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 required to be shown on a return, or if an underpayment exceeds a computational threshold called a substantial understatement, respectively. IRC § 6662(b) also authorizes the IRS to impose the accuracy-related penalty on an underpayment of tax in six other circumstances.[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 Appeal an IRS Decision in an Independent Forum*
- *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] An 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]

In computing the amount of underpayment for accuracy-related penalty purposes, Congress changed the law in 2015 to provide that the excess of refundable credits over the tax is taken into account as a negative

1 Internal Revenue Code (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 tax; IRC § 6662(b)(6) authorizes a penalty when the IRS disallows the tax benefits claimed by the taxpayer when the transaction lacks economic substance; IRC § 6662(b)(7) authorizes a penalty for any undisclosed foreign financial asset understatement; and IRC § 6662(b)(8) authorizes a penalty for any inconsistent estate basis. IRC § 6662(b)(8) was added by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, § 2004(c), 129 Stat. 443, 456 (2015). We have chosen not to cover the IRC §§ 6662(b)(3)-(8) penalties in this report, as these 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 (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the IRC. *See* Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

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

4 IRC § 6664(a).

amount.[5] Therefore, for returns filed after December 18, 2015, or for returns filed on or before that date for which the period of limitations on assessment under IRC § 6501 has not expired, a taxpayer can be subject to an IRC § 6662 underpayment penalty 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").[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 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."[8] Negligence includes a failure to keep adequate books and records or to substantiate items that give 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,[10] as defined in IRC § 6724(d)(1),[11] or failed to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion.[12] The IRS can also consider various other factors in determining whether the taxpayer's actions were negligent.[13]

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.[14] 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

5 IRC § 6664(a). Prior to December 18, 2015, refundable credits could not reduce below zero the amount shown as tax by the taxpayer on a return. *See Rand v. Comm'r*, 141 T.C. 376 (2013). On December 18, 2015, Congress enacted a law that reversed the Tax Court's decision in *Rand* and amended IRC § 6664(a) to be consistent with the rule of IRC § 6211(b)(4). *See* Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title II, § 209, 129 Stat. 2242, 3084 (2015).

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." IRC § 6662(h)(1); Treas. Reg. § 1.6662-5(a).

7 IRC § 6664(c)(1).

8 IRC § 6662(c).

9 Treas. Reg. § 1.6662-3(b)(1).

10 Treas. Reg. § 1.6662-3(b)(1)(i).

11 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).

12 Treas. Reg. § 1.6662-3(b)(1)(ii).

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

14 IRC § 6662(d)(2)(A)(i)-(ii).

item's tax treatment and the taxpayer had a reasonable basis for the tax treatment.[15] 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 for the taxable year.[16] 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 for the taxable year (or, if greater, $10,000), or $10,000,000.[17]

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

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.[21] 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).[22] 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.[23]

15 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).

16 IRC § 6662(d)(1)(A)(i)-(ii).

17 IRC § 6662(d)(1)(B)(i)-(ii).

18 IRC § 6664(c)(1).

19 Treas. Reg. § 1.6664-4(b)(1).

20 *Id.*

21 IRC § 6662(d)(2)(B)(ii)(I), (II).

22 Treas. Reg. § 1.6662-3(b)(3).

23 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[24] and through its Automated Underreporter (AUR) computer system.[25] Before a taxpayer receives a notice of deficiency, he or she generally has an opportunity to engage the IRS on the merits of the penalty.[26] Once the IRS concludes an accuracy-related penalty is warranted, it must follow deficiency procedures (*i.e.*, IRC §§ 6211-6213).[27] 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.[28] Alternatively, taxpayers may seek judicial review through refund litigation.[29] 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.[30]

Burden of Proof

In court proceedings, the IRS bears the initial burden of production regarding the accuracy-related penalty.[31] The IRS must first present sufficient evidence to establish that the penalty was warranted.[32] The burden of proof then shifts to the taxpayer to establish any exception to the penalty, such as reasonable cause.[33] Because the reasonable basis standard is a higher standard to meet, it is possible that

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24 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).

25 The Automated Underreporter (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.").

26 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).

27 IRC § 6665(a)(1).

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

29 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).

