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 causes an underpayment of tax or if an underpayment exceeds a computational threshold called a substantial understatement, respectively. IRC § 6662(b) also authorizes the IRS to impose five other accuracy-related penalties.[1]

TAXPAYER RIGHTS IMPACTED[2]

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to a Fair and Just Tax System*

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] Underpayment is the amount by which any tax imposed by the IRC exceeds the excess of:

> The sum of (A) the amount shown as the tax by the taxpayer on his return, plus (B) amounts not shown on the return but previously assessed (or collected without assessment), over the amount of rebates made.[4]

Prior to December 18, 2015, refundable credits could not reduce below zero the amount shown as tax by the taxpayer on a return.[5] However, recently enacted law reversed the Tax Court's decision in *Rand v. Commissioner*, and amended IRC § 6664(a) to be consistent with the rule of IRC § 6211(b)(4), which would allow the IRS to calculate negative tax in computing the amount of underpayment for

1 IRC § 6662(b)(3) authorizes a penalty for any substantial valuation misstatement under chapter 1 [IRC §§ 1-1400U-3]; 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. We have chosen not to cover them in this report, as those penalties were not litigated nearly as much as IRC §§ 6662(b)(1) and 6662(b)(2) during the period we reviewed.

2 See Taxpayer Bill of Rights, *available at* www.TaxpayerAdvocate.irs.gov/taxpayer-rights.

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

4 IRC § 6664(a).

5 *Rand v. Comm'r*, 141 T.C. 376 (2013). *See also* National Taxpayer Advocate 2014 Annual Report to Congress 449; IRS, Chief Counsel Notice CC-2014-007, *Application of the Accuracy-Related or Fraud Penalty in Tax Court Cases Involving Disallowed Refundable Credits* (July 31, 2014) (litigation guidelines for cases impacted by the *Rand* decision). The Chief Counsel Notice is deemed to be "effective until further notice," perhaps implying that this is not the last word on the issue from the IRS's perspective. Following *Rand*, there has been a legislative proposal to calculate negative tax in computing the amount of underpayment for accuracy-related penalty purposes. See H.R. 1, § 6306, 113th Cong. 2d Sess. (2014). *See also* Joint Committee on Taxation, *Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title VI- Tax Administration and Compliance* (JCX-17-14) (Feb. 26, 2014), at 41-43.

accuracy-related penalty purposes.[6] Thus, for returns filed after December 18, 2015, or for returns filed before that date for which the period of limitations on assessment under IRC § 6501 has not expired, a taxpayer can be subject to an underpayment penalty in IRC § 6662 based on a refundable credit which reduces tax below zero.

The IRS may assess penalties under IRC §§ 6662(b)(1) and 6662(b)(2), but the total penalty rate generally cannot exceed 20 percent (*i.e.*, the penalties are not "stackable").[7] 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.[8] 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 sources 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."[9] Negligence includes a failure to keep adequate books and records or to substantiate items that give rise to the underpayment.[10] Strong indicators of negligence include instances where a taxpayer failed to report income on a tax return that a payor reported on an information return[11] as defined in IRC § 6724(d)(1),[12] or failed to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion.[13] The IRS can also consider various other factors in determining whether the taxpayer's actions were negligent.[14]

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.[15] 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.[16] For individuals, the understatement

6 Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, § 209 (2015).

7 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." IRC § 6662(h)(1); Treas. Reg. § 1.6662-2(c).

8 IRC § 6664(c)(1).

9 IRC § 6662(c).

10 Treas. Reg. § 1.6662-3(b)(1).

11 Treas. Reg. § 1.6662-3(b)(1)(i).

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

13 Treas. Reg. § 1.6662-3(b)(1)(ii).

14 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). *See also* IRM 20.1.5.2(6), *Common Features of Accuracy-Related and Civil Fraud Penalties* (Jan. 24, 2012).

15 IRC §§ 6662(d)(2)(A)(i)-(ii).

16 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). If a return position is reasonably based on one or more of the authorities set forth in Treas. Reg. § 1.6662-4(d)(3)(iii), the return position will generally satisfy the reasonable basis standard. This may be true even if the return position does not satisfy the substantial authority standard found in Treas. Reg. § 1.6662-4(d)(2). *See* Treas. Reg. § 1.6662-3(b)(3).

