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60th Annual William & Mary Tax Conference

OVERVIEW OF CIVIL TAX PENALTIES[1]

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1.1 Introduction and Overview

The Code imposes a variety of deadlines upon taxpayers for filing tax returns and paying tax. The deadlines are straightforward and uncomplicated; yet, many taxpayers fail to meet them and, as a result, face a daunting array of potential monetary sanctions. Monetary sanctions include penalties for:

(1) late or non-filing;
(2) late or non-payment of taxes;
(3) not prepaying an adequate amount of tax liability; and
(4) certain accuracy related issues.[2]

Overview:

- The late filing penalty (section 6651(a)(1)) is imposed when a taxpayer has not filed a tax return by its original due date or its validly extended due date. The late filing penalty applies to late filing and non-filing. For most Form 1040s, a return filed after April 15 (or October 15, assuming a valid extension was requested) is subject to the penalty. Generally, the penalty is at the rate of five percent per month (maximum of 25%) of the tax due.
- There are two late payment penalties: section 6651(a)(2) and section 6651(a)(3). The late payment penalty under section 6651(a)(2) arises when a taxpayer fails to pay the tax *shown on the return* by the payment due date.[3] The late payment penalty under section 6651(a)(3) arises when a taxpayer fails to pay an *assessed deficiency* (generally after the Service audits the taxpayer resulting in additional tax liability) within a short period of time after notice and demand is made. The rate for both penalties is one-half of one percent per month of the amount shown as tax due (maximum of 25%).[4]
- Section 6654 requires that taxpayers prepay 90% of their tax liability through withholding, making voluntary installment payments during the year, or by applying a prior year's tax refund to the current year. If the 90% requirement is not met, the estimated tax penalty automatically applies unless the taxpayer can establish that he qualifies for one of the mathematical safe harbors. The most commonly used defense to the estimated tax penalty is that the amount paid during the subject year was equal to or greater than the tax liability for the previous year.

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[2] The Internal Revenue Manual ("Manual") contains a Penalty Handbook, containing extensive guidance for Service personnel regarding the civil penalties discussed. The Penalty Handbook can be found on the Service's website at http://www.irs.gov/irm/part20/index.html.

[3] Filing a Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax, does not extend the time to pay taxes. If a valid extension of time to file has been requested, and the taxpayer pays at least 90 percent of the taxes owed by April 15, then they may not face a failure-to-pay penalty. However, they must pay the remaining balance by the extended due date, and they will owe interest on any taxes paid after April 15.

[4] The Service does not impose the late payment penalty on top of the late filing penalty. See section 6651(c)(1). Instead, the Service imposes a 4.5% penalty per month for the late filing penalty (for the first five months) and the .5% late payment penalty per month.

1.2 Due Dates and Extensions of Time to File and Pay

Sections 6072 and 6151 establish the due dates for filing income tax returns and paying the tax due. For individuals and partnerships, the due date is April 15 (or day 15 of the fourth month following the end of the taxpayer's taxable year). For corporations, the due date is day 15 of the third month following the end of the taxable year. If the due date falls on a weekend or holiday, the due date is extended until the next business day for filing purposes.[5] For example, the statute of limitations for the Service to assess additional tax for a 2011 Form 1040 filed on April 16, 2012, is April 15, 2012, even though April 15, 2012 was a Sunday and the return was not due until April 16.[6]

Returns are generally deemed filed when received rather than when mailed. The one exception to this rule is when the "timely mailed, timely filed" rule of section 7502 applies. When the "timely mailed, timely filed" exception applies, the mailing date is the filing date for SOL purposes. Thus, if a return was postmarked April 15, 20012, and received by the Service on April 17, 20012, the postmarked date of April 15 is deemed the filing date.

The taxpayer may seek an extension if he cannot file his return on time. Extensions are taken into account in determining whether the return filing is timely. For individual taxpayers, an extension of time to file until October 15 is automatic. All the taxpayer must do is file Form 4868 on or before the original due date of the return and properly estimate his tax liability. A taxpayer should file an extension request properly estimating tax liability and, if funds are not available when the return is eventually filed, attach a Form 9465 requesting an installment payment plan or file an Offer in Compromise (OIC) on Form 656. When requesting an extension of time to file, a taxpayer should try to pay as much of the tax as possible in order to reduce the accrual of interest and late payment or estimated tax penalties.

1.3 How "Late" Penalties Are Assessed

When a taxpayer files a return, the Service is authorized to assess and collect the tax shown on the return automatically. If the return is filed late or if the amount of tax paid during the year does not meet the 90% estimated prepayment requirement of section 6654, the Service may summarily assess the appropriate penalties. Because the penalties are computed based on the information on the self-assessing return, they too are treated as self-assessing.[7] As a result, taxpayers frequently learn for the first time that the Service has assessed a penalty when they receive a notice and demand for its payment.

By contrast, if the Service determines a deficiency in tax with respect to a return that was filed late, a late filing penalty attributable to and calculated as a percentage of the deficiency will be added to the balance of the deficiency. It cannot be assessed automatically. The penalty, itself part of the overall deficiency, is entitled to the same deficiency procedures as the underlying

[5] I.R.C. § 7503.

[6] See Rev. Rul. 81-269, 1981-2 CB 243

[7] I.R.C. § 6665(b).

tax.[8] Thus, before the amount proposed by the Agent can be assessed and the Service can turn to collections, the taxpayer is entitled to: (1) an administrative hearing with the Service and (2) review by the U.S. Tax Court.

The procedures discussed above are limited to reviewing the appropriateness of the late filing and late payment penalties, not the estimated tax penalty. For the estimated tax penalty, little can be done other than to complete a Form 2210 (individuals) or 2220 (corporations) to calculate whether one of the mathematical safe-harbors applies. If a safe-harbor applies, the assessment will be abated or reduced accordingly.

1.4 When and How to Present Defenses to the "Late" Penalties

Administratively, taxpayers normally present defenses to the penalties by letter, oral presentation, or a claim for refund. Alternatively, a taxpayer can file an Offer In Compromise or a request for a CDP hearing.[9]

Generally, a taxpayer would send a letter, along with a late-filed return to request non-assessment or in response to a notice of assessment and demand for payment, requesting abatement of the penalty. Typically, the taxpayer's request for waiver of the penalty must be in writing and signed under penalties of perjury.[10] However, in the interest of fairness, the Service will consider oral and unsigned requests, and requests submitted by the taxpayer's practitioner with a valid power of attorney (Form 2848).

A taxpayer would normally make an oral presentation before the Revenue Agent, or Officer, who is in the process of examining him and proposing to assert the penalty. A taxpayer would likely file a claim for refund (or abatement) on Form 843 when the penalty already has been assessed and paid. A refund claim is more formal than a simple letter and is a critical step the taxpayer must take if he believes that litigation is possible, because a refund claim is a prerequisite to refund litigation. Submitting an OIC (Form 656), based on doubt as to liability, is an unusual way to begin the process. But, an OIC might be the taxpayer's only avenue.

1.4.1 What to Include in the Presentation

The late filing and late payment penalties can be avoided only upon a showing that the lateness for the filing or payment was reasonable under the circumstances, and that the taxpayer did not willfully neglect his responsibilities.[11] Thus, the presentation should be directed at establishing that the taxpayer exercised ordinary business care and prudence and was still unable to meet his obligation through no fault of his own. The taxpayer must be clear and correct on the facts when

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[8] I.R.C. § 6665(b)(1).

[9] I.R.C. § 6330(c)(2)(B).

[10] Reg. § 301.6651-1(c).

[11] I.R.C. § 6651(a).

presenting a case for penalty avoidance. The most persuasive cases have documentation or affidavits supporting the reasonableness of the cause for the lateness.

