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THE LEGAL RESPONSIBILITIES OF THE PERSON PREPARING THE TAX RETURNS AND FURNISHING TAX ADVICE AND RELIANCE UPON ADVICE OF COUNSEL

LOUIS L. MELDMAN**

The preparation of income tax returns and the furnishing of tax advice and assistance by the tax practitioner results in many responsibilities. The practitioner has a duty first, to his client, the taxpayer. Secondly, he has a duty to the government, the treasury department. And, finally, he has a duty to society to aid in the administration of justice. All of his actions must, in the last analysis, be guided by his own conscience.¹

RESPONSIBILITY TO THE CLIENT, THE TAXPAYER

The attorney, C.P.A., or the accountant has a responsibility to his client. The preparation of a tax return, the furnishing of tax advice and assistance in tax matters by the tax practitioner is the result of a contractual relationship. The practitioner is requested to prepare returns, give advice or assistance in tax matters. He receives compensation for his work, and is charged with a duty in performance of his work under such contractual relationship. Therefore, the practitioner has the responsibility of exercising reasonable care and skill in fulfilling the contract. He must use all legal and ethical means available to the taxpayer to minimize the taxes. Inasmuch as the taxpayer has a legal right to handle his affairs (or have them handled for him) in such a way as to save taxes, the advisor should take advantage of all permissible items in the preparation of returns so as to reduce the legal tax liability. The law is clear that:

A taxpayer has the legal right to decrease the amount of what otherwise would be his taxes, or to avoid them altogether by means which the law permits.²

On the other hand, all the responsibilities imposed upon the taxpayer by the government in the preparation of the return are also imposed on the practitioner to the extent that he has knowledge of the facts in-

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¹Darrell, *Conscience and Propriety in Tax Practice*, 17 N.Y.U. INST. 1 (1959) and Dendy, *What is the Liability of the Person Preparing the Tax Return*, 9 N.Y.U. INST. 517 (1950).

²Jones v. Grinnell Exrx., 179 F. 2d 873 (10th Cir. 1950); Gregory v. Helvering, 293 U.S. 465 (1935).

volved. Our system of income taxation is one of voluntary assessment. Therefore, the taxpayer or the preparer of the return and the advisor, have a serious responsibility in the proper preparation of the return because the Commissioner relies on the return in making the initial tax assessment.³

Because of the contractual relationship, the practitioner may be liable to the taxpayer, his client, for negligence resulting in damages. If there is an understatement of tax on the original return which later results in a deficiency upon audit, the practitioner may be liable, because of his negligence, for additional interest on the deficiency. On the other hand, say the original return overstates the tax and subsequently the statute of limitations is applicable, the practitioner may also be liable to his client for overpayment of taxes. In general, it may be stated that a tax practitioner could be held liable for malpractice arising out of negligence in the performances of his professional work. In the case of *Edward H. Clark v. Comm.*,⁴ the taxpayer had his and his wife's returns prepared by an experienced tax counsel, who advised that joint returns would result in less tax than separate returns. Later, upon audit by revenue agents, it was disclosed that the original returns resulted in an erroneous tax liability of \$19,941.10. The tax counsel admitted the error and made restitution to the taxpayer. The Commissioner of Internal Revenue subsequently included this amount as income to the taxpayer when received. The Court overruled the Commissioner and held that the money received by the taxpayer was compensation for a loss suffered and was not income. The Court stated:

In paying that obligation [the additional tax on the joint return] he [the taxpayer] sustained a loss which was caused by the *negligence of his tax counsel*. The measure of that loss . . . was the sum of money (received) because of that negligence.

Incidentally, the Commissioner originally nonacquiesced to this decision, but later withdrew the nonacquiescence by Rev. Rul. 54-47.

Another case in point is *Lillie Rassieur v. Chas. & Hulbert Askew Stanley, et al.*⁵ Here the accountants set up a set of books and erroneously understated the cost basis of certain stock. The taxpayer sold the stock, thinking that he had a large profit, but in fact, he actually had a loss. The accountant, during that year, advised the sale of other securities at a loss to offset the apparent profit from the first sale. Later, when it developed that losses resulted from all the sales because the basis of the stock first sold was understated, the client sued the accountant for damages, being the difference between the market value of securities sold to create a tax loss on the advice of the accountant and

³ See Olsen, *The Revenue Agent Reacts to the Taxpayer and His Representative*, 12 N.Y.U. INST. 1002 (1954).

