MLI #1 Accuracy-Related Penalty Under IRC §§ 6662(b)(1) and (2)

SUMMARY

Internal Revenue Code (IRC) §§ 6662(b)(1) and (2) authorize the IRS to impose a penalty if a taxpayer's negligence or disregard of rules or regulations caused an underpayment of tax, or if an underpayment exceeded a computational threshold called a substantial understatement, respectively. IRC § 6662(b) also authorizes the IRS to impose five other accuracy-related penalties.[1] We did not analyze these other accuracy-related penalties because during our review period of June 1, 2012, through May 31, 2013, taxpayers litigated these penalties less frequently than the negligence and substantial understatement penalties.[2]

PRESENT LAW

The amount of an accuracy-related penalty equals 20 percent of the portion of the underpayment attributable to the taxpayer's negligence or disregard of rules or regulations or to a substantial understatement.[3] The IRS may assess penalties under both IRC § 6662(b)(1) and IRC § 6662(b)(2), but the total penalty rate cannot exceed 20 percent (*i.e.*, the penalties are not "stackable").[4] Generally, taxpayers are not subject to the accuracy-related penalty if they establish that they had reasonable cause for the underpayment and acted in good faith.[5] In addition, a taxpayer will be subject to the negligence component of the penalty only on the portion of the underpayment attributable to negligence. If a taxpayer wrongly reports multiple items of income, for example, some errors may be justifiable mistakes while others might be the result of negligence; the penalty applies only to the latter.

Negligence

The IRS may impose the IRC § 6662(b)(1) negligence penalty if it concludes that a taxpayer's negligence or disregard of the rules or regulations caused the underpayment. Negligence is defined to include "any failure to make a reasonable attempt to comply with the provisions of this title, and the term 'disregard' includes any careless, reckless, or intentional disregard."[6] Negligence includes a failure to keep adequate books and records or to substantiate items that gave rise to the underpayment.[7] Strong indicators of negligence include instances where a taxpayer failed to report income on a tax return that a payor reported on

1 IRC § 6662(b)(3) authorizes a penalty for any substantial valuation misstatement for income taxes; IRC § 6662(b)(4) authorizes a penalty for any substantial overstatement of pension liabilities; IRC § 6662(b)(5) authorizes a penalty for any substantial valuation understatement of estate or gift taxes; IRC § 6662(b)(6) authorizes a penalty when the IRS disallows the tax benefits claimed by the taxpayer when the transaction lacks economic substance; and IRC § 6662(b)(7) authorizes a penalty for any undisclosed foreign financial asset understatement.

2 Note, however, that there has been some recent significant litigation involving IRC § 6662(h) (the 40 percent penalty in the case of a gross valuation misstatement). *See, e.g., United States v. Woods*, 471 F. App'x 320 (5th Cir. 2012), *aff'g per curiam* 794 F. Supp. 2d 714 (W.D. Tex. 2011), *cert. granted*, 133 S. Ct. 1632 (Mar. 25, 2013); *Nevada Partners Fund L.L.C. v United States*, 111 A.F.T.R.2d (RIA) 2416 (5th Cir. 2013), *aff'g* 714 F. Supp. 2d 598 (S.D. Miss. 2010).

3 IRC § 6662(b)(1) (negligence/disregard of rules or regulations) and IRC § 6662(b)(2) (substantial understatement).

4 Treas. Reg. § 1.6662-2(c). The penalty rises to 40 percent if any portion of the underpayment is due to a "gross valuation misstatement." *See* IRC § 6662(h)(1).

