

MLI
#1**Accuracy-Related Penalty Under IRC §§ 6662(b)(1), (2), and (3)****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. This year, we also analyzed accuracy-related penalties under IRC § 6662(b)(3) (substantial valuation misstatement) and the increased penalty amount under IRC § 6662(h) for a gross valuation misstatement because during our review period of June 1, 2013, through May 31, 2014, taxpayers litigated these penalties more frequently than in past years.¹ Specifically, we reviewed 12 cases involving IRC § 6662(b)(3), and 14 cases involving IRC § 6662(h). IRC § 6662(b) also authorizes the IRS to impose four other accuracy-related 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 Underpayment is the amount by which any tax imposed by the Internal Revenue Code exceeds the excess of

1. 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
2. The amount of rebates made.⁴

Refundable credits cannot reduce the amount shown as tax, by the taxpayer on a return, below zero.⁵

The IRS may assess penalties under IRC § 6662(b)(1), IRC § 6662(b)(2), and IRC § 6662(b)(3), but the total penalty rate generally cannot exceed 20 percent (*i.e.*, the penalties are not “stackable”).⁶ 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.⁷ 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

1 The United States Supreme Court has recently interpreted IRC § 6662(h) in the context of a partner claiming outside basis in a sham partnership. See *United States v. Woods*, 134 S. Ct. 557 (2013), *rev'g* 471 F. App'x 320 (5th Cir. 2012), *aff'g per curiam* 794 F. Supp. 2d 714 (W.D. Tex. 2011). For a more detailed discussion of *Woods*, see Significant Cases, *infra*.

2 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.

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

4 I.R.C. § 6664(a).

5 *Rand v. Comm'r*, 141 T.C. 376 (2013). Following *Rand*, there has been a proposal to calculate negative tax in computing the amount of underpayment for accuracy-related penalty purposes. See 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 42-43.

6 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).

7 IRC § 6664(c)(1).

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."⁸ Negligence includes a failure to keep adequate books and records or to substantiate items that gave rise to the underpayment.⁹ 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 as defined in IRC § 6724(d)(1),¹⁰ or failed to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion.¹¹ The IRS can also consider various other factors in determining whether the taxpayer's actions were negligent.¹²

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.¹³ 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.¹⁴ 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.¹⁵ 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 \$10,000,000.¹⁶

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.

8 IRC § 6662(c).

9 Treas. Reg. § 1.6662-3(b)(1).

10 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).

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

12 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 under-reported income. Internal Revenue Manual (IRM) 4.10.6.2.1, *Negligence* (May 14, 1999).

13 IRC § 6662(d)(2)(A)(i)-(ii).

14 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). Types of authority found in Treas. Reg. § 6662-4(d)(3)(iii) include (among others): applicable provisions of the Internal Revenue Code, proposed, temporary and final regulations construing such statutes, revenue rulings and revenue procedures, and tax treaties and regulations thereunder. A taxpayer may qualify for relief under the reasonable cause and good faith exception even if a return does not satisfy the reasonable basis standard. See Treas. Reg. § 1.6662-3(b)(3).

15 IRC § 6662(d)(1)(A)(i)-(ii).

16 IRC § 6662(d)(1)(B)(i)-(ii).

Substantial Valuation Misstatement/Gross Valuation Misstatement

IRC § 6662(b)(3) imposes a 20 percent penalty on any portion of an underpayment shown to be due to a substantial valuation misstatement. This occurs when the value of any property (or adjusted basis of any property) claimed on an income tax return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis.¹⁷ The penalty does not apply, however, unless the portion of the underpayment attributable to substantial valuation misstatements exceeds \$5,000 (\$10,000 in the case of a corporation other than an S corporation or a personal holding company).¹⁸

If any part of the underpayment is attributable to a gross valuation misstatement, the penalty increases from 20 percent to 40 percent.¹⁹ A gross valuation misstatement occurs if the value or adjusted basis of the property claimed on any return is 200 percent or more of the correct amount of such valuation or adjusted basis.²⁰