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.[17] 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.[18]

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.[19] A reasonable cause determination takes into account all of the pertinent facts and circumstances.[20] Generally, the most important factor is the extent to which the taxpayer made an effort to determine the proper tax liability.[21]

Reasonable Basis

An understatement of tax may be reduced by any portion of the understatement attributable to an item for which the tax treatment is adequately disclosed and supported by a reasonable basis.[22] This standard is met if the taxpayer's position reasonably relies on one or more authorities listed in Treas. Reg. § 1.6662-4(d)(3)(iii).[23] Applicable authority could include information such as sections of the IRC; proposed, temporary, or final regulations; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; and congressional intent as reflected in committee reports.[24]

17 IRC §§ 6662(d)(1)(A)(i)-(ii).
18 IRC §§ 6662(d)(1)(B)(i)-(ii).
19 IRC § 6664(c)(1).
20 Treas. Reg. § 1.6664-4(b)(1).
21 *Id*.
22 IRC § 6662(d)(2)(B)(ii)(II).
23 Treas. Reg. § 1.6662-3(b)(3).
24 Treas. Reg. § 1.6662-4(d)(3)(iii).

Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process[25] and through its Automated Underreporter (AUR) computer system.[26] Theoretically, before a taxpayer receives a notice of deficiency, he or she has an opportunity to engage the IRS on the merits of the penalty.[27] Once the IRS concludes an accuracy-related penalty is warranted, it must follow deficiency procedures (*i.e.*, IRC §§ 6211-6213).[28] 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.[29] Alternatively, taxpayers may seek judicial review through refund litigation.[30] Under certain circumstances, a taxpayer can request an administrative review of IRS collection procedures (and the underlying liability) through a Collection Due Process hearing.[31]

Burden of Proof

In court proceedings, the IRS bears the initial burden of production regarding the accuracy-related penalty.[32] The IRS must first present sufficient evidence to establish that the penalty is warranted.[33] The burden of proof then shifts to the taxpayer to establish any exception to the penalty, such as reasonable cause.[34] Because the reasonable basis standard is a higher standard to meet, it is possible that a taxpayer

25 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).

26 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. IRM 4.19.3.1(3)-(8), *Overview of IMF Automated Underreporter* (Sept. 30, 2014). 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 without managerial review. IRM 4.19.3.20.1.4, *Accuracy-Related Penalties* (Sept. 1, 2012). *See also* National Taxpayer Advocate 2014 Annual Report to Congress 404-10 (Legislative Recommendation: *Managerial Approval: Amend IRC § 6751(b) to Require IRS Employees to Seek Managerial Approval Before Assessing the Accuracy-Related Penalty Attributable to Negligence Under IRC § 6662(b)(1)*); 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.").

27 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).

28 IRC § 6665(a)(1).

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

30 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 or the Court of Federal Claims. 28 U.S.C. § 1346(a)(1); 28 U.S.C. § 1491; 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).

31 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)(B).

32 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."

33 *Higbee v. Comm'r*, 116 T.C. 438, 446 (2001).

34 IRC § 7491(a). *See also* Tax Ct. R. 142(a).

may obtain relief from a penalty assessment by successfully arguing a reasonable cause defense, even if that defense does not satisfy the reasonable basis standard.[35]

ANALYSIS OF LITIGATED CASES

We identified 113 opinions issued between June 1, 2014, and May 31, 2015 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 87 cases (77 percent), taxpayers prevailed in full in 20 cases (18 percent), and six cases (five percent) resulted in split decisions. Table 1 in Appendix 3 provides a detailed list of these cases.

Taxpayers appeared *pro se* (without representation) in 68 of the 113 cases (60 percent) and convinced the court to dismiss or reduce the penalty in 14 (21 percent) of those cases. Represented taxpayers fared approximately the same, achieving full or partial relief from the penalty in 12 of their 45 cases (27 percent). This difference was considerably smaller than the large disparity between represented and unrepresented taxpayers over the same period last year.[36]

In some cases, the court found taxpayers liable for the accuracy-related penalty but failed to clarify whether it was for negligence under IRC § 6662(b)(1) or a substantial understatement of tax under IRC § 6662(b)(2), or both.[37] Regardless of the subsection at issue, the analysis of reasonable cause is generally 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.[38] The failure "to keep adequate books and records or to substantiate items properly" was the primary factor in roughly 74 percent of cases (34 out of 46) where the court found a taxpayer liable for an underpayment penalty due to negligence.[39]

In *Sawyer v. Commissioner*,[40] a married couple owned an asphalt business operated by the husband, Mr. Sawyer. Mr. Sawyer paid his day laborers in cash, without issuing Forms W-2, *Wage and Tax Statement*, or 1099-MISC, *Miscellaneous Income*.[41] Customers also paid Mr. Sawyer by cash or check, and he conceded that he deposited only a portion of the payments into his personal bank account. The only records he kept included invoices from his jobs.