⁴ 40 B.T.A. 333 (1939).

⁵ 354 Mo. 117, 188 S.W.2d 817 (1945).

the market value at the time the client learned that the loss was ill-advised. The Court held that the accountant was negligent and liable for damages to the extent of \$15,000.00.

It can be seen, therefore, that the professional tax advisor, in the preparation of the return or in giving tax advice, has a primary duty to his client, within the limits of the law. The advisor must legally protect the interests of the client so that the client pays the proper amount of tax. That means that the taxpayer does not underpay the tax, does not pay more than is legally due, and finally, makes the proper initial self assessment on the tax return.

RESPONSIBILITIES TO THE GOVERNMENT

The preparer, other than the taxpayer, must verify the return. Federal Regulation⁶ provides, in part:

. . . if a return . . . is prepared for a taxpayer by another person for compensation or as an incident to the performance of other services for which such person receives compensation, and the return . . . requires that it shall contain or be verified by a written declaration that it is prepared under the penalties of perjury, the preparer must so certify the return. . . .

It is to be noted that under the Regulation, preparation of a return without compensation, directly or indirectly, does not require a signature. Therefore, the preparation of a return for a friend or relative without compensation would not require verification by the preparer. On the other hand, say that an accountant regularly audits the books of a corporation and prepares its income tax returns, and as a courtesy to the officers and principal stockholders, he prepares their individual returns and does not charge them. In such a situation it would seem that the accountant, in reality, gets indirect compensation from the corporation and, therefore, must sign the individual returns. Also, it is recommended that the stockholder officers make some payment for the preparation of their personal returns. Otherwise, it could be claimed that part of the corporate fee paid the accountant constituted a personal expense, could be partially disallowed as a deduction to the corporation, and could be treated as a constructive dividend to the individuals. In this connection, the rendering of mere mechanical assistance does not constitute preparation of a return and, therefore, does not require verification. Accordingly, a typist or a stenographer would not be covered by this Regulation. The purpose of this Regulation is to fix responsibility on the preparer of the return for truth, accuracy and completeness as to all information of which the attorney, accountant or agent has knowledge.

The law is clear that if you prepared the return you must sign and verify it. Sec. 7203 I.R.C. provides:

⁶ Treas. Reg. §1.6065-1 (b) (1959).

Any person required by this title—or by regulations made under authority thereof to make a return . . . or supply such information . . . shall . . . be guilty of a misdemeanor.

Furthermore, the return must be verified by a written declaration that it is made under the penalties of perjury.⁷ Sec. 7203 I.R.C., also provides penalties for willful failure to file a return as required by law and designates the crime as a misdemeanor carrying a fine of not more than \$10,000 or imprisonment of not more than one year, or both. In addition to the statutory provisions for willful failure to sign a return, such action by a practitioner may result in disbarment or suspension from practice before the Internal Revenue Service.⁸

Reg. 10.50: Authority to disbar or suspend . . . the Secretary of the Treasury . . . may suspend or disbar from further practice before the Internal Revenue Service any enrolled attorney or agent . . . who refuses to comply with the rules and regulations.

Reg. 10.52: Any enrolled attorney or agent may be disbarred or suspended from practice before the Internal Revenue Service for *willful* violation of any of the regulations. . . .

Therefore, in order to comply with the provisions of the Internal Revenue Code and the Rules of Practice before the Internal Revenue Service, the preparer of a return must verify the return as required by law.

Many practitioners feel that it is necessary for them to qualify their signature as a preparer of a return. As the Internal Revenue Service has ruled that the agent making the return is responsible only for information of which he has knowledge,⁹ the agent is not responsible for the truth or accuracy of the information furnished him unless he was hired to verify the information in addition to the preparation of the return. The agent is not required to make a complete audit in the preparation of a return. Therefore, one should not use a qualifying statement after the signature of the preparer. First of all, such qualification does not limit responsibility. If the return was prepared in good faith, there is nothing to worry about and the qualification adds nothing. On the other hand, if the attorney, C.P.A., accountant or agent did not prepare the return in good faith, he cannot be relieved of responsibility by any qualifications before or after his signature. His conduct regardless of qualifications is governed by numerous sections of the Internal Revenue Code which provide in effect that any person who wilfully aids or assists in, or procures, counsels or advises in the preparation of a false return shall be guilty of a crime. Secondly, in doubtful cases, the qualification of the signature of the preparer may result in the return being spotted by revenue agents in the classification section with the result that the return may be audited.

