



IRS Insights | A closer look

The IRS issued Notice 2021-39,¹ *Transition Period Penalty Relief for New Schedules K-2 and K-3 for Forms 1065, 1120-S and 8865*, announcing transition relief for taxable years beginning in 2021. The Notice provides background on the new Schedules K-2 and K-3, and considerations for penalty relief for potential incorrect or incomplete reporting on the new schedules

The new Schedules K-2 and K-3 are required for Forms 1065, *US Return of Partnership Income*, 1120-S, *US Income Tax Return for an S Corporation*, and 8865, *Return of US Persons with Respect to Certain Foreign Partnerships*, but only if the entity for which the form is being filed has items of international tax relevance (generally foreign activities or foreign partners). The Schedules K-2 and K-3 are intended to replace, supplement, and clarify the reporting of certain amounts formerly reported on Schedule K and Schedule K-1 of the respective forms. The new standardized format assists partnerships with respect to the international tax aspects of the Internal Revenue Code.

Generally, partnerships are subject to penalties for failure to file or show information on a partnership return (section 6698), failure to electronically file Schedules K-1 (section 6721), failure to furnish Schedules K-1 to partners (section 6722), and failure to furnish information on Forms 8865 (section 6038).

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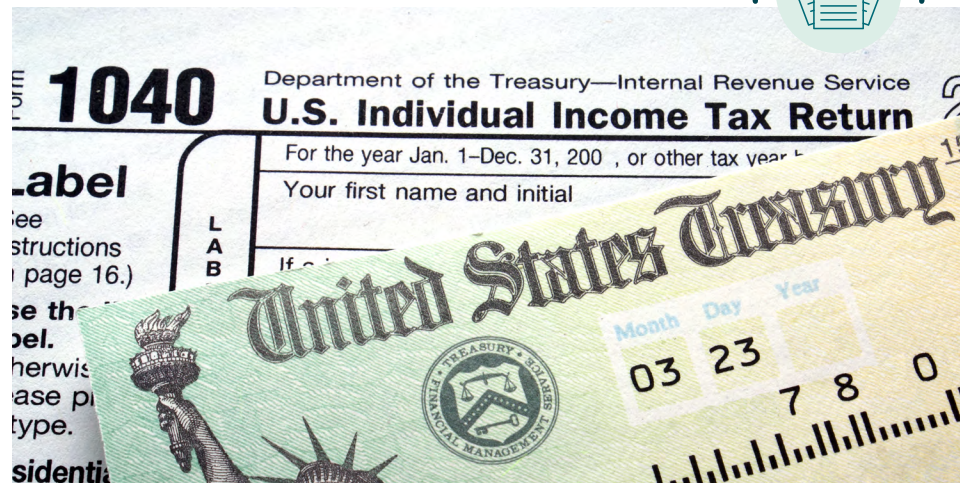
The Fifth Circuit upheld failure to file and failure to pay penalties due to lack of reasonable cause despite taxpayer's POA lying and embezzling

The US Court of Federal Claims dismisses taxpayer's electronically signed refund claims as not duly filed within the three-year statute of limitations on refunds

For partnership taxable years beginning in 2021, the information subject to these penalties will include Schedules K-2 and K-3. S corporations are subject to similar penalties under sections 6699 and 6722.

The Notice provides transition relief for taxable years that begin in 2021 (processing year 2022) with respect to Schedules K-2 and K-3 required for Forms 1065, 1120-S, and 8865. During this transition period, a partnership required to file Form 1065, an S corporation required to file Form 1120-S, or a US partner required to file Form 8865 (a "Schedule K-2/K-3 filer") will not be subject to the above penalties for any incorrect or incomplete reporting on Schedules K-2 and K-3 if the filer establishes to the satisfaction of the Commissioner that it made a good faith effort to comply with the Schedules K-2 and K-3 filing requirements (and the Schedule K-3 furnishing requirements) per the form instructions. A Schedule K-2/K-3 filer that does not establish that it made a good faith effort to comply with the new requirements, however, will not be eligible for penalty relief under the Notice.