As part of the examination, the revenue agent conducted an analysis of bank deposits and was unable to link the invoices provided with specific bank deposits. As a result, the revenue agent determined the business's gross receipts were underreported in tax years (TYs) 2008 and 2009. The revenue agent also denied

35 Treas. Reg. § 1.6662-3(b)(3).

36 *See* National Taxpayer Advocate 2014 Annual Report to Congress 446 (penalties were reduced in 14 percent of the *pro se* cases versus 32 percent of cases involving represented taxpayers).

37 *See, e.g., Coburn v. Comm'r*, T.C. Memo. 2014-113; *Cooper v. Comm'r*, 143 T.C. 194 (2014).

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

39 *See, e.g., Burrell v. Comm'r*, T.C. Memo. 2014-217; *Kunkel v. Comm'r*, T.C. Memo. 2015-71; *Briley v. Comm'r*, T.C. Memo. 2014-114.

40 T.C. Memo. 2015-55.

41 Form 1099-MISC, *Miscellaneous Income*, is used to report non-employee compensation.

deductions claimed for labor costs for TY 2008 because the taxpayer failed to establish that costs were paid or incurred in TY 2008 (or accounted for as labor completed by Mr. Sawyer or his family).

The court found the Sawyers liable for a penalty under IRC § 6662(b)(1). The Sawyers had argued a reasonable cause defense based on Mr. Sawyer's reliance on his accountant in preparing the tax return. However, the court found that Mr. Sawyer had not provided his accountant with the necessary information for reasonable reliance, as the invoices and receipts had not been provided and labor costs were merely an estimate.

In the more than 30 cases where the court attributed an underpayment to taxpayer negligence primarily due to record keeping, the court found the taxpayer acted with reasonable cause and in good faith in only one instance.[42] Inadequate record keeping was also an important factor in many determinations of whether the reasonable cause and good faith exception applied to a taxpayer's conduct. Some courts examined the issues of negligent record keeping and reasonable cause concurrently.

For example, in *Engstrom, Lipscomb & Lack, APC v. Commissioner*,[43] the taxpayer, a law firm, claimed travel expense deductions in connection with the use of two private jets. Mr. Lack was 50 percent owner of the law firm (hereinafter Engstrom). Mr. Girardi was a close friend of Mr. Lack. Together they had several joint business ventures, including G&L Aviation, a general partnership that owned aircraft and a luxury suite at the Staples Center in Los Angeles. Mr. Lack and Mr. Girardi used the aircraft extensively. Engstrom was not a partner of G&L Aviation and had no financial interest in the aircraft.

Engstrom claimed travel expense deductions for use of the aircraft and luxury suite in the amounts of $1,425,000; $1,157,797; $687,310; and $1,062,469 for years 2007 through 2010, respectively. Engstrom made payments to G&L Aviation and Mr. Lack also made payments to G&L Aviation from his personal account. There was no written agreement between Engstrom and G&L Aviation, and Engstrom did not receive invoices for payments made. However, Mr. Lack's secretary, Ms. Carter, who was employed by Engstrom, also performed recordkeeping duties for G&L Aviation. She prepared revenue schedules to show dates of payments to G&L Aviation, but these schedules did not include flight information, passenger information, or the purpose of each flight. G&L maintained flight logs, but these logs did not show the business purpose for each flight or provide detailed passenger information. Lastly, Mr. Lack maintained an executive calendar but did not include amounts for travel expenditures or detailed information regarding the business purpose for each trip.

IRC § 162 allows for the deduction of all ordinary and necessary expenses paid or incurred while carrying on a trade or business.[44] Such expenses can include the costs of travel.[45] To substantiate its claim for deductions at trial, Engstrom offered a reconstruction of the trips that included the date, destination, and passengers. This information was reconstructed from logs prepared by Ms. Carter and Mr. Lack.

42 *Lain v. Comm'r*, T.C. Summ. Op. 2015-5 (finding that the taxpayers substantiated only a portion of their claimed deductions, however; also finding that a burst water pipe may have prevented the taxpayers from substantiating all of the deductions).

