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The Internal Revenue Service (IRS) Accuracy-Related Penalty

A taxpayer who submits a return that is not accurate may be subject to an accuracy-related penalty equal to 20 percent of the underpayment amount (Internal Revenue Code (IRC) Section 6662). Generally, this penalty is imposed by the IRS either through an examination, or the Automated Underreporter (AUR) program. The AUR is a division of the IRS that compares the amount of income reported on a tax return to the amounts reported by third parties like banks, stockbrokers and employers to detect discrepancies. The penalty is imposed when it is discovered that there is a negligence or disregard of rules or regulations, or any substantial understatement of income tax liability on a tax return. Combined with other statutory additions such as interest and failure-to-pay penalties, this hefty penalty may come as a surprise to taxpayers when they receive a tax bill in the mail. The purpose of a penalty assessment is, of course, to encourage voluntary compliance with tax laws. However, what appears to be a failure to comply with tax laws, may not always be the result of the taxpayer's negligence. The IRC Section 6664 states:

"No penalty shall be imposed under Section 6662 or 6663 with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion".

Determining Reasonable Cause and Good Faith

To determine whether a taxpayer acted with reasonable cause and in good faith, the IRS will take all the pertinent facts and circumstances into consideration. Generally, the most important factor is the extent to which the taxpayer made an effort to determine the proper tax liability. *<Treasury Regulations Section 6664-4(b)(1)>.* Other factors to consider are the taxpayer's experience, knowledge, education, and the taxpayer's reliance on the advice of a tax adviser. *<Internal Revenue Manual (IRM) 20.1.5.7.1>*

During the examination of the tax return, the taxpayer generally has an opportunity to present facts supporting his "reasonable cause" to avoid the assessment of an accuracy-related penalty. However, according to the IRS Data Book for 2018, out of $1.8 billion of accuracy-related penalties in that year, only $272 million were abated. As a result of this large discrepancy, the application of accuracy-related penalties was the most litigated tax issue over the past several years.

Whether reasonable cause and good faith exist, is determined on a case-by-case basis. One of the most used basis for a reasonable cause defense is the reliance on a tax professional. Reliance on a tax professional may constitute reasonable cause and good faith if the reliance was reasonable and the taxpayer acted in good faith. *Neonatology Associates v. Commissioner*<*115 Tax Court (T.C.) 43 (2000)*> established the three-part test for reasonable reliance on a tax professional.

- Adviser was a competent professional who had sufficient expertise to justify reliance
- The taxpayer provided necessary and accurate information to the adviser
- The taxpayer actually relied in good faith on the adviser’s judgement

Reliance on a Tax Professional

Please note that reliance on a tax professional alone is not a sufficient defense. The adviser must be someone the taxpayer knew or should have known was qualified. In the Neonatology case, the court disagreed with the taxpayer’s reliance because the tax preparer was an insurance agent and not a competent tax professional. In *Coblenz v. Commissioner* <*79 T.C. Memo 1881 (2000)*>, the Tax Court found that Mr. Coblenz, a Houston resident, acted reasonably and in good faith, notwithstanding the erroneous advice because he relied upon a tax adviser who was practicing as a tax attorney, CPA, former IRS Revenue Agent and Appeals Officer. Another example of a reasonable cause defense is the case of *McGuire v. Commissioner* <*149 T.C. 254 (2017)*>. When Mrs. McGuire applied for the advanced premium tax credit (“APTC”), she was unemployed and expected her household income to be below 400 percent of the federal poverty level. In the middle of the year, she received a job that increased her household income and disqualified her for the APTC. She notified the health insurance provider of her income change several times. However, her health insurance provider did not update her status change. They also failed to update her new mailing address after she notified them of this change.

As a result, she did not receive the Form 1095-A from her health insurance provider. When she filed her tax return, she did not report the APTC and the IRS imposed an accuracy-related penalty for the under-reported APTC. The Tax Court determined that she was not liable for the accuracy-related penalty due to her reasonable cause and good faith. The court noted that, although not receiving an information return generally is not enough reasonable cause, it could contribute to a reasonable cause finding if the taxpayer did not know or have reason to know about receiving the income. In her case, the APTC was paid directly to the health insurance provider by the government and she had relied on a third party (health insurance provider) to properly determine and adjust her eligibility status for the APTC. In addition, she relied on a CPA to prepare her tax return.

Not Reasonable Cause

An example of what is not reasonable cause can be illustrated by the classic "the dog ate my homework" excuse. Most of the denied reasonable basis claims were due to the taxpayer's failure to keep adequate books and records. As recently as June 13, 2019 in the *Rose v. Commissioner* case*<T.C.Memo 2019-73>,* the Tax Court denied another taxpayer's request for abatement of an accuracy-related penalty because the taxpayer had not maintained sufficient recordkeeping. The importance of keeping thorough and accurate records cannot be emphasized enough because the IRS can easily determine that the taxpayer has acted out of negligence when they are utilizing improper recordkeeping practices.

As shown in these cases, proper recordkeeping and working with qualified tax professionals are the keys to avoiding tax deficiencies and accuracy-related penalties. If you have been notified by the IRS that your tax return has been selected for audit, we would be happy to assist you in reviewing your books and records and gathering pertinent information to respond to the IRS. Even if an audit has been recently closed and penalties have been assessed there are certain remedies that may still be available to you.

If you have any questions regarding this newsletter, please call or email us.

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