5 IRC § 6664(c)(1).

6 IRC § 6662(c).

7 Treas. Reg. § 1.6662-3(b)(1).

an information return as defined in IRC § 6724(d)(1),[8] or failed to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion.[9] The IRS can also consider various other factors in determining whether the taxpayer's actions were negligent.[10]

Substantial Understatement

Generally, an "understatement" is the difference between (1) the correct amount of tax and (2) the tax reported on the return, reduced by any rebate.[11] Understatements are reduced by the portion attributable to (1) an item for which the taxpayer had substantial authority, or (2) any item for which the taxpayer, in the return or an attached statement, adequately disclosed the relevant facts affecting the item's tax treatment and the taxpayer had a reasonable basis for the tax treatment.[12] For individuals, the understatement of tax is substantial if it exceeds the greater of $5,000 or ten percent of the tax that must be shown on the return.[13] For corporations (other than S corporations or personal holding companies), an understatement is substantial if it exceeds the lesser of ten percent of the tax required to be shown on the return (or, if greater, $10,000), or $10,000,000.[14]

For example, if the correct amount of tax is $10,000 and an individual taxpayer reported $6,000, the substantial underpayment penalty under IRC § 6662(b)(2) would not apply because although the $4,000 shortfall is more than ten percent of the correct tax, it is less than the fixed $5,000 threshold. Conversely, if the same individual reported a tax of $4,000, the substantial understatement penalty would apply because the $6,000 shortfall is more than $5,000, which is the greater of the two thresholds.

Reasonable Cause

The accuracy-related penalty does not apply to any portion of an underpayment where the taxpayer acted with reasonable cause and in good faith.[15] A reasonable cause determination takes into account all of the pertinent facts and circumstances.[16] Generally, the most important factor is the extent to which the taxpayer made an effort to determine the proper tax liability.[17]

8 IRC § 6724(d)(1) defines an information return by cross-referencing various other sections of the Code that require information returns (*e.g.*, IRC § 6724(d)(1)(A)(ii) cross-references IRC § 6042(a)(1) for reporting of dividend payments).

9 Treas. Reg. § 1.6662-3(b)(1)(i)-(ii).

10 These factors include the taxpayer's history of noncompliance; the taxpayer's failure to maintain adequate books and records; actions taken by the taxpayer to ensure the tax was correct; and whether the taxpayer had an adequate explanation for underreported income. Internal Revenue Manual (IRM) 4.10.6.2.1, *Negligence* (May 14, 1999).

11 IRC § 6662(d)(2)(A)(i)-(ii).

12 IRC § 6662(d)(2)(B)(i)-(ii). No reduction is permitted, however, for any item attributable to a tax shelter. *See* IRC § 6662(d)(2)(C)(i).

13 IRC § 6662(d)(1)(A)(i)-(ii).

14 IRC § 6662(d)(1)(B)(i)-(ii).

15 IRC § 6664(c)(1).

16 Treas. Reg. § 1.6664-4(b)(1).

17 *Id*.

Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process[18] and through its Automated Underreporter (AUR) computer system.[19] Before a taxpayer receives a notice of deficiency, he or she has opportunities to engage the IRS on the merits of the penalty.[20] Once the IRS concludes an accuracy-related penalty is warranted, it must follow deficiency procedures (*i.e.*, IRC § 6211-6213).[21] Thus, the IRS must send a notice of deficiency with the proposed adjustments and inform the taxpayer that he or she has 90 days to petition the United States Tax Court to challenge the assessment.[22] Alternatively, taxpayers may seek judicial review through refund litigation.[23] Under certain circumstances, a taxpayer can request an administrative review of IRS collection procedures (and the underlying liability) through a Collection Due Process (CDP) hearing.[24]

Burden of Proof

In court proceedings, the IRS bears the initial burden of production regarding the accuracy-related penalty.[25] The IRS must first present sufficient evidence to establish that the penalty is warranted. The burden of proof then shifts to the taxpayer to establish any exception to the penalty, such as reasonable cause.[26]

ANALYSIS OF LITIGATED CASES

We identified 178 opinions issued between June 1, 2012 and May 31, 2013 where taxpayers litigated the negligence/disregard of rules or regulations or substantial understatement components of the accuracy-related penalty. The IRS prevailed in full in 139 cases (78 percent), the taxpayers prevailed in full in 28

18 IRM 4.10.6.2(1), *Recognizing Noncompliance* (May 14, 1999) ("assessment of penalties should be considered throughout the audit"). *See also* IRM 20.1.5.3(1)-(2), *Examination Penalty Assertion* (Jan. 24, 2012).