43 T.C. Memo. 2014-221, *appeal docketed*, No. 15-70591 (9th Cir. Feb. 26, 2015).

44 For a detailed discussion of IRC § 162 and deductibility of expenses, see Most Litigated Issue: *Trade or Business Expenses Under IRC § 162 and Related Sections*, *infra*.

45 IRC § 162(a)(2).

Two pertinent issues at trial included whether Engstrom was entitled to travel expense deductions under IRC § 162 and if Engstrom was liable for an accuracy-related penalty under IRC § 6662. To make its determination, the court divided the flights into three categories:

1. Flights on which Mr. Lack and Engstrom employees were passengers;
2. Flights on which Mr. Lack was the only Engstrom employee; and
3. Flights on which neither Mr. Lack nor any other Engstrom employee was a passenger.

The court found that Engstrom would be entitled to deductions for the first category only when the expense for each flight was properly substantiated. For the second category, the court allowed deductions only when it was readily apparent that the flight had a business purpose for Engstrom. No deductions were allowed for flights in the third category. Within this framework, the court found that many of the flights did not meet the heightened requirements for substantiation under IRC § 274(d).[46]

The court noted that the revenue schedules prepared by Ms. Carter included payment information but lacked flight information, such as a list of passengers or the business purpose for the flight. Mr. Lack's executive calendar did not include amounts of travel expenses or the business purpose for each flight. The flight logs kept by the pilots also failed to note any business purpose for the flights and did not contain passenger information. The court deemed the logs prepared by Ms. Carter and Mr. Lack noncontemporaneous and prepared in anticipation of trial. As a result, the court allowed only a portion of the claimed travel expenses to be deducted.

The court imposed a penalty for negligence under IRC § 6662(b)(1) for failure to keep adequate records. In its analysis of reasonable cause, the court found that the "[p]etitioner failed to establish reasonable cause for not keeping sufficient contemporaneous records showing important flight details and the business purpose of the travel."[47] Thus, reasonable cause was rejected based on the same evidence that established negligence.

Reasonable cause and good faith may be found if there is "an honest misunderstanding of fact or law."[48] For example, in *Dabney v. Commissioner*,[49] Mr. Dabney wanted to increase the value of his individual retirement account (IRA) by investing in real estate with funds from his IRA. He researched this investment option on the Internet and found that IRAs could hold property for investment. He spoke with a customer service representative at Charles Schwab, his investment firm, who informed him that Charles Schwab did not allow the purchase and holding of real estate. Mr. Dabney also contacted his accountant, who agreed with Mr. Dabney's assessment after reviewing his research material.

Mr. Dabney went through with his plan and had $114,000 withdrawn from his IRA. The money was wired directly to a title company in order to purchase real estate for investment purposes. He requested that the title be issued in his name along with the name of his IRA account with Charles Schwab. He later sold the property and had the proceeds of the sale sent directly to his account at Charles Schwab as a

46 To be deductible as a business expense under IRC § 162, travel expenses require sufficient evidence of (1) the amount of the expense; (2) the time and place of the travel; (3) the business purpose of the expense; and (4) the business relationship of the taxpayer to the person using the property. IRC § 274(d). While a contemporaneous record is not required, "a record of the elements of an expenditure or of a business use of listed property made at or near the time of the expenditure or use, supported by sufficient documentary evidence, has a high degree of credibility not present with respect to a statement prepared subsequent thereto when generally there is a lack of accurate recall." Treas. Reg. § 1.274-5T(c)(1).

47 T.C. Memo. 2014-221.

48 Treas. Reg. § 1.6664–4(b)(1).

49 T.C. Memo. 2014-108.

rollover contribution. Charles Schwab issued a Form 1099 to the Dabneys, though Mr. Dabney did not recall receiving it. Mr. Dabney did not report this withdrawal as income on the couple's 2009 tax return. The IRS subsequently determined a deficiency of $42,431 against the couple and imposed an accuracy-related penalty of $8,486.

