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#1**Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2)****SUMMARY**

Internal Revenue Code (IRC) § 6662(b)(1) and (2) authorizes 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 IMPACTED²

- *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 amount.⁵ Therefore, for returns filed after December 18, 2015, or for returns filed on or before

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 estate or gift tax valuation understatement; 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)(1), 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 often 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 also codified in the IRC. See 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).

5 *Id.* 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).

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 that reduces tax below zero.

The IRS may assess penalties under IRC § 6662(b)(1) and (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

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. 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 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 further 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

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), a nondisclosed noneconomic substance transaction (IRC § 6662(i)(1)), or an undisclosed foreign financial asset understatement (IRC § 6662(j)(3)).

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 underreported income. Internal Revenue Manual (IRM 4.10.6.2.1, *Negligence* (May 14, 1999)). See also IRM 20.1.5.2.2, *Common Features of Accuracy-Related and Civil Fraud Penalties* (Dec. 13, 2016).

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 and Good Faith

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 considers all 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 Reliance on a return preparer may constitute reasonable cause and good faith if the reliance was reasonable and the taxpayer acted in good faith.²¹ *Neonatology Associates v. Commissioner* establishes the three-part test for reasonable reliance on a tax professional in accuracy-related penalty cases:

- (1) The adviser was a competent professional who had sufficient expertise to justify reliance;
- (2) The taxpayer provided necessary and accurate information to the adviser; and
- (3) The taxpayer actually relied in good faith on the adviser's judgment.²²

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.²³ 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).²⁴ Applicable authority could include information such as sections of the IRC; proposed, temporary, or final regulations; revenue rulings and revenue procedures; tax treaties

15 IRC § 6662(d)(2)(A)(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). S corporations and personal holding companies are subject to the same thresholds as individuals and all other non-C corporation taxpayers, found in IRC § 6662(d)(1)(A)(i) - (ii).

18 IRC § 6664(c)(1).

19 Treas. Reg. § 1.6664-4(b)(1).

20 *Id.*

21 Treas. Reg. § 1.6664-4(b).

22 115 T.C. 43, 99 (2000) (citations omitted), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

23 IRC § 6662(d)(2)(B)(ii)(I), (II).

24 Treas. Reg. § 1.6662-3(b)(3).

and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; and congressional intent as reflected in committee reports.²⁵

Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process²⁶ and through its Automated Underreporter (AUR) computer system.²⁷ Before a taxpayer receives a notice of deficiency, he or she generally has an opportunity to engage the IRS on the merits of the penalty.²⁸ Once the IRS concludes an accuracy-related penalty is warranted, it must follow deficiency procedures (*i.e.*, IRC §§ 6211-6213).²⁹ Thus, the IRS must send a notice of deficiency with the proposed adjustments and inform the taxpayer that he or she has 90 days to petition the United States Tax Court to challenge the assessment.³⁰ Alternatively, taxpayers may seek judicial review through refund litigation.³¹ Under certain circumstances, a taxpayer can request an administrative review of IRS collection procedures (and the underlying liability) through a Collection Due Process hearing.³²

IRC § 6751(b)(1) provides the general rule that no penalties may be assessed “unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher-level official as the Secretary may designate.” However, IRC § 6751(b)(2)(B) provides an exception for penalties calculated automatically “through electronic means.” The IRS interprets this exception as allowing it to use its AUR system to propose

25 Treas. Reg. § 1.6662-4(d)(3)(iii).

26 IRM 4.10.6.2(1), *Recognizing Noncompliance* (May 14, 1999) (“assessment of penalties should be considered throughout the audit”). See also IRM 20.1.5.3, *Examination Penalty Assertion* (Dec. 13, 2016).

27 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 4.19.3.2, *Overview of IMF Automated Underreporter* (Dec. 15, 2017); IRM 4.19.3.17.6, *Accuracy-Related Penalty Due to Negligence or Disregard of Rules or Regulations (Negligence Disregard Penalty)* (May 19, 2017).

