the Fund for nearly a decade. Counsel made the following comments in this regard:

> And, you know, our investors, Your Honor, are not accredited investors. These are smaller, mom and pop individual investors who, you know, [invest] 1,000 here or 10,000 there or 25,000 there. And they have been awaiting a recovery since 2005. And that is who is going to be punished here by this penalty … They are innocent investors. They played no role in any fraud whatsoever. And, in fact, they were victims of a substantial accounting fraud. And this is really just going to pour salt in the wound.[51]

The DOJ emphasized that the Fund made few efforts to obtain the relevant data about SMFF and file Forms 1065 and Schedules K-1. It underscored that the Fund could have filed these items based on the data readily available from the JOLs or using reasonable estimates, it could have attached a "statement" to timely returns explaining the uncertainty of the data and the efforts made to obtain accurate data, and it could have requested filing extensions each year to obtain additional time for completing its tax filings.[52] The solution cannot be, emphasized the DOJ, that taxpayers can unilaterally decide not to file returns (*i.e.*, Forms 1065) and payee statements (*i.e.*, Schedules K-1) for three consecutive years, especially when doing so affects the tax filings of approximately 1,600 partners each year.[53]

The DOJ pointed out that the argument by the Fund that penalties related to Forms 1065 and Schedules K-1 should not be asserted because the failure to file these items did not cause any direct tax harm to the IRS is specious for several reasons. These include that the penalties under Code Sec. 6698 and Code Sec. 6722 were specifically enacted for this type of violation; other types of penalties are based on the size of the tax underpayment, and partnerships are nontaxable entities, such that acceptance of the Fund's argument here would mean that no partnership would ever be penalized.[54]

The DOJ focused on the fact that the Fund never hired a tax attorney to discuss options or possible tax treatments of the uncertain issues related to SMFF and never hired an accountant to address the same items and/or prepare Forms 1065 and Schedules K-1.[55]

The bankruptcy court summarized the positions of both parties, with their approval. The court described the position of the DOJ as follows:

> You may not care that much about [the Fund], their return, but the fact is that this affects 1,500 additional returns [each year] and the knock-off effect is so detrimental to the revenue system that we need to stop this and, you know, a $4 million penalty is part of the process of stopping it.[56]

The court then summed up the position of the Fund in this way:

> So your point is the [Fund] did the responsible thing that it could do. It had zero information that it could rely upon which it could file a return. Ergo, we did not file a return … We had zero confidence that the situation would change. Ergo, we did not ask for an extension … And we then—and then we, as the [Fund], stand before you, Judge, and say these are the circumstances. We have reasonable cause for not filing. And, therefore, relieve us of the penalty.[57]

F. Phase Six—Decision by the Bankruptcy Court[58]

The court held that the Fund should not be penalized. In doing so, the court focused on the special standards for "reasonable cause" set forth in the regulations under Code Sec. 6722 and Code Sec. 6724 related to "payee statements," like Schedules K-1. As explained above, these require a taxpayer to demonstrate that it acted in a "responsible manner," both before and after the violations, *and* that either there were significant mitigating factors with respect to the violation, *or* the violations arose as a result of events beyond the taxpayer's control.[59]

The bankruptcy court's analysis regarding mitigating factors was brief. It noted that since its formation in 2003 until the problems with SMFF a few years later, the Fund filed timely Forms 1065 and Schedules K-1. This history, albeit short, showed a pattern of tax compliance. Then, based on the "totality of the circumstances," the court summarily concluded that mitigating factors existed.

With respect to events beyond the Fund's control, the bankruptcy court highlighted the following: (i) The Fund invested nearly all of its money in SMFF and thus relied on SMFF to provide a Schedule K-1; (ii) SMFF stopped issuing Schedules K-1 after 2005 due to reasons unrelated to the Fund, namely, SMFF entering liquidation proceedings in the Cayman Islands and the JOLs uncovering material inaccuracies with the books and records (including extensive co-mingling of funds, misstatements of cash, failure to process redemptions, inadequate documentation about certain transactions, failure to properly allocate shares, maintaining two sets of books, net value calculations based on incomplete data, *etc.*); (iii) Uncertainty remained with respect to numerous liquidation issues until 2013; and (iv) The problems were particularly acute for the Fund because it was an accrual-basis taxpayer, as opposed to a cash-basis taxpayer.