In trying to craft a letter to the Service seeking non-assertion or abatement of the penalty, the practitioner will need the taxpayer to help establish the reasons for his failure to comply. The practitioner should present the critical facts in order that is the most persuasive explanation of reasonable cause to the Service. It is not necessary to limit the letter to only one defense when the facts indicate otherwise (*e.g.*, if the taxpayer had a death in the family and the business records were destroyed, both reasons should be advanced). However, it probably does more harm than good to advance non-meritorious reasons in connection with meritorious defenses as it may decrease the likelihood that the Service believes the taxpayer's defenses.

2.1 The Penalty for Failure to File a Timely Return

2.1.1 How the Failure to File Penalty Is Calculated

A penalty is imposed if the required tax return is not filed on or before its due date (taking into account any extensions of time to file), unless the "failure is due to reasonable cause and not due to willful neglect."[12] The amount of the late filing penalty is the product of three variables:

1. The penalty rate (generally five percent with a maximum of 25%).;
2. The penalty period; and
3. The net tax amount required to be shown on the return.

The failure to file penalty accrues from the prescribed due date of the tax return (including extensions of time to file) to the date the Service actually receives the return. If an extension was granted, the extended due date becomes the beginning point for determining the number of months late.[13]

The failure to file penalty is imposed based on the number of months (including any fraction of a month) during which the taxpayer's failure to file continues. The maximum is reached after only four months and one day. Thus, when the return is received by the Service, or treated as being received, is critical. Normally, the receipt date is the date the return reaches any Service Office or Service Center—not the date the return is mailed. However, if a return is mailed prior to the due date but received after it, the "timely mailed, timely filed" rule of section 7502 treats the return as filed on the date it was mailed. Similarly, if the due date falls on a weekend or holiday and the taxpayer mailed the return the first business day thereafter, the return is deemed timely filed pursuant to sections 7502 and 7503. If the return is not filed by the prescribed due date, including valid extensions, the determination of the number of months a return is late is unaffected by sections 7502 and 7503.

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[12] I.R.C. § 6651(a)(1).

[13] *See* I.R.M. 20.1.2.1.3.1.1 (providing examples where extensions were not granted or were violated).

The taxpayer bears the burden of proving the date of mailing. He can meet this burden by presenting proof that the return was sent by registered or certified mail. In such case, the date of mailing is the date of registration or the U.S. postmark date stamped on the sender's certified mail receipt. Alternatively, he may use certain private delivery services (*e.g.*, Federal Express or United Parcel Service (UPS)).[14]

The failure to file penalty is calculated as a percentage of the "net tax amount required to be shown on the tax return." If there is no net amount due, there is no late filing penalty. The "Net Tax Amount" is the tax required to be shown on the return—for both income and employment taxes—reduced by any tax payments made, or credits allowed, on or before the prescribed due date of the return.[15] Extensions to file are disregarded for these purposes. Thus, payments made between the prescribed due date and the extended due date do not reduce the Net Tax Amount. In addition, any net operating loss or credit carryback does not reduce the tax required to be shown on the return.

The "tax required to be shown on the return" includes not only the tax shown as due on the return as filed but also the tax later determined to be due as the result of an examination.

2.1.2 Fraudulent Failure to File

The traditional fraud penalty only applies when a return has been filed. For situations where no return is filed, the fraudulent failure to file penalty imposes a similar sanction. Where the failure to file a return is fraudulent, the civil penalty is increased to 15% per month, up to a maximum 75%.[16] Fraudulent failure to file generally involves evidence of intentional wrongdoing on the part of the taxpayer with the specific purpose of evading a tax known, or believed, to be owed. The Service bears the burden of proving civil fraud by clear and convincing evidence, and considers the following factors, among others, to be indicators of fraud:[17]

- The taxpayer refuses, or is unable, to explain his failure to file;
- The taxpayer's statements do not comport with the facts of the case;
- The taxpayer has a history of failing to timely file but an apparent ability to pay;
- The taxpayer fails to reveal or tries to conceal assets;
- The taxpayer pays personal and business expenses in cash when cash payments are not usual, or cashes, rather than deposits, checks which are business receipts; and
- The taxpayer's occupation shows he should be aware of the obligation to pay tax, regardless of the amount due (*e.g.*, lawyers, teachers, accountants, real estate brokers, and public officials).

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[14] *See* ¶ 7.1.5.

[15] I.R.C. § 6657(b)(1).

[16] I.R.C. § 6651(f).

[17] *See generally* I.R.C. § 7491(c) and I.R.M. 25.1.7.4; I.R.M. 25.1.2.2.

If the Service is unable to sustain its burden of proof on the fraud issue, the basic failure to file penalty (five percent up to a maximum of 25%) may still be imposed. Both the fraudulent failure to file penalty and the 75% accuracy-related fraud penalty under section 6663 can apply.

3.1 The Penalty for Failure to Timely Pay Tax

3.1.1 Failure to Pay the Tax Shown as Due on the Return—Section 6651(a)(2)

The Service imposes a penalty on a taxpayer who fails to timely pay the amount shown as tax on any return, except if the failure is due to reasonable cause and not willful neglect.[18] The late payment penalty is generally one-half of one percent of the unpaid tax due for each month (or fraction of a month) that the payment is late, up to a maximum of 25% (or 50 months).[19] The penalty applies to all individual, corporate, trust and estate, estate and gift, and certain excise tax returns.

Like the failure to file penalty, the failure to pay penalty is a percentage of the "net amount due." In the case of a taxpayer's failure to pay the amount shown due on the return, the penalty is imposed on the amount shown on the return less amounts that have been withheld, estimated tax payments, partial payments, and other applicable credits. Further, for purposes of computing the late payment penalty for any month, the tax liability is reduced by any payments of tax made on or before the beginning of each month.

The failure to pay penalty runs for the number of months, or part thereof, from the payment's due date (determined with regard to extensions of time to pay but without regard of extension of time to file) through the date on which the Service receives payment. The due date of a tax payment is generally the date on which the return is required to be filed. If the last day prescribed for payment falls on Saturday, Sunday, or a holiday, the payment can be made on the next business day and will not accrue another month of penalty.

3.1.2 Extensions of Time to File or Pay

Extensions of time to file a return do not extend the due date to pay. As a result, such extensions generally do not affect the period for computing the late payment penalty. However, an automatic extension of time to file an individual income tax return on Form 4868 is treated as an extension of time to pay the tax—or, more technically, reasonable cause—if at least 90% of the tax shown on the return was paid by the due date (without regard to the extension) and the balance is paid with the return. If the balance due is more than 10% of the total tax or if it is not paid with the return, the penalty applies to the total balance due from the original due date.[20] Remember, interest accrues from the original due date.

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[18] I.R.C. § 6651(a)(2).

[19] *See* I.R.M. 20.1.2.2.

[20] Reg. § 301.6651-1(c)(3).

An extension of time to pay will avoid the application of the penalty during the extension period. Obtaining an extension to pay is difficult, requiring a showing that payment would impose an "undue hardship" on the taxpayer. Unless the amount of tax involved is great, it probably is not cost-effective for the practitioner to complete an extension to pay request (Form 1127), because the penalty rate is so small.

3.1.3 Failure to Pay Tax Deficiency—Section 6651(a)(3)

If the Service determines that additional tax was required to be (but was not) shown on a return, it will issue a notice that it has assessed an additional amount in excess of that which has been paid and demand that the taxpayer pay the assessed amount. Failure to pay such tax within 21 days after the date of the Service's notice and demand will subject the taxpayer to the failure to pay penalty for the additional tax[21]. Again, the penalty does not apply if the taxpayer shows that his failure to timely pay the deficiency was due to reasonable cause and not willful neglect.

The penalty for failure to pay an amount not shown on the return under section 6651(a)(3) is imposed at the rate of one-half of one percent for each month (or part thereof) that the assessment remains unpaid, up to a maximum of 25%. In the case of an installment agreement under section 6159, the penalty rate is one-quarter of one percent per month, but only if the taxpayer filed his return timely, including extensions.[22] As the Service has the discretion to accept or reject an installment agreement,[23] the reduction in rate under section 6651(h) takes place when the installment agreement is accepted by the Service, not when it is submitted by the taxpayer.