In evaluating whether a Schedule K-2/K-3 filer made a good faith effort, the IRS will



take into account the degree to which a Schedule K-2/K-3 filer has made changes to its systems, processes, and procedures for collecting and processing the relevant information required by the forms. In addition, the IRS will take into account the extent to which the filer tried to obtain information from partners, shareholders of controlled foreign partnerships, or applied reasonable assumptions when information is not obtained. The IRS will also look to steps taken to modify the partnership or S corporation agreement to facilitate the sharing of information with

partners or shareholders that are relevant to determining whether and how to file Schedules K-2 and K-3. The appropriate level of diligence and/or reasonableness of assumption may differ with respect to a partner that manages or controls the partnership, or a partnership with a partner with a significant interest in the partnership.



In *Mills v. United States*,² a taxpayer brought an action seeking a refund for tax years 2015 and 2016, that he claimed on amended returns signed with an electronic signature. The United States Court of Federal Claims dismissed the taxpayer's refund claims for lack of jurisdiction holding that these amended returns were not valid claims for refund because they did not contain valid signatures and, thus, they were not duly filed

In *Mills v. United States*, a taxpayer ("Taxpayer") brought an action seeking a refund for tax years 2015 and 2016, that he claimed on amended returns signed with an electronic signature. The United States Court of Federal Claims dismissed the taxpayer's refund claims for lack of jurisdiction holding that these amended returns were not valid claims for refund because they did not contain valid signatures and, thus, they were not duly filed. The Taxpayer brought an action, seeking refunds of amounts for Foreign Earned Income Exclusion ("FEIE") and a tax exclusion for employer-provided lodging that the Taxpayer claimed on his amended returns for 2015 and 2016. After learning that his first set of amended returns were defective because they lacked his signature, Taxpayer filed a second set of amended returns with a digital signature. The IRS did not refund the money and Taxpayer initiated suit in the United States Court of Federal Claims ("Court of Federal Claims"). The Court of Federal Claims was presented with the question of whether these amended returns were valid claims for refund or if they were not duly filed because they each lacked an appropriate signature.

Background

Taxpayer is a US citizen who in 2015 and 2016 lived in employer-provided lodging in Australia while working for a defense contractor. While living in Australia, Taxpayer timely filed his Form 1040, *US Individual Income Tax Return*. In 2018, Taxpayer hired a tax consulting firm to assist him in preparing amended returns, allowing him to claim FEIE credits and exclude certain employer-provided lodging for both years. Taxpayer was still residing in Australia at the time and, therefore, an associate at Taxpayer's Tax Consulting firm signed each amended return. However, Taxpayer did not

include a Form 2848, *Power of Attorney and Declaration of Representative*, with his return. When Taxpayer finally did submit a Form 2848 to the IRS, it did not check the box in line 5a, specifically authorizing Taxpayer's appointed representatives to sign a return on his behalf.

After filing his first set of amended returns, Taxpayer received a letter from the IRS advising him that those amended returns did not appear to have his signature and that his representative was not authorized to sign a return on his behalf. The IRS requested that the Taxpayer submit a Form 1040X bearing his original signature. In response, on August 27, 2019, Taxpayer filed a second set of amended returns. At the time of filing, Taxpayer was working in Afghanistan and did not have easy access to a printer. As a result, Taxpayer electronically signed each of the amended returns with his initials. On April 13, 2020, after no action was taken by the IRS with respect to his second set of amended returns, Taxpayer filed a complaint in the Court of Federal Claims seeking a tax refund for the amounts claimed on

this second set of amended returns. The government moved to dismiss the case for lack of subject-matter jurisdiction.

Analysis

In order for the Court of Federal Claims to have jurisdiction over a tax refund suit, the refund claim must be duly filed in accordance with the Internal Revenue Code ("the Code"). The Code provides that "no suit shall be maintained in any court for the recovery of any internal revenue tax... until a claim for refund or credit has been duly filed with the Secretary, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof."³ The Code requires that a valid refund claim comply with the IRS regulations.⁴ The Treasury Regulations require verification of a refund claim by written declaration under penalty of perjury.⁵ The Court of Federal Claims has consistently held that in order for a refund claim to satisfy the subject-matter jurisdiction requirement,



the claim must fulfill the regulatory requirement by either 1) the taxpayer signing the claim under penalties of perjury, or 2) the taxpayer's authorized power of attorney signing the refund claim pursuant to a valid power of attorney.⁶