19 The AUR is an automated program that identifies discrepancies between the amounts that taxpayers reported on their returns and what payors reported via Form W-2, Form 1099, and other information returns. *See* IRM 4.19.2, *Liability Determination, IMF Automated Underreporter (AUR) Control* (Aug. 16, 2013). IRC § 6751(b)(1) provides the general rule that IRS employees must have written supervisory approval before assessing any penalty. However, IRC § 6751(b)(2)(B) allows an exception for situations where the IRS can calculate a penalty automatically "through electronic means." The IRS interprets this exception as allowing it to use its AUR system to propose the substantial understatement and negligence components of the accuracy-related penalty without human review. If a taxpayer responds to an AUR-proposed assessment, the IRS first involves its employees at that point to determine whether the penalty is appropriate. If the taxpayer does not respond timely to the notice, the computers automatically convert the proposed penalty to an assessment. *See* National Taxpayer Advocate 2007 Annual Report to Congress 259 ("Although automation has allowed the IRS to more efficiently identify and determine when such underreporting occurs, the IRS's over-reliance on automated systems rather than personal contact has led to insufficient levels of customer service for taxpayers subject to AUR. It has also resulted in audit reconsideration and tax abatement rates that are significantly higher than those of all other IRS examination programs.").

20 For example, when the IRS proposes to adjust a taxpayer's liability, including additions to tax such as the accuracy-related penalty, it typically sends a notice ("30-day letter") of proposed adjustments to the taxpayer. A taxpayer has 30 days to contest the proposed adjustments to the IRS Office of Appeals, during which time he or she may raise issues related to the deficiency, including any reasonable cause defense to a proposed penalty. If the issue is not resolved after the 30-day letter, the IRS sends a statutory notice of deficiency ("90-day letter") to the taxpayer. *See* IRS Pub. 5, *Your Appeal Rights and How to Prepare a Protest If You Don't Agree* (Jan. 1999); IRS Pub. 3498, *The Examination Process* (Nov. 2004).

21 IRC § 6665(a)(1).

22 IRC § 6213(a). A taxpayer has 150 days instead of 90 to petition the Tax Court if the notice of deficiency is addressed to the taxpayer outside the United States.

23 Taxpayers may litigate an accuracy-related penalty by paying the tax liability (including the penalty) in full, filing a timely claim for refund, and then timely instituting a refund suit in the appropriate United States District Court of the Court of Federal Claims. 28 U.S.C. § 1346(a)(1); IRC §§ 7422(a), 6532(a)(1); *Flora v. United States*, 362 U.S. 145 (1960) (requiring full payment of tax liabilities as a prerequisite for jurisdiction over refund litigation).

24 IRC §§ 6320 and 6330 provide for due process hearings in which a taxpayer may raise a variety of issues including the underlying liability, provided the taxpayer did not receive a statutory notice of deficiency or did not otherwise have an opportunity to dispute such liability. IRC §§ 6320(c), 6330(c)(2).

25 IRC § 7491(c) provides that "the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title."

26 IRC § 7491(a). *See also* Tax Court Rule 142(a).

cases (16 percent) and 11 cases (six percent) resulted in split decisions. Table 1 in Appendix III provides a detailed list of these cases.

Taxpayers appeared *pro se* (without representation) in 100 of the 178 cases (56 percent) and convinced the court to dismiss or reduce the penalty in 20 (20 percent) of those cases. Represented taxpayers fared slightly better, achieving full or partial relief from the penalty in 19 of their 78 cases (24 percent).

In some cases, the court found taxpayers liable for the accuracy-related penalty but failed to clarify whether it was for negligence under § 6662(b)(1), or a substantial understatement of tax under § 6662(b)(2), or both.[27] Regardless of the subsection at issue, the analysis of reasonable cause is the same. As such, we have combined our analyses of reasonable cause for the negligence and substantial understatement cases.