⁷ INT. REV. CODE OF 1954, §6065.

⁸ 31 C.F.R. §10 (1959).

⁹ G.C.M. 14509, XIV-1 CUM. BULL. 84 (1935).

A Revenue Service official once stated that an unnecessary apology which seems to disclaim responsibility is not conducive to acceptance of a return without examination.¹⁰

In conclusion, it can be definitely stated that the signature of an attorney, C.P.A., accountant or agent on the tax return in no way implies that he "certifies" the data submitted. The wording above the signatures on the 1961 Federal tax return states :

I declare, under the penalties of perjury, that I have examined this return (including all accompanying schedules and statements) and to the best of my knowledge and belief it is true, correct and complete. If prepared by a person other than taxpayer, his declaration is based on all information to which he has any knowledge.

Therefore, if the preparer knows that the return is wrong, he should not prepare it. If he has no reason to believe it is wrong, he is under no further obligation to qualify the signature. And, as previously stated, the qualification of the signature may lead to field examinations. The disclaimer or modification of the statement of verification is not required by law or professional ethics.¹¹

The duties of enrolled attorneys or agents are set forth in detail in the rules governing practice before the treasury.

Each enrolled attorney or agent who knows that a client has not complied with the law, or has made an error in, or omission from, any return, document, affidavit, or other paper which the client is required by law to execute in connection with any matter administered by the Internal Revenue Service, shall advise the client promptly of the fact of such non-compliance, error or omission.¹²

Therefore, the practitioner has a duty to advise the client promptly of the fact of such non-compliance, error or omission. It is not believed, however, that the practitioner has a duty to become an informer. As an attorney, if the information is privileged, he surely cannot disclose such information to anyone except the client. As a protection, it is recommended to the practitioner, that if such information of non-compliance, error or omission comes to his attention, that he make a detailed memorandum to the effect that he has advised the client pursuant to Reg. 10.23.

Regulation 10.24 with reference to the preparation of a return states that each enrolled attorney or agent shall exercise due diligence in preparing or assisting in the preparation of, approving, and filing returns,

¹⁰ See Lewis and Barker, *When You Sign That Return*, 28 TAXES 1077 (1950); Meldman, *A Checklist for the Individual Return*, 30 TAXES 180 (1952); Balter, *The Issue of Fraud and the Accountant*, 30 TAXES 431 (1952).

¹¹ Spandorf, *The Preparation of Individual Income Tax Returns*, 19 N.Y.U. INST. 1375 (1961).

¹² Treas. Reg. §10.23 (1958).

documents, affidavits and other papers relating to Internal Revenue Service matters to determine the correctness of representations made by him to the Internal Revenue Service. He must also exercise due diligence in this respect in order to determine the correctness of representations made by him to clients with reference to any matter administered by the Internal Revenue Service. It is to be noted that the dictionary defines "diligence" as "proper heed, attention, care, assiduous industry."

In a situation where he is not engaged to verify the information, the preparer cannot accept blindly the information submitted by the taxpayer. The preparer should attempt to reconcile by further inquiry, the information which he believes to be inconsistent with available prior tax returns or with the known financial status of the taxpayer.¹³

Let us assume that a small businessman shows no interest income for the year 1961. In 1962 he discloses to the tax preparer the receipt of large sums of interest from bank deposits. Also let us assume that the net profit from the small business disclosed to the tax preparer shows no possibility of savings. In such a situation inquiry should be made as to the source of funds deposited into the bank. The preparer cannot close his eyes to such facts, but must account to his own satisfaction for the additional bank deposits.

In addition to the duties prescribed by the rules of practice before the treasury department, the practitioner should be acquainted with the various criminal responsibilities involved in preparation of returns.