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.²¹ A reasonable cause determination takes into account all of the pertinent facts and circumstances.²² Generally, the most important factor is the extent to which the taxpayer made an effort to determine the proper tax liability.²³ In the context of a substantial (or gross) valuation misstatement of charitable deduction property,²⁴ there can be no reasonable cause unless: (i) the claimed value of property was based on a qualified appraisal by a qualified appraiser, and (ii) the taxpayer made a good faith investigation of the value of the contributed property.²⁵

Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process²⁶ and through its Automated Underreporter (AUR) computer system.²⁷ Before a taxpayer receives a notice of deficiency,

17 IRC § 6662(e)(1)(A).

18 IRC § 6662(e)(2).

19 IRC § 6662(h)(1).

20 IRC § 6662(h)(2)(A)(i).

21 IRC § 6664(c)(1).

22 Treas. Reg. § 1.6664-4(b)(1).

23 *Id.*

24 See Treas. Reg. § 1.6664-4(h)(2) for the definition of charitable deduction property.

25 Treas. Reg. § 1.6664-4(h)(1)(i)-(ii).

26 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).

27 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.”).

he or she generally has an opportunity to engage the IRS on the merits of the penalty.²⁸ Once the IRS concludes an accuracy-related penalty is warranted, it must follow deficiency procedures (*i.e.*, IRC § 6211-6213).²⁹ 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.³⁰ Alternatively, taxpayers may seek judicial review through refund litigation.³¹ 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.³²

Burden of Proof

In court proceedings, the IRS bears the initial burden of production regarding the accuracy-related penalty.³³ 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.³⁴

ANALYSIS OF LITIGATED CASES

We identified 153 opinions issued between June 1, 2013 and May 31, 2014 where taxpayers litigated the negligence/disregard of rules or regulations, substantial understatement, or substantial (or gross) valuation misstatement components of the accuracy-related penalty. The IRS prevailed in full in 119 cases (78 percent), the taxpayers prevailed in full in 24 cases (16 percent) and 10 cases (seven percent) resulted in split decisions. Table 1 in Appendix III provides a detailed list of these cases.

Taxpayers appeared *pro se* (without representation) in 81 of the 153 cases (53 percent) and convinced the court to dismiss or reduce the penalty in 11 (14 percent) of those cases. Represented taxpayers fared significantly better, achieving full or partial relief from the penalty in 23 of their 72 cases (32 percent).

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), a substantial understatement of tax under § 6662(b)(2),

28 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).

29 IRC § 6665(a)(1).

30 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.

31 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); 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).

32 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).

33 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."

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

or both.³⁵ Regardless of the subsection at issue, the analysis of reasonable cause is generally the same.³⁶ As such, we have combined our analyses of reasonable cause for the negligence, substantial understatement, and substantial (or gross) misstatement 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.³⁷ 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 *Rodriguez v. Commissioner*,³⁸ the taxpayers sought to deduct losses from their horse breeding activities. Although a deduction is allowed for ordinary and necessary expenses paid or incurred by a taxpayer in carrying on a trade or business,³⁹ the IRS disallowed the reported losses in this case for failure to substantiate that the activity was conducted in “a businesslike manner.”⁴⁰ In *Rodriguez*, the taxpayers kept electronic records of their farm's finances; however, the court did not find these records credible or adequate to substantiate the losses taken on Schedule F.⁴¹ The court did not uphold the accuracy-related penalty asserted against the taxpayers because their records demonstrated that they made a good faith effort to maintain a record of their horse breeding activities even though their attempt at recordkeeping fell short for substantiation purposes.⁴²

