Internal Revenue Service

memorandum

CC:WTA-N-1000091-97
Br1:WBLowrance

date: JUL 28 1997

to: Chief, Examination Division
Assistant Commissioner (International)

from: Chief, Branch No. 1
Associate Chief Counsel (International) CC:INTL:1

subject: [redacted]

This responds to a memorandum dated December 26, 1996, from Mr. John Hawley, Manager, Group [redacted], Examination Division. Mr. Hawley requested an opinion regarding a request from [redacted] (EIN [redacted]) and [redacted] (EIN [redacted]), known collectively as the [redacted], for a waiver of the filing requirements of I.R.C. § 874(a) pursuant to section 1.874-1(b)(2) of the Treasury Regulations. [redacted] requests a waiver for the nonresident alien individual partners' individual income tax returns (Forms 1040NR).

DISCLOSURE LIMITATIONS

FIELD SERVICE ADVICE CONSTITUTES RETURN INFORMATION SUBJECT TO I.R.C. § 6103. FIELD SERVICE ADVICE CONTAINS CONFIDENTIAL INFORMATION SUBJECT TO ATTORNEY-CLIENT AND DELIBERATIVE PROCESS PRIVILEGES AND IF PREPARED IN CONTEMPLATION OF LITIGATION, SUBJECT TO THE ATTORNEY WORK PRODUCT PRIVILEGE. ACCORDINGLY, THE EXAMINATION, APPEALS, OR COUNSEL RECIPIENT OF THE DOCUMENT MAY PROVIDE IT ONLY TO THOSE PERSONS WHOSE OFFICIAL TAX ADMINISTRATION DUTIES WITH RESPECT TO THIS CASE REQUIRE SUCH DISCLOSURE. IN NO EVENT MAY THIS DOCUMENT BE PROVIDED TO EXAMINATION, APPEALS, COUNSEL, OR OTHER PERSONS BEYOND THOSE SPECIFICALLY INDICATED IN THIS STATEMENT. FIELD SERVICE ADVICE MAY NOT BE DISCLOSED TO TAXPAYERS OR THEIR REPRESENTATIVES.

FIELD SERVICE ADVICE IS NOT BINDING ON EXAMINATION OR APPEALS AND IS NOT A FINAL CASE DETERMINATION. SUCH ADVICE IS ADVISORY AND DOES NOT RESOLVE SERVICE POSITION ON AN ISSUE OR PROVIDE THE BASIS FOR CLOSING A SPECIFIC CASE. THE DETERMINATION OF THE SERVICE IN THE CASE IS TO BE MADE THROUGH THE EXERCISE OF THE INDEPENDENT JUDGMENT OF THE FIELD OFFICE WITH JURISDICTION OVER THE CASE.

ISSUE

Whether certain nonresident alien individuals have established that they are entitled to a waiver under section 1.874-1(b)(2) of the Treasury Regulations of the filing deadlines for returns?

BACKGROUND

[redacted] letter contains a statement of facts and representations, which we have not verified, but which is summarized as follows:

The [redacted] partnerships are Dutch entities treated for U.S. tax purposes as limited partnerships. Since [redacted] has engaged in real estate development in [redacted] Initially, [redacted] purchased approximately [redacted] acres near established [redacted] areas. [redacted] intended to develop the land as a recreational [redacted]. At the end of [redacted] there were [redacted] investors (limited partners). Currently, there are [redacted] limited partners of which [redacted] are individual citizens and residents of the Netherlands; [redacted] are individual residents of other countries; and [redacted] are U.S. citizens and residents.

From [redacted] to [redacted], the project was delayed while [redacted] perfected title and development rights. In [redacted] these problems were eliminated, and [redacted] started active development. Master plans were prepared in [redacted] and approved by county government officials in [redacted], subject to the resolution of several issues, including a government proposal to construct a [redacted] on the property. From [redacted] to [redacted], [redacted] worked to resolve the issues raised by the county government.