Sec. 7203 I.R.C. deals with the willful failure to file a return or supply information and has already been discussed. This crime is a misdemeanor and has not been used too much. It must be remembered that in this situation, as in all criminal situations, the failure to file a return or to supply information in order to constitute a crime, must be willful rather than the result of mistake, ignorance of law or inadvertence.

Sec. 7206 I.R.C. deals with felonies which carry a \$5,000 fine and a three year imprisonment.

Sec. 7206(1) I.R.C. provides that any person who willfully makes and subscribes any return which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter shall be guilty of a felony. In order to be convicted under this statute, it is necessary for the government to prove that there was a willful making and subscribing of a return or statement which contained a declaration that it was made under penalty of perjury. Furthermore, the person making the statement must believe it to be true and correct as to every

¹³ Spandorf, *supra* note 11, at 1371.

material matter. Therefore, a false net worth statement furnished to a revenue agent may constitute such a statement.¹⁴

Sec. 7206(2) I.R.C. provides as follows:

Any person who "Aids or assists" in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim or document . . . shall be guilty of a felony.

Under this section any person who willfully aids or assists or advises the preparation or presentation of any return which is false as to any material matter may be guilty of a felony. It is to be noted that even though the taxpayer personally does not know of the fraud, the preparer may still become involved. In the case of *U.S. v. Kelley*,¹⁵ an attorney for Ringling Bros. was convicted for improperly claiming depreciation on non-existing assets even though the taxpayer had no knowledge of the fraudulent acts. In that decision Judge Leonard Hand stated:

The purpose of the statute was very plainly to reach the advisors of taxpayers who got up their returns, and who might wish to keep down the taxes because of the credit they would get with their principals who might be altogether innocent.

Improper conduct of the practitioner may also constitute a crime under Sec. 7201 I.R.C. which refers to "Attempt to evade or defeat tax." The tax advisor or tax preparer should be familiar with all of these provisions. Accountants who prepared a large number of income tax returns and obtained refunds by inflating deductions were found guilty of willfully aiding, assisting in and counseling, procuring and advising the preparation of false and fraudulent income tax returns.¹⁶

In *U.S. v. Unger*,¹⁷ an attorney closed a real estate transaction on December 30, 1949, and received proceeds from the sale as agent for his client. He delivered gross proceeds to the client on January 3, 1950. In the preparation of the 1949 income tax return the attorney advised his client not to report the transaction as a capital gain in 1949. The Commissioner required an indictment under Sec. 7206(2) I.R.C. and claimed that the attorney improperly aided or assisted the taxpayer in not reporting the capital gain in 1949, the year in which the proceeds of the transaction were received by the attorney as agent for his client. The Court disregarded the strict rules of agencies and held that the proceeds ($\frac{1}{4}$ million) received by the attorney in 1949 was not construc-

¹⁴ *Knowles v. U.S.*, 224 F.2d 68 (10th Cir. 1955).

¹⁵ 105 F.2d 912 (1939).

¹⁶ *U.S. v. Herkskovitz*, 209 F.2d 881 (1951). See also, *Newton v. U.S.*, 162 F.2d 795 (1947) and *U.S. v. Lustig*, 163 F.2d 85 (1947), both involving accountants who prepared fraudulent returns.

¹⁷ 159 F. Supp. 850 (1958).

tively received by the client (taxpayer) until 1950. This case, nevertheless, demonstrates to what extent the government will go in trying to enforce the provisions of Sec. 7206 I.R.C. with reference to tax practitioners.

Standards of conduct for persons enrolled to practice before the Internal Revenue Service are set forth in detail in 31 C.F.R. Part 10 (1959).¹⁸ Excerpts from these Regulations follow:

Reg. 10.51: Disreputable conduct for which an enrolled attorney or agent may be disbarred or suspended from practice before the Internal Revenue Service includes any conduct violative of the ordinary standards of professional obligation and honor.

Forms of conduct listed:

Reg. 10.51(b)(3): Preparing or filing for himself or another, a false Federal tax return or other statement on which Federal taxes may be based, knowing the same to be false.

Reg. 10.51(b)(5): Suggesting to a client or a prospective client an illegal plan for evading Federal taxes or the payment thereof, knowing the same to be illegal.

Reg. 10.51(b)(7): Filing any false or fraudulent altered document or affidavit in any case or other proceeding before the Internal Revenue Service or procuring the filing thereof knowing the same to be false or fraudulent.