The court found that, as a matter of policy, the Charles Schwab IRA did not allow real property to be held for investment and therefore the transfer of funds was not between trustees, as required for a rollover contribution. As a result, Mr. Dabney was required to report this withdrawal as income on his tax return. However, the court declined to impose an accuracy-related penalty on the Dabneys. In reaching this determination, the court analyzed Mr. Dabney's good faith attempt at compliance. The court noted that Mr. Dabney was not a sophisticated taxpayer, had no background in tax or accounting, and had gone to great lengths to ensure that using funds from his IRA would be non-taxable. Mr. Dabney's research confirmed that IRAs are permitted to hold real property, he made sure the property was held for investment purposes, he obtained a scrivener's affidavit to fix an issue with the title, and made sure the funds were wired directly. He also conferred with a Charles Schwab customer service representative and his accountant on multiple occasions regarding the transaction. Although Mr. Dabney was mistaken, the court found that he had acted with reasonable cause and in good faith.[50]

Reasonable Basis

In some situations, a taxpayer may not be certain as to how the IRS will respond to the tax treatment employed for a specific set of circumstances. Disclosing the tax treatment used for an issue on the return, supported by a reasonable basis, can reduce the amount of an underpayment for purposes of the accuracy-related penalty.[51] A tax position supported by a reasonable basis will also defeat a negligence claim.[52]

For example, in *Wells Fargo & Co. v. United States*,[53] the taxpayer, a bank, claimed foreign tax credits from income taxes paid to the United Kingdom and expenses attributable to a Structured Trust Advantaged Repackaged Securities (STARS) transaction. Wells Fargo entered into the STARS transaction with Barclays, a bank based in the United Kingdom (U.K.).[54] The transaction was intended to provide tax benefits to both banks from the same income tax payments in the United Kingdom, but the IRS viewed it as a sham transaction and imposed an accuracy-related penalty on negligence grounds.

50 Though this case involved a deficiency on a joint return and liability for the accuracy-related penalty for both Mr. and Mrs. Dabney, the court granted a motion to dismiss Mrs. Dabney for lack of prosecution and held that it would hold her to a liability consistent with the opinion.

51 IRC § 6662(d)(2)(B)(ii).

52 Treas. Reg. § 1.6662-3(b)(1) ("A return position that has a reasonable basis… is not attributable to negligence.").

53 114 A.F.T.R.2d (RIA) 5414 (D. Minn. 2014).

54 In general, a STARS transaction is a multistep transaction that enables a U.S. participant to realize an economic benefit by claiming foreign tax credits. The STARS transaction in *Wells Fargo* consisted of a loan and a trust component. Wells Fargo transferred income-producing assets to a U.K.-based trust. The assets had no relation to the U.K. However, the trust was considered a resident of the U.K., and thus, the income generated by the trust was subject to U.K taxes. The income realized by the U.K. trust and the U.K. income taxes paid by it were treated as received and paid by Wells Fargo. Under U.K. law, almost all of the after-U.K. tax income of the trust was treated as a distribution to Barclays. The after-U.K. tax trust income allocated to Barclays was immediately credited to a blocked account ("Bx") in the name of Barclays that was maintained by Wells Fargo and then reinvested in the trust. Barclays was obligated to pay consideration to Wells Fargo of a fixed amount each month that was calculated to be a percentage of the U.K. tax credits that Barclays expected to enjoy as a result of the allocation of trust income. Barclays also deducted the Bx amounts in the calculation of its U.K. income tax liability. The combination of U.K. tax credits and U.K. deductions (for the amounts allocated to the blocked account and contributed back to the trust and the Bx payments) created a net profit to Barclays under U.K. tax law as a result of its involvement in the STARS transaction. Barclays effectively loaned $1.25 billion to Wells Fargo at an interest rate of 0.2 percent. *See also* Ajay Gupta, *Interest Deductibility in Stars Cases*, Tax Notes Today, Jan. 26, 2015, 2015 TNT 16-4.

The IRS argued that taxpayer participation in a sham transaction is necessarily negligent, requiring that the issue of the transaction's economic substance be determined. The court found there was insufficient support for the IRS's position. It held that the negligence penalty would be avoided if Wells Fargo's position was supported by a reasonable basis, even if the sham transaction issue is eventually lost. The court held that Wells Fargo had established a reasonable basis, supported by (1) the tax code, (2) regulations, (3) tax treaties, and (4) judicial decisions; and granted the taxpayer's motion for partial summary judgment that there was a reasonable basis for the STARS transaction reporting.