While the Tax Court has been sympathetic to honest misunderstandings of a complex tax code,⁴³ it will still impose an accuracy-related penalty on taxpayers not demonstrating a good faith effort to comply with the law. For example, in *Adeyemo v. Commissioner*,⁴⁴ the taxpayers (a husband and wife) maintained a logbook of time spent on rental activities. Although the court acknowledged the husband put in a certain amount of effort, it found that taxpayers' actions did not amount to good faith because they did not maintain records for all of their business expenses and did not rely on the logbook when filing their returns.⁴⁵

In contrast, in *Goralski v. Commissioner*,⁴⁶ the taxpayers (a husband and wife) sought to obtain the First-Time Homebuyer Credit (FTHBC) pursuant to IRC § 36. The husband's mother had passed away

35 See, e.g., *Douglas v. Comm'r*, T.C. Memo. 2014-104 (IRS assessed 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 *Sampson v. Comm'r*, T.C. Memo. 2013-212 (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).

36 As discussed earlier, the reasonable cause exception is narrower in the context of a substantial (or gross) valuation misstatement of charitable deduction property.

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

38 T.C. Memo. 2013-221.

39 IRC § 162(a).

40 See also Treas. Reg. § 1.183-2(b)(1).

41 *Rodriguez*, T.C. Memo. 2013-221.

42 *Id.*

43 See, e.g., *Faylor v. Comm'r*, T.C. Memo. 2013-143 (relieving from the accuracy-related penalty a taxpayer who improperly deducted a payment to his ex-spouse as alimony because of his inexperience and honest misunderstanding).

44 T.C. Memo. 2014-1.

45 *Id.* The court also did not find that the taxpayers had established reasonable cause.

46 T.C. Memo. 2014-87.

during the taxable year in question, and his sister was experiencing difficulty with their mother's loss.⁴⁷ During this time, the husband shared his late mother's house, which he had inherited, with his sister. The husband and wife subsequently bought their own house and the IRS disallowed their FTHBC claim for failure to substantiate that the house the husband inherited from his mother was *not* his principal residence. The IRS assessed an accuracy-related penalty. However, the court found that the taxpayers had reasonable cause for believing that they were entitled to the FTHBC as a result of "honest misunderstanding of law that was reasonable in the light of all the facts and circumstances, including [the husband's] experience, knowledge, and education." The court sympathized with the family's circumstances and, among other factors, relied on the fact that the taxpayers acted in good faith by researching the relevant law before claiming the credit.

While expectations for compliance with the tax code are high, taxpayers avoided an accuracy-related penalty attributable to negligence or disregard of rules and regulations by showing that their tax position had a reasonable basis.⁴⁸ In *TIFD III-E, Inc. v. United States*,⁴⁹ the taxpayer treated banks that held its preferred shares as equity partners. The Second Circuit denied the taxpayer's equity characterization, upheld the IRS's assessment of a 20 percent penalty for substantial understatement, and reversed the district court's holding without remand.⁵⁰ However, the government later realized that the substantial understatement penalty could not be assessed because the ten percent substantial understatement threshold had not been satisfied. The parties jointly moved to alter the judgment, and then the district court evaluated whether to impose the penalty. The district court concluded that the uncertain state of the law and the uncertain outcome of litigation were factors to support a finding of reasonable basis to the taxpayer's tax position, and therefore the court found that the negligence penalty was not applicable.⁵¹

In *Chandler v. Commissioner*,⁵² the taxpayers were found liable for gross valuation misstatement when they deducted the value of easements as a charitable deduction, which was improperly substantiated. The IRS imposed accuracy-related penalties on the understatement that arose from the unsubstantiated basis increase. However, the correct method of valuing conservation easements was unsettled at the time the taxpayers filed their returns. The court focused the penalty application in this case on whether the deduction had been properly substantiated through appraisals as a sign of a good faith effort to comply with the tax code.⁵³ The court found that even though Mr. Chandler had a law degree and was an experienced businessman, he reasonably relied on a professional appraiser and his accountant. Further, the court found that the valuation of easements is not an issue that most taxpayers encounter.