Reg. 10.51(b)(10): Preparing a false financial statement for a corporation, partnership, association or individual or certifying the correctness of such false statement, knowing the same to be false.

Reg. 10.51(b)(11): Imparting to a client false information relative to the progress of a case or other proceeding before the Internal Revenue Service knowing the same to be false.

Reg. 10.51(b)(13): Preparing or assisting in the preparation of or filing a false claim against the U.S. knowing the same to be false.

Reg. 10.51(b)(14): Approving for filing a false Federal tax return prepared by some other person or advising or aiding in the preparation of such a false tax return, knowing the same to be false.

Reg. 10.51(b)(23): Failure of an enrolled attorney to conduct himself and his practice before the Internal Revenue Service in accordance with recognized ethical standards applicable to attorneys generally.

Reg. 10.51(b)(24): Failure of an enrolled agent to conduct himself and his practice before the Internal Revenue Service in accordance with recognized ethical standards.

Reg. 10.51(b)(27): Knowingly aiding or abetting another by any means to defraud or attempt to defraud the United States or by af-

¹⁸ Treas. Reg. §10.0 (1958).

firmatively assisting or participating in any way in the concealment of a failure to report income, receipts or other property subject to taxation by the United States.

THE PRACTITIONER HAS A MORAL RESPONSIBILITY TO SOCIETY
AND TO HIS OWN CONSCIENCE

We operate under a system of self-assessment. Therefore, in order to keep everybody's legal tax liability as low as possible, everyone must report and pay what is legally due. If the advisor improperly reports a client's tax liability, he in effect, is taking property from all the other taxpayers. If everyone properly paid their just tax, we would all have lower tax burdens.

In the last analysis, let your conscience be your guide. Do not enter into a transaction or sanction any acts which you know are wrong. If you want peace of mind, think before the act is performed, then you won't have to worry about it later.

Therefore, under the contractual obligation to the client, the practitioner must prepare the return or give advice which will result in the minimum amount of legal tax liability. The practitioner's liability to the government is covered by rules of practice as set forth in the Regulations and by criminal statutes. At first blush the criminal responsibility to the government is very frightening and it would seem that no one would care to prepare tax returns. Remember, however, that before there can be any criminal liability, there must be "willfulness." Carelessness alone or negligence or errors on the part of the practitioner will not result in a crime and, therefore, cannot result in penalties. Before there can be fraud or perjury there must be a "willful" intent to commit such acts. It must always be kept in mind that in these criminal matters the burden of proof is on the government, and such burden must be carried beyond a reasonable doubt.

An attorney, a C.P.A., or tax practitioner cannot be held liable for fraud unless he has knowledge that the return was fraudulent at the time it was prepared or before it was delivered to the client or there was good and sufficient reason to believe that such return was fraudulent at that time. Therefore, if one exercises due care and skill in the performance of his duties as a tax advisor or preparer of returns and he can produce sufficient evidence of having done so, he will not incur any of the liabilities discussed herein.¹⁹

RELIANCE UPON ADVICE OF COUNSEL AS "REASONABLE CAUSE"
IN AVOIDING PENALTIES

It is now generally held that the taxpayer as a matter of law is entitled to rely upon the tax advice of an attorney or certified public accountant. There have been many cases that have sustained this position.

¹⁹ Dendy, *supra* note 1.

Especially in cases involving failure to file personal holding company returns, the Courts have held that reasonable cause existed for failure to file personal holding company returns where taxpayer relied on advice of *licensed* Certified Public Accountants who were expert in tax matters.²⁰ In *Hermax Co. Inc. v. Comm.*,²¹ the corporation president turned records over to a public accountant who was "not an expert in Federal tax law" for preparation of the tax returns. The accountant decided that the corporation was not a personal holding company and did not prepare such a return. It was held that failure to file the return was not due to reasonable cause.