Reliance on the 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 reliance on tax advice was reasonable.[55] 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.[56]

Taxpayers argued their good faith reliance on a competent tax professional in several cases this year, including *Evans v. Commissioner*.[57] In *Evans*, the married taxpayers ran a construction company, Dave Evans Construction (DEC). The taxpayers sponsored their son's successful motocross racing as a promotional activity for DEC. They deducted these expenses (including the purchase of a motorhome, a Mirage trailer, and a utility trailer) as ordinary and necessary expenses for their company pursuant to IRC § 162. The IRS argued that such expenses were not ordinary and necessary for the business and instead were personal expenses that should not have been deducted.[58]

The court ruled in favor of Mr. and Mrs. Evans. The court found that the expenses were business in nature, as the promotion of motocross led to increased exposure to clients, investors, and subcontractors. In particular, the court noted the local construction industry's significant involvement in motocross racing. Further, only one child's expenses were deducted, other corporate support was acquired for his racing, and their deductions stopped when the son became a professional racer. The court held that the expenses were reasonable in amount, as they totaled less than one percent of gross receipts for DEC. Additionally, the court found that the motorhome was not primarily used for lodging as it had a ramp and was used to store, transport, and repair motorbikes as well. The court did not allow expenses to be deducted in association with the utility trailer, as the taxpayers did not prove it was used for an advertising purpose.

The taxpayers hired Ms. Chacon, a certified public accountant (CPA), who testified that she provided necessary documents to Mr. Anderson, a separate CPA, and answered questions as he prepared the returns. The court held that taxpayers had reasonably relied in good faith on Mr. Anderson's judgment for the disallowed deductions and, therefore, were not subject to a penalty under IRC § 6662.

In *Gardner v. Commissioner*,[59] Mr. Gardner was involved in many businesses, including insurance and home construction. In 2001, he entered into agreements with David Pearl and John Pearl to breed

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

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

57 T.C. Memo. 2014-237. *See also VisionMonitor Software, LLC v. Comm'r.*, T.C. Memo. 2014-182.

58 For information on business expenses deductions, see IRC § 162 and Most Litigated Issue: *Trade or Business Expenses Under IRC § 162 and Related Sections*, *infra*.

59 T.C. Memo. 2014-148.

genetically superior cattle, which would be jointly owned. Mr. Gardner executed 24 promissory notes with entities owned by the Pearls, with the cattle as collateral. The cattle operation amassed $991,842 in expenses over ten years for a net reported loss of $621,677. Although the only evidence of payment was checks totaling $74,618, the taxpayer deducted all of these losses as business expenses under IRC § 162. The court held that the Mr. Gardner was not eligible to claim these deductions because the cattle operation was an activity not engaged in for profit.[60]

Mr. Gardner argued for a reasonable cause and good faith exception based on his reliance on his CPA. His accountant relied solely upon income and expense summaries prepared by David Pearl for the cattle operation. While the court found the CPA to be a competent professional, it found that Mr. Gardner had, in fact, relied upon David Pearl for tax purposes and not the CPA. As David Pearl had no expertise in accounting or taxation, the court found Mr. Gardner failed the first prong of the reasonable reliance test. The court further found that he had failed to provide the necessary and accurate information to his CPA, a requirement under the second prong in *Neonatology Associates, P.A. v. Commissioner*.

Reliance on tax advice from the promoter of a transaction or an advisor with an inherent conflict of interest may also not be reasonable. For example, in *Salem Financial, Inc. v. United States*, Salem Financial, a subsidiary of Branch Banking and Trust (BB&T), sought a tax refund related to a STARS transaction.[61]

In 2002, BB&T entered into the STARS transaction with Barclays Bank, which was located in the United Kingdom (U.K.). Barclays developed the STARS transaction along with KPMG LLP, an international accounting firm. KPMG also recommended that BB&T hire Sidley, Austin, Brown & Wood LLP (Sidley) as its tax advisor on the STARS transaction. BB&T followed this recommendation and also requested that its accounting firm PricewaterhouseCoopers (PwC) review the transaction, but not for tax compliance purposes.

Essentially, BB&T created a trust and contributed $5.755 billion of assets to it. Barclays gave $1.5 billion to the trust in return for an interest in the trust. The terms of this part of the agreement meant the $1.5 billion was a loan from Barclays to BB&T. BB&T appointed a U.K. trustee to the trust, subjecting the trust to taxation in the U.K. BB&T used trust funds to pay the U.K. tax on the trust's income. Barclays then received U.K. tax deductions and credits, and it made a monthly payment to BB&T, which was equal to 51 percent of the U.K. taxes paid by the trust. BB&T then claimed a foreign tax credit. The ability for there to be a profit from this transaction relied on both BB&T and Barclays being able to successfully obtain their respective tax credits.