In early [redacted], the U.S. Bureau of Reclamation (Bureau) asked [redacted] to voluntarily sell land needed for construction of the [redacted]. [redacted] refused, and the land was taken by the Bureau through a condemnation proceeding. The [redacted], were under construction from [redacted]. During this period, [redacted] stopped development of its remaining land and pursued legal action concerning compensation for the condemned property. A final judgment was entered in early [redacted]

From the beginning of the project, Mayflower engaged an accountant to prepare and file U.S. tax returns for the partnerships and the nonresident alien individual partners. [redacted] filed U.S. partnership returns, Forms 1065, with Forms K-1 for each individual partner, for every year since 1978. According to [redacted] "most of the nonresident alien

individual partners" filed Forms 1040NR from [redacted] through [redacted]. The nonresident alien partners did not file returns in [redacted] through [redacted].

[redacted] representative advised our office on March 11, 1997, that [redacted] disposed of the real estate in [redacted]. Apparently, for all years prior to [redacted], the partnerships reported net operating losses on the Forms 1065. It was not until [redacted], when the realty was sold, that the partnerships had net income. The individual partners seek to reduce their [redacted] taxable income by net operating loss carryovers from the years for which they did not file U.S. income tax returns. However, section 874(a) allows a nonresident alien the benefit of deductions for a year only if a true and accurate return is filed for such year. Therefore, the nonresident alien partners request that the Assistant Commissioner (International) waive the filing deadline rule in section 874(a) for [redacted] through [redacted] pursuant to section 1.874-1(b)(2) of the Treasury Regulations, and allow them the benefit of the deductions which would generate a net operating loss carryover to [redacted].

Under the filing deadline rule in section 1.874-1(b)(1) of the Regulations, the question of whether a timely return has been filed turns on whether a return was filed for the taxable year preceding the current taxable year (i.e., the year for which deductions and/or credits are claimed). If a return was filed for the preceding taxable year (or the current year is the first year for which a return is required), a return must be filed within 16 months of the due date under section 6072 for filing the return for the current taxable year. If a return was not filed for the preceding taxable year, a return must be filed no later than the earlier of 16 months of the due date under section 6072 for filing the return for the current taxable year or the date that the IRS mails a notice to the taxpayer that a return has not been filed for the current taxable year and that no deductions or credits (other than those provided in sections 31, 32, 33, 34 and 852(b)(3)(D)(ii) may be claimed by the taxpayer. Taxpayers concede that they filed no returns for the years for which they seek deductions.

One of the arguments advanced by the partnerships is that the net operating losses in years prior to [redacted] were passive losses and not deductible until [redacted] when the partnerships first realized net income. Thus, the partnerships argue that reporting the losses on a return for [redacted] will satisfy the return filing requirement in section 874(a) with respect to such losses. You have not asked for our views on this question. We also note that the partnerships reserve the

right to request a ruling on this issue should the Service deny its request for a waiver under section 1.874-1(b)(2) of the Regulations.

DISCUSSION[1]/

[redacted] was required to file partnership returns for the first year in which it received income or incurred any expenditure treated as a deduction for federal income tax purposes if it carried on any business, financial operation or venture as a partnership in the U.S. Treas. Reg. § 1.6031-1(a)(1).

A nonresident alien individual engaged in a trade or business in the U.S.[2]/ or having income which is subject to taxation under subtitle A of the Code must file a return on Form 1040NR, even if such individual has no income. Treas. Reg. § 1.6012-1(b)(1)(i). Income is taxable at graduated rates applicable to U.S. residents enumerated in section 1 of the Code. See I.R.C. § 871(b)(1). Deductions are allowed for purposes of section 871(b) only if and to the extent they are connected with income that is effectively connected with the conduct of a U.S. trade or business. I.R.C. § 873(a).

However, I.R.C. § 874(a) allows a nonresident alien to claim deductions and credits permitted by subtitle A only if a return is filed in accordance with the rules of subtitle F, as follows:

> (a) RETURN PREREQUISITE TO ALLOWANCE.-A nonresident alien individual shall receive the benefit of the deductions and credits allowed to him in this subtitle only by filing or causing to be filed with the Secretary a true and accurate return, in the manner prescribed in subtitle F (sec. 6001 and following, ...) including

---

[1]/ While [redacted] request is that the IRS waive the filing requirement for nonresident alien individuals, the rare and unusual/good cause waiver standard is also applicable to foreign corporations. I.R.C. § 882(c)(2) and Treas. Reg. § 1.882-4(a)(3)(ii). Therefore, our discussion applies to both nonresident alien individuals and foreign corporations.