4.1 Combined Late Filing and Late Payment Penalties

If the failure to file penalty and the section 6651(a)(2) failure to pay penalty apply for the same month, or fraction thereof, the failure to file penalty for that month is reduced by the amount of the failure to pay penalty. In most cases, this results in an effective failure to file penalty of four and one-half percent a month and a simultaneous failure to pay penalty of one-half of one percent a month. Thus, the maximum failure to file penalty, if there is a simultaneous failure to pay penalty imposed, is 22.5% (accruing over four months and one day), with maximum combined penalties of 47.5% (22.5% failure to file plus 25% failure to pay accruing over 49 months and one day).

There is no reduction for a failure to pay penalty assessed under section 6651(a)(3) (failure to pay tax not shown due) because the penalty applies only after the Service assesses a deficiency and issues a notice and demand for payment.

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[21] For tax liabilities over $100,000, failure to pay within ten days after the date of the Service's notice and demand will subject the taxpayer to the penalty.

[22] *See* I.R.C. § 6651(h).

[23] *See* Reg. § 301.6159-1(b)(1)(i).

5.1 The Reasonable Cause Exceptions to the Failure to File and Pay Penalties

5.1.1 How to Claim Reasonable Cause

Establishing reasonable cause avoids both the failure to file and failure to pay penalties under section 6651. Reasonable cause determinations are based on the facts and circumstances of each case. The taxpayer bears the burden of proving reasonable cause. Although the taxpayer has the burden of proving reasonable cause, the Service has the burden, in a court proceeding, of producing evidence that it is appropriate to apply the penalty to the taxpayer.[24] There is no reasonable cause exception to the estimated tax penalty imposed under section 6654.

By requiring the penalty to be imposed "unless" the failure is due to reasonable cause, the statute precludes any partial waiver of the penalty. Thus, the Service must either waive or impose the penalty in full. Despite this, the Appeals Office can (and often does) settle a penalty for an amount other than "all or nothing" if there are hazards to litigating the issue.

The request for nonassertion or abatement should be accompanied by supporting documentary evidence and legal authority whenever possible. This might include affidavits of tax advisors or return preparers, death certificates, doctor's statements, insurance statements, police or fire reports, etc. The Service may request additional information if needed to make its determination.

5.1.2 General Requirements for the Exception to Apply

The penalties require the taxpayer to show that there is reasonable cause for the failure and an absence of willful neglect. Willful neglect is a conscious, intentional failure or reckless indifference. The requirement for reasonable cause tends to encompass a concurrent showing of the absence of willful neglect. As a result, the courts and the Service generally discuss the exception under the heading of "reasonable cause" alone. Reasonable cause is shown when, despite the taxpayer's exercise of ordinary business care and prudence, he is unable to meet his tax requirement (to file or to pay), which arise due to circumstances beyond his control.[25] Because the taxpayer's obligation is ongoing, ordinary business care and prudence requires him to attempt to meet the requirement as soon as possible, even if late.[26] In making a determination as to whether there is reasonable cause, the Service will consider the following, among other factors, in making its decision to abate or not abate the penalties:[27]

- Whether the taxpayer's reasons address the penalty imposed;
- The taxpayer's payment and penalty history;
- The length of time between the event cited as a reason for noncompliance and the subsequent compliance; and

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[24] I.R.C. § 7491(c).

[25] Reg. § 301.6651-1(c); I.R.M. 20.1.1.3.1.

[26] Reg. § 301.6651-1(c).

[27] I.R.M. 20.1.1.3 (providing criteria for release from penalties).

- Whether the event that caused the taxpayer's noncompliance could have reasonably been anticipated.

To qualify for abatement of the penalties, the events constituting reasonable cause must be directly connected to the taxpayer's failure to comply and must continue throughout the delinquency period. The longer the delay in compliance once the cause ceases to exist, the more likely the Service will impose a penalty.[28] Service employees are also directed to consider:[29]

- What happened and when;
- During the period of time the taxpayer was noncompliant, what facts and circumstances prevented him from filing a return, paying a tax, or otherwise complying with the law;
- How did the facts and circumstances prevent the taxpayer from complying;
- How did the taxpayer handle the remainder of his affairs during this time; and
- Once the facts and circumstances changed, what attempts did the taxpayer make to comply.

5.1.3 Reasons Offered as Reasonable Cause for Late or Non-filing

The Manual includes a list of the Service's most commonly accepted reasons for reasonable cause. Some reasons are more appropriate to late filing, others to late payment; some are appropriate to both.[30]

5.1.3.1 Reliance on a Tax Advisor or Other Third Person[31]

Normally, a taxpayer cannot shift blame away from himself for filing late, or not filing at all, by pointing fingers at his tax advisor or another third person (*e.g.*, employee or spouse). Everyone is deemed to know they have an obligation to file and an obligation to learn when that is to be done. However, cases distinguish between those situations where the tax advisor or third person was given the ministerial duty to file on the taxpayer's behalf, and those situations where a tax advisor gave substantive advice regarding the requirements associated with filing.

A competent taxpayer cannot avoid the failure to file penalty by relying on his advisor to *file* (the "ministerial duty" to file) the return because the taxpayer is charged with sufficient knowledge to ascertain a deadline and see that it is met. Thus, if the taxpayer were to give his tax advisor the information necessary to prepare the return with instructions to sign and file it when completed, and if the advisor failed to mail it by its due date, the taxpayer does not have a reasonable cause defense. However, reasonable reliance on a tax professional's advice regarding the requirement to file or the return's due date constitutes reasonable cause. Reliance on a tax advisor with

[28] I.R.M. 20.1.1.3.2.2.

[29] I.R.M. 20.1.1.3.2(5).

[30] I.R.M. 1.2.12.1.2.

[31] I.R.M. 20.1.1.3.2.4.3.

respect to a question of substantive law may constitute reasonable cause when such advice turns out to be mistaken.

In order for the taxpayer to prevail on the basis that he relied on the advice of a competent tax advisor (*e.g.*, tax attorney, certified or licensed public accountant, or enrolled agent), the taxpayer must have received incorrect advice after contacting a tax advisor who was competent on the specific tax matter, and the taxpayer must have furnished necessary and relevant information. In addition, the taxpayer must have exercised ordinary business care and prudence in determining whether to obtain additional advice, based on his own information and knowledge. The Service may consider the following factors:

- When and how the taxpayer became aware of the mistake;
- Whether the taxpayer provided complete and accurate information to the tax advisor;
- Whether the taxpayer actually relied on the advice of the tax advisor; and
- Supporting documentation (*i.e.*, a copy of the advice requested, a copy of the advice provided, and a statement from the tax advisor explaining the circumstances).[32]

Where a position taken on the return depends on nontax facts, the taxpayer also has a duty to investigate such underlying facts.[33] He cannot simply rely on statements by another person (*e.g.*, investment promoter). Moreover, if the tax advisor is not versed in the nontax facts, mere reliance on the tax advisor does not suffice. For example, reasonable cause relief was denied when an estate relied on the advice of a tax expert that conveyed that it was better to wait and file (untimely) an estate tax return rather than file on time with incomplete or inaccurate property value information.

5.1.3.2 Records Unavailable[34]

The unavailability of records is generally not considered reasonable cause for a taxpayer's failure to file a return.[35] Rather, the taxpayer must estimate his tax liability based on the best information available and, where necessary, obtain an extension of time to file. However, if a proper return cannot be filed because information remains unavailable despite ordinary business care and prudence by the taxpayer, there is reasonable cause.

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[32] Reg. § 1.6664-4(c).

[33] Practitioners are required to utilize a degree of due diligence; they may not rely on unreasonable representations from a client or third party in preparing their advice. Circular 230 §§ 10.35, 10.37.

[34] I.R.M. 20.1.1.3.1.2.5.