In its analysis, the Court of Federal Claims observed that the Code requires that tax returns be signed in accordance with the forms or regulations as prescribed by the Secretary.⁷ The Court of Federal Claims noted that the IRS's long-standing position is that the Code requires original signatures for amended returns.⁸ However, the Code does not define "sign" or "signature." In addition, since 1998, the Code has directed the Secretary to develop procedures to accept electronic signatures and to provide guidance on electronic signing of returns and other documents until it does so.⁹ Therefore, the Court of Federal Claims turned to the instructions of the IRS's Form 1040 and Form 1040X for guidance on proper submission.¹⁰ The instructions for filing Form 1040 tax returns for the years at issue permit electronic signatures for those with a personal identification number, but the instructions from Form 1040X amended

return are silent on whether electronic signatures are authorized.

The Taxpayer argued that he complied with the verification requirement by signing under penalties of perjury. Taxpayer relies on the definition of signature found in 1 U.S.C. § 1, which provides that a signature includes a mark when the person making it intended it as such.¹¹ The Taxpayer argued that because he was in Afghanistan, without ready access to printers, he had opted to use the digital marking of his initials as his signature. Taxpayer argued that, as a matter of policy, given his unique circumstances, his electronic signature should be accepted. The Taxpayer further argued that his signature was valid because, as mentioned above, the Internal Revenue Code authorizes the Secretary to develop procedures to accept digital or electronic signatures.¹² The Taxpayer cited a 2016 IRS Chief Counsel Advisory memorandum to support that digital signatures are legally sufficient.¹³

The Court of Federal Claims disagreed with the Taxpayer, pointing out that while the Code authorizes the Secretary to establish procedures, it is left to the Secretary's

discretion to determine whether to waive the signature requirement or provide alternative methods of signing.¹⁴ In its opinion, the court observed that the plaintiff did not point to any waiver or alternative method that authorized him to sign the returns using digital signatures. The Court of Federal Claims dismissed the Taxpayer's contention that his digital signature was allowed per 1 U.S.C. § 1, determining that the Code expressly governs electronic signatures on tax returns.¹⁵ In addition, the Court of Federal Claims noted that Chief Counsel Advisory opinions clearly cannot be cited as precedent.¹⁶ In conclusion, the Court of Federal Claims found that the Taxpayer's electronic signatures were not valid and therefore Taxpayer's refund claims were not verified by a written declaration that it was made under penalties of perjury. Accordingly, the Court of Federal Claims held that the returns were not duly filed and, thus, the court dismissed the Taxpayer's suit for lack of subject-matter jurisdiction.

In *Lindsay v. United States*,¹⁷ the Fifth Circuit upheld failure to file and failure to pay penalties due to lack of reasonable cause even though the taxpayer's attorney in fact, who was appointed on a Universal Power of Attorney ("POA"), lied about filing and paying the taxes while embezzling from the taxpayer

Factual Background

During the years at issue, the taxpayer was in prison. While he was incarcerated, the taxpayer provided the POA complete control of the taxpayer's bank accounts and full authority to manage his affairs. The taxpayer directed his POA to file his tax returns and pay his taxes. The POA told the taxpayer he did so, but he did not. Instead, the POA embezzled hundreds of thousands of dollars from the taxpayer.

Once released from prison, the taxpayer filed the delinquent tax returns and paid the taxes owed, plus interest and approximately \$425,000 in penalties. The taxpayer sought a refund of the penalties on the grounds that he had reasonable cause for failing to file and pay his taxes. The IRS denied his refund claim. The taxpayer then filed a lawsuit in district court, but the district court granted the IRS's motion to dismiss. The taxpayer appealed to the Fifth Circuit.