28 For example, when the IRS proposes to adjust a taxpayer’s liability, including additions to tax such as the accuracy-related penalty, it typically sends a notice (“30-day letter”) of proposed adjustments to the taxpayer. A taxpayer has 30 days to contest the proposed adjustments to the IRS Office of Appeals, during which time he or she may raise issues related to the deficiency, including any reasonable cause defense to a proposed penalty. If the issue is not resolved after the 30-day letter, the IRS sends a statutory notice of deficiency (“90-day letter”) to the taxpayer. See IRS Pub. 5, *Your Appeal Rights and How to Prepare a Protest if You Don’t Agree* (Jan. 1999); IRS Pub. 3498, *The Examination Process* (Nov. 2004). However, for some taxpayers, the IRS sends a “combo” letter that combines the initial contact letter and the 30-day letter, which confuses taxpayers who do not know whether they should continue working with the examination function, file an appeal, or both. See National Taxpayer Advocate 2011 Annual Report to Congress, vol. 2, 85-86.

29 IRC § 6665(a)(1).

30 IRC § 6213(a). A taxpayer has 150 days instead of 90 to petition the Tax Court if the notice of deficiency is addressed to a taxpayer outside of the United States. See Most Serious Problem: *Statutory Notices of Deficiency: The IRS Fails to Clearly Convey Critical Information in Statutory Notices of Deficiency, Making it Difficult for Taxpayers to Understand and Exercise Their Rights, Thereby Diminishing Customer Service Quality, Eroding Voluntary Compliance, and Impeding Case Resolution*, *supra*.

31 Taxpayers may litigate an accuracy-related penalty by paying the tax liability (including the penalty) in full, filing a timely claim for refund, and then timely instituting a refund suit in the appropriate United States District Court or the Court of Federal Claims. 28 U.S.C. § 1346(a)(1); 28 U.S.C. § 1491; IRC §§ 7422(a); 6532(a)(1); *Flora v. United States*, 362 U.S. 145 (1960) (generally requiring full payment of tax liabilities as a prerequisite for jurisdiction over refund litigation). For exceptions to the *Flora* rule, see Legislative Recommendation: *Fix the Flora Rule: Give Taxpayers Who Cannot Pay the Same Access to Judicial Review as Those Who Can*, *supra*.

32 IRC §§ 6320 and 6330 provide for due process hearings in which a taxpayer may raise a variety of issues, including the underlying liability, provided the taxpayer did not 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). See Most Serious Problem: *Collection Due Process Notices: Despite Recent Changes to Collection Due Process Notices, Taxpayers Are Still at Risk for Not Understanding Important Procedures and Deadlines, Thereby Missing Their Right to an Independent Hearing and Tax Court Review*, *supra*.

the substantial understatement and negligence components of the accuracy-related penalty without supervisor review.³³

Burden of Proof

In court proceedings involving individual taxpayers, the IRS bears the initial burden of production regarding the accuracy-related penalty.³⁴ The IRS must first present sufficient evidence to establish that the penalty was warranted.³⁵ The burden of proof then shifts to the taxpayer to establish any exception to the penalty, such as reasonable cause.³⁶ Because the reasonable basis standard is a higher standard to meet than reasonable cause, it is possible that 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.³⁷

ANALYSIS OF LITIGATED CASES

We identified 120 opinions issued between June 1, 2017, and May 31, 2018, where taxpayers litigated the negligence or disregard of rules or regulations, or the substantial understatement components of the accuracy-related penalty. The IRS prevailed in full in 86 cases (72 percent), taxpayers prevailed in full in 29 cases (24 percent), and five cases (four percent) were split decisions. Table 1 in Appendix 3 provides a detailed list of these cases.

Taxpayers appeared *pro se* (without representation) in 60 of the 120 cases (50 percent). *Pro se* taxpayers convinced the court to dismiss or reduce the penalty in 22 percent of those 60 cases, which is slightly below the overall success rate for taxpayers challenging these penalties. 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.