Definition of Underpayment

We also reviewed several cases in which taxpayers contested an accuracy-related penalty assessed by the IRS after it challenged their claim to refundable tax credits. In computing their penalties, the IRS reduced the amount of tax shown by taxpayers on their return by the amount of refundable tax credits they claimed. Until recently, the Tax Court has not addressed, in a precedential opinion, whether the amount

47 T.C. Memo. 2014-87.

48 IRC § 6662(a), (b)(1), and (c). A return position that has a reasonable basis is not attributable to negligence. Treas. Reg. §§ 1.6662-3(b)(1).

49 113 A.F.T.R.2d (R.I.A.) 1557 (D. Conn. 2014), *appeal docketed*, No. 14-1952 (2d Cir. June 9, 2014).

50 *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006).

51 *TIFD III-E, Inc.* 113 A.F.T.R.2d (R.I.A.) 1557 (D.Conn. 2014).

52 142 T.C. No. 16 (2014).

53 *Id.*

of tax shown by a taxpayer on his or her return could be reduced below zero by refundable credits, including the Earned Income Tax Credit.⁵⁴

In *Rand v. Commissioner*,⁵⁵ the taxpayers were able to reduce their liability for accuracy-related penalties from about \$1,494 to about \$29. The taxpayers had claimed the earned income tax credit, the child tax credit, and the recovery rebate credit. However, the IRS determined that the taxpayers were not entitled to any of these credits and assessed an accuracy-related penalty against them. On their return, the taxpayers had shown a tax liability of \$144 and claimed credits worth \$7,471. In computing the penalty amount, the IRS reduced the amount of tax shown by the taxpayers on their return below zero, to -\$7,327, by subtracting the amount of credits they had claimed.

The taxpayers challenged the IRS's method of computing underpayment. The case centered on the meaning of "the amount shown as tax," a component to determining underpayment. First, the taxpayers argued that the amount shown on their tax return is limited to the amount actually reported on the return (without reducing that amount for refundable credits). Second, they asserted that refundable credits cannot reduce the amount shown on the return below zero. The Tax Court agreed with the taxpayers' second argument. Relying on the definition of "deficiency,"⁵⁶ and on the legislative history of links between the definitions of "deficiency" and "underpayment," the court's majority held that rebates—such as refundable credits—*can* reduce the amount of tax shown on the return, but *not* below zero. Consequently, the amount of tax shown on the taxpayers' return was not -\$7,327 but \$0, the amount of underpayment was \$144, and the penalty amount \$29. The Tax Court had reached similar conclusions on the computation of amount of tax shown on the return in earlier cases, but *Rand* is the first precedential opinion of the court to reach this conclusion.⁵⁷

The Office of Chief Counsel recently issued litigating guidelines for handling Tax Court cases involving the accuracy-related penalty determined with respect to disallowed refundable credits in light of the *Rand* decision.⁵⁸ Chief Counsel has ceded to the Tax Court's position. Attorneys are instructed to not treat claims for refund or credit based on erroneous refundable credits as a negative amount of tax shown on the return when determining the amount of an underpayment subject to a penalty under IRC § 6662. It should be noted that this guidance is provided "pending any future guidance" and is effective until further notice, perhaps suggesting that the issue is not settled.⁵⁹

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.⁶⁰ 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

54 See IRC § 32.

55 141 T.C. 376 (2013).

56 See I.R.C. § 6211(b)(4).

57 See, e.g., *Solomon v. Comm'r*, T.C. Summ.Op. 2008-95.

58 See Chief Counsel Notice CC-2014-007 (July 31, 2014).

59 *Id.*

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

3. The taxpayer actually relied in good faith on the adviser's judgment.⁶¹

Taxpayers argued their good faith reliance on a competent tax professional in several cases this year,⁶² including *Moore v. Commissioner*.⁶³ In *Moore*, the IRS imposed an accuracy-related penalty for a substantial understatement of income tax resulting from transactions in which the taxpayers' cost basis in stock was overstated. The taxpayers hired a professional tax advisory firm to help them prepare their returns and provided the advisors with all facts concerning the transactions in good faith to properly report their basis in stock. The Tax Court declined to uphold the accuracy-related penalty because the taxpayers established good faith reliance on a competent tax professional.