Adequacy of Records and Substantiation of Deductions to Show Reasonable Cause and as Proof of Taxpayer's Good Faith

Taxpayers are required to maintain records sufficient to establish the amount of gross income, deductions, and credits claimed on a return.[28] Taxpayers were most successful in establishing a defense for an asserted underpayment when they produced adequate records or proved they made a reasonable attempt to comply with the requirements of law. For example, in *Bauer v. Commissioner*,[29] the taxpayer engaged in a household goods transport business and sought to deduct contract labor expenses. Although a deduction is allowed for ordinary and necessary expenses paid or incurred by a taxpayer in carrying on a trade or business,[30] the IRS disallowed the contract labor expenses for failure to substantiate the deduction. In *Bauer*, the taxpayer kept a logbook of contract labor expenses that the court deemed inadequate to substantiate the deduction taken on Schedule C.[31] Pursuant to the *Cohan* rule,[32] however, the court was able to estimate the amount of deductible expense. The court did not uphold the accuracy-related penalty asserted against the taxpayer because his logbook demonstrated that he made a good faith effort to maintain a record of his contract labor expenses even though his attempt at recordkeeping fell short for substantiation purposes.[33]

While the Tax Court has been sympathetic to honest misunderstandings of a complex tax code,[34] it will still impose an accuracy-related penalty on taxpayers not demonstrating a good faith effort to comply with

27 *See, e.g., Snow v. Comm'r*, T.C. Memo. 2013-114 (IRS proposed accuracy-related penalties against the taxpayer for both § 6662(b)(1) and (b)(2), but the Tax Court ultimately held him liable for "the accuracy-related penalty under section 6662(a)," without identifying which subsection applied). *Compare with Holmes v. Comm'r*, T.C. Memo. 2012-251 (IRS proposed accuracy-related penalties under both § 6662(b)(1) and (b)(2); however, once the IRS established that the taxpayer had substantially understated his income under § 6662(b)(2), the court declined to consider the negligence claim).

28 IRC § 6001; Treas. Reg. § 1.6001-1(a).

29 T.C. Memo. 2012-156.

30 IRC § 162(a).

31 *Bauer*, T.C. Memo. 2012-156.

32 *See Cohan v. Comm'r*, 39 F.2d 540, 544 (2d Cir. 1930) (holding that if a taxpayer establishes that he or she paid a deductible business expense but cannot substantiate the precise amount, the court may estimate the amount of the deductible expense, "bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making").

33 *Bauer*, T.C. Memo. 2012-156.

34 *See, e.g., Armstrong v. Comm'r*, 139 T.C. No. 18 (2012) (declining to impose an accuracy-related penalty on a taxpayer who improperly claimed a dependency exemption but was not sufficiently experienced in tax accounting and law to be found negligent); *Chien v. Comm'r*, T.C. Memo. 2012-277 (relieving from the accuracy-related penalty a taxpayer who failed to understand that she was liable for self-employment tax because of her inexperience and honest misunderstanding, after consulting instructions for Form 1040, of her employment status).

the law. For example, in *Striefel v. Commissioner*,[35] the taxpayer destroyed records because he was told he would die soon. Although the court acknowledges the taxpayer was understandably upset, it found the taxpayer's actions negligent and not justifiable pursuant to IRC § 6001, which requires the maintenance of tax records.[36] In *Fitch v. Commissioner*,[37] the taxpayers sought to deduct a net operating loss carried over from prior years pursuant to IRC § 172(a). The IRS disallowed the deduction for failure to substantiate, and the taxpayers were responsible for an accuracy-related penalty. Although the husband, who worked as a certified public accountant (CPA), suffered a brain aneurysm during the tax year, the deterioration of his health did not suffice to support a finding that the married couple acted with reasonable cause sufficient to avoid the accuracy-related penalty.[38] While the court sympathized with the taxpayer's health circumstances, it relied on Mr. Fitch's continued practice as a CPA to show that the illness alone did not support a reasonable cause or good faith defense sufficient to avoid the penalty.[39]