Reasonable Cause Defense to Failure to File and Failure to Pay Penalties

If a taxpayer fails to file his tax return or pay his tax liability, the taxpayer is subject to penalties "unless it is shown that such failure is due to reasonable cause and not willful neglect."¹⁸ Congress did not include a definition of "reasonable cause" in the Code. However, Treasury regulations address what constitutes reasonable cause. Under the regulations, if a taxpayer "exercised ordinary business care and prudence and was nevertheless unable to" file the tax return and pay the tax liability, the taxpayer had reasonable cause for failing to timely file and pay the taxes.¹⁹

The IRS's internal revenue manual has also identified certain specific examples of reasons that could potentially constitute reasonable cause, including death, serious illness, unavoidable absence, fire, casualty,

natural disaster or other disturbance, and unable to obtain records.²⁰

Court's Analysis

The taxpayer argued that he met the reasonable cause requirement because he exercised ordinary business care and diligence by appointing a POA while incarcerated and directing that POA to file and pay his taxes. The Fifth Circuit said the Supreme Court had already rejected the taxpayer's argument in *Boyle*.²¹

In that case, Boyle had hired an attorney to file and pay an estate's tax returns, but the attorney filed the returns three months late. Boyle argued the failure to file and pay penalties did not apply because he "exercised ordinary business care and prudence" by hiring an attorney to file and pay the taxes. The Supreme Court rejected the argument. The Court stated, "one does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due."²² Because *Boyle* establishes a taxpayer has a non-delegable duty to promptly file and pay his taxes, the Fifth Circuit rejected the taxpayer's argument that he exercised reasonable cause by delegating a POA and directing the POA to file and pay his taxes.

The taxpayer went on to argue that *Boyle* does not apply to him because his "incarceration rendered him incapable of complying with his filing deadline." The Fifth Circuit disagreed and noted that the taxpayer conducted business and employed a CPA while incarcerated so he clearly was "not incapable" of meeting the tax deadlines.

Finally, the Fifth Circuit summarily rejected the taxpayer's argument that he fit the IRS's internal definition of reasonable cause because he had an "unavoidable absence." The Fifth Circuit stated that the mere fact that the taxpayer was incarcerated cannot establish reasonable cause for failing to timely file and pay his taxes.

This case is another in a long line of cases that strictly hold a taxpayer's obligations to file and pay taxes cannot be delegated, although some of the cases do not necessarily take into account all of the nuances discussed by the Supreme Court in *Boyle*. Taxpayers raising a reasonable cause and good faith defense to failure to file and failure to pay penalties, including penalties for failing to file Forms 5471 and 5472, should affirmatively explain to the IRS why *Boyle* is distinguishable to the extent possible.



In *McCaffery v. United States*,²³ the IRS received the taxpayers' refund claim after the expiration of the three-year statute of limitations on refunds. The court refused to consider evidence establishing that the refund claim was mailed before the statutory deadline because there was no postmark on the refund claim's envelope

Factual Background

The McCafferys had until April 18, 2017 to file a claim with the IRS for a refund of their 2013 income taxes. The IRS did not receive the refund claim until April 24, 2017—six days after the deadline. The envelope in which the claim was mailed did not have a postmark. Mr. McCaffery stated he mailed the refund claim on April 17, 2017 and offered other evidence to prove it (e.g., emails with their accountant). The IRS denied McCafferys' refund claim as untimely.

The McCafferys filed suit in the Court of Federal Claims seeking an approximately \$69,000 refund of their 2013 income taxes. The United States moved to dismiss for lack of subject matter jurisdiction because the McCafferys did not timely file an administrative refund claim with the IRS.

Deemed Delivery Rule

Generally, a taxpayer must file a refund claim with the IRS within three years from the date the tax return was filed.²⁴ The IRS must deny untimely claims.²⁵ If a taxpayer does not timely file a refund claim with the IRS, it cannot sue for a refund.²⁶

A taxpayer can timely file its refund claim by delivering the claim to the IRS within the deadline or mailing the claim in accordance with the "deemed delivery" rule. Under the deemed delivery rule, if the IRS receives a claim after the deadline, the date of the United States postmark stamped on the envelope is the deemed date of delivery.²⁷ The deemed delivery rule applies only if proper postage is paid and the claim is properly addressed.²⁸ The following can be treated as "United States postmark" equivalents: non-United States postmarks, registered and certified mail, markings made by private delivery services (e.g., FedEx, UPS).²⁹

If the envelope has a US Postal Service postmark but it is illegible, the taxpayer bears the burden of proving the date the postmark was made and may use extrinsic evidence (i.e., evidence other than the envelope) to prove the content of illegible postmark.³⁰

Court's Analysis

The government and the McCafferys agreed the refund claim's envelope did not have a postmark. The issue was whether the McCafferys could use evidence other than the envelope to satisfy the deemed delivery rule. The Court of Federal Claims held they could not.