[2]/ A nonresident alien individual is considered as being engaged in a trade or business in the U.S. if the partnership of which such individual is a member is so engaged. I.R.C. § 875(1).

> therein all the information which the Secretary may deem necessary for the calculation of such deductions and credits.

Section 882(c)(2) is the parallel provision for foreign corporations.

The History of section 874(a)

Section 874(a) was first enacted in the Revenue Act of 1918, section 217.[3]/ The provision originated in the House Bill, and the only reference to the section in the legislative history is in the Ways and Means Committee Report. The Committee Report states the following:

> The bill provides that the normal tax upon nonresident aliens be made the same as in the case of citizens or residents, namely, 12 per cent of the net income in excess of the credits provided in section 216 ... and that nonresident aliens be entitled (sec. 217) to the same deductions and credits as citizens of the United States if they file or cause to be filed with the collector a true and accurate return of their total income received from all sources corporate or otherwise in the United States, and include therein all the information which the commissioner may deem necessary for the calculation of such deductions and credits.

H. Rep. No. 767, 65th Cong., 2d Sess. 6-7 (Sept. 3, 1918).[4]/ The courts have noted the close similarity between the predecessors of and current sections 874(a) and 882(c)(2) and interpret application of both sections the same. See, e.g., Espinosa v. Commissioner, 107 T.C. 146 (1996), footnote 7.

---

[3]/ Section 217 of the 1918 Act provided "[t]hat a nonresident alien individual shall receive the benefit of the deductions and credits in this title only by filing or causing to be filed with the collector a true and accurate return of his total income received from all sources corporate or otherwise in the United States, in the manner prescribed by this title, including therein all the information which the Commissioner may deem necessary ...."

[4]/ Section 882(c)(2) was first enacted in the Revenue Act of 1928, § 233, which provided that "[a] foreign corporation shall receive the benefit of the deductions and credits allowed to it in this title only by filing or causing to be filed with the collector a true and accurate return ... in the manner prescribed in this title."

Neither statute included a reasonable cause exception to denial of deductions when a return is not filed. However, as explained below, certain exceptions to strict application of the sanction developed in the case law.

In Anglo-American Direct Tea Trading Co., Ltd. v. Commissioner, 38 B.T.A. 711 (1938), the petitioner, a U.K. corporation, owned all of the stock of and received dividends from a U.S. corporation. In the course of an audit of the U.S. corporation, an IRS agent discovered that the petitioner had not filed U.S. income tax returns for 1932 and 1933; and in 1935, the agent prepared returns for petitioner that reflected income in the amount of the dividends it received from the U.S. corporation. No deductions were allowed under the authority of section 233 of the Revenue Acts of 1928 and 1932, the predecessor of current section 882(c)(2). While the agent prepared the returns, the IRS never actually determined tax deficiencies based on these returns. Within a week that the agent prepared substitute returns, petitioner itself filed returns that reported the dividends it received from the U.S. corporation and claimed a deduction in the same amount for dividends received from a domestic corporation under section 23(p)(1).

The issue in Anglo-American was whether petitioner had filed its returns "in the manner prescribed by this title" as required by section 233, in that the return was not timely filed. The Board of Tax Appeals concluded that the use of the term "manner" in the statute, without a specific reference to "time," precluded the Commissioner from arguing that deductions could be denied under section 233 when a foreign corporation files an untimely return.

However, in Taylor Securities, Inc. v. Commissioner, 40 B.T.A. 696 (1939), the Board of Tax Appeals limited the timeliness exception it adopted in Anglo-American. In Taylor Securities, the petitioner, a Canadian corporation, received income from U.S. sources during tax years 1930 through 1935 but did not file U.S. income tax returns. On the basis of information contained in a 1936 letter from the petitioner, the Commissioner prepared returns for these years in March 1937. No deductions were allowed on these returns. A statutory notice of deficiency was sent to the petitioner, which filed a petition with the Board in June 1937. In December 1938, during the pendency of the litigation, petitioner filed returns with the IRS for the years in question. Relying on the Board's opinion in Anglo-American, the petitioner argued that the untimely filed returns prevented the Commissioner from denying it the benefit of deductions.

