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SUBSTANTIAL AUTHORITY UPDATE: TAX PENALTY AVOIDANCE BY GOOD FAITH REFERENCE TO JUDICIAL, ADMINISTRATIVE AND LEGISLATIVE AUTHORITIES

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ABSTRACT

Internal Revenue Code (IRC) §§ 6662(b) authorizes the Internal Revenue Service (IRS) to impose a penalty if an underpayment of income tax by a taxpayer exceeds a computational threshold called a substantial understatement. An understatement is reduced, however, by the portion attributable to an item for which the taxpayer had "substantial authority." Substantial authority is defined in Treasury Regulation §1,6662-4(d)(2), but taxpayers are required to recognize and take into account the relative weight of various authorities such as regulations, revenue rulings, legislative histories, court cases and IRS pronouncements. Alternatively, taxpayers may make a "reasonable cause" argument for the waiver of underpayment penalties, claiming that they made a good faith effort to comply with the IRC requirements. We examine the manner and extent to which courts have been willing to waive penalties based on substantial authority cited by taxpayers. We also analyze cases in which taxpayers have claimed reasonable cause. We draw conclusions about judicial responses to these two penalty avoidance arguments.

JEL: H26, K34, M48

KEYWORDS: Preparer Penalties, Substantial Authority, Taxation, Tax Penalties, Accuracy-Related Penalty

INTRODUCTION

The Taxpayer Advocate Service is an independently functioning organization within the Internal Revenue Service. Each year the United States Taxpayer Advocate prepares and delivers to Congress an annual report that for the last seven years has included data about the top ten tax issues most litigated in federal courts (Taxpayer Advocate Service, 2015, 2014, 2013, 2012, 2011, 2010, 2009). As has been the case for all years since this reporting protocol was initiated in 2008, litigation of accuracy-related tax penalties has made this top ten list. In fact, for the most recent annual report, disputes involving these penalties were more numerous than for any other issue (Taxpayer Advocate Service, 2015, p. 426).

Internal Revenue Code § 6662(b) authorizes the IRS to impose a penalty if a taxpayer's negligence or disregard of rules or regulations causes a material underpayment of tax, or if an underpayment amounts to a substantial understatement (Internal Revenue Code, 2016). An income tax preparer may also be subject to a penalty under Code § 6694(a) if the preparer knew or should have known that a tax return position taken by his or her client would or did result in an understatement of taxable income. For purposes of the penalty calculations, Code § 6662(d)(2)(B) provides that the amount penalized as an understatement can be reduced by the portion attributable to an item for which the taxpayer had "substantial authority."

As a rule, the tax treatment of an item has substantial authority only if the weight of published cases, rulings and other legal and administrative authorities is substantial in relation to the weight of opposing authorities. That is, if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. Treasury regulation Treas. § 1.6662-4(d)(3)(iii) provides a lengthy list of what constitutes authority for purposes of the substantial authority exception. Treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not considered to be authoritative as such. However, the authorities underlying those opinions may give rise to substantial authority. Code § 6662(d)(2)(B) also provides for penalty abatement to the extent that a taxpayer's (erroneous) tax position was adequately disclosed in the tax return and there is a reasonable basis (even without substantial authority) for the treatment of item.

Separately, Internal Revenue Code § 6664(c) provides a more subjective exception to the section 6662(a) accuracy-related penalty if there was reasonable cause for the portion of the underpayment subject to the penalty and the taxpayer acted in good faith with respect to that portion. The determination as to 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. These factors can include such considerations as the extent of a taxpayer's efforts to determine the proper tax liability, the taxpayer's tax knowledge, education and experience, and whether the taxpayer sought the advice of a competent professional tax adviser.

In some cases, taxpayer reliance on such advice of a competent tax professional can also help to establish reasonable cause. To qualify for such reasonable cause, it must be shown that the advice was objectively reasonable and based on all pertinent facts and circumstances and the law as it relates to those facts and circumstances, and not based on any unreasonable factual or legal assumptions. In addition, the advisor may not solely or unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person (106 Ltd. v. Commissioner, 2012; Neonatology Associates, P.A. v. Commissioner, 2000; United States v. Boyle, 1985).

The Internal Revenue Service often assesses accuracy-related penalties along with tax deficiencies. Questions about whether substantial authority or reasonable cause exists, for penalty abatement purposes, are often decided only after taxpayers appeal the tax and penalty assessments to a federal court. As a result of the litigation of these tax and penalty assessments, a body of reported court opinions has been generated. This paper applies legal case study research methodology in an effort to analyze many of the more recent court opinions, in an effort to determine whether they might yield practical guidance about what constitutes substantial authority for purposes of penalty relief, and what does not. Particular attention is paid to those factors that, in the view of federal courts, weigh in favor of penalty relief based on substantial authority or reasonable cause considerations.