On March 30, 2007, the IRS issued proposed regulations addressing schemes such as the STARS transaction. BB&T terminated the trust six days later. It filed returns claiming foreign tax credits and interest deductions. Upon review, the IRS denied both claims and imposed accuracy-related penalties. BB&T sued in the Court of Federal Claims for federal tax credits and interest deductions disallowed by the IRS as well as accuracy-related penalties imposed.[62] The Court of Federal Claims denied the claim finding that it was not reasonable for Salem Financial to have relied on KPMG, Sidley, or PwC for tax advice, and BB&T appealed.

60 *See generally* IRC § 183 and the nine-factor test in Treas. Reg. § 1.183-2(b).

61 786 F.3d 932 (Fed. Cir. 2015), *aff'g in part*, *reversing in part and remanding*, 112 Fed. Cl. 543 (2013), *petition for cert. filed*, No. 15-380 (Sept. 29, 2015). See footnote 53, *supra*, for a detailed discussion of the same STARS transaction involving Barclays and Wells Fargo.

62 *Salem Fin., Inc. v. United States*, 112 Fed. Cl. 543 (2013), *rev'd in part and remanded by* 786 F.3d 932 (Fed. Cir. 2015), *petition for cert. filed*, No. 15-380 (Sept. 29, 2015).

On appeal, the Court of Appeals for the Federal Circuit found the STARS transaction to be a sham and disregarded all of its tax consequences. The court also upheld the imposition of accuracy-related penalties against Salem Financial. At trial, Salem Financial asserted that it reasonably relied upon the favorable tax opinion from Sidley and supportive advice from its accounting firm, PwC.

In its decision, the court notes that reliance on an advisor is not reasonable if that advisor has a conflict of interest that the taxpayer is aware of or if the transaction is "too good to be true." The court found reliance on Sidley to be unreasonable because Sidley had been selected by Salem Financial on recommendation of KPMG, the principal marketer of the STARS transaction. KPMG and Sidley were also involved with putting the transaction together; therefore, KPMG and Sidley had an interest in the transaction and their advice was deemed suspect by the court.

The court also rejected reasonable reliance upon the opinion of PwC. PwC had not been tasked with reviewing the tax compliance of the STARS transaction. As a result, PwC did not provide a tax opinion. Even so, PwC explicitly informed Salem Financial that it was not providing an opinion regarding the larger transaction and had qualified its advice by suggesting a low level of comfort that the IRS would accept the STARS transaction.

Lastly, the court rejected a reasonable reliance defense because Salem Financial should have known that the STARS transaction was "too good to be true." The court reached this conclusion based on the education and experience of the company's executives. The court upheld the accuracy-related penalty but required reassessment of the amount to allow for interest deductions on part of the transaction.

No Affirmative Defense Offered by the Taxpayer

Many taxpayers offered no affirmative defense for the underpayment of tax, failing completely to claim the reasonable cause and good faith defense under IRC § 6664(c). Nearly two-thirds (21 cases out of 32 cases) of those failing to make an argument or present evidence of good faith were unrepresented in this reporting period.[63] The burden of proof to raise an affirmative defense is on the taxpayer and as a result, taxpayers must provide documentation to substantiate any disputed deductions or credits, explain why the records were inadequate, or show reliance on a tax professional.[64] When the taxpayer fails to present any evidence for an affirmative defense, courts may do a cursory examination of the *pro se* taxpayer's reliance on a tax professional.[65] While some *pro se* taxpayers may be unaware of the good faith exception, in many cases the taxpayer did not keep adequate records to support his or her position.[66]

An exception is *Nguyen v. Commissioner*, where evidence of reasonable reliance on the tax return preparer might have made a difference in the court's decision to impose the penalty under IRC § 6662.[67] The taxpayers, a married couple, were audited for TYs 2009 and 2010. The audit focused on the hardwood floor installation business owned and operated by Mr. Nguyen. A flood in the taxpayers' house destroyed some of Mr. Nguyen's records for 2009. Mr. Nguyen provided the surviving records to Mr. Wynn, a tax return preparer, who prepared a 2009 return for the taxpayers. Mr. Wynn reported cost of goods sold for Mr. Nguyen's business as $43,503 and supplies totaling $5,675. Mr. Wynn did not explain the difference between these two elements to the taxpayers. Ultimately, the IRS allowed only $18,095.66 for cost of

63 *See* Table 1 in Appendix 3, *infra*.