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- 33 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. See National Taxpayer Advocate 2014 Annual Report to Congress 404-410 (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.”).
- 34 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.”
- 35 *Higbee v. Comm’r*, 116 T.C. 438, 446 (2001); IRC § 7491(c). See *Portillo v. Comm’r*, 932 F.2d 1128 (5th Cir. 1991), *rev’g in part, aff’g in part, remanding* T.C. Memo. 1990-68, which involved an assessment based solely on an information return submitted by a third party and held that the presumption of correctness does not apply to the IRS’s deficiency assessment in a case involving unreported income if the IRS cannot present any evidence supporting the determination.
- 36 IRC § 7491(a). See also Tax Ct. R. 142(a).
- 37 Treas. Reg. § 1.6662-3(b)(3).

Requirement for Managerial Approval Prior to Assessment of Penalties

In last year's Accuracy-Related Penalty Most Litigated Issue, we reported on two significant decisions regarding the IRC § 6751(b)(1) requirement to have a supervisor approve the penalties in writing prior to the initial determination of assessment. In *Chai v. Commissioner*, the Second Circuit held that the supervisory approval requirement is an element of a penalty claim for which the IRS bears the burden of production, and the court allowed the taxpayer to raise the lack of supervisory approval after trial.³⁸ Following *Chai*, the United States Tax Court vacated its 2016 decision in *Graev v. Commissioner*, where it had held that it was premature to conclude that the IRS had failed to comply with the supervisory approval requirement during trial because the penalty had not yet been assessed and written approval of the initial determination of the assessment could occur any time before the assessment.³⁹

*Graev v. Commissioner (Graev III)*⁴⁰

In late 2017, the Tax Court overruled in part its 2016 *Graev* decision and held that it was appropriate in the deficiency proceeding to consider the taxpayers' argument that the IRS failed to comply with the IRC § 6751(b)(1) supervisory approval requirement. The Graevs had claimed a charitable deduction for the donation of a facade easement. A revenue agent disallowed the deduction and proposed penalties. The agent's manager approved a 40 percent gross valuation misstatement penalty under IRC § 6662(h). IRS Counsel subsequently recommended the IRS assert, in the alternative, the 20 percent accuracy-related penalty under IRC § 6662(a). The revenue agent revised the notice of deficiency to include both penalties for the alternative noncash contributions, as recommended, but did not resubmit it for written supervisory approval. In litigation, the IRS conceded the 40 percent penalty, but continued to assert the 20 percent penalty. In the amendment to the answer, the IRS also asserted for the first time IRC § 6662(a) penalties at the 20 percent rate for the cash charitable contribution deduction and carryover deduction.

The Tax Court agreed with *Chai* that compliance with the supervisory approval requirement was part of the IRS's burden of production under IRC § 7491(c).⁴¹ However, the court did not adopt *Chai*'s holding that the burden of proof with respect to the penalties also rests with the IRS.⁴² The court found the IRS satisfied the IRC § 6751(b) requirement with respect to the alternative noncash contributions included in the notice of deficiency because the IRS Area Counsel docket attorney's memorandum, recommending the IRS assert the 20 percent penalty in the alternative, was approved in writing by his immediate supervisor, an Associate Area Counsel.⁴³ As to the cash charitable contribution deduction, which was not raised until the amendment to the answer, the court found the IRS had also met its burden because the amendment to the answer was approved in writing by the supervisor of the attorney who made and filed the amendment.⁴⁴

38 *Chai v. Comm'r*, 851 F.3d 190 (2d Cir. 2017).

39 *Graev v. Comm'r*, 147 T.C. No. 16 (2016), vacated, Docket No. 30638-08 (T.C. Mar. 30, 2017).

40 149 T.C. No. 23 (2017) (hereinafter *Graev III*). This decision is the third in a series of Tax Court decisions related to the Graevs' liability for tax years 2004 and 2005.