Finally, the bankruptcy court turned its attention to whether the Fund acted in a responsible manner in deciding not to prepare and file Forms 1065 and not to issue Schedules K-1 to its 1,600 investors for three consecutive years without approaching the IRS to discuss possible solutions. The court noted that the Fund was on notice that it did not have acceptable tax and financial data because the JOLs repeatedly told investors since 2006 that the records were unreliable, the general partner of the Fund knew that allocation mistakes existed because they did not take into consideration certain settlements, the JOLs submitted periodic reports to the court identifying material accounting errors, and the value of the S shares issued to the Fund remained unknown until 2013. The court found that, under these circumstances, a reasonable person would be reluctant to sign a declaration to the IRS indicating that the information on Form 1065 (and the attached Schedules K-1) was true, accurate and complete. The court further indicated that a reasonable person would be concerned about potential penalties, including return-preparer penalties, as well as the possible need to file amended Forms 1065 and thousands of amended Schedules K-1. The bankruptcy court broadly interpreted the responsible manner standard under Code Sec. 6724 in the following way: "Ultimately, the inquiry under the responsible manner standard is not whether the [Fund] undertook, or even considered, every conceivable option; rather, it is whether the [Fund] exercised reasonable care under the circumstances." The court held that it did.

IV. Interesting Issues

Most people will limit themselves to reading the published decision and then citing *In re Refco Public Commodity Pool, LP* to the extent that it benefits their personal situation. This type of abbreviated review is understandable, but it has downsides, like missing some of the most interesting aspects of the case. Examining the more obscure issues requires one to obtain and review the main court documents, dig deeper into the motives for passing the relevant tax provisions and regulations, *etc.* Below are descriptions of just a few of the noteworthy issues.

A. Undiscovered Sources

It appears that counsel for the Fund never raised with the bankruptcy court some favorable tax authorities directly on point. As explained above, to secure penalty abatement related to unfiled Schedules K-1, the Fund needed to show that "reasonable cause" existed because either there were significant mitigating factors or the violation was caused by events beyond the Fund's control. If counsel were to have transcended the tax provisions and regulations, going all the way to the "preamble" of the regulations where the IRS explains issues with which it grappled in drafting the final version of regulations, counsel would have identified language that might have sealed the Fund's position. The preamble to the regulations explains that, in a multi-tier structure, the inability to obtain sufficient or correct information from an upstream/downstream party by the filing deadline constitutes "reasonable cause":

> [P]enalties imposed for failure to furnish timely, correct and complete payee statements [including Schedules K-1] may be waived if the filer demonstrates that the failure is due to the filer's inability to obtain the necessary information from a person on whom the filer must rely to furnish correct and complete payee statements.[60]

> [The temporary regulations state] that an event beyond the filer's control can result from the failure of the payee (or another person required to provide

necessary information to the filer) to provide timely correct information to the filer. Commentators requested clarification that an inability to obtain information from any person, including upstream payors who may not be required to provide information until after the required filing date of the taxpayer's information returns … qualify as "action of the payee or other person." The final regulations adopt this clarification.[61]

B. Significance of Filing Returns, Even Late Ones

In rendering its decision, the bankruptcy court rejected the argument by the DOJ that the Fund did not act reasonably and responsibly, as required, when it failed to at least file annual Forms 1065 with the IRS attaching a statement explaining the problems, information deficiencies and uncertainties, *etc*. The bankruptcy court stated the following in justifying its decision to discard the fact that the Fund never filed any Forms 1065 or Schedules K-1 whatsoever for the relevant years:

> It seems illogical to consider under the 'responsible manner' analysis whether a filer submitted a return. The failure-to-file waiver statutes, such as IRC sections 6724(a) and 6698(a)(1), are *only* implicated when a taxpayer does *not* file a return. Where a return is filed, these statutes are inapplicable. It is circular, and therefore improper, to consider that the taxpayer did not file a return when determining whether a taxpayer exercised reasonable care. Indeed, these waiver statutes would serve no purpose if the failure to file a return (with or without a disclosure) demonstrated a lack of reasonable care.[62]