[35] Taxpayers are required to maintain adequate records. I.R.C. § 6001.

5.1.3.3 Ignorance of the Law[36]

Ignorance of the law, in and of itself, does not constitute reasonable cause (*e.g.*, a taxpayer's erroneous belief, not based on advice of counsel, that no return is required to be filed, lack of knowledge as to the correct due date, or erroneous belief that the proceeds of a transaction were not taxable). Ordinary business care and prudence requires taxpayers to be aware of their tax obligations. However, ignorance of the law in conjunction with other facts and circumstances (*e.g.*, limited education or lack of experience with taxes, especially if in a complex area of Federal tax law) may support a claim of reasonable cause. Similarly, a taxpayer may have reasonable cause if there is a recent change in the tax law or forms of which he could not reasonably be expected to know.

5.1.3.4 Miscellaneous

The following are not successful explanations in establishing reasonable cause:

- Belief that no tax was due.
- All information necessary to complete the return was not available.[37]

5.1.4 Reasons Offered as Reasonable Cause for Late or Non-payment

If there was an extension of time to file and payment of the balance due was made with a timely extended return, the taxpayer is deemed to have acted reasonably if the amount due was less than ten percent of his total tax liability.[38]

A claim of insufficient funds is never reasonable cause for failure to file a return. However, lack of funds may be an acceptable reason for failure to pay any tax when the taxpayer can demonstrate that, despite the exercise of ordinary business care and prudence, he either lacked the funds to pay the tax or would experience an undue hardship if he paid on time (determine whether Form 1127 would be appropriate for extending the time to pay).[39]

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[36] I.R.M. 20.1.1.3.1.2.1.

[37] *See Estate of Maltaman v. Commissioner*, 73 T.C. Memo. (CCH) 2162, 1997 T.C. Memo. (RIA) ¶ 97,110.

[38] Reg. § 301.6651-1(c)(3).

[39] *See* Reg. § 301.6651-1(c) (explaining reasonable cause for failure to file tax return or pay tax). *Compare Fran Corp. v. United States*, 164 F.3d 814, 817 (2d Cir. 1999) (finding a financial difficulties defense to be a facts and circumstances determination in all late payments) *with Brewery Inc. v. United States*, 33 F.3d 589, 592 (6th Cir. 1994) (finding that financial difficulties may be a reason for not paying income taxes timely, but never equates to reasonable cause with respect to depositing employment taxes).

5.1.5 Reasonable Cause for Either Late Filing or Late Payment

5.1.5.1 Death, Serious Illness, or Unavoidable Absence[40]

The death, serious illness, or unavoidable absence of the taxpayer, or the death or serious illness of a family member, may constitute reasonable cause. In the case of an entity, the incapacity must relate to the individual having the sole authority to take the required action. In making the determination as to whether an illness constitutes reasonable cause, the courts have focused on the severity and duration of the illness.[41] The incapacity must be so severe that the taxpayer cannot function during the period, and so sudden that he could not reasonably have planned for it. Do not overlook the serious effects of mental illness, drug or alcohol dependency, battered spouse situations, issues of old age, infirmity, and mental capacity in exploring bases for reasonable cause. Sometimes these are successful, but not always.

Though a taxpayer may have a reasonable cause for late filing because of death or illness for some period, the waiver does not apply forever. At some point, the Service will expect the taxpayer to get his act together and file or pay. Too great a delay might vitiate the earlier reasonable cause.

5.1.5.2 Mistake or Forgetfulness[42]

A taxpayer's or subordinate's mistake, forgetfulness, or carelessness does not constitute ordinary business care and prudence and is not a basis of reasonable cause. Absent the affirmative advice of counsel, even a good faith but mistaken belief does not relieve the taxpayer from the penalty. The Tax Court has expressly rejected any notion that a good faith dispute as to the proper treatment of a particular item constitutes reasonable cause for any failure to file a return (unless the failure is based on the advice of competent counsel).

The neglect or misfeasance by the taxpayer's employee or agent is not reasonable cause. In instances where his employee has failed to file timely tax returns or pay taxes, the courts have held that the taxpayer still has a duty to file, pay, and deposit taxes and cannot avoid responsibility by simply relying on his employee to comply with the law.

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[40] I.R.M. 1.2.12.1.2.

[41] *See Tamberella v. Commissioner*, 2005-2. U.S.T.C. ¶ 50,487, 96 A.F.T.R.2d 5311 (2d Cir. 2005) (finding taxpayer was not incapacitated when he could manage personal affairs, including defending himself in a lawsuit).

A return that is filed, or a payment that is made, within the period of an invalid extension is still late. A voided automatic extension is not reasonable cause for failing to file a timely return. Similarly, filing within an extension period that is requested but not granted does not constitute reasonable cause. A taxpayer cannot presume that his request for an extension of time will be granted. Accordingly, the mere request for an extension does not eliminate the penalty.

[42] I.R.M. 20.1.1.3.2.2.4; I.R.M. 20.1.1.3.2.2.7.

5.1.5.3 Time and Business Pressures

The taxpayer's heavy workload does not constitute reasonable cause for his failure to perform a required act. A person exercising ordinary business care and prudence does not take on assignments that would prohibit him from fulfilling his own legal obligations within the prescribed time. Similarly, the time pressure of a taxpayer's agent (*e.g.*, return preparer) cannot excuse the taxpayer's failure to file a return.

5.1.5.4 Invalid Extension

During a period of invalid extension, a return that is filed, or a payment that is made, is still late. Even an automatic extension can be voided (*e.g.*, the taxpayer fails to estimate his tax properly). A voided automatic extension is not reasonable cause for failing to file a timely return.

Similarly, filing within an extension period that is requested but not granted does not constitute reasonable cause. A taxpayer cannot presume that his request for an extension of time will be granted. Accordingly, the mere request for an extension does not eliminate the penalty.

5.1.5.5 Fire, Casualty, Natural Disaster, or Other Disturbance[43]

A fire, casualty, natural disaster, or other disturbance may constitute reasonable cause if the taxpayer exercised ordinary business care and prudence but was unable to comply due to circumstances beyond his control. In the case of a significant disaster affecting numerous taxpayers, the Service generally provides disaster relief pursuant to section 7508A.[44]

6.1 The Penalty for Failure to Pay Estimated Tax[45]

6.1.1 How the Estimated Tax Penalty Is Imposed

As a general rule, taxpayers are required to pay their income and employment taxes during the year in which the income is earned on a "pay-as-you-go" basis. Most wage earners who complete an accurate Form W-4 will have enough taxes withheld at the source by the employer relative to those earnings to avoid the penalty. Taxpayers whose tax liabilities are not covered through withholding, or are under-withheld, are required to make their "pay-as-you-go" payments via estimated quarterly tax payments. For calendar year taxpayers, the due dates are April 15, June 15, and September 15 of the subject tax year, and January 15 of the following tax year. Taxpayers are generally required to pay 25% of their annual estimated taxes on or before each installment payment due date. When individuals, estates, and most trusts underpay any required

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[43] I.R.M. 20.1.1.3.3.5.

[44] *See, e.g.*, Notice 2005-73, 2005-2 C.B. 723 (providing relief under tax-related deadlines to victims of Hurricane Katrina).

[45] *See* I.R.M. 20.1.3.1 *et seq.* (providing guidance to the Service regarding estimated tax penalties).

installment of estimated income tax liabilities reportable on Forms 1040 or 1041, they are penalized.[46]

A taxpayer's annual combined tax payments (between withholding, estimated payments, and prior year's application of a refund to the current year's liability) must be equal to the lesser of:

1. 90% of the tax for the current year; or
2. 100% of the tax shown on the preceding 12-month year's return (110% if the individual's AGI for the preceding year exceeds $150,000).[47]

3. The amount determined under the annualized installment method (applicable to taxpayers who do not receive income evenly throughout the year). This method allows estimated tax payments that actually reflect the income earned in the period immediately preceding the installment due date.[48]

The amount of the estimated tax penalty is computed by applying the "underpayment rate" to the amount of the underpayment of estimated tax for the period of underpayment. The underpayment rate is the interest rate established under section 6621, which is adjusted quarterly. For purposes of this penalty, it is a simple interest rate, not compounded daily. Further, for purposes of determining the underpayment rate in computing estimated tax penalties, the rate that applies to the third month following the close of the taxable year also applies to the first 15 days of the fourth month. This is because estimated tax payments are due on day 15 of the month following each quarter.