41 149 T.C. No. 23.

42 149 T.C. No. 23, 2017 U.S. Tax Ct. LEXIS 58 at *15 n.20 ("Once the Commissioner's burden of production is met, the taxpayer has the burden of proof with respect to defenses, *Higbee v. Commissioner*, 116 T.C. at 446, except that if the Commissioner pleads a new matter, an increase in deficiency, or an affirmative defense in the answer, the burden of proof is on the Commissioner.").

43 149 T.C. No. 23.

44 *Id.*

The taxpayers argued that, although Chief Counsel attorneys can sometimes make the initial determination of penalties, they never have the authority to make the initial penalty determination if the penalties are included in the notice of deficiency. The court rejected this argument and the argument that an initial determination cannot take the form of advice. The court found nothing in the legislative history that would suggest the person considered to make the initial determination is dependent on whether the penalty is included in the notice of deficiency.⁴⁵ Further, the court found that an initial determination under IRC § 6751(b), whether made by an examination employee or Chief Counsel attorney, is advice until it receives supervisory approval and is finalized by the Commissioner or one of his agents.⁴⁶

Other Decisions Addressing IRC § 6751(b)

Of the 120 cases we reviewed this year, there were eight decisions where the court found the taxpayers not liable for the accuracy-related penalty under IRC § 6662(b)(1) or (b)(2) because the IRS did not meet its burden of production with respect to the supervisory approval requirement.⁴⁷ In two of these eight cases, the court refused to reopen the record to allow additional evidence of compliance with IRC § 6751(b).⁴⁸ In addition to *Graev III*, in ten of the cases reviewed, the court specifically noted that the IRS met its burden of production with respect to the IRC § 6751(b) requirement, including two cases where it chose to reopen the record to allow evidence of compliance.⁴⁹ In *Dynamo Holdings Limited Partnership v. Commissioner*, an opinion not included in the 120 cases because it was not a final decision on the merits of IRC § 6662, the taxpayers' motion to dismiss the accuracy-related penalties based on lack of supervisory approval was denied.⁵⁰ The court concluded that under IRC § 7491(c), the IRS did not have the burden of production with respect to the penalties because it was a partnership-level proceeding, which is not a proceeding with respect to an individual and by its nature inconsistent with IRC § 7491(c), which relates to liability. However, the court noted that the IRS's not bearing the burden of production does not necessarily mean a motion by the IRS to reopen the record should be denied. A taxpayer may raise the lack of supervisory approval as a defense to the penalties. Then the IRS might want to reopen the record to demonstrate compliance if the issue was properly raised as a defense. However, in *Dynamo Holdings*, the partnership did not raise the lack of supervisory approval until after the record was closed and the case was fully submitted, and did not seek to reopen the record to argue there was no written approval.

Dynamo Holdings and the other cases where the court either did or did not allow for the record to be reopened demonstrate the confusion and variability following the aftermath of the *Chai* and *Graev* decisions. In June 2018, the IRS Office of Chief Counsel issued a Notice, explaining how to address IRC § 6751(b) issues in litigation.⁵¹ The Notice advises that if an attorney raises the penalty in an answer or amended answer, the attorney's immediate supervisor must provide written approval. If an IRS employee receives a recommendation from a Chief Counsel attorney that a penalty should be asserted, the Notice states that the attorney should advise the IRS employee to document his or her acceptance of that recommendation and have his or her immediate supervisor approve the acceptance in

45 149 T.C. No. 23.

46 *Id.*

47 See, e.g., *Ford v. Comm'r*, T.C. Memo. 2018-8, *aff'd*, 2018 U.S. App. LEXIS 31221 (6th Cir., Nov. 5, 2018); *Azam v. Comm'r*, T.C. Memo. 2018-72.

48 *Rademacher v. Comm'r*, T.C. Memo. 2018-43; *Azam v. Comm'r*, T.C. Memo. 2018-72.