64 IRC § 7491(a). *See also* Tax Ct. R. 142(a).

65 *See, e.g., Peterson v. Comm'r*, T.C. Memo. 2015-23, *appeal docketed*, No. 15-73092 (9th Cir. Oct. 8, 2015); *Smith v. Comm'r*, T.C. Memo. 2014-203.

66 *See, e.g., Duong v. Comm'r*, T.C. Memo. 2015-90; *Flores v. Comm'r*, T.C. Memo. 2015-9.

67 T.C. Memo. 2014-199.

goods sold but did allow the entire amount claimed for supplies. The Nguyens used a different return preparer in 2010, but this preparer relied on the 2009 return in preparing the 2010 return. While the taxpayers' 2010 return claimed $39,894 for supplies, the IRS allowed only $24,668.26.

At trial, the Nguyens, who had representation, provided an incomplete bank statement for 2009 and some bank statements for 2010. They provided no additional testimony to substantiate expenses. The court allowed deductions equal to the amounts calculated by the IRS. The court then considered a reasonable cause defense prior to imposing a penalty on the Nguyens. First, the court determined that the 2009 flood could not be a reason for lack of substantiation because Mr. Nguyen had explained that most of his transactions would appear in his bank account statements, which he could have obtained for the trial.

The court then considered Mr. Nguyen's background. Mr. Nguyen had come to the United States from Vietnam and had obtained a ninth grade education. He had limited English skills but had successfully operated his business since 1997. Mr. Nguyen testified that he trusted Mr. Wynn and relied on his judgment. Mr. Wynn did not appear in court, despite the fact that Mr. Nguyen had issued him a subpoena to appear. However, Mr. Nguyen also did not submit any evidence to show Mr. Wynn's credibility or experience. Without this information, the taxpayers were unable to show that they relied on Mr. Wynn in good faith.

CONCLUSION

Over this last reporting period, the issue of accuracy-related penalties was decided by the courts in 113 cases. Litigation on the issue has continued to decline over the last two periods.[68]

Courts most often cited inadequate maintenance of records when imposing an accuracy-related penalty. When accepting a defense for reasonable cause and good faith, courts were most likely to cite reliance on a tax professional and manifestations of taxpayer efforts to comply with the tax code. About one-third of *pro se* taxpayers (21 cases out of 68 cases) and nearly one-fifth of represented taxpayers (11 cases out of 45 cases) failed to argue or present evidence of good faith.

As mentioned above, the IRS has the burden to prove the existence of an underpayment attributable to negligence/disregard of rules or regulations or an underpayment attributable to a substantial understatement.[69] However, if the taxpayer does not raise the issue of penalty assessment in the court pleadings, the taxpayer is deemed to have conceded the issue and the IRS is not required to provide evidence that the penalty is appropriate.[70] Likewise, the rules of the Tax Court require the taxpayer to include all arguments in the petition.[71]

Finally, it is important to note that Congress enacted law reversing the Tax Court's decision in *Rand v. Commissioner*, in which the Tax Court had held that refundable credits cannot reduce the amount shown as tax, by the taxpayer on a return, below zero.[72] IRC § 6664(a) was amended to be consistent with the rule of IRC § 6211(b)(4), which would allow the IRS to calculate negative tax in computing the amount

68 *See* National Taxpayer Advocate 2013 Annual Report to Congress 341 and National Taxpayer Advocate 2014 Annual Report to Congress 446.

69 IRC § 7491(c).

70 *Swain v. Comm'r*, 118 T.C. 358 (2002).

71 Tax Ct. R. 34(b)(4) ("Any issue not raised in the assignments of error shall be deemed to be conceded.").

72 Consolidated Appropriations Act, 2016, § 209 (2015). *See also Rand v. Comm'r*, 141 T.C. 376 (2013).

of underpayment for accuracy-related penalty purposes.[73] Thus, for returns filed after December 18, 2015, or for returns filed before that date for which the period of limitations on assessment under IRC § 6501 has not expired, a taxpayer can be subject to an underpayment penalty in IRC § 6662 based on a refundable credit which reduces tax below zero.

73 Consolidated Appropriations Act, 2016, § 209 (2015).