The problem with the preceding statement, and thus with the rejection of the DOJ's argument by the court, is that it seems inconsistent with the literal words of the relevant tax authorities. For example, the IRS may assert penalties under Code Sec. 6721 (related to Schedules K-1) when information returns are not filed, when information returns are filed late, when incomplete information returns are filed and/or when inaccurate information returns are filed.[63] Lest there be any doubt about the types of violations that may be sanctioned, the regulations state the following: "The failures to which Section 6721(a) and paragraph (a)(1) of this section apply are (i) a failure to file an information return on or before the required filing date ('failure to file timely') and (ii) a failure to include all of the information required to be shown on the return or the inclusion of incorrect information ('failure to include correct information')."[64] It is nearly the same story with Code Sec. 6698 (related to Form 1065), which expressly states that the IRS may assert penalties when a taxpayer does not file timely Forms 1065 or files incomplete Forms 1065.[65] Consequently, contrary to the statement by the bankruptcy court, Code Sec. 6724 and Code Sec. 6698 are applicable to many situations in which returns have been filed.

As explained above, to avoid penalties under Code Sec. 6721, the taxpayer has the burden of proving that there was "reasonable cause" (because of significant mitigating factors or because of events beyond the taxpayer's control) and that the taxpayer acted in a "responsible manner," both before and after the violation.[66] The regulations go on to clarify that the concept of responsibility requires the taxpayer to undertake significant steps, to avoid a violation in the first place, and then to fix any violations that still might occur.[67] With respect to the second duty, the regulations expressly state that promptly rectifying a violation can be achieved by "filing or correcting the information return" with the IRS or "furnishing or correcting" the payee statement to the taxpayer.[68] This, too, confirms that Code Sec. 6724 is applicable to situations where returns have been filed.

C. Notion of Equity

In addition to arguing that it met the standards for relief under Code Secs. 6724 and 6698, the Fund also suggested to the bankruptcy court, in various filings, that penalty relief should be granted out of "equity." This is interesting because equity has nothing to do with the relevant tax provisions. A common misstep by taxpayers and representatives is to believe that the standards for penalty mitigation are the same in all contexts. They are not. Take the following examples. Generally, the IRS may assert accuracy-related penalties under Code Sec. 6662 on tax underpayments resulting from certain types of misconduct, including negligence.[69] Penalties may not be imposed, however, if there was "reasonable cause" and the taxpayer acted in "good faith."[70] The IRS ordinarily can assert penalties under Code Sec. 6651 if a taxpayer files tax returns late or makes tax payments late. The IRS cannot unleash these delinquency penalties, though, if the taxpayer shows that the violation was due to "reasonable cause" and not due to "willful neglect."[71] Code Sec. 6654(a) generally authorizes penalties when there is an underpayment of estimated taxes. There are exceptions to this general rule, of course, such as when a taxpayer can show that imposing the penalty would be "against equity and good conscience" because of casualty, disaster or "other unusual circumstances."[72] This list of potential penalties is extremely long, and the differing standards for clemency are, too. Suffice it to say that, despite urgings by counsel for the Fund, the concept of equity does not factor into the only tax provisions relevant to *In re Refco Public Commodity Pool, LP*, Code Sec. 6698 and Code Secs. 6721–6724. The bankruptcy court seemed to understand this, not identifying equity as one of the grounds for its decision.

D. Supposed Lack of Tax Harm

The Fund argued to the bankruptcy court that penalties should not be asserted because there was no "tax harm" to the IRS. This is misguided for several reasons, three of which are discussed here. First, the reality is that very few penalties in the tax code are based on the amount of direct economic/tax harm to the IRS. Classic examples consist of delinquency penalties under Code Sec. 6651, accuracy-related penalties under Code Sec. 6662 and civil fraud penalties under Code Sec. 6663. These sanctions are directly related to the size of the "tax underpayment" to the IRS. However, hundreds of penalties are asserted because taxpayers failed to file timely, accurate and complete information to the IRS, data that it needs to effectively administer the tax system as a whole. See, for example, the long, long list of penalties described in Code Secs. 6671 through 6725, as well as those applicable to "Information Returns" identified in Code Secs. 6031 through 6091. Second, if the bankruptcy court were to have accepted the position advanced by the Fund that it should not be punished because it is a passthrough entity, not personally subject to federal income tax, this would have set an untenable precedent that all passthrough entities, including partnerships, subchapter S corporations, certain limited liability companies and others, could flout the law without consequences. Third, and perhaps most importantly, the failure by the Fund to issue Schedules K-1 for three consecutive years to approximately 1,600 partners likely had a tax impact on the IRS. The record *In re Refco Public Commodity Pool, LP* did not contain any details about the tax positions taken by the partners. Nevertheless, in light of the lack of information from the Fund for an extended period of time, one must assume that certain partners claimed losses on their individual income tax returns related to their investment in the Fund and that this necessarily involved considerable guesswork in terms of the size of the loss, the tax character of the loss, the appropriate year to claim it, *etc*. Without these data, the contention by the Fund that its violations did not trigger any tax harm to the IRS is unfounded. The bankruptcy court appeared to grasp this; it did not mention the existence or inexistence of tax harm as one of the pillars supporting its analysis.