49 *Fiedziuszko v. Comm'r*, T.C. Memo. 2018-75; *Sarvak v. Comm'r*, T.C. Memo. 2018-68.

50 150 T.C. No. 10 (2018). The taxpayers in these consolidated cases were a corporation and the tax matters partner of a partnership. The IRS sought to impose the accuracy-related penalty only against the tax matters partner.

51 IRS Chief Counsel Notice Section 6751(b), Compliance Issues for Penalties in Litigation, CC-2018-006 (June 6, 2018).

writing. In cases where there is no sufficient evidence to meet the burden of production with respect to the supervisory approval requirement, the Notice advises Counsel attorneys to concede the case.

Reasonable Cause

*Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner*⁵²

The taxpayer, a foreign corporation, bought an interest in a U.S. limited liability company that was a partnership for tax purposes. In 2008, the partnership redeemed the taxpayer's interest and made two liquidating payments to the taxpayer. The taxpayer did not report any gain from the redemption. Although the taxpayer conceded that the gain realized that was attributable to U.S. real property interests was taxable income, the taxpayer challenged the remainder of the gain that was not U.S.-source income and not effectively connected to a U.S. trade or business, and the accuracy-related penalty for the conceded liability.

The court found the taxpayer was not liable for the accuracy-related penalty because the taxpayer established reasonable cause and good faith. The court noted that the foreign corporation had no other involvement in U.S. business, outside the investment in the partnership. The taxpayer's central financial officer did not understand the concept of a partnership for tax purposes. The taxpayer relied on advice from a trusted advisor to hire a tax professional, which the court found was reasonable given what little the taxpayer knew of the U.S. tax system. Although the tax professional did not specialize in international tax or have an LL.M. degree, the court found that as a licensed attorney and certified public accountant, the tax professional met the *Neonatology* test requiring "a competent professional who had sufficient expertise to justify reliance."⁵³

*Petersen v. Commissioner*⁵⁴

The married taxpayers were shareholders of a closely held S corporation, which formed an employee stock ownership plan (ESOP) and transferred stock and cash to the related ESOP trust. As a matter of first impression, the court held that the entity holding the corporation's stock for the benefit of its ESOP participants was a "trust" under the Code. Also as a matter of first impression, the court held the S corporation and employees taking part in the ESOP were "related persons" under IRC § 267(a), which defers deductions for expenses paid by a taxpayer to a related person until those payments are includable in the person's gross income. In determining the taxpayers met the reasonable cause and good faith exception to the accuracy-related penalty, the court relied solely on the fact that the application of IRC § 267(a) to employers and ESOP participants was a question of first impression. The court noted that it had previously decided not to impose a penalty where it was an issue of first impression and the statutory language was not fully clear.⁵⁵ Because the taxpayers made a good-faith effort to assess their tax liabilities properly and acted reasonably and in good faith, the court refused to impose any accuracy-related penalty.

⁵² 149 T.C. No. 3 (2017).

⁵³ 149 T.C. No. 3, 2017 U.S. Tax Ct. LEXIS 36 at *51 (quoting *Neonatology Assocs., P.A. v. Comm'r*, 115 T.C. at 99).

⁵⁴ *Petersen v. Comm'r*, 2017 WL 2558852 (T.C. 2017), appeal docketed, No. 17-9003 (10th Cir., Aug. 8, 2017).

⁵⁵ *Id.* at *26 (citing *Hitchens v. Comm'r*, 103 T.C. 711, 719-720 (1994)). See also *Avrahami v. Comm'r*, 2017 WL 3610601 (T.C. Aug. 21, 2017), another case we reviewed this year, in which the court found reasonable cause and good faith based partly on the fact that the issue involving a captive insurance company was one of first impression.