The failure to file a return may be due to "reasonable cause" and not to willful neglect where the taxpayer has been advised by reputable counsel that he is not liable for tax. The taxpayer has done all that is required when "he selects a competent tax expert, supplies him with all necessary information and requests him to prepare proper returns. Negligence by the expert may not be imputed to the taxpayer."²²

In the case of *Genesee Valley Gas Co. v. Comm.*,²³ the penalty was imposed where taxpayer's officer believed he knew the law and determined no personal holding company return was required. For the year 1939 the officer prepared the return for the corporation and answered "no" to the question whether it was a personal holding company. A draft of the tax return was submitted to tax counsel, who approved answer. For 1940, 1941, and 1942, the same answer was inserted on the tax return, but the drafts were not given to tax counsel for approval. In that case the Court held that the failure to file personal holding company returns for the years 1940, 1941, and 1942, was not due to reasonable cause and the penalty was imposed.

In Rev. Rul. 172²⁴ the Internal Revenue Service acquiesced to the long line of judicial authority and finally held that the penalty would not be asserted for failure to file a personal holding company return "attributable to reliance in good faith upon the advice of a reputable accountant or attorney, experienced in Federal tax matters, and to whom all relevant information has been furnished." However, in the case of *Clark v. Comm.*,²⁵ a penalty for failure to file a declaration was sustained because "there was no proof of the reasonableness of so great a reliance by the taxpayer."

The advice of counsel is most relevant on the question of fraud. In fraud cases the burden is always on the government to show intent. It may be generally stated that reliance on a tax advisor may be the

²⁰ *Orient Invest & Finance Co., Inc. v. Comm.*, 166 F. 2d 601 (1948), and others.
²¹ 11 T.C. 442 (1948).

²² *Haywood Lumber & Mining Co. v. Comm.*, 178 F. 2d 769 (1950), *reversing* 12 T.C. 735 (1949).

²³ 180 F. 2d 41 (1950), *affirming* 11 T.C. 184 (1948).

²⁴ 1953-2 CUM. BULL. 226.

²⁵ 253 F. 2d 745 (1958).

basis for elimination of the fraud penalty. In order to prove fraud the government must show affirmative evidence of wrongful intent.

In the case of *Walter M. Ferguson*,²⁶ involving a net worth audit, the Court indicated that even though they should have kept better records and they should have known that their net income was higher there was no proof of fraud.

In *Davis v. Comm.*,²⁷ a husband and wife operated a ranch and omitted a considerable amount of income. The Court there held that fraud could not be predicated upon even "flagrant" discrepancies in income and deductions resulting from computations by the C.P.A. where complete records were furnished by the taxpayer and where there was no affirmative evidence of wrongful intent.

In *United Dressed Beef Co.*,²⁸ the taxpayer was advised by competent legal counsel that certain items were not income. The Court held that there could be no fraud penalty even though such advice was erroneous. In the *Clark* case, which involved a net worth audit even though the failure to file a declaration resulted in a negligence penalty there was no fraud because of reliance upon a competent tax advisor.

In *U.S. v. Rexach*,²⁹ there was no fraud where the taxpayer's lawyer and tax advisor advised that it was not necessary to report foreign business income. On the other hand, in *Marsden R. Leeder*,³⁰ the opposite result was reached and the return was held to be fraudulent where a lawyer did not report foreign business income.

In conclusion, it may be stated that a taxpayer who acts upon the advice of reputable counsel or a certified public accountant is not to be considered guilty of either fraud, negligence or delinquency.³¹

However, before the taxpayer can be relieved of this responsibility it must be shown that full information was turned over by the taxpayer to the tax advisor and that the taxpayer relied upon such advice in good faith.

The burden of establishing reasonable cause in reliance on a tax advisor is on the taxpayer in "failure to file" cases. The taxpayer has the burden of proving that the so-called "expert" was qualified to advise the taxpayers concerning tax matters and that his reliance was well placed.

Advice of counsel is most relevant on the question of fraud because in fraud cases the burden is on the government to show that there was willful intent on the part of the taxpayer to defeat the tax. Therefore, if the taxpayer is advised by competent legal counsel that certain items do not constitute income, and even though such advice may be erroneous there can be no fraud penalty.

²⁶ 14 T.C. 846 (1950). ²⁷ 184 F. 2d 86 (1950). ²⁸ 23 T.C. 579 (1955).

²⁹ 185 F. Supp. 465 (1960).

³⁰ 29 P-H Tax Ct. Mem. 396-60 (1960).

³¹ See Vol. 10 Mertens Law of Federal Income Taxation 55.27 (1958).