



# ACCURACY-RELATED PENALTY AND REASONABLE CAUSE AND GOOD FAITH DEFENSE

## PRIMER

### Introduction

§ 6662 of the Internal Revenue Code (IRC) imposes an accuracy-related penalty (the ARP) on persons who have underpaid their income tax as a result of certain enumerated circumstances including, but not limited to, negligence and substantial understatement of income tax. According to the National Taxpayer Advocate's *Annual Reports to Congress* from 2013 to 2018, the application of this accuracy-related penalty has been the most litigated federal tax issue over the last several years<sup>1</sup>. Taxpayers can be excepted from the ARP in most cases if they show that there was reasonable cause for the underpayment and that they acted in good faith with respect to it, pursuant to § 6664(c). This exception is often called the "reasonable cause and good faith" defense or just "reasonable cause."

After reviewing key concepts and legislation relating to the ARP and the reasonable cause and good faith defense, this primer focuses on identifying and discussing the factors driving the determination of whether the reasonable cause and good faith exception applies.

### Key Principle

#### IRC § 6662: Accuracy-Related Penalty

§ 6662(b) states that the ARP applies to underpayments attributable to 1 or more of the following:

- negligence or disregard of rules or regulations;
  - any substantial understatement of income tax;
  - any substantial valuation misstatement;
  - any substantial overstatement of pension liabilities;
  - any substantial estate or gift tax valuation understatement;
  - any disallowance of claimed tax benefits by reason of a transaction lacking economic substance;
  - any undisclosed foreign financial asset understatement; or
  - any inconsistent estate basis.
- computational or transcriptional error;
  - reliance on an information return;
  - reliance on advice of a professional tax adviser or appraiser;
  - reliance on erroneous information;
  - in the case of a corporate taxpayer, the corporation's employment of internal controls and procedures to identify errors;
  - whether there is an appraisal of the value of property and the circumstances around it.

## Key Factors for Determining Reasonable Cause and Good Faith

The factors relevant to a reasonable cause and good faith defense can be grouped into the following categories.

### 1. Education, Experience, and Knowledge of the Taxpayer

Treas. Reg. 1.6664-4(b)(1) provides that "circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge and education of the taxpayer." Evidence in this category includes the taxpayer's educational level and work experience generally as well as tax-specific education and experience, the complexity and/or ambiguity of the tax law or issues at play, and the information that the taxpayer had or ought to have had, such as IRS information returns, forms and/or published guidance.

For example, in *Neonatology Associates*,<sup>2</sup> the taxpayers were doctors who owned medical corporations. It was noted that "as highly educated professionals," they ought to have recognized, even without consulting others, that the tax shelter they

As per § 6662(a), the amount of the ARP is 20% of the taxpayer's underpayment, generally. The ARP can increase to 40% if the cause of the underpayment is: a "gross valuation misstatement" as per § 6662(h); an undisclosed foreign financial asset understatement; or a disallowance of claimed tax benefits by reason of a non-economic substance transaction that is undisclosed.

### Reasonable Cause and Good Faith

Treasury Regulation 1.6664-4 outlines how one can establish the reasonable cause and good faith defense under § 6662: "[t]he determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances... Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability."

Pertinent facts and circumstances identified by Treas. Reg. 1.6664-4 include:

- the experience, knowledge, and education of the taxpayer;
- whether the mistake was an isolated

were entering into was too good to be true.

## 2. Good Faith Efforts

Treas. Reg. 1.6664-4(b)(2) provides some examples of good faith efforts:

- seeking advice and/or information from a professional tax adviser (even if the taxpayer doesn't retain that adviser to actually prepare a tax return) or of other people (even if they are not professional tax advisers) who might have knowledge about the issue;
- relying on an information return, or lack thereof, unless there was reason for the taxpayer to know that the information return had an error or that it was missing;
- keeping tidy records and preparing tax returns carefully instead of in a rush at the last minute with hastily gathered records.

In other words, good faith efforts can generally be evidenced by keeping adequate records and making independent attempts to verify the liabilities or calculations at issue. Failing to keep books or adequate records for one's business in general detracts from a taxpayer's ability to defend against the ARP because it significantly impacts the taxpayer's credibility (e.g. *Vallejo v. Commissioner*, T.C. Memo 2018-39, where Mr. Vallejo simply did not keep books or adequate records for his "alleged" business at all).<sup>3</sup>

Good faith efforts are also supported by circumstances indicating that there was no way the taxpayer could have known there was a problem needing additional verification – such as, for example, when an error is relatively small and gets lost in the numbers, and the taxpayer can otherwise show they were careful in other aspects of the research and preparation.

## 3. Reasonable Reliance on Others' Advice

Approximately one third of the § 6662(b)(1) and (2) judgments reviewed by the Taxpayer Advocate Service in 2016 discussed whether or not the taxpayer established reasonable cause due to reasonable reliance on a tax professional. The taxpayer prevailed in about 32 percent of these cases, which is substantially higher than the 20 percent overall success rate for challenging section 6662(b)(1) and (2) penalties.<sup>4</sup> Thus, demonstrating reliance on a tax professional can be considered a strong method of establishing one's reasonable cause and good faith defense.

The basic test for whether reliance on an adviser's advice is reasonable is set out in *Neonatology Associates*:<sup>5</sup>

1. The adviser being relied on has to be "a competent professional who had sufficient expertise to justify reliance;
2. The taxpayer must have provided necessary and accurate information to the adviser; and
3. The taxpayer must have actually relied in good faith on the adviser's judgment.

It is important to note that the tax adviser must have done more than merely prepare the tax return. This is illustrated in the recent case of *Russian Recovery Fund Ltd.*<sup>6</sup> where the court held that simply having one's accountant sign off on a tax return does not constitute reliance on the advice of a tax professional.

## Blue J Tax

Is your client excepted from a § 6662 accuracy-related penalty due to showing reasonable cause and good faith with respect to an underpayment of tax? Find out!

Blue J Tax's **§ 6662 Accuracy-Related Penalty: Reasonable Cause and Good Faith Classifier**

requires you to complete a questionnaire about the facts of your case. Each of the questions represents a factor or factors found to inform court decisions about the reasonable cause and good faith defense to the § 6662 accuracy-related penalty. Once you answer all the questions, Blue J Tax will compute the likelihood of a reasonable cause and good faith defense being successful, comparing your scenario to previous relevant cases.

## Endnotes

- 1 Taxpayer Advocate Service, *Annual Reports to Congress*, 2013 to 2018. <https://taxpayeradvocate.irs.gov/reports>.
- 2 *Neonatology Associates P.A. v. Commissioner*, 299 F.3d 221 (2d Cir.: 2002), aff'g 115 TC 43 (2000).
- 3 *Vallejo v. Commissioner*, T.C. Memo 2018-39.
- 4 Taxpayer Advocate Service, *2017 Annual Report to Congress*, Volume 1, p. 371 (January 2018).
- 5 *Supra*.
- 6 *Russian Recovery Fund Ltd. v. United States*, 851 F.3d 1253 (Fed. Cir. 2017).