In Taylor Securities, the Board distinguished the facts in Anglo-American on the ground that in the earlier case the Commissioner never actually determined tax deficiencies on the basis of returns prepared by the revenue agent. The Board concluded, however, that once the Commissioner determined a deficiency, as in Taylor Securities, a taxpayer's ability to avoid the effect of section 233 by filing an untimely return was eliminated. The Board observed the following:

> we are unable to conclude that in enacting section 233 ... it was the intention of Congress that delinquent returns filed by a foreign corporation after the respondent's determination should constitute the returns required as a prerequisite to the allowance of the credits and deductions ordinarily allowable to the corporations. ... In view of such a specific prerequisite it is inconceivable that Congress contemplated by that section that taxpayers could wait indefinitely to file returns and eventually when the respondent determined deficiencies against them they could then by filing returns obtain all the benefits to which they would have been entitled if their returns had been timely filed. Such a construction would put a premium on evasion, since a taxpayer would have nothing to lose by not filing a return as required by statute.

The position of the Board of Tax Appeals in Taylor Securities was adopted by the appellate court in Blenheim Co., Ltd. v. Commissioner, 125 F.2d 906 (4th Cir. 1942), aff'g 42 B.T.A. 1248 (1940). In Blenheim Co., the taxpayer, a Newfoundland corporation, filed a U.S. personal holding company surtax return for its fiscal year 1935 reporting a net loss. The Commissioner sent "numerous" letters to the taxpayer, and to its representatives in the U.S. and Canada, requesting that it file a normal income tax return. In April 1938, the Commissioner prepared an income tax return for the taxpayer that reflected dividend income from U.S. sources and allowed no deductions; and a statutory notice of deficiency was mailed to the taxpayer in May 1938. Approximately three months later, the taxpayer prepared an income tax return for 1935 and filed it with the IRS. The taxpayer's return reported a net loss.

The Fourth Circuit in Blenheim Co. observed that the first amount required to be reported on a personal holding company return is taxable income; and that a taxpayer was not required to explain computation of such amount on the return. Therefore, the court upheld the Commissioner's view that a personal holding company return is not sufficient to avoid the

denial of deductions on an income tax return prepared by the IRS. The appellate court observed the following:

> That Congress intended the condition in Section 233 to be strictly applied is apparent both from the use of the limitation "only" and from the fact that the "reasonable cause" exception relating to the 25% [late filing] penalty was not included in Section 233.
>
> * * *
>
> The conclusion that the preparation of a return by the Commissioner a reasonable time after the date it was due terminates the period in which the taxpayer may enjoy the privilege of receiving deductions by filing its own return, is consistent not only with the intention of Congress as evidenced by the legislative history of Section 233, but also with considerations of sound administrative procedure ....

Thus, while the courts required a taxpayer to file a complete income tax return in order to avoid the disallowance of deductions,[5]/ a late return was sufficient to avoid disallowance of deductions so long as the return was filed before the Commissioner determined a tax deficiency. However, where the taxpayer filed no return at all, the courts uniformly upheld the Commissioner's disallowance of deductions. See Ross v. Commissioner, 44 B.T.A. 1 (1941), vac'd and rem'd 43-2 U.S.T.C. par. 9686 (4th Cir. 1943); Roerich v. Commissioner, 38 B.T.A. 567 (1938), aff'd 115 F.2d 39 (D.C. Cir. 1940); Furst v. Commissioner, 19 B.T.A. 471 (1930); Brittingham v. Commissioner, 66 T.C. 373, 408-409 (1976), aff'd per curiam 598 F.2d 1375 (5th Cir. 1979); and Inverworld, Inc. v. Commissioner, T.C. Memo 1996-301.