First, the court held, despite the McCafferys' claim that the Post Office usually applies a postmark, it could not presume a postmark was applied when none was visible and there was no other evidence to show one was applied.

Second, the court held taxpayers can use extrinsic evidence to satisfy the deemed delivery rule only if there is a postmark (albeit illegible). The McCafferys relied on a US Tax Court case, *Sylvan v. Comm'r*,³¹ which held the opposite—that taxpayers could use extrinsic evidence to satisfy the deemed delivery rule even when there was no postmark. The Court of Federal Claims was unpersuaded; it said the Tax Court's reasoning in *Sylvan* was flawed.

In *Sylvan*, the Tax Court concluded extrinsic evidence was permissible even when a postmark was missing because the Internal Revenue Code and legislative history did not indicate what result Congress intended when a postmark was illegible or missing. The Court of Federal Claims said this reasoning was erroneous because the Code does address those situations—the Tax Court just doesn't like the results. Because I.R.C. § 7502 and applicable regulations provide rules for when a postmark is illegible, the Court of Federal Claims said it is clear Congress and the IRS intended the deemed delivery rule to apply only when there is a postmark. If they had wanted the deemed delivery rule to apply to missing postmarks, they could have written it as such.

The Court of Federal Claims concluded that although the result—a missing postmark costing the McCafferys a potential \$69,000 refund—is harsh, it is the result required by the Code. The court granted the United States' motion to dismiss the McCafferys' refund lawsuit. Although there is now a court split between the Court of Federal Claims and the US Tax Court on what satisfies the deemed delivery rule, this case is a good reminder that taxpayers and tax practitioners should ensure they have adequate proof of the timely mailing of their refund claims consistent with the deemed delivery rule.



Endnotes

1. See IRC Notice 2021-39: <https://www.irs.gov/pub/irs-drop/n-21-39.pdf>.
2. *Mills v. United States*, No. 20-417T (Fed. Cl. July 14, 2021).
3. I.R.C. Section 7422(a).
4. *Chicago Milwaukee Corp. v. United States*, 40 F.3d 373, 374 (Fed. Cir. 1994).
5. Treas. Reg. § 301.6402-2(b)(1).
6. See e.g., *Gregory*, 149 Fed. Cl. at 723; *Clark v. United States*, 149 Fed. Cl. 409, 414 (2020).
7. I.R.C. 6061(a).
8. See Rev. Proc 84-9.
9. See I.R.C. § 6061(b)(1).
10. Treas. Reg. § 301.6061-1(b).
11. 1 U.S.C. § 1.
12. I.R.C. § 6061(b)(1).
13. IRS CCA 201650019 (Dec. 9, 2016).
14. See I.R.C. § 6061(b)(1).
15. See *First Nationwide Bank v. United States*, 431 F.3d 1342, 1348 (Fed. Cir. 2005).
16. I.R.C. § 6110(k)(3).
17. *Lindsay v. United States*, 2021 U.S. App. LEXIS 20446, *1, 4 F.4th 292, 293 (5th Cir. 2021).
18. I.R.C. § 6651(a)(1) (failure to file); I.R.C. § 6651(a)(2) (failure to pay).
19. Treas. Reg. § 301.6651-1(c)(1).
20. I.R.M. 20.1.1.3.2.2.
21. *United States v. Boyle*, 469 U.S. 241 (1985).
22. *Id.* at 251.
23. 2021 U.S. Claims LEXIS 1566, *1, ___ Fed.Cl. ___, 2021 WL 3486662 (August 9, 2021).
24. I.R.C. § 6511(a).
25. I.R.C. § 6511(b)(1).
26. I.R.C. § 7422(a).
27. I.R.C. § 7502(a)(1).
28. I.R.C. § 7502(a)(2)(B).
29. I.R.C. § 7502(b), (c), (d); Treas. Reg. § 301.7502-1(c)(iii)(B).
30. 26 C.F.R. § 301.7502-1(c)(1)(iii)(A).
31. 65 T.C. 548 (1975).

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