*McGuire v. Commissioner*⁵⁶

The married taxpayers received the advanced premium tax credit (APTC) under the Affordable Care Act, which was paid directly to their health insurance provider to reduce their insurance premiums. During the tax year, Mrs. McGuire, who was not working at the start of the year, received a job that increased their household income above 400 percent of the federal poverty level, disqualifying them for the APTC. The taxpayers made repeated attempts to notify their health insurance provider of this change in income. However, their health insurance provider did not make any changes to account for this change in income, nor did it update the taxpayers' address after the taxpayers notified them of this change. Thus, the taxpayers did not receive correspondence from the provider or Form 1095-A, *Health Insurance Marketplace Statement*.

When the taxpayers filed their annual return, they did not report the APTC of \$7,092 that was paid to the healthcare provider. First, the court noted that in the notice of deficiency, the IRS made “a boilerplate determination of an accuracy-related penalty” by identifying “four possible causes for the underpayment: negligence, a substantial understatement of income tax, a substantial valuation misstatement, and a transaction lacking economic substance.” The court immediately disregarded the latter two as having no relevance to the facts of this case. Likewise, the court disregarded the negligence penalty, noting that the IRS had the burden of production with respect to penalties but did not provide any evidence as to why the negligence penalty might apply.⁵⁷ Finally, the court determined that even though the amount of understatement met the threshold under IRC § 6662(d)(1)(A), the taxpayers were not liable for the accuracy-related penalty due to reasonable cause and good faith. The court stated that not receiving an information return generally is not enough in and of itself to constitute reasonable cause. However, the court noted that it had recently held in *Frias v. Commissioner* that nonreceipt of an information return could contribute to a reasonable cause finding if the taxpayer did not know or have reason to know about receiving the income.⁵⁸ The court noted that the taxpayers did not receive the Form 1095-A, and the APTC was paid directly to the health insurance provider. The taxpayers had relied on a third party (the healthcare provider) to properly determine and adjust their eligibility for the APTC. In addition, the taxpayers relied on a certified public accountant to prepare their return.

Calculation of the Understatement*Galloway v. Commissioner*⁵⁹

The married taxpayers filed a return claiming the American Opportunity Tax Credit (AOC), which was calculated on Form 8863 as \$7,500 (\$2,500 for each of their children). However, due to what appears to be a clerical error, the taxpayers only reported the refundable portion of the credit (\$3,000) on their Form 1040, and omitted the \$4,500 nonrefundable portion. The taxpayers claimed a refund of \$4,303 on their return, but during processing the IRS adjusted their return to account for the nonrefundable portion of the AOC and issued a refund of \$8,803. Subsequently during examination, the IRS disallowed the AOC in full.

56 *McGuire v. Comm’r*, 2017 WL 3730620 (T.C. Aug. 28, 2017).

57 The National Taxpayer Advocate has previously written about how the IRS’s assessment of negligence penalties by automatic means without speaking to the taxpayer infringes on taxpayer rights. National Taxpayer Advocate 2014 Annual Report to Congress 404-410 (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)*).

58 In *Frias v. Commissioner*, the taxpayer was on maternity leave from her job and did not know or have reason to know that her loan from her retirement plan was treated as a deemed distribution because her employer did not deduct the loan repayment amounts from her paycheck. T.C. Memo. 2017-139.

59 149 T.C. No. 19 (2017).

Mr. Galloway conceded at trial that they were not entitled to any portion of the AOC, and the opinion suggests the AOC had already been claimed for the children in the prior four taxable years, making the children ineligible. However, the taxpayers argued that the IRS did not meet its burden of production with respect to the accuracy-related penalty under IRC § 6662(b)(2) because the understatement should be limited to \$3,000, which was the amount of the refund they sought on their return. The taxpayers posited that had the IRS not issued them the refund, the amount of the deficiency would be under the statutory \$5,000 threshold. The court disagreed, citing the definition of an understatement in IRC § 6662(d)(2)(A), which states that the amount of tax shown on a taxpayer's return is "reduced by any rebate."⁶⁰ The court rejected the argument that the taxpayers were being penalized by the IRS's action and noted that for a refund to meet the definition of "rebate," it must be based on a determination that the tax imposed is less than the tax shown on the taxpayer's return. The court considered the tax shown on the return to include the nonrefundable AOC shown on the Form 8863 and considered its omission on the Form 1040, *U.S. Individual Income Tax Return*, to be a clerical error.