While expectations for compliance with the tax code are high, taxpayers avoided an accuracy-related penalty by adequately substantiating deductions to show reasonable cause and proof of good faith in connection with an unresolved legal issue. For example, in *Patel v. Commissioner*,[40] the taxpayers claimed a charitable contribution when they donated their house to the local fire department to conduct live fire training exercises on the property. The state of the law regarding the type of ownership interest in the house that the taxpayers transferred to the fire department was unsettled. The Tax Court denied the deduction but declined to impose the accuracy-related penalty. The IRS disagrees with the Tax Court's conclusion that the uncertain state of the law is a factor that supports a finding of reasonable cause when the taxpayers failed to obtain competent professional advice or do their own investigation of the state of the law.[41]

In *Olive v. Commissioner*,[42] the taxpayer was found negligent for failure to keep adequate books and records, and he substantially understated income in connection with his medical marijuana dispensary. The taxpayer deducted costs of goods sold and other business expenditures, some of which were properly substantiated while others were not. Accuracy-related penalties were imposed on the portion of the understatement that arose from unsubstantiated deductions, but not on the portion of the understatement stemming from properly substantiated deductions. Because the correct treatment of expenditures for the sale of marijuana was not resolved at the time the taxpayer filed the returns, the court focused the penalty application on whether the expenses had been properly substantiated as a sign of a good faith effort to comply with the tax code.[43]

35 T.C. Memo. 2013-102.

36 *See supra*, note 28.

37 T.C. Memo. 2012-358.

38 *Id.*

39 *Id. See also Perry v. Comm'r*, T.C. Memo. 2012-237 (holding an accuracy-related penalty was appropriate where the taxpayer was a certified public accountant (CPA) and former IRS revenue agent and failed to substantiate deductions for travel expenses and depreciation on his home).

40 138 T.C. 395 (2012).

41 *See Patel*, 138 T.C. at 395, *action on dec.*, 2013-7 (Feb. 11, 2013).

42 139 T.C. 19 (2012).

43 139 T.C. 19 (2012).

Negligence by Creation of Artificial Capital Loss

We also reviewed several cases in which the taxpayer contested an accuracy-related penalty after creating an artificial capital loss by implementing a scheme called CARDS (Custom Adjustable Rate Debt Structure). In *Kerman v. Commissioner*,[44] the taxpayer was held liable for an accuracy-related penalty for a substantial understatement in tax resulting from the implementation of a CARDS scheme to generate tax losses to offset the capital gain realized from the sale of securities. A CARDS strategy begins with a foreign borrower taking a loan from a foreign bank in foreign currency. The taxpayer for whom the strategy is designed would then receive some of the funds from the company, agreeing to be jointly liable for the full amount of the loan. The taxpayer would then exchange the foreign currency for United States dollars. As the exchange of foreign currency is a taxable event, the taxpayer claims a basis in the foreign currency equal to the entire value of the loan taken from the foreign financial institution. The U.S. currency is then paid to the foreign company and the loan is paid off after a year, so as to avoid discharge of indebtedness income. This scheme lacks economic substance as it creates noneconomic losses to be used for tax benefits.[45]

The taxpayer in *Kerman* had been warned in the CARDS promotional materials "that tax losses from transactions similar to CARDS that are designed to produce noneconomic tax losses by artificially overstating basis are not allowable as deductions for Federal income tax purposes."[46] Relying in part on the copy of Notice 2000-44 the taxpayer received prior to engaging in the CARDS strategy, the court held that the taxpayer did not act with reasonable cause when entering into a transaction that lacked economic substance and was, therefore, a sham. Other courts besides the Tax Court have disallowed deductions resulting from this strategy and they impose accuracy-related penalties accordingly,[47] often times increasing the penalty to 40 percent for a gross misstatement penalty under IRC § 6662(h).[48]

Reliance on Advice of a Tax Professional as Reasonable Cause

Another commonly litigated question was whether reliance on a tax professional established reasonable cause. The taxpayer's education, sophistication, and business experience are relevant in determining whether his or her reliance on tax advice was reasonable.[49] To prevail, a taxpayer must establish that:

1. The adviser was a competent professional who had sufficient expertise to justify reliance;
2. The taxpayer provided necessary and accurate information to the adviser; and
3. The taxpayer actually relied in good faith on the adviser's judgment.[50]

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44 713 F.3d 849 (6th Cir. 2013), *aff'g* T.C. Memo. 2011-54.