30 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 actually receive a statutory notice of deficiency or did not otherwise have an opportunity to dispute such liability. IRC §§ 6320(c), 6330(c)(2)(B).

31 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."

32 *Higbee v. Comm'r*, 116 T.C. 438, 446 (2001); IRC § 7491(c).

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

a taxpayer 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.[34]

ANALYSIS OF LITIGATED CASES

We identified 122 opinions issued between June 1, 2015 and May 31, 2016, where taxpayers litigated the negligence or disregard of rules or regulations or substantial understatement components of the accuracy-related penalty. The IRS prevailed in full in 86 cases (70 percent), taxpayers prevailed in full in 20 cases (16 percent), and 16 cases (13 percent) resulted in split decisions. Table 1 in Appendix 3 provides a detailed list of these cases.

During the period covered by this report, we noticed a nearly threefold uptick in the number of split decisions in the accuracy-related penalty category. For the period covered by the 2015 Annual Report to Congress, only six out of the 113 total accuracy-related penalty cases (five percent) resulted in split decisions.[35] However, in our review for this year's report, we identified 16 out of the 122 total cases (13 percent) as split decisions.

Taxpayers appeared *pro se* (without representation) in 70 of the 122 cases (57 percent) and convinced the court to dismiss or reduce the penalty in 22 (31 percent) of those cases. Surprisingly, represented taxpayers fared slightly worse, achieving full or partial relief from the penalty in 14 of their 52 cases (27 percent). In contrast, during the same period last year, *pro se* taxpayers did not fare as well, having achieved full or partial penalty relief in 21 percent of cases while represented taxpayers achieved full or partial penalty relief in a similar percentage of cases as this year (27 percent).[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. 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.[37] The failure to "keep adequate books and records or to substantiate items properly" was stated as a primary factor in 55 percent of cases (31 out of 56) where the court found a taxpayer liable for an underpayment penalty due to negligence.[38]

For example, in *Avery v. Commissioner*,[39] married taxpayers operated an information technology company where the wife was the sole shareholder and president of the company and the husband was the executive vice president and sole technician. Mr. Avery worked out of the basement of the couple's home and would make daily automobile trips to the company's clients to provide onsite technical support services

34 Treas. Reg. § 1.6662-3(b)(3).

35 *See* National Taxpayer Advocate 2015 Annual Report to Congress 450.

36 *Id*.

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

38 *See, e.g.*, *Boneparte v. Comm'r*, T.C. Memo. 2015-128; *Holden v. Comm'r*, T.C. Memo. 2015-131.

39 T.C. Memo. 2016-50.

as well as to stores to purchase materials. He was not reimbursed by the company for his automobile expenses.

The couple engaged a tax return preparer, who was referred to them by acquaintances, to prepare their 2011 Form 1040, *U.S. Individual Income Tax Return*. Their return reflected an automobile expense of $39,991, an amount that would indicate that Mr. Avery drove approximately 75,000 miles for business according to the IRS's standard mileage rate for 2011. The IRS selected the couple's return for examination and the agent conducting the exam requested substantiation of the claimed automobile expenses. Mr. Avery claimed he maintained a mileage log where he would record the dates, number, and mileage of the trips he made in the automobile but stated that he lost this log. The IRS issued a notice of deficiency, which disallowed the claimed automobile expenses and asserted an accuracy-related penalty for negligence.[40]

The couple challenged the notice of deficiency in the Tax Court. At trial, Mr. Avery was the taxpayers' only witness but he did not produce his mileage log. Instead, he provided three items:

1. A list of names of the company's clients and related invoices;
2. Receipts for the servicing and repair of Mr. Avery's automobile that he used for business travel; and
3. A list reflecting his estimated business mileage from January through April 2011.

The court noted that IRC § 162 allows a deduction from income for all ordinary and necessary expenses for carrying on a trade or business and that, under IRC § 6001, taxpayers are generally required to keep records substantiating amounts reported on a tax return.[41] The court also pointed out that automobile expense deductions are subject to the strict substantiation requirements of IRC § 274(d), which provides, among other things, that no deduction may be allowed with respect to any property listed in § 280F(d)(4) unless the taxpayer establishes:

(A) The amount of the expense or other item;

(B) The time and place of the use of the property;

(C) The business purpose of the expense; and

(D) The business relationship to the taxpayer of the person using the property.