The taxpayers argued that the amount of the understatement should nonetheless be reduced to \$3,000 because there was substantial authority for the taxpayers to not claim the nonrefundable portion of the credit. In the alternative, they argued the form used to calculate the credits served as a disclosure, and there was a reasonable basis for the taxpayers not to claim the \$4,500 on the return. The court dismissed these arguments because:

We do not view petitioners as having claimed only a \$3,000 refundable AOC: Their Form 8863 reported a total AOC of \$7,500. Petitioners are not subject to the accuracy-related penalty for their failure to claim a \$4,500 nonrefundable AOC on their Form 1040 but instead for their claim of such a credit on their Form 8863. Because the refundable portion of the AOC is, by definition, 40% of the total AOC to which a taxpayer is entitled, sec. 25A(i)(6), claiming a \$3,000 refundable AOC and no nonrefundable AOC cannot be supported by substantial authority.⁶¹

Finally, the taxpayers argued reasonable cause and good faith, stating they attempted to follow the instructions of a return preparation program and the error was due to confusion. The court relied heavily on the unambiguous statutory language that states the credit is only available for the first four years of post-secondary education and the clear instructions on Form 8863 to conclude that the taxpayers' confusion was not reasonable based on the circumstances.

This case demonstrates that an understatement can give rise to an accuracy-related penalty where the taxpayer actually entered a larger refund on part of his or her return, but did not claim it, and the IRS adjusted the return. In a footnote, the court notes that in theory, an understatement could arise from a refund that is based on an erroneous third-party information return, but presumably a taxpayer would be able to show reasonable cause and good faith if he or she did nothing to initiate the refund and bore no responsibility for the erroneous third-party reporting.⁶²

60 *Galloway*, 149 T.C. No. 19.

61 *Galloway*, 149 T.C. No. 19, 2017 U.S. Tax Ct. LEXIS 53 at *20.

62 *Galloway*, 149 T.C. No. 19, 2017 U.S. Tax Ct. LEXIS 53 at *19 n.4.

CONCLUSION

The accuracy-related penalty under IRC § 6662(b)(1) and (2) remains the number one most litigated tax issue, continuing a trend from the last five years. The *Graev III* decision should bring more clarity for future cases by establishing that the Tax Court will follow the *Chai* decision with respect to the requirement for the IRS to show compliance with IRC § 6751(b) as part of its burden of production. However, because of the multiple cases that were initiated before *Graev III* and some even before *Chai*, the Tax Court is likely to continue to grapple with under what circumstances it is appropriate to reopen the record to allow the IRS to demonstrate compliance. This year, we saw courts allow it in some circumstances, but not in others. In addition, because the Tax Court declined to adopt *Chai*'s holding that compliance with IRC § 6751(b) is part of the burden of proof, there may be some uncertainty for taxpayers depending on where their cases may be appealed.

The cases of *Petersen v. Commissioner* and *McGuire v. Commissioner* were positive for taxpayers. In *Petersen*, the court suggested that issues of first impression should generally give rise to a reasonable cause finding. Conversely, in *McGuire*, the court held that nonreceipt of an information return does not generally constitute reasonable cause by itself, but that such nonreceipt could contribute to a reasonable cause finding.

The *Galloway* decision shows that the IRS can find an accuracy-related penalty as a result of an adjustment it makes to a return, based on an attached form. The court mentioned in a footnote the possibility of finding an understatement based on a third-party's information return but noted that such a taxpayer could qualify for the reasonable cause exception. Future cases may show how far the IRS can go in terms of basing an accuracy-related penalty on an adjustment it makes to a return.