45 *See* IRS Notice 2000-44, 2000-2 C.B. 255 ("Taxpayers and their representatives are alerted that the purported losses arising from certain types of transactions are not properly allowable for federal income tax purposes."); IRS Notice 2002-21, 2002-1 C.B. 730 (where CARDS transactions are listed).

46 *Kerman*, 713 F.3d at 870.

47 *See Crispin v. Comm'r*, 708 F.3d 507 (3d Cir. 2013), *aff'g* T.C. Memo. 2012-70; *Gustashaw v. Comm'r*, 696 F.3d 1124 (11th Cir. 2012), *aff'g* T.C. Memo. 2011-195.

48 IRC § 6662(h) (an overstatement in the basis of property by 400 percent or more will be treated as a gross valuation misstatement, thus doubling the penalty from 20 to 40 percent of the underpayment of income tax).

49 Treas. Reg. § 1.6664-4(c)(1). *See also* IRM 20.1.5.6.1(6), *Reasonable Cause* (Jan. 24, 2012).

50 *Neonatology Associates, P.A. v. Comm'r*, 115 T.C. 43, 99 (2000) (citations omitted), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

Taxpayers argued their good faith reliance on a competent tax professional in several cases this year,[51] including *Meinhardt v. Commissioner*.[52] In *Meinhardt*, the IRS imposed an accuracy-related penalty for a substantial understatement of income tax resulting from a failure to substantiate business expense deductions. The taxpayers, having recognized their relative unfamiliarity with tax law, hired a practicing attorney to help them prepare their returns. Their attorney regularly handled tax returns in the community, and the taxpayers gave him all of the materials they thought were relevant to their tax return. Having established good faith reliance on a competent tax professional, the court declined to uphold the accuracy-related penalty.

In *Romanowski v. Commissioner*,[53] the IRS imposed an accuracy-related penalty on the taxpayers for income tax deficiencies related to the improper deduction of expenses of their horse-breeding activity. The Tax Court found that the horse-breeding activity was not engaged in for profit, and therefore disallowed the deductions.[54] The taxpayers, however, presented credible evidence of good faith reliance on a competent tax professional. The taxpayers were unsophisticated in the field of tax and they hired a "very experienced and highly accomplished accountant" and an "accomplished lawyer familiar with tax law," upon whose advice they relied.[55] The taxpayers were able to establish the three criteria above, and the court held they were not liable for any accuracy-related penalties.

In several cases, the taxpayer could not establish all three of the above-mentioned criteria. For example, in *Mills v. Commissioner*,[56] the taxpayers hired their tax preparer to advise whether the LLC they had formed could amortize the value of the husband's time and expertise in real estate management. The tax preparer was an accountant, but he was not a lawyer or a CPA. He was an enrolled agent who had passed a written examination administered by the IRS Office of Professional Responsibility, but his status became inactive while working with the taxpayers. At the time of trial, the tax preparer resided in a Colorado Federal penitentiary after stealing from clients' individual retirement accounts using forged power of attorney forms. As the taxpayers were not able to establish the competence of the tax preparer, they failed to meet the *Neonatology* test and were liable for an accuracy-related penalty.

There are many more examples of taxpayers' failure to establish the competence of their tax preparers.[57] While some taxpayers choose to use tax software to prepare their tax returns, the Tax Court does not find reliance on tax preparation software justifiable to avoid an accuracy-related penalty. In this regard, the Tax

51 *See, e.g., Cook v. Comm'r*, T.C. Memo. 2012-167 (finding the taxpayer reasonably relied on his CPA with respect to misplacement of commission expense on the wrong schedule for which the taxpayer provided proper documentation to his CPA; also finding the taxpayer failed to show that he had provided adequate documentation to his CPA for non-commission expenses and was, therefore, liable for an accuracy-related penalty for that portion of the underpayment in tax).