The court further noted that deductions arising from property subject to the strict substantiation requirements set forth in § 274(d) are disallowed in full unless that taxpayer meets each element of these requirements and also discussed the related regulations.[42]

Turning to the evidence introduced by Mr. Avery, the court first highlighted the fact that he failed to produce his mileage log at trial. The court then found that each of the three pieces of evidence that he provided failed to meet the § 274(d) substantiation requirements. Mr. Avery had failed to explain how he calculated his mileage driven, receipts he provided did not explain business use of the automobile, and he

40 Because the taxpayers' automobile expenses were incorrectly claimed on a Schedule C, *Profit or Loss From Business (Sole Proprietor)*, the IRS mistakenly believed that Mr. Avery operated a sole proprietorship and was therefore also liable for self-employment tax. The IRS later conceded that Mr. Avery did not operate a sole proprietorship and was not liable for the self-employment tax.

41 For a more detailed discussion of whether or not a taxpayer is considered to be in a trade or business and entitled to certain deductions, *see* Most Litigated Issue: *Trade or Business Expenses Under IRC § 162 and Related Sections*, *infra*.

42 *See* Treas. Reg. § 1.274-5T(c).

acknowledged that his recollection of trips made to client sites was not reliable and that he did not keep records regarding daily visits to clients who had ongoing maintenance contracts with the company.

The court stated that it had no doubt that Mr. Avery drove to the worksites of the company's clients. However, because he did not meet the strict substantiation requirements of § 274(d), the court disallowed the taxpayers' claimed automobile expense deductions. The court also imposed the § 6662(b)(1) accuracy-related penalty for negligence, as it found the taxpayers failed to keep adequate books and records. Finally, the court dismissed the taxpayers' defense to the penalty by claiming reasonable cause and good faith reliance on a tax professional, an area that will be discussed in more detail below.

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 *Boneparte v. Commissioner*,[43] the taxpayer petitioned the Tax Court to challenge a notice of deficiency stemming from claimed deductions relating to gambling losses, medical transportation expenses, nonbusiness bad debts, an IRC § 72(t) ten percent additional tax on an early retirement plan distribution, and an accuracy-related penalty under IRC § 6662(b)(1). The court found, among other things, that the taxpayer did not maintain appropriate records of his gambling activity, medical transportation expenses, and nonbusiness bad debts. It therefore did not allow any of these deductions. The court also imposed an IRC § 6662(b)(1) accuracy-related penalty for negligence, noting the taxpayer's failure to keep accurate records for his claimed deductions and that he did not show reasonable cause for this failure. Thus, the court rejected reasonable cause based on the same evidence that established negligence.

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 or her reliance on tax advice was reasonable.[44] To prevail, a taxpayer must establish that:

1. The advisor was a competent professional who had sufficient expertise to justify reliance;
2. The taxpayer provided necessary and accurate information to the advisor; and
3. The taxpayer actually relied in good faith on the adviser's judgment.[45]

Taxpayers argued their good faith reliance on a competent tax professional in several cases this year, including *Espaillat v. Commissioner*.[46] In *Espaillat*, a married couple filed joint Federal income tax returns for 2008 and 2009 claiming losses that stemmed from a scrap metal business operated by Mr. Espaillat's brother. The couple primarily ran a successful landscaping business but Mr. Espaillat and other family members also spent a significant amount of time assisting his brother with the scrap metal business, which was not successful. Under the advice of their certified public accountant (CPA), the Espaillats claimed the losses as "other expenses" deductions on their Schedule C. The IRS later audited the couple's tax returns for these years and disallowed the "other expenses" deductions. Due to the disallowed deductions, the IRS also assessed an accuracy-related penalty under IRC § 6662(b)(1) or, in the alternative, § 6662(b)(2).

43 T.C. Memo. 2015-128.

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

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

46 T.C. Memo. 2015-202. *See also Lamas-Richie v. Comm'r*, T.C. Memo. 2016-63; *Vandenbosch v. Comm'r*, T.C. Memo. 2016-29.