The penalty runs for the "underpayment period," which is the number of days from the payment due date to the earlier of the date the payment is received or day 15 of the fourth month following the close of the taxable year (the due date of the return without regard to extensions, usually April 15 of the following year). Each underpaid installment period must be separately computed. The underpayment period is not reduced by an extension of time to pay the tax.

The amount of the underpayment of an installment of estimated tax is the excess of the required installment over the amount, if any, of the installment paid on or before its due date. Payments of estimated tax are credited against the unpaid portion of the required installment in the order in which such installments are required to be paid. Withholding is divided evenly among the four installments, unless the taxpayer completes and attaches Form 2210 to the return, indicating his choice to apply the withholding to the installment in which it was actually withheld.

Estimated tax requirements are based on the amount of tax reported on the original return. If the tax is adjusted on an amended return on or before the due date, including extensions, the penalty amount may be adjusted. If the tax is adjusted after the due date, including extensions, either as a

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[46] I.R.C. § 6654.

[47] I.R.C. § 6654(d)(1)(C)(i).

[48] *See* Instructions for Form 2210. Special rules apply to non-resident aliens, deceased taxpayers, and taxpayers with at least two-thirds of their gross income derived from farming or fishing.

result of audit or an amended return, the penalty amount will not be adjusted unless an amended joint return is filed after separate returns, in which case the penalty is based on the joint return.

6.1.2 Defenses to the Estimated Tax Penalty

Normally, a taxpayer's defense to the possibility of the penalty is to prove that one of the exceptions applies. This is accomplished by completing Form 2210. The most common exception is that the total amount of prepayments (*i.e.*, amounts withheld and quarterly payments) for the current year equaled or exceeded the amount of tax liability for the preceding year.[49]

In addition to the bankruptcy exception, taxpayers may assert certain other defenses to the estimated tax penalty.[50] The estimated tax penalty will not apply if the tax shown on the return, reduced by the credit allowed for taxes withheld, is less than $1,000. Further, the penalty will not be imposed for a taxable year if there was no tax liability for the preceding 12-month taxable year and the taxpayer was a U.S. citizen or resident throughout the entire preceding taxable year.[51]

A taxpayer may claim abatement or waiver of the penalty based on a change in the tax law on the tax return, on Form 2210 or 2210F, by letter or other correspondence, by telephone, or through personal contact. The Service may waive the estimated tax penalty if it determines that the imposition of the penalty would "be against equity and good conscience" because of a casualty, disaster, or other unusual circumstances.[52] This is not equivalent to reasonable cause. Requests for such a waiver must be submitted in writing and signed by the taxpayer. The Manual provides examples of situations where such a waiver of the estimated tax penalty may be granted:

- The taxpayer's records are destroyed by natural disaster;
- The taxpayer becomes seriously ill or is seriously injured and is unable to manage his affairs; or
- The taxpayer designates that an overpayment of tax shown on a prior return is to be credited against his estimated tax, but the overpayment is offset for either past due child support or non-tax federal debt under section 6402(c), and he is not notified of the offset before the due date of the estimated tax installment.

The waiver may not be granted based on:[53]

- Reliance on the advice of a competent tax advisor;

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[49] *See* I.R.M. 20.1.3.2.1.1.

[50] I.R.C. § 6654(e)(1).

[51] I.R.C. § 6654(e)(2).

[52] I.R.C. § 6654(e)(3)(A); *see* I.R.M. 20.1.3.4.1.3.

[53] *See generally* I.R.M. 20.1.3.4.1.

- Retroactive application of a statute or regulation unless a specific waiver of the estimated tax penalty is granted by the statute or regulation, or the Service; or
- Certain erroneous advice from the Service.

Finally, a taxpayer may be eligible for a waiver of the penalty if the underpayment is due to reasonable cause and not willful neglect, and he either retired after having attained the age of 62, or became disabled in the tax year in which the payments came due, or in the preceding tax year.[54]

7.1. Accuracy-Related Penalties – Introduction and Overview

Taxpayers facing proposed adjustments to their taxable income may also have to deal with the possible imposition of a group of penalties commonly known as the "accuracy-related penalties." Accuracy-related penalties are several separate and distinct penalties, including: those imposed for negligent reporting positions; those for reporting certain positions without substantial authority and adequate disclosure; or, those for substantially misstated valuations.[55]

When the Service imposes accuracy-related penalties, the taxpayer is entitled to certain procedural rights before the Service can assess the penalty. In addition, taxpayers are entitled to certain procedural rights after the collection process has begun. To best represent their clients, practitioners must understand the basis for the imposition of the accuracy-related penalties and to raise all possible defenses and exceptions.

7.2 Scope and Amount of the Penalty

The section 6662 penalty is imposed at the rate of 20% of that portion of an underpayment of tax required to be shown on a tax return and which is attributable to any of the following:[56]

- Negligence or disregard of rules and regulations;
- Substantial understatement of income tax;
- Substantial valuation misstatement;
- Substantial overstatement of pension liabilities;
- Substantial estate or gift tax valuation understatement;
- Disallowance of claimed tax benefits because of a transaction lacking economic substance; and
- Undisclosed foreign financial asset understatement.[57]

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[54] I.R.C. § 6654(e)(3)(B); *see* I.R.M. 20.1.3.4.1.3.

[55] I.R.C. § 6662.

[56] I.R.C. § 6662(b)(1)-(7).

[57] As a practical matter, practitioners are most likely to see only two of the accuracy-related penalties asserted in their cases: negligence or disregard of rules and regulations, and substantial understatement. I.R.C. § 6662(b)(1)-(2).

However, if any portion of an underpayment is attributable to a "gross" valuation misstatement, the penalty will be increased to 40%. The section 6662 penalty can only be applied to a filed return. Therefore, if no return has been filed, other penalties (*e.g.*, the failure to file penalty) may be applicable, but section 6662 will not come into play. However, a late filed return which also contains an understatement of tax will be subject to *both* the late filing penalty and an accuracy-related penalty. The fact that a return is filed late is not supposed to be taken into account by the Service when making a further determination as to whether a section 6662 penalty should be imposed. However, as a practical matter, these subjective judgment calls by the Service are very difficult to pinpoint, or to refute as an abuse of discretion.

In addition, section 6662A imposes an accuracy related penalty equal to 20% (or 30% in certain situations) for understatements with respect to listed transactions and any reportable transaction if a significant purpose of such transaction is the avoidance or evasion of Federal income tax.

7.3 Calculating the Penalty

Because the section 6662 penalty can be imposed only on that portion of the tax underpayment attributable to the requisite misconduct, it is important to understand what constitutes the underpayment. According to section 6664, "underpayment" is the amount by which the tax imposed (or proposed to be imposed) exceeds the excess of the tax shown on the original return, increased by any previous assessments (or collections without assessment), over any previous rebates. "Rebates" are most often refunds, credits, or abatements that occurred at an earlier time in connection with the same tax return.

The term underpayment is defined by section 6664(a).[58] It consists of four components[59]:

(1) the "tax imposed"

(2) "the amount shown as the tax by the taxpayer on his return"

(3) "amounts not so shown previously assessed (or collected without assessment)" and

(4) "the amount of rebates made".