In *Palmer Ranch Holdings Ltd. v. Commissioner*,⁶⁴ the IRS imposed a 40 percent accuracy-related penalty on the taxpayer (a partnership) for a gross valuation misstatement.⁶⁵ Alternatively, the IRS argued that the taxpayer was liable for a 20 percent accuracy-related penalty for negligence or disregard of rules or regulations, a substantial understatement of income tax, or a substantial valuation misstatement.⁶⁶ The taxpayer had donated a conservation easement and claimed its appraised value as a charitable deduction. The Tax Court found that the actual value of the easement was less than what the taxpayer had claimed, and therefore disallowed a portion of its deduction.⁶⁷ However, because the amount of overstatement was about 20 percent, it was not a gross valuation misstatement and the 40 percent penalty was inapplicable. The taxpayer presented credible evidence of good faith reliance on competent professionals, including a tax attorney, a licensed appraiser, and a land planning and engineering firm. The partnership was unsophisticated in the field of tax and relied on a tax attorney to "advise it on how to donate the easement in compliance with the Internal Revenue Code."⁶⁸ The partnership was able to establish the three criteria above, and the court held it was not liable for any accuracy-related penalties.

In several cases, the taxpayer could not establish all three of the above-mentioned criteria had been satisfied. For example, in *Ames-Mechelke v. Commissioner*,⁶⁹ the taxpayer hired a tax return preparer to determine the tax consequences of her income and expenses. The taxpayer participated in an abusive trust arrangement, the promoter of which had introduced the taxpayer to her return preparer. As her participation in the abusive transaction escalated, the taxpayer became aware of the tax avoidance aspect of the trust arrangement. Eventually, she engaged in a more aggressive trust arrangement organized by the same promoter. The Tax Court concluded that the taxpayer could not have relied on her return preparer in good faith once she gained knowledge of the tax avoidance aspect of the trust arrangement. As the taxpayer was not able to establish actual reliance in good faith, she failed to meet the third prong of the *Neonatology* test described above and was liable for an accuracy-related penalty.⁷⁰

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

62 See, e.g., *Azimzadeh v. Comm'r*, T.C. Memo. 2013-169 (finding the taxpayer reasonably relied on his CPA's judgment in claiming a real-estate loss and home mortgage interest deductions to which he was not entitled; but finding that the taxpayer failed to show that he had provided adequate documentation to his CPA for unreported wages and was, therefore, liable for an accuracy-related penalty for that portion of the underpayment of tax).

63 T.C. Memo. 2013-249.

64 T.C. Memo. 2014-79.

65 See IRC § 6662(h)(2).

66 See IRC §§ 6662(a) and (b)(1), (2), and (3).

67 Generally, the charitable contribution amount is the contributed property's fair market value at the time it is contributed. See Treas. Reg. §§ 1.170A-1(a), (c)(1).

68 *Palmer Ranch Holdings Ltd.*, T.C. Memo. 2014-79.

69 T.C. Memo. 2013-176.

70 *Neonatology*, 115 T.C. at 99.