The 1990 Regulations

In July of 1989, the Treasury Department issued proposed regulations under 874 and 882 imposing bright-line limits on the filing of late returns by nonresident aliens and foreign corporations. The notice of proposed rulemaking provided that

---

[5]/ See, e.g., Gladstone Co., Ltd. v. Commissioner, 35 B.T.A. 764 (1937), appeal dismissed by Second Circuit Court of Appeals without opinion June 24, 1938, in which a Newfoundland corporation filed a U.S. income tax return reporting dividend income but did not report a net income or attach a Schedule H describing the source of the dividends. The Board concluded that the taxpayer had not filed a return.

the regulation would be effective for the first tax year ending after July 31, 1990. See 1989-2 C.B. 823. In 1990, the Treasury Department promulgated section 1.874-1(b) of the Treasury Regulations. The final regulation adopts a bright-line test of when a nonresident alien may avoid denial of deductions under section 874(a) by filing an untimely return, as follows:

> (1) General Rule. As provided in paragraph (a) of this section, for purposes of computing the nonresident alien individual's taxable income for any taxable year, otherwise allowable deductions and credits will be allowed only if a true and accurate return for that taxable year is filed by the nonresident alien individual on a timely basis. For taxable years of a nonresident alien ending after July 31, 1990, whether a return for the current taxable year has been filed on a timely basis is dependent upon whether the nonresident alien individual filed a return for the taxable year immediately preceding the current taxable year. If a return was filed for that immediately preceding taxable year, or if the current taxable year is the first taxable year of the nonresident alien individual for which a return is required to be filed, the required return for the current taxable year must be filed within 16 months of the due date, as set forth in section 6072 and the regulations under that section, for filing the return for the current taxable year. If no return for the taxable year immediately preceding the current taxable year has been filed, the required return for the current taxable year (other than the first taxable year of the nonresident alien individual for which a return is required to be filed) must have been filed no later than the earlier of the date which is 16 months after the due date, as set forth in section 6072, for filing the return for the current taxable year or the date the Internal Revenue Service mails a notice to the nonresident alien individual advising the nonresident alien individual that the current year tax return has not been filed and that no deduction or credits (other than those provided in sections 31, 32, 33, 34 and 852(b)(3)(D)(ii) may be claimed by the nonresident alien individual.

Treas. Reg. § 1.874-1(b)(2) allows a District Director (or the Assistant Commissioner (International) to waive the filing deadlines set forth in paragraph (b)(1) in very limited circumstances, as follows:

> Waiver. The filing deadlines set forth in paragraph (b)(1) of this section may be waived by the District

> Director or Assistant Commissioner (International) in rare and unusual circumstances if good cause for such waiver, based on the facts and circumstances, is established by the nonresident alien individual.

Further, section 1.874-1(b)(4) of the Regulations provides a protective return procedure. Under this procedure, a nonresident alien who determines that he has no gross income that is effectively connected to a U.S. trade or business, or alternatively that his gross income is exempt from U.S. tax under a tax treaty, may file a protective return. The protective return need not report any gross income or claim any deductions or credits. If it is later determined that some or all of the taxpayer's gross income was effectively connected to a U.S. trade or business, or that some or all of the income was not exempt under a treaty, the taxpayer will have protected his right to the benefit of deductions and credits with respect to such income.

These Regulations, adopted in T.D. 8322, 1990-2 C.B. 172, also adopted section 1.882-4, which provides similar return filing deadlines, and a good cause waiver, for foreign corporations under section 882(c)(2), except that 18 months is substituted for the 16 months applicable to individuals.

The issue in Espinosa v. Commissioner, 107 T.C. 146 (1996), was whether the Commissioner properly disallowed deductions that a nonresident alien would otherwise be entitled to under the authority of section 874(a). The tax years involved were 1987 through 1991 and, therefore, included years prior and subsequent to the effective date of section 1.874-1(b)(1) of the Regulations. In Espinosa, a nonresident alien did not file U.S. income tax returns for the years in question even though he received gross rent from U.S. real estate exceeding $10,000 per year. When deductions which could have been claimed on timely returns are taken into account, petitioner's U.S. rental activities produced a net loss.