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[58] Regulation 1.6664-2 provides a formula for calculating the underpayment. An underpayment is equal to W - (X + Y - Z), "where W = the amount of income tax imposed; X = the amount shown as the tax by the taxpayer on his return; Y = amounts not so shown previously assessed (or collected without assessment); and Z = the amount of rebates made." See *Snow v. Commissioner*, T.C. No. 6 (2013). The Tax Court held that the Service correctly calculated the section 6662(a) penalty on the underpayment amount that "the Government was deprived of as a result of the amounts actually shown on the petitioner's return." T.C. No. 6 at 6. The tax amount shown on the petitioner's return was a negative number because the taxpayer had computed an inaccurate refund greater than his withholding.

[59] I.R.C. § 6664(a)(1)(A).

It is important to note that a carryback of a subsequent tax year's loss or credit, which eliminates the tax liability in the year in controversy, will not reduce the amount of an underpayment and will not eliminate the penalty application.[60] Irrespective of the carryback's offset to the tax, the penalty calculation will be made with respect to the original amount of tax proposed to be assessed. This assessed penalty will also accrue interest from the original due date of the return.

Recently there has been litigation surrounding the second component of the underpayment. In *Rand v. Commissioner*, the Tax Court decided whether "the amount shown as the tax by the taxpayer on his return" should take into account refundable credits such as the earned income tax credit, the additional child tax credit and the recovery rebate credit.[61] It distinguished *Feller v. Commissioner*, 135 T.C. 497 (2010) where it held that section 6664 was silent and ambiguous with respect as to whether the underpayment included taxpayer's overstated withholding credits. Through a detailed discussion of the validity of a regulation, section 6664(a)(1)(A), the instructiveness of section 6211(a)(1)(A), the Tax Court held that section 6662 does not impose a penalty on the refundable portion of erroneously claimed earned income credits, additional child tax credits and recovery rebate credits.

7.4 The "Catch-All" Penalty—Negligence

Section 6662(b)(1) applies to any portion of an underpayment attributable to negligence or disregard of rules or regulations. Although (b)(1) is commonly thought of as just the "negligence" penalty, it is useful to think of this section as having two separate components, the negligence aspect and the disregard of rules or regulations aspect.

7.4.1 Negligence

"Negligence" is "any failure to make a reasonable attempt to comply with" the tax laws.[62] The regulations further explain that negligence also includes any failure to exercise ordinary and reasonable care in the preparation of a tax return, any failure to keep adequate books and records, or to substantiate items properly. A position with respect to an item is not negligent if it has a reasonable basis, and that "reasonable basis" is a relatively high standard of tax reporting, significantly higher than "not frivolous" or "not patently improper."[63] A position must be more than merely arguable or represent a mere colorable claim. The regulations provide that a tax return position will satisfy the "reasonable basis" standard if it is "reasonably based" on one or more authorities (as defined in Reg. § 1.6662-4(d)(2)(iii)). Those authorities include primary sources, such as the Code, most legislative history, court cases, proposed, temporary, and final regulations, revenue rulings and procedures, and private letter rulings issued after October 31, 1976. Importantly, authorities do not include secondary sources, like treatises or law review

[60] Reg. § 1.6664-2(f).

[61] *Rand v. Commissioner*, 141 T.C. No. 12 (2013).

[62] I.R.C. § 6662(c).

[63] Reg. § 1.6662-3(b)(3).

articles, although the analysis contained in those texts may contain support a position by reference to primary authorities.[64]

Courts have defined negligence as the failure to do what a reasonable and prudent person would do under the circumstances.[65] Indicators of negligence include the following:

- Failure to report income appearing on Forms 1099 received by the taxpayer;
- Failure to make a "reasonable attempt to ascertain the accuracy of a deduction, credit, exclusion on a return" which would seem "too good to be true" to a reasonable and prudent person under the circumstances;
- Treating a passthrough item differently than what is reflected on the K-1 without proper disclosure;[66] or
- Failure to file returns with balances due.[67]

A penalty will not be imposed where the law was unsettled or where the taxpayer, despite acting in good faith, made a mistake of law or fact. Reliance on a professional advisor is not an absolute defense but, depending upon the issue, it can absolve the taxpayer of the penalty under the reasonable cause defense.[68]

7.4.2 Disregard of Rules or Regulations

The disregard of rules or regulations "includes any careless, reckless, or intentional disregard."[69] The rules or regulations includes the provisions of the Code, temporary and final regulations (*not* proposed regulations), revenue rulings, and notices issued by the Service and published in the Internal Revenue Bulletin.

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[64] Compare a position which is "reasonably based" on one or more authorities as a defense to the negligence penalty with a position which has "substantial authority" with respect to those same authorities as a defense to the substantial understatement penalty.

[65] *See Neely v. Commissioner*, 85 T.C. 934, 947-48 (1985) (applying definition).

[66] Reg. § 1.6662-3(b)(1).

[67] *See Korshin v. Commissioner*, 91 F.3d 670, 672 (4th Cir. 1996) (discussing a situation where taxpayer did not file a return on the mistaken belief that his deductions would offset most of the income and that the Service would just "bill" him for the balance). *Romanowski v. Commissioner*, T.C. Memo. 2013-55 (taxpayers were held to be unsophisticated in the field of tax and thus their reliance upon advisors was reasonable and in good faith).

[68] *See Chamberlain v. Commissioner*, 66 F.3d 729 (5th Cir. 1995) (finding it reasonable to rely on expert's advice); *Henry v. Commissioner*, 170 F.3d 1217, 1220 (9th Cir. 1999) (holding taxpayer had no obligation to independently verify his tax liability after receiving advice by accountant).

[69] I.R.C. § 6662(c); Reg. § 1.6662-3(b)(2).

"Careless" disregard occurs when a taxpayer fails to exercise reasonable diligence to determine the correctness of a return position that is contrary to a rule or regulation. The disregard becomes "reckless" if the taxpayer makes little or no effort to ascertain whether a rule or regulation exists, under circumstances that are a substantial deviation from the conduct expected from a reasonable person. An "intentional" disregard is one in which the taxpayer is aware of the rule or regulation being disregarded.[70]

For positions contrary to a revenue ruling or a Service notice, there is no disregard if the taxpayer's contrary position has a "realistic possibility of being sustained on its merits." [71]

7.4.3 Impact of Disclosure on the Negligence Penalty Being Asserted

The standard for making a qualifying disclosure under the disregard prong is "reasonable basis." As a general rule, disclosure for these purposes must be made on Form 8275 (or 8275 R for positions inconsistent with a regulation), and attached to the taxpayer's return or qualified amended return. Challenges to a regulation must represent a good faith challenge to the regulation's validity. In other words, a taxpayer's challenge to a regulation that satisfies the reasonable basis or substantial authority standard is not sufficient, absent disclosure, to avoid the disregard portion of the negligence penalty. In addition, taxpayers also must keep adequate books and records, or substantiate items properly in order to avail themselves of the disclosure defense.

7.5 The Substantial Understatement Component of the Accuracy-Related Penalty

The 20% accuracy-related penalty applies when there has been a "substantial understatement" of income tax.[72] An understatement is substantial if the understatement exceeds the greater of ten percent of the tax required to be shown on the return for the taxable year, or $5,000 ($10,000 for corporations other than S corporations or personal holding companies).[73] For these purposes, an understatement is the "excess of the amount of tax required to be shown on the return for a taxable year over the amount of tax imposed which is shown on the return, reduced by any rebates."[74] This is not exactly the same concept as an "underpayment." An understatement is reduced to the extent it is attributable to an item:[75]

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[70] Reg. § 1.6662-3(b)(2).

[71] Reg. § 1.6662-3(b)(2).

[72] I.R.C. § 6662(b)(2).

[73] I.R.C. § 6662(d)(1).

[74] I.R.C. § 6662(d)(2)(A).

[75] I.R.C. § 6662(d)(2)(B).

- For which there is, or was, substantial authority for the taxpayer's treatment;[76] or
- For which there is attached to the tax return sufficient disclosure of the relevant facts affecting the item's tax treatment;[77] and there is a reasonable basis for the position taken.