Although it found various reasons why the taxpayers were not entitled to their claimed loss deductions for 2008 and 2009, the court ruled that the couple was not liable for accuracy-related penalties because they acted with reasonable cause and relied in good faith on their CPA. In examining this defense, the court noted that the couple ran a successful landscaping business and that Mr. Espaillat was familiar with running a business and keeping appropriate records but was unfamiliar with the tax code. It also highlighted the fact that the taxpayers had sought the help of a CPA, who had assisted them for over a decade, to prepare their returns for the years in issue. The CPA had the taxpayers each fill out a questionnaire each year before preparing their returns, which they thoroughly completed. The CPA also testified that the taxpayers provided all requisite information and that he discussed the taxpayers' situation with them and thought the Schedule C reporting of the scrap metal loss deduction was appropriate. Finally, the court mentioned that the CPA had over 30 years of experience and that because the taxpayers had always used a Schedule C for their landscaping business, they acted in good faith in relying on their CPA's advice to report their scrap metal financial dealings on a Schedule C. Because they acted with reasonable cause and in good faith reliance on their CPA, they were not liable for accuracy-related penalties under IRC § 6662(b)(1) or (b)(2).[47]

In contrast, married taxpayers in *Ogden v. Commissioner*[48] were held liable for an accuracy-related penalty because the couple had neither reasonably, nor in good faith relied on their CPA's advice in preparation of their Federal income tax return.

In 2010, Mr. and Mrs. Ogden filed a joint Federal income tax return, with most of the income coming from Mr. Ogden's law practice. The IRS audited the Ogdens' return and determined that they had claimed a contract labor expense of approximately $500,000 twice and had failed to report $450,000 of gross receipts. Based on this, the IRS asserted a deficiency of $255,040 and an accuracy-related penalty of $51,008. The taxpayers accepted the deficiency but contested the penalty,[49] arguing that they reasonably relied on advice from their CPA to prepare their return and that the underpayment was the result of an isolated computational error.[50]

The court found that the taxpayers did not reasonably and in good faith rely on the advice of the CPA who prepared their 2010 return. It noted that the taxpayers did not call as a witness the CPA who prepared their return nor did they present any evidence that he provided advice that they could rely on. The court also pointed out that had the taxpayers conducted a reasonable inspection of the return, they would have discovered the duplicated expense deduction and the unreported income. The court believed that Mr. Ogden had sufficient knowledge of the workings of his law firm to detect these errors and that more diligence was necessary to assess the taxpayers' proper tax liability. Therefore, the taxpayers could not claim reasonable cause and good faith reliance on their CPA and were liable for the accuracy-related penalty.

47 Interestingly, the court did not cite the *Neonatology* case in discussing the requirements for good faith reliance on a tax professional. Rather, it cited *Estate of Goldman v. Commissioner*, 112 T.C. 317, 324 (1999) (citing *Metra Chem Corp. v. Commissioner*, 88 T.C. 654, 662 (1987)), *aff'd without published opinion sub nom., Schutter v. Commissioner*, 242 F.3d 390 (10th Cir. 2000). *Estate of Goldman* has a slightly different formulation of the three requirements for good faith reliance on a tax professional but they are substantially the same as the *Neonatology* ones.

48 T.C. Memo. 2015-241.

49 The taxpayers stipulated that they were liable for an accuracy-related penalty for the unreported income so the court only examined whether they were liable for the penalty as it related to the duplicated contract labor expenses.

50 This is a rare case in which only the accuracy-related penalty was at issue before the court. In most cases, taxpayers challenged both the deficiency and the accuracy-related penalty.