On November 13, 1992, the Commissioner sent petitioner a letter asking if he had filed U.S. income tax returns and if not, to file such returns. Receiving no response from petitioner, a second similar letter was sent on January 12, 1993. On February 3, 1993, the Commissioner sent a letter advising petitioner that substitute returns had been filed; and by letter dated March 23, 1993, the Commissioner advised the taxpayer that no deductions were allowed on the substitute returns. On October 7, 1993, petitioner filed income tax returns for all of the years reporting net losses for each year. On January 13, 1994, the Commissioner issued a

statutory notice of deficiency based on her determination that petitioner's U.S. source income was effectively connected to a U.S. trade or business but that petitioner was not entitled to any deductions under the authority of section 874(a).

- - The issue in Espinosa was whether the returns filed by the petitioner in October 1993, after the Commissioner notified the taxpayer that substitute returns had been prepared but before a statutory notice of deficiency was issued, were sufficient to avoid the disallowance of deductions under section 874(a). For years prior to the effective date of section 1.874-1(b)(1) of the Regulations (years 1987 through 1989), the Tax Court rejected the petitioner's argument that it could avoid the effect of section 874(a) by filing returns prior to issuance of a statutory notice of deficiency. The court concluded that where the petitioner did not respond to the Commissioner's letters dated November 13, 1992, January 12 and February 3, 1993, and waited seven months to file returns after the letter dated March 23, 1993, the taxpayer could not avoid the disallowance of deductions under section 874(a). 107 T.C. at 156-158.

With respect to tax years 1990 and 1991, the Tax Court in Espinosa did not address the petitioner's argument that section 1.874-1(b) of the Regulations is invalid. Rather, the Court upheld the Commissioner's disallowance of deductions under the circumstances of the case. 107 T.C. at 158.

The petitioner in Espinosa also argued that the Commissioner should have granted a waiver of the return filing requirement pursuant to section 1.874-1(b)(2) of the Regulations. The Tax Court rejected this argument, because the petitioner failed to request the waiver and by noting that it had "no basis upon which to make a determination that respondent's action constituted an abuse of discretion. [Citation omitted.]"

Waiver of filing date rule

Subsection (b)(2) of the Regulation permits a District Director or the Assistant Commissioner (International) to waive the filing deadlines:

> in rare and unusual circumstances if good cause for such waiver, based on the facts and circumstances, is established by the nonresident alien individual.

Certain penalties in the Internal Revenue Code include "reasonable cause" exceptions. It is our view that the

precedent that has developed with respect to these exceptions is relevant to the "good cause" waiver of the filing deadlines in the Regulations under sections 874(a) and 882(c)(2). However, because the "good cause" waiver is not required by the statutes and is permitted by the regulations in only "rare and unusual circumstances," a higher standard is appropriate for the waiver than is required for the penalty exceptions. That is, taxpayers seeking a waiver from the operation of sections 874(a) or 882(c)(2) should be required to make an extraordinary showing of reasonable or good cause for not having filed a return within the period required by the Regulations.

Section 6651(a)(1) imposes a penalty for failure to file a required return. The section states that the penalty will be imposed "unless it is shown that such failure is due to reasonable cause and not due to willful neglect ...." The burden of showing reasonable cause under the penalty sections is on the taxpayer, and "[i]f the taxpayer offers no excuse, the penalty will be sustained by the court." Norton v. United States, 551 F.2d 821, 827 (Ct. Cl. 1977).

Section 301.6651-1(c)(1) of the Regulations states that

> [i]f the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause.

In United States v. Boyle, 469 U.S. 241, 245 (1985), the Supreme Court concludes that

> [t]o escape the penalty [for failing to file a return], the taxpayer bears the heavy burden of proving both (1) that the failure did not result from 'willful neglect,' and (2) that the failure was 'due to reasonable cause.'