52 T.C. Memo. 2013-85.

53 T.C. Memo. 2013-55.

54 IRC § 183(a) ("In the case of an activity engaged in by an individual, … if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.").

55 *Romanowski*, T.C. Memo. 2013-55.

56 T.C. Memo. 2013-4.

57 *See, e.g., Yates v. Comm'r*, T.C. Memo. 2013-28, appeal filed (4th Cir. July 1, 2013) (holding taxpayers liable for an accuracy-related penalty because they offered no evidence concerning the expertise of their accountant); *Deutsch v. Comm'r*, T.C. Memo. 2012-318 (finding the taxpayer liable for an accuracy-related penalty because he failed to establish his CPA had adequate expertise). Taxpayers may have a difficult time demonstrating the competency of the majority of return preparers if the government is barred from regulating unenrolled preparers. *See Loving v. Internal Revenue Service*, 111 A.F.T.R.2d (RIA) 589 (D.D.C. 2013); Nina E. Olson, *More Than a 'Mere' Preparer: Loving and Return Preparation*, 2013 TNT 92-31 (May 13, 2013).

Court has observed that "[t]he misuse of tax preparation software, even if unintentional or accidental, is no defense to accuracy-related penalties under section 6662." [58]

In *Bartlett v. Commissioner*,[59] the taxpayer admitted to underpayment of tax due to misreporting the amount of taxable pension benefits received. The taxpayer sought to avoid an accuracy-related penalty by claiming the underpayment was an "honest mistake" and that she believed that the tax preparation software would "catch any mistakes she otherwise might make."[60] The Tax Court found that the information the taxpayer had entered into the preparation software was incorrect, and the system was "only as good as the information entered into its software program."[61] The Tax Court found the taxpayer liable for an accuracy-related penalty as the mistakes were not made by the software, but by the taxpayer herself. Unless the taxpayer proves the software itself is flawed, the Tax Court is unlikely to accept reliance on tax preparation software as a justification to avoid an accuracy-related penalty.[62]

No Affirmative Defense Offered by the Taxpayer

Many litigants offered no affirmative defense for the understatement in tax, failing completely to claim the reasonable cause and good faith defense under IRC § 6664(c). In *Powers v. Commissioner*,[63] the taxpayers were negligent in keeping adequate books and records related to their telephone company. In addition, the taxpayers failed to report income and claimed deductions to which they were not entitled, which resulted in a substantial understatement of income tax. While the taxpayers claimed that their 44 years of tax compliance should be a significant factor in determining the existence of negligence, the court held that evidence of prior compliance with the Code was insufficient on its own to avoid the accuracy-related penalty.[64] The taxpayers failed to raise any affirmative defense and were, therefore, held liable for the penalty.

CONCLUSION

Of the 178 cases we reviewed, the courts upheld the underlying tax deficiency, or portions of the deficiency, determined by the IRS in all cases. In over a fifth of the cases, the courts abated the accuracy-related penalties, partially or in full, where the taxpayer showed a reasonable and good faith attempt to ascertain the correct amount of tax due. The courts most commonly found reasonable cause on the bases of maintenance of adequate records to substantiate deductions and reasonable reliance on a competent tax professional. Taxpayers should also be aware that they must raise an affirmative defense to the penalty in order to have a chance at avoiding liability for the penalty.

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58 *See Langley v. Comm'r*, T.C. Memo. 2013-22, 2013 Tax Ct. Memo. LEXIS 22 at *10 (citations omitted).

59 T.C. Memo. 2012-254.

60 *Id*.

61 *Id*.

62 *See Morales v. Comm'r*, T.C. 2012-341.

63 T.C. Memo. 2013-134.

64 *Id.*