Individual Retirement Accounts

As in previous years, we identified several accuracy-related penalty cases under IRC § 6662(b)(1) and (b)(2) that involved individual retirement accounts (IRA) issues.[51]

For example, in *Ellis v. Commissioner*,[52] married taxpayers appealed a Tax Court decision holding that the taxpayers were liable for a deficiency, a ten percent additional tax on an early distribution from a qualified retirement plan, and an IRC § 6662(b)(2) accuracy-related penalty due to Mr. Ellis's engaging in a prohibited transaction with his IRA. In 2005, Mr. Ellis formed a limited liability company (LLC) to engage in the business of used automobile sales. He was also designated to act as the general manager of the LLC and received a salary. In order to fund this venture, Mr. Ellis transferred funds from a 401(k) he had established with a previous employer into a newly formed IRA. He then purchased shares of the LLC with funds from the IRA. Mr. Ellis reported the distributions on his 2005 return but did not report them as taxable.

The IRS examined the Ellis's tax returns for 2005 and 2006 and determined that Mr. Ellis had engaged in prohibited transactions under IRC § 4975(c) by directing his IRA to acquire a membership interest in the LLC with the expectation that the company would employ him and receiving wages from the LLC.[53] As a result, the IRS asserted that Mr. Ellis's IRA lost its status as an individual retirement account and, under IRC § 408(e)(2), its entire fair market value was to be treated as taxable income. The IRS also asserted an IRC § 6662 accuracy-related penalty.

The Tax Court agreed with the IRS that Mr. Ellis engaged in a prohibited transaction by causing the LLC to pay him wages in 2005, which violated the rules of IRC § 4975. The Tax Court also sustained the IRC § 6662 accuracy-related penalty, as it found that the taxpayers had a substantial understatement of income under IRC § 6662(b)(2) and had not demonstrated reasonable cause. On appeal, the Eighth Circuit affirmed the Tax Court's decision, agreeing that Mr. Ellis had indeed engaged in a prohibited transaction with the LLC and was therefore liable for the deficiency and accuracy-related penalty.

CONCLUSION

Over this last reporting period, the issue of accuracy-related penalties under IRC § 6662(b)(1) and (b)(2) was decided by the courts in 122 cases. Litigation on the issue climbed by nine cases (from 113) over the last reporting period.[54] For the current reporting period, the IRS prevailed in full in 70 percent of these cases, which is the lowest percentage reported since 2012.[55]

Also notable is the fact that *pro se* taxpayers fared slightly better than represented ones and an increase in the number of split decisions. In addition, as the National Taxpayer Advocate discussed in a research study in her 2013 Annual Report to Congress, there are circumstances where the IRS's imposition of accuracy-related penalties, and where penalized taxpayers were subject to a default assessment, appealed their assessment, or whose penalty was subsequently abated, may lead to increased future

51 *See, e.g.*, *Dunn v. Comm'r*, T.C. Memo. 2015-208; *Niemann v. Comm'r*, T.C. Memo. 2016-11.

52 *Ellis v. Comm'r*, 787 F.3d 1213 (8th Cir. 2015), *aff'g* T.C. Memo. 2013-245.

53 The IRS asserted deficiencies and penalties in the alternative for either 2005 or 2006.

54 *See* National Taxpayer Advocate 2015 Annual Report to Congress 450.

55 *See* National Taxpayer Advocate 2015 Annual Report to Congress 450 (77 percent); National Taxpayer Advocate 2014 Annual Report to Congress 446 (78 percent); National Taxpayer Advocate 2013 Annual Report to Congress 341 (78 percent); National Taxpayer Advocate 2012 Annual Report to Congress 589 (66 percent).

noncompliance.[56] As noted in the study, this may be due to taxpayer perception of accuracy-related penalties in these circumstances as unfair, thereby undermining the purpose of these penalties, which are supposed to promote voluntary compliance.[57]

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.

It is also important to note that Congress enacted law in 2015 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.[58] Congress amended IRC § 6664(a) to be consistent with the rule of IRC § 6211(b)(4), which allows the IRS to calculate negative tax in computing the amount of underpayment for accuracy-related penalty purposes.[59] Thus, for returns filed after December 18, 2015, or for returns filed on or 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.

56 *See* National Taxpayer Advocate 2013 Annual Report to Congress vol. 2, 1-14 (Research Study: *Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?*).

57 *Id.*

58 Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title II, § 209, 129 Stat. 2242, 3084 (2015). *See also Rand v. Comm'r*, 141 T.C. 376 (2013).

59 Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title II, § 209, 129 Stat. 2242, 3084 (2015).