12 T.C. 735 (1949)

A taxpayer cannot avoid penalties for failure to file a tax return by passively relying on a tax preparer when the taxpayer is aware of facts suggesting a potential filing obligation.

Summary

Haywood Lumber and Mining Company was assessed penalties for failing to file personal holding company surtax returns for 1941 and 1942. The company argued it relied on a CPA to prepare its returns and fully disclosed all relevant information. The Tax Court found that the company's secretary-treasurer knew enough about the company's stock ownership and income sources to suspect it might be a personal holding company. Therefore, he had a duty to inquire further, and passive reliance on the CPA was not reasonable cause for failing to file the returns.

Facts

Haywood Lumber and Mining Company was incorporated in 1902. By 1926, its primary asset was a mica mine. In 1941 and 1942, more than 80% of the company's income came from royalties from this mine. The company's stock was closely held, with the five largest stockholders owning more than 50% of the outstanding stock in 1941 and 1942. Kenneth Sprague, the secretary-treasurer, was aware of the personal holding company surtax statute and knew the facts about the company's stock ownership and income. He engaged Wolcott, a CPA, to prepare the company's tax returns but did not specifically ask Wolcott about the company's potential personal holding company status.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the company's income tax, declared value excess profits tax, and personal holding company surtax for 1941 and 1942, and imposed penalties for failing to file personal holding company surtax returns. The company conceded all issues except the penalty for failing to file the personal holding company returns. The Tax Court upheld the Commissioner's determination.

Issue(s)

Whether the taxpayer's failure to file personal holding company surtax returns for 1941 and 1942 was due to reasonable cause and not willful neglect, thus precluding the imposition of penalties under section 3612 (d) (1) of the Internal Revenue code.

Holding

No, because the taxpayer's secretary-treasurer was aware of facts that should have put him on notice of the potential personal holding company status, and he failed to

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make a specific inquiry of a qualified tax advisor or conduct his own investigation.

Court's Reasoning

The court stated that "Reasonable cause" means the exercise of ordinary business care and prudence. The court distinguished this case from *Hatfried, Inc. v. Commissioner*, where the taxpayer had relied on affirmative advice from its accountant that it was not a personal holding company. Here, the taxpayer's officer, Sprague, knew of the personal holding company surtax statute and the facts that could trigger its application. The court emphasized that, "all the circumstances of which Sprague was aware in 1941 and 1942 put him on notice that petitioner might come within the definition of a personal holding company as defined by section 501 of the code." The court found Sprague's inaction—failing to investigate or specifically inquire about the company's status—did not constitute reasonable cause. The court noted that "ignorance of the necessity for filing a tax return will not of itself relieve a taxpayer of the 25 per cent penalty."

Practical Implications

This case highlights the importance of taxpayers taking an active role in understanding their tax obligations, especially when dealing with complex areas of tax law. Taxpayers cannot simply rely on a tax preparer to identify all potential filing requirements, particularly if they possess information suggesting a specific obligation. *Haywood Lumber* underscores the duty of inquiry: if a taxpayer is aware of facts that reasonably indicate a potential tax liability, they must take reasonable steps to investigate and determine their obligations. This case serves as a caution against passive reliance on tax professionals and emphasizes the need for proactive engagement in tax planning and compliance. Later cases have cited *Haywood Lumber* to support the proposition that taxpayers must demonstrate reasonable care and prudence in determining their tax liabilities, and that a simple delegation to a tax preparer, without further inquiry, is not always sufficient to avoid penalties.

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