In Boyle, the executor of an estate engaged an attorney experienced in probate to handle the estate's tax matters. However, because the attorney failed to note the due date of the estate tax return on his calendar, the federal estate tax return was filed three months late. The facts indicated that while the executor inquired of the attorney on a number of occasions as to whether the return was being prepared, and was assured that it was, the executor never asked for the date that the return was due. While the Commissioner conceded that the failure to file the estate tax return did not result from willful neglect, the IRS argued that reliance on an attorney under the circumstances was not reasonable cause for failure to file on time. The Court upheld imposition of the penalty

noting that it was not reasonable for the executor to not ascertain the due date and ensure that the return was timely filed. The Court concluded that the statutory due date of an estate tax return is unambiguous and distinguished that from a case where a taxpayer relies on the advice of a competent attorney that the law does not require the filing of a return.

Furthermore, ignorance of the tax law, or even an inability to understand the English language, have been held to not constitute reasonable cause for not filing a tax return.[6]/ Failure to file penalties have been imposed even where taxpayers may have an honest belief that their income is nontaxable. See, e.g., Nilson v. Commissioner, T.C. Memo. 1985-535. In Linseman v. Commissioner, 82 T.C. 514 (1984), a Canadian citizen and resident played on a professional hockey team that was a member of a league that included both U.S. and Canadian teams. The taxpayer allocated a sign-on bonus solely to Canadian sources and did not report any of the bonus as income on a U.S. tax return. The Tax Court upheld an allocation to U.S. sources of a portion of the bonus and also imposition of a failure to file penalty. The court observed, at page 523, that

> [t]he mere fact that petitioner thought that, because of the method of allocation he adopted, he owed no tax is not sufficient to excuse his failure timely to file a return.

In contrast, under certain circumstances, physical disabilities have been held sufficient grounds to excuse a failure to timely file and to avoid the penalty. See, e.g., United States v. Isaac, 91-2 U.S.T.C. 89,059 (E.D. Ky. 1991), aff'd by the 6th Cir. in an unpublished opinion (July 10, 1992), in which the taxpayer established that he was paralyzed in all four limbs, was unable to function, and was under treatment at the Mayo Clinic during the years in issue.[7]/ Similarly, the court in In the Matter of Joseph A. Sims, 1992-1 U.S.T.C. 83,141 (B.C. E.D. La. 1991), held that there was reasonable cause for not filing income tax returns where information needed by the taxpayer to complete his returns was held by business ventures and partnerships that refused

---

[6]/ See, e.g., Belaieff v. Commissioner, T.C. Memo. 1956-273.

[7]/ Compare Bloch v. Commissioner, T.C. Memo. 1992-1, where the court rejected a taxpayer's argument that a failure to timely file a return was due to mental illness but did not provide medical proof of any illness. See also Heber v. Commissioner, T.C. Memo. 1989-85.

taxpayer access to the records. The court noted that the taxpayer "had no control over these entities[']financial reporting procedures and could not generate these records himself."

Clearly, courts have found reasonable cause for a failure to file in only a limited number of situations and have resisted expanding the circumstances in which taxpayers have been excused from a penalty. The circumstances under which taxpayers are granted waivers from the return filing deadlines in sections 874(a) and 882(c)(2) should be even more limited and available in only rare and unusual circumstances. These sections were intended to offer strong incentives to nonresident aliens and foreign corporations to file U.S. income tax returns and, consequently, to reduce the opportunity for tax evasion. See Espinosa, 107 T.C. at 152. Furthermore, section 1.874-1(b)(4) of the Regulations, in allowing taxpayers to file protective income tax returns in certain circumstances, provides an easy method by which nonresident aliens can avoid the operation of section 874(a).

For example, if a nonresident alien argues that he should be granted a waiver under section 1.874-1(b)(2) on the grounds that he was advised by counsel that he had no U.S. tax liability and no requirement to file a return, the individual should be required to submit evidence that the counsel was competent to make such legal determinations; a sworn statement from his attorney that such advice had been given and the basis on which the attorney had reached his erroneous conclusions; and that the taxpayer had sought and received the same erroneous advice from a second competent source. If the attorney's incorrect advice in this regard was in any respect conditional or suspect, good cause for not filing a return did not exist, unless the taxpayer confirmed the advice with a second person experienced in federal taxes. In this regard, a prudent taxpayer who receives conditional, or tentative, advice that he has no gross income effectively connected to a U.S. trade or business, or that there is no income tax liability as the result of a tax treaty, may reasonably be expected to file a protective return pursuant to section 1.874-1(b)(4) of the Regulations.