E. Lurking Constitutional Issues

Counsel for the Fund initially argued that penalties under Code Sec. 6698 (for not filing Forms 1065 for three years) and under Code Sec. 6721 (for not filing Schedules K-1 to 1,600 partners for three years) would constitute an excessive fine in violation of the eighth amendment to the U.S. Constitution because they are not linked to the size of any tax harm to the IRS. This position was not examined by the bankruptcy court because it held in favor of the Fund on other grounds. It is interesting to note, though, that this constitutional argument, had it been advanced, would have faced some significant challenges.

First, for the reasons explained in the preceding segment of this article, the argument about lack of "tax harm" to the IRS is specious.

Moreover, unlike most penalty provisions, Code Sec. 6721 specifically takes into consideration different circumstances in determining the size of the sanction; it contains a general penalty, a reduced penalty in situations where taxpayers correct violations within a specified period of time, an exception for penalties for *de minimis* violations, lower penalties for smaller taxpayers (as measured by gross receipts), higher penalties in case of "intentional disregard" of the filing requirement and a lengthy, detailed, liberal set of special rules for penalty abatement in Code Sec. 6724.

Challenging constitutionality would also be difficult considering that Congress has examined the general penalty under Code Sec. 6721 many times during its existence, each time significantly raising it because of continued noncompliance by taxpayers and the serious problems that these failures to file timely, accurate and complete information returns, statements and other items cause to the IRS's ability to administer the entire tax system. The maximum general penalty has increased over time from $50,000 to $3 million, with the most sizable jumps occurring recently, in 2010 and 2015.[73] In enacting the uptick in penalties, Congress often expressly stated its efforts to ensure that the punishment remains commensurate with the violation and consistent with other federal statutes:

> The committee is concerned that the current maximum of $50,000 for each of these penalties may diminish the efficacy of these penalties in instances where there has been a massive failure to file these

information returns. The committee is also concerned, however, that the total elimination of these maximum amounts could subject taxpayers to enormous potential liability that would be disproportionate both to the taxpayer's culpability and to the penalties for many other federal offenses. Consequently, the committee has preserved a maximum amount for each of these penalties, but has also raised the dollar amounts of those maximums.[74]

Finally, the chances of the courts warming to the excessive fines argument in the context of Code Sec. 6698 and Code Sec. 6721 (where the per-violation amount is small, the penalty is linked directly to the number of violations committed by a taxpayer, there is a maximum/cap on the penalty, and, in the case of Code Sec. 6721, there are numerous taxpayer-favorable considerations built into the statute) seem small when such argument has been rejected by the courts in cases involving penalties related to Forms TD F 90-22.1 (now called FinCEN Form 114). In those situations, if the IRS can demonstrate that a taxpayer's violation was "willful," then the penalty equals 50 percent of the highest balance in each unreported foreign account, each year, for each year remaining open in the six-year assessment period. This, in practice, means that the IRS asserts penalties many times larger than the total amount of money that taxpayer had in the foreign accounts, thereby making it unfeasible for the taxpayer to pay the penalty, much less the related taxes and interest charges for the unreported income deposited into and/or generated by the accounts.[75]