7.5.1 Impact of Disclosure on the Substantial Understatement Penalty

To the extent that any adjustment item had a reasonable basis and was properly disclosed on the original tax return, or on a qualified amended return as described in Regulation section 1.6664-2(c), the amount of tax as shown on the return is deemed to include the tax calculated for the disclosed item as if it had been properly reported on the original return. The effect of disclosure is to treat the item as if it were properly reported on the return, thereby reducing the amount of understatement for that year.

One of the practitioner's responsibilities in determining whether the substantial understatement penalty can be avoided is to consider whether the taxpayer's facts, position, or treatment have been adequately disclosed on the return. Adequate disclosure may be provided on Forms 8275 or 8275R attached to a tax return, but disclosure may also be adequate if made in the body of the tax return for the year in question if such disclosure is in accord with the annual revenue procedure addressing return disclosure.[78] Common types of disclosures, deemed to have been adequate if made on the proper schedule and line of the tax return, include:

- Schedule A itemized deductions for medical, taxes, interest, contributions, and casualty and theft losses;
- Schedule E deductions for casualty and theft losses, legal expenses, bad debts, officer compensation (to avoid unreasonableness challenge), repairs, and taxes;
- Moving expenses; and
- Employee business expenses.

For tax returns due after December 31, 1993, disclosure does not reduce the understatement unless the disclosed return position has at least a "reasonable basis" which is significantly higher than a "not frivolous" standard.[79] Regulations have been promulgated to help define the elusive concept of reasonable basis; the approach taken centers on whether the position is reasonably based on one or more "authorities." Authorities are primary sources, such as the Code, most legislative history (including Joint Committee Blue Books), temporary, final, and proposed regulations, revenue rulings and procedures, and most other Service administrative

[76] The taxpayer must have substantial authority at the end of the tax year, or when the return is filed. Reg. § 1.6662-4(d)(3)(iv)(C).

[77] The disclosure exception does not apply to certain items treated as "tax shelter items." *See* I.R.C. § 6662(d)(2)(C)(ii). *See also* I.R.C. § 6662A regarding the imposition of accuracy-related penalties for understatements of income with respect to reportable transactions.

[78] Reg. § 1.6662-4; Rev. Proc. 2014-15; 2014-5 IRB 456.

[79] Reg. § 1.6662-4(e)(2)(i).

pronouncements, including private letter rulings issued after October 31, 1976.[80] Conspicuously absent from this list are treatises, legal periodicals, and opinions rendered by professional tax advisors. Whether a position is reasonably based on an authority is determined by taking into account the relevance and persuasiveness of the authorities, and subsequent developments.[81]

In addition, disclosure of information is inadequate if a taxpayer fails to substantiate an item or keep adequate books and records with respect to that item.[82] This substantiation requirement may be acutely critical for taxpayers who are typical clients of low-income tax clinics; experience has shown that they are less likely to maintain adequate documentation in support of underlying positions. For carryover or carryback items, taxpayers generally need only to disclose in the return in the year in which the carryback or carryover arises.[83] For recurring items,[84] the disclosure must be made for each taxable year in which the item appears on a return.

The practitioner may be faced with the practical question in the context of return preparation or advice-giving as to whether the taxpayer should disclose an item (either on the original return or on a qualified amended return) that may give rise to Service scrutiny. Because disclosure will serve as a roadmap to the issue for the Service, the practitioner should consider how likely it is that the issue would come to the Service's attention anyway (*i.e.*, is this an item likely to be brought up or identified in the context of an examination?). Consider whether prior examinations raised the issue, the Service raised the issue with similarly situated taxpayers, or if the issue involves an area that the Service (through an announced position in notices, market segment specialization projects, or other guidance) has expressed an interest in challenging or litigating. But, keep in mind the preparer penalties under section 6694, requiring disclosure by a return preparer of items that are at a level of less than substantial authority.[85] A practitioner must determine whether he is a "preparer."

Taxpayers may feel that disclosure of an item offers protection with little cost. But, with a requirement that a disclosed position have at least a reasonable basis, the circumstances under which disclosure offers protection for taxpayers are now more limited.[86] The practitioner must consider whether a court will conclude that an item with a reasonable basis does not have substantial authority. However, as a practical matter, it may be easier to convince the Service during an examination that a disclosed item has a reasonable basis than to convince that same

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[80] Reg. § 1.6662-4(d)(3)(iii).

[81] Reg. § 1.6662-4(d)(3)(ii).

[82] Reg. § 1.6662-4(e)(2)(iii).

[83] Reg. § 1.6662-4(f)(4).

[84] *See* Reg. § 1.6662-4(f)(3).

[85] See Reg. § 1.6694-1(b)(1).

[86] The Omnibus Budget Reconciliation Act of 1998 (OBRA) revised the standard necessary for a disclosure to be effective from "not frivolous" to "reasonable basis."

Agent there is substantial authority for an undisclosed item. Practitioners must also consider whether the good faith or reasonable cause exception applies, which would exempt the taxpayer from penalty even absent disclosure (this is generally a post-filing analysis).

7.5.2 What Constitutes Substantial Authority?

If there is substantial authority for an item, that item is treated as if it were properly reported on an income tax return in computing the amount of tax shown on the return for purposes of determining whether the substantial understatement component of the accuracy-related penalty applies (thus lowering the amount of the understatement to which the penalty applies). The substantial authority standard is less stringent than the "more likely than not" standard (*i.e.*, greater than 50% likelihood of success if litigated), but higher than the "reasonable basis" standard (*i.e.*, arguable but unlikely to prevail if litigated; perhaps a 33% chance of prevailing) applied to the negligence penalty. Under applicable regulations, a taxpayer has substantial authority for a position if the weight of authorities supporting the position is substantial in relation to the weight of authorities opposing the position.[87] The test is objective, and the regulations clarify that a taxpayer's belief that he had substantial authority is irrelevant in determining whether substantial authority exists.[88]

In determining whether a document constitutes substantial authority, all relevant authorities must be weighed.[89] The weight afforded any authority depends on its relevance and persuasiveness. As an example of relevance, the regulations suggest that a document may not be particularly relevant if it is materially distinguishable on its facts. As to persuasiveness, the regulations provide that an authority that merely states a conclusion is usually less persuasive than one that contains a cogent analysis of the issue. Further, the regulations afford differing weight to the types of documents constituting authority (*e.g.*, a revenue ruling is afforded more weight than a private letter ruling, and more recent letter rulings or technical advice generally must be accorded more weight than older ones). The list of authorities available for use in analysis includes:

- The Code and Regulations;
- Court decisions (if the precedent is controlling on appeal);
- Revenue Rulings and Revenue Procedures;
- Letter Rulings and Tax Advice Memorandums issued after October 31, 1976;
- Actions on Decisions and General Counsel Memorandums issued after March 12, 1981;
- Legislative history (including interim committee reports);
- The "Blue Book" (general explanations of tax statutes issued by the Joint Committee on Taxation);
- Tax Treaties (regulations and official explanations); and
- Service information and press releases.

[87] Reg. § 1.6662-4(d)(3)(i).

[88] Reg. § 1.6662-4(d)(3)(i).

[89] Reg. § 1.6662-4(d)(3).

Certain items are automatically considered substantial authority so that a taxpayer need not weigh authorities or consider disclosure (*e.g.*, private letter rulings issued to the taxpayer in question, technical advice memoranda naming the taxpayer in question, and affirmative statements in a Revenue Agent's Reports).[90] In addition, there is substantial authority if an item is supported by controlling precedent from the U.S. Court of Appeals for the Circuit to which the taxpayer has the right of appeal with respect to the item.

It is extremely difficult to quantify the chances of success or consider with certainty whether the weight of authority on an item is substantial in relation to other authorities. Because reasonable people may disagree as to whether authority rises to the level of being substantial, serious consideration must be given to the disclosure exception.