Similarly, if a taxpayer argues that a medical condition prevented him from timely filing a tax return, he should be required to submit sworn statements from competent medical personnel that a medical disability prevented the taxpayer from filing his own return and from engaging a return preparer to complete and file a return on taxpayer's behalf.

If a taxpayer alleges that he does not have access to necessary records, he should be required to submit evidence that information needed to prepare his return was unavailable from other sources and statements from the persons who have the records that they refused to allow taxpayer access to the records and for what reasons. As in other situations, a taxpayer who determines that he has no gross income effectively connected with a U.S. trade or business can avoid the operation of section 874(a) by filing a protective return pursuant to section 1.874-1(b)(4) of the Regulations.

In sum, in cases in which a waiver is requested from the return filing deadline in the Regulations, the taxpayer should be required to establish that it failed to file a timely return for a reason that exceeds the normal reasonable cause standard for avoiding a failure to file penalty. With respect to the case under discussion, the general partner of the [redacted] requests a waiver of the return filing deadline in section 1.874-1(b)(2) of the Regulations with respect to the nonresident alien partners. According to the information submitted with the request, the nonresident aliens filed Forms 1049NR for tax years [redacted] through [redacted] but not for [redacted] through [redacted]. Therefore, the nonresident aliens knew of the filing requirement and there is no allegation, or evidence, that they stopped filing returns on the basis of advice of counsel.

The following reasons are given by the representative of the nonresident alien partners for not filing Forms 1040NR:

1. The [redacted] partnerships filed information returns, Forms 1065, for all years, including years subsequent to [redacted] reporting losses for all of the nonresident alien partners.[8/]

Taxpayers do not argue that they sought the advice of anyone before they stopped filing returns.[9/] There is some indication that they stopped because of the expense of filing

---

[8/] It was not until [redacted] when the real estate was sold at a gain that the question arose as to deductibility of a loss carryover from years for which returns were not filed.

[9/] See, e.g., Coshocton Securities Co. v. Commissioner, 26 T.C. 935, 939 (1956), in which the court upheld a penalty for failing to file a personal holding company return where the "petitioner never attempted to ascertain its true status as to whether it was a personal holding company. Nor did petitioner ever seek expert advice on this matter or attempt to rely on an attorney or accountant."

returns that reported no taxable income. However, neither the expense of filing returns that reported no tax liability nor the fact that the partnerships filed information returns constitutes reasonable cause for the individual partners not filing returns. Further, taxpayers may have been able to file protective returns under section 1.874-1(b)(4) of the Regulations and preserved their right to deductions and credits.

2. The U.S. accountant for the [redacted] partnerships never advised the nonresident aliens that failure to file a return could result in denial of deductions pursuant to section 874(a).

Taxpayers do not argue that the accountant gave them erroneous advice or that they sought his advice. The fact that their accountant gave the taxpayers no advice at all does not constitute reasonable cause for not filing returns.

3. The IRS did not send notices to the nonresident aliens advising them that the Service had not received returns for years after [redacted].

Taxpayers do not allege that the IRS at any time misrepresented their filing requirements or that they relied on any incorrect advice or misrepresentations. Compare, e.g., Haley v. Commissioner, T.C. Memo. 1977-348, in which the Court refused to uphold a failure to file penalty where the taxpayer established that necessary records were unavailable and that he had relied on advice of IRS agents in filing an income tax return containing no information other than an estimated tax liability.

It is our view that the nonresident alien individuals who were partners in the [redacted] partnerships have not met the normal reasonable cause test for avoiding a failure to file penalty, and therefore, they clearly have not met the even higher extraordinary showing of "good cause" required for a waiver under section 1.874-1(b)(2) of the Regulations. Accordingly, we recommend that the Assistant Commissioner (International) not grant a waiver to the taxpayers from the return filing deadlines in section 1.874-1(b)(1) of the Regulations.

If you have any questions or if we can be of further assistance in this matter, please call Bill Lowrance at 874-1490.

GEORGE M. SELLINGER