V. Conclusion

As with all cases, this one will be interpreted in different manners. Taxpayers facing similar penalties in the future under Code Sec. 6721 and/or Code Sec. 6698 likely will argue that *In re Refco Public Commodity Pool, LP* stands for the notion that (i) taxpayers should be exempt from penalties for not filing Forms 1065 and Schedules K-1, for several consecutive years, if the third-party on which they depend for tax-related information has not made its own tax filings or otherwise provided reliable data; (ii) in order to obtain this penalty waiver, it is not necessary for taxpayers to file returns with the IRS using the best available data, along with a statement explaining problems with the data, efforts made to comply, affected parties, *etc.*; (iii) taxpayers are not otherwise required to contact the IRS to broach the nonfiling issue; and (iv) taxpayers are not even obligated to seek advice or possible solutions from accountants and/or tax attorneys when they encounter challenges in meeting their tax-filing duties of this type. The IRS and DOJ, on the other hand, might characterize this as a fact-specific case with no broad precedential value, one wrongly decided, by a bankruptcy court (not a specialized tax court), by a person who acknowledged that he is a "non-tax guy."[76] Regardless of which interpretation is more accurate, it is indisputable that *In re Refco Public Commodity Pool, LP* is an interesting case study. It is a cautionary tale, too, reminding all taxpayers facing significant tax penalties or problems to retain specialized tax counsel early in the process because many taxpayers encounter more formidable resistance than the Fund when seeking relief from the IRS or tax court.

ENDNOTES

1 *In re Refco Public Commodity Pool, LP*, 118 AFTR 2d 2016–XXXX (Bktcy. Ct. DE) (Aug. 2, 2016).
2 Code Sec. 6011(a); Reg. §1.6001-1(a).
3 Code Sec. 6031(a); Reg. §1.6031(a)-1(a)(1).
4 Code Sec. 6031(e); Reg. §1.6031(a)-1(b).
5 Code Sec. 6031(b); Reg. §1.6031(b)-1T.
6 Reg. §1.6031(b)-1T(a)(3)(i) and (ii).
7 Code Sec. 6698(b). The base penalty amount has changed several times in the past decade, increasing from \$50, to \$85, to \$89, to \$195.
8 Code Sec. 6698(a).
9 Code Sec. 6722(a); Reg. §301.6722-1(a).
10 Reg. §301.6672-1(d)(2)(i).
11 Code Sec. 6722(a)(1).
12 Code Sec. 6722(e).
13 The special rules in Code Sec. 6724 and the corresponding regulations are applicable to the information-reporting duties found in Code Sec. 6721 (covering certain "statements," "returns" and "other items"), Code Sec. 6722 (covering "payee statements") and Code Sec. 6723 (covering other "specified information reporting requirements").
14 Code Sec. 6724(a); Reg. §301.6724-1(a)(1) and (2).
15 Reg. §301.6724-1(a)(2)(i) and (ii).
16 Reg. §301.6724-1(a)(2), Flush Language.
17 Reg. §301.6724-1(b)(1); *See also* IRM, pt. 20.1.7.9.1 (Aug. 20, 1998).
18 Reg. §301.6724-1(b)(2).
19 Reg. §301.6724-1(b)(2)(i) and (ii).
20 IRM, pt. 20.1.7.9.1 (Aug. 20, 1998).
21 Reg. §301.6724-1(c).
22 Reg. §301.6724-1(c)(2).
23 Reg. §301.6724-1(c)(2) and Reg. §301.6724-1(c)(2)(ii). The regulations identify three examples of "supervening events," but state that this is a nonexhaustive list of acceptable "supervening events" for purposes of penalty abatement.
24 Reg. §301.6724-1(c)(5)(i).
25 Reg. §301.6724-1(c)(5)(ii).
26 Reg. §301.6724-1(c)(5). The regulation is entitled *Actions of Agent—Imputed Reasonable Cause*.
27 IRM, pt. 20.1.7.9.1 (Nov. 16, 2007).
28 IRM, pt. 20.1.7.9.1 (Nov. 16, 2007).
29 IRM, pt. 20.1.2.4.1(9) (July 2, 2013).
30 T.D. 8386, 56 FR 67189, Dec. 30, 1991 (emphasis added).
31 *See, e.g.*, *R.W. Boyle*, SCt, 85-1 USTC ¶13,602, 469 US 241, 242, 105 SCt 687 and *D.B. McMahan*, CA-2, 97-1 USTC ¶50,443, 114 F3d 366.
32 *G.B.P.C. Lefcourt*, 80 AFTR2d 97-6523 (CA-2, 97-2 USTC ¶50,648, 125 F3d 79).
33 Reg. §301.6724-1(c)(6)(i).
34 Reg. §301.6724-1(c)(6)(ii).
35 Reg. §301.6724-1(d)(1); IRM, pt. 20.1.7.9.2 (Nov. 16, 2007).
36 Code Sec. 6721(e); Reg. §301.6721-1(f)(2).
37 Reg. §301.6721-1(f)(2)(ii).
38 Reg. §301.6721-1(f)(3).
39 Reg. §301.6721-1(f)(6).
40 IRS Field Service Advisory, 1997 WL 33314303 (Dec. 1, 1997) (internal citations omitted).
41 IRS Field Service Advisory, 1192 WL 1354918 (July 8, 1992).
42 Objection to Amended Proof of Claim Filed by the IRS and Motion to Determine Tax Liability filed January 20, 2015.