7.6 Substantial Valuation Misstatements

The substantial valuation misstatement component of the accuracy-related penalty can apply if there is a substantial valuation misstatement with respect to the value or adjusted basis of property, or with respect to a section 482 transaction.[91] This discussion will only consider the first element of the penalty.[92] There is a substantial valuation misstatement if the value or adjusted basis of the property is 150%[93] or more of the correct value or adjusted basis.[94] However, there is an underpayment threshold amount of $5,000 for individuals.[95] When there are gross valuation misstatements (*i.e.*, where the value or basis of any property claimed on an income tax return is 200% or more of the correct amount), the penalty is increased from 20% to 40% of the understatement.[96]

The substantial valuation misstatement penalty also gives rise to the possibility of multiple year penalties with respect to the same item recurring on the tax return for multiple years (*e.g.*, depreciation deductions taken on an item for which the original cost or subsequently adjusted

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[90] Reg. § 1.6662-4(d)(3)(iv)(A). This rule does not apply if the determination was based on incomplete facts or is later revoked by notice to the taxpayer, Supreme Court decision, later Service pronouncement, or temporary or final regulations.

[91] I.R.C. § 6662(e).

[92] *See* Michael I. Saltzman, IRS PRACTICE & PROCEDURE Revised 7B.04.

[93] This amount was changed from 200% by the Pension Protection Act of 2006, Pub. L. No. 109-280, § 1219(a)(1)(A), 120 Stat. 780, effective for returns filed after August 17, 2006. As this provision is so new, a majority of the cases involving this penalty will still be under the old 200% threshold of section 6662(e)(1).

[94] I.R.C. § 6662(e)(1)(A). *See* I.R.M. 20.1.5.9.

[95] I.R.C. § 6662(e)(2).

[96] I.R.C. § 6662(h)(2), *amended by* Pension Protection Act of 2006. Prior to the 2006 amendment, there was a 400% gross valuation misstatement threshold.

basis has been overstated). However, the total disallowance of an item cannot be subject to a valuation penalty.[97]

The Supreme Court recently decided that the substantial valuation misstatement penalty can apply when a transaction is found to lack economic substance.[98] The relevant issue here is where the Supreme Court upheld the application of the penalty where the taxpayer reported artificial losses derived from an inflated basis in a sham partnership (known as a Son of Boss tax shelter).[99] The penalty was imposed because the partners had zero basis in their purported partnership interests because the partnership itself was a sham, thus any basis overstatement automatically was "gross" for the purposes of the application of the substantial valuation misstatement penalty.[100]

7.7 The Reasonable Cause Exception to the Section 6662 Penalties

The accuracy-related penalty does not apply to any portion of an underpayment if it is shown that there was reasonable cause for such portion and the taxpayer acted in good faith.[101]

Reasonable cause relief is generally granted when the taxpayer exercises ordinary business care and prudence in determining his tax obligations, but is unable to comply with those obligations. Accordingly, the Service is precluded from imposing an accuracy-related penalty if it can be established that a taxpayer acted in good faith and had reasonable cause for the error on the return. Whether a taxpayer acted with reasonable cause and good faith is made on a case-by-case basis, taking into account all facts and circumstances.[102] The "most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability."[103]

7.7.1 Reliance on Advice of Tax Professionals

Case law and applicable regulations have provided that a taxpayer's good faith and reasonable reliance on a professional tax advisor will insulate him from the imposition of accuracy-related

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[97] *See Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990).

[98] *United States v. Woods*, 135 S.Ct 557 (2013). *See Woods: A Path Through The Penalty Maze*, 2014 TAX NOTES TODAY, 829-38 (February 24, 2014).

[99] The Supreme Court also decided that it had the jurisdiction in a partnership-level TEFRA proceeding to determine the applicability of penalties triggered by a partner's misstatement of basis in a sham partnership. *Woods*, 135 S.Ct. at 655-656.

[100] See I.R.C. § 6662(e)(1) and (h); Reg. § 6662-5(g).

[101] I.R.C. § 6664; *See* I.R.M. 20.1.5.6.1.

[102] Reg. § 1.6664-4(b)(1).

[103] Reg. § 1.6664-4(b)(1).

penalties.[104] In *Henry v. Commissioner*,[105] the court held that the assertion by the Service of a negligence penalty when the taxpayer relied on the advice of counsel was not substantially justified and that the attorney's fees and costs were appropriate.

If a taxpayer asserts that he relied on the advice of counsel, the Internal Revenue Service will likely seek production of the counsel's records and advice. The taxpayer needs to address his ability to assert privilege for attorney-client communications. In *AD Investment 2001 Fund LLC, et al. v. Commissioner*, 142 T.C. No 13, Docket Nos. 9177-08, 9178-08 (April 16, 2014), the Internal Revenue Service sought to compel the production of letters of petitioners' attorneys' opinions in anticipation of the possible affirmative defenses of reasonable cause. The Tax Court granted the Internal Revenue Service's motion to compel on the grounds of waiver of attorney-client privilege.

Assuming a practitioner overcomes the hurdle of showing that the taxpayer has actually relied on professional advice,[106] the challenge for the practitioner is to demonstrate that a taxpayer's reliance is both reasonable and in good faith.[107] There are fairly detailed minimum requirements, which must be satisfied in order to justify such a finding.[108] The following must be considered:

- The advisor must have considered all pertinent facts and circumstances.[109] Also, if a taxpayer has failed to disclose a fact that he knows (or should know) is relevant, reliance will not be considered reasonable or in good faith.[110]
- The advice must not be based on unreasonable factual or legal assumptions.[111]

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[104] *See Boyle*, 469 U.S. at 246 ("When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice"); *Reser v. Commissioner*, 112 F.3d 1258 (5th Cir. 1997); *Heasley*, 902 F.2d at 383; Reg. § 1.6664-4(b)-(c).

[105] *Henry v. Commissioner*, 2002-1 U.S.T.C. ¶ 50,396, 89 A.F.T.R.2d 2437 (9th Cir. 2002).

[106] "Advice" is any communication setting forth the analysis or conclusion of a person (including a professional tax advisor), other than the taxpayer, provided to or for the benefit of the taxpayer, and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the section 6662 penalty.

[107] *See DeCleene v. Commissioner*, 115 T.C. 457 (2000) (finding taxpayer's reliance on counsel with respect to a complex section 1031 exchange was justified).

[108] Reg. § 1.6664-4(c)(1)(i).

[109] See *Romanowski v. Commissioner*, T.C. Memo. 2013-55 (taxpayer's reliance on an experienced independent accountant not affiliated with the attorney who had a conflict of interest demonstrated good faith and reasonable reliance).

[110] Reg. § 1.6664-4(c)(1)(i).

[111] Reg. § 1.6664-4(c)(1)(ii).

- Reliance may not be reasonable if the taxpayer knew, or should have known, that the advisor lacked knowledge in relevant aspects of federal tax law.[112]

Appraisals may provide a means of insulation from the accuracy-related penalties to the extent an underpayment is attributable to a valuation error. But, a taxpayer's use of an appraisal alone is not sufficient to establish reasonable cause and good faith. To test his supposedly good faith and reasonable reliance on the appraisal, the Service will consider factors like the appraisal's underlying assumptions, the appraiser's relation to the taxpayer, or the activity in which the property is used, and the circumstances under which the taxpayer obtained the appraisal.

7.7.2 Other Matters to Consider Concerning Reasonable Cause and Good Faith

Reliance on information, even if erroneous, reported on a Form 1099 or W-2 (or other information return) will generally indicate good faith and reasonable cause, unless such information is inconsistent with other information reported to the taxpayer, or with his knowledge of the transaction.[113] Thus, absent evidence to suggest why reliance on an information return was not reasonable, the taxpayer should be able to rely on information returns furnished by third parties.

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[112] Reg. § 1.6664-4(c)(1)(ii).

[113] Reg. § 1.6664-4(b).