There are many more examples of taxpayers' failure to establish the competence of their tax return preparers.⁷¹ While some taxpayers choose to use tax software to prepare their tax returns, the Tax Court may not find reliance on tax return preparation software justifiable to avoid an accuracy-related penalty. In this regard, the Tax Court has observed “[a] mistake in entering the amount into the tax preparation software, albeit accidental, is not a defense to the imposition of the section 6662(a) penalty.”⁷² In particular, relying on tax preparation software without doing any independent research or consulting a tax expert may not provide a defense of reasonable cause.⁷³ Prior year cases indicate that the Tax Court may be open to allowing a reasonable cause defense if there is a tax preparation software programming error.⁷⁴

No Affirmative Defense Offered by the Taxpayer

Many taxpayers 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 *Schlievert v. Commissioner*,⁷⁵ the taxpayers substantially understated income tax by deducting losses associated with investments in record label activities. The court found that the taxpayers were not allowed to deduct expenses in excess of gross income because they were not engaged in the record label for profit, as defined in IRC § 183.

The taxpayers did not address the penalty issue in their brief, and they presented no evidence on reasonable cause for their underpayment. Consequently, the court held that the taxpayers were liable for the accuracy-related penalty. The taxpayers appeared *pro se* in this case. It may be that some *pro se* taxpayers are unaware that they bear the burden of proving reasonable cause.

CONCLUSION

In approximately one 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.

Our review of cases this year shows that taxpayers with representation fared significantly better than their unrepresented counterparts. Represented taxpayers were successful in dismissing or reducing their penalties in 32 percent of the cases with representation versus 14 percent of unrepresented taxpayers.⁷⁶

71 See, e.g., *Curtis v. Comm’r*, T.C. Memo. 2014-19 (finding taxpayer liable for an accuracy-related penalty because he failed to show any credible evidence that he had hired a competent tax return preparer). Taxpayers may have a difficult time demonstrating the competency of many tax return preparers if the government is barred from regulating unenrolled return preparers. See *Loving v. Internal Revenue Service*, 742 F.3d 1013 (D.C. Cir. 2014), *aff’g* 917 F.Supp.2d 67 (D.D.C. 2013); Written Statement of Nina E. Olson, National Taxpayer Advocate, Hearing on Protecting Taxpayers From Incompetent and Unethical Return Preparers Before the Committee on Finance, U.S. Senate, at 9 (Apr. 8, 2014) (citing Nina E. Olson, *More Than a ‘Mere’ Preparer: Loving and Return Preparation*, 2013 TNT 92-31 (May 13, 2013)).

72 See *Brooks v. Comm’r*, T.C. Memo. 2013-141, 2013 Tax Ct. Memo. LEXIS 142 at *50-*51 (citation omitted).

73 See *Bigdeli v. Comm’r*, T.C. Memo 2013-148 (June 11, 2013); *Estate of Limborea v. Comm’r*, T.C. Summ. Op. 2013-50 (June 24, 2013).

74 See *Langley v. Comm’r*, T.C. Memo 2013-22, 10 (Jan. 17, 2013) (“Although they have not shown exactly the manner in which they relied on TurboTax or its instructions, we find it unlikely that TurboTax was responsible for the items giving rise to the Petitioners’ deficiency.”); *Morales v. Comm’r*, T.C. Memo 2012-341, 6 (Dec. 6, 2012) (“Moreover, Petitioners failed to introduce other evidence that demonstrates their improperly claiming the first-time homebuyer credit was the result of a TurboTax programming flaw or instructional error.”)

75 T.C. Memo. 2013-239.

76 See Analysis of Litigated Cases discussion, *supra*.

Represented taxpayers fared better than they did over the same period last year, while unrepresented taxpayers fared worse over the same period.⁷⁷

Taxpayers should be aware that they must raise an affirmative defense to the penalty in order to have a chance at avoiding liability for the penalty, because taxpayers are deemed to have conceded those issues that they do not raise.⁷⁸

77 Compare National Taxpayer Advocate 2013 Annual Report to Congress 342 (Most Litigated Issue: *Accuracy-Related Penalty Under IRC §§ 6662(b)(1) and (2)*) (the court dismissed or reduced penalties in 20 percent of the cases for *pro se* taxpayers and 24 percent of the cases for represented taxpayers).

78 See Tax Ct. R. 34(b)(4).