[43] The motion filed by SPhinX only covered 2005, 2006 and 2007 because, as a foreign partnership with no U.S.-source income after 2007, it was not required to file Forms 1065 and Schedules K-1 for 2008 and future years.

[44] Objection to Amended Proof of Claim Filed by the IRS and Motion to Determine Tax Liability filed January 20, 2015, at 3.

[45] Objection to Amended Proof of Claim Filed by the IRS and Motion to Determine Tax Liability filed January 20, 2015, at 19.

[46] U.S.' Response to the Debtor's Objection to the IRS's Proof of Claim dated March 11, 2016.

[47] U.S.' Response to the Debtor's Objection to the IRS's Proof of Claim dated March 11, 2016, at 4.

[48] Reply in Support of Objection to Amended Proof of Claim Filed by the IRS and Motion to Determine Tax Liability dated March 30, 2016.

[49] Reply in Support of Objection to Amended Proof of Claim Filed by the IRS and Motion to Determine Tax Liability dated March 30, 2016, at 27.

[50] Court transcript from hearing conducted on June 16, 2016.

[51] Court transcript from hearing conducted on June 16, 2016, at 171.

[52] Court transcript from hearing conducted on June 16, 2016, at 27, 173–175.

[53] Court transcript from hearing conducted on June 16, 2016, at 173–175.

[54] Court transcript from hearing conducted on June 16, 2016, at 25–26.

[55] Court transcript from hearing conducted on June 16, 2016, at 72–73, 80–81, 84–85.

[56] Court transcript from hearing conducted on June 16, 2016, at 126.

[57] Court transcript from hearing conducted on June 16, 2016, at 162–163.

[58] *In re Refco Public Commodity Pool, LP*, 118 AFTR 2d 2016–XXXX (Bktcy. Ct. DE) (Aug. 2, 2016).

[59] Reg. §301.6724-1(a)(2) and Flush Language.

[60] T.D. 8386, 56 FR 67179, Dec. 30, 1991.

[61] T.D. 8386, 56 FR 67181, Dec. 30, 1991.

[62] *In re Refco Public Commodity Pool, LP*, 118 AFTR 2d 2016–XXXX (Bktcy. Ct. DE) (Aug. 2, 2016), fn 15.

[63] Code Sec. 6721(a)(2).

[64] Reg. §301.6721-1(b)(2).

[65] Code Sec. 6698(a).

[66] Reg. §301.6724-1(a)(2), Flush Language.

[67] Reg. §301.6724-1(d)(1)(ii).

[68] Reg. §301.6724-1(d)(1)(ii).

[69] Code Sec. 6662(a).

[70] Code Sec. 6664(c).

[71] Code Sec. 6651(a); Reg. §301.6651-1(a)(1).

[72] Code Sec. 6654(e)(3)(A).

[73] *See* Creating Small Business Jobs Act of 2010 (P.L. 111-240), Code Sec. 2102, and Trade Preferences Extension Act of 2015 (P.L. 114-27), Code Sec. 806.

[74] U.S. House of Representatives, Report 99-426, 99th Cong., 1st session (Dec. 7, 1985), at 828–829; U.S. Senate, Report 99-313, 99th Cong., 2d Sess. (May 29, 1985), at 176; U.S. Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, JCS-10-87, May 4, 1987, at 1269–1270.

[75] *See, e.g.,* Tyler R. Murray, *The Eighth Amendment and Tax Evasion: Whether FATCA Non-Compliance Fines and FBAR Penalties Are Excessive*, 24 William & Wary Bill of Rights J. 553 (2015).

[76] Court transcript from hearing conducted on June 16, 2016, at 191, Line 10.