In the remainder of this paper we will consider the prior research and review the literature regarding accuracy-related penalties. In the context of that literature, we consider recent cases wherein taxpayers have pointed to substantial authority pursuant to Internal Revenue Code § 6662(d)(2)(B) in their efforts to avoid the imposition of accuracy-related penalties. We then consider recent cases wherein taxpayers have pointed to reasonable cause pursuant to Internal Revenue Code § § 6664(c) in their efforts to avoid the imposition of accuracy-related penalties. We conclude with an analysis of these cases and their implications for future research.

PRIOR RESEARCH OF ACCURACY-RELATED PENALTY CASES

Much of the prior analysis of penalty-abatement court cases has been published in The Tax Adviser, a publication of the American Institute of Certified Public Accountants. Most recently, Beavers (2014) published in that journal a case study of AD Inv. 2000 Fund LLC v. Commissioner (2014), a tax and penalty appeal involving two limited liability companies who had relied on opinion letters from a law firm when they reported certain losses to the Internal Revenue Service. The taxpayers insisted that, as a result of the legal opinion letters (which were, in the opinion of the taxpayers, subject to attorney-client privilege), they reasonably believed that the tax losses were properly reported. The Internal Revenue Service countered by asserting that the taxpayers had effectively waived their attorney-client privilege by claiming reliance on the tax opinion letters. The court ruled in favor of the government, and Beavers observed that, "simply put if a taxpayer raises a defense that can be effectively disproven only through the discovery of attorney-client communications, the taxpayer impliedly waives attorney-client privilege" (p. 524).

Puckett (2012) analyzed five accuracy-related penalty cases in an earlier issue of The Tax Adviser. In all but one of the cases studied and discussed by Puckett, the taxpayers' appeals of the assessment of accuracy-related penalties were denied. The court granted relief in the fifth case, McGowen v. Commissioner (2011), after noting that the taxpayer lacked knowledge and experience in tax law, reasonably believed that the income item in question was not taxable, and determined in good faith to not report the income item on her 2006 income tax return. Puckett observed that even though the court viewed the taxpayer's efforts in reporting her income tax liability favorably, the court "could have gone either way, considering that the taxpayer was a financial analyst and at least somewhat sophisticated" (p. 305).

A two-part series in The Tax Adviser in 2010 described and explained the accuracy-related penalties and the manner in which they are administered. The first article (Cook & Ocheltree, 2010a) set forth and explicated the rules and requirements pertaining to the assertion of the penalties. The second (Cook & Ocheltree, 2010b) focused on rules and requirements regarding the defenses that might be raised by taxpayers, such as substantial authority or reasonable cause (as set forth above). Both articles pointed primarily to the various statutory provisions, regulations and administrative pronouncements that serve as guidance for navigating these penalties. Only a handful of court cases were cited, and none were analyzed in detail.

Keenan and Patel (2009) provided an analysis of January Transport, Inc. v. Commissioner (2008), a case involving the taxpayer's assertion that the taxpayer's good faith reliance on the advice of a tax professional was proper grounds for penalty relief. In that case the court denied the taxpayer's request for penalty relief, because the taxpayer relied primarily on an article regarding pending, rather than existing, legislation. The court concluded that this reliance was not reasonable and did not trigger the reasonable cause exception under Internal Revenue Code § 6664(c). Keenan and Patel observed that the January Transport case "serves as a good reminder for taxpayers and their tax professionals that reliance upon a tax professional's advice does not guarantee that a taxpayer cannot be assessed an accuracy-related penalty if the tax return position does not meet basic reporting standards" (p. 253).

Other recent guidance in The Tax Adviser has included information about how accuracy-related penalties are calculated (Keenan, Lessman & Hummel, 2013); the impact of substantial authority requirements on preparer penalty assessments (Gardner, Kastantin and Maas, 2012; Beavers, 2009); the relevance of substantial authority to the propriety of tax return positions for purposes of tax accountants' compliance with professional ethics rules (Gardner, Eide, May & May, 2012); and the manner in which substantial authority is taken into account by public corporations for purposes of their compliance with the reporting requirements of a newly issued tax form (Hennig & Sonnier, 2011).

In addition to the contributors to The Tax Adviser as described above, other authors have provided succinct and helpful summaries of the accuracy-related penalty regime. Examples include Skarlatos (2015), who offers guidelines for ascertaining the level of certainty that taxpayers and tax preparers should have before signing tax returns; Knight & Knight (2013), who provide a comprehensive survey and analysis of extant court cases addressing the issues surrounding reliance on a tax professional as grounds for a reasonable cause exemption from the imposition of penalties; and Purcell, Sansone & Tracy (2010), who consider the practice-related implications of the accuracy-related penalties and the manner in which they integrate with professional ethics, standing to practice before the Internal Revenue Service, and tax preparation and consultation generally.

In-depth investigations of the legal and public policy aspects tax penalties have also become an important part of the body of literature on this topic. Wright (2015), for example, takes into account the Internal Revenue Code § 6662(b) accuracy-related penalties (applicable primarily to tax positions taken on tax returns) as part of his larger critique of the separate Internal Revenue Code § 6676 penalties applicable to bogus refund claims based on transactions lacking economic substance. And Moldenhauer (2012) considers the conflict interest and related professional ethics implications of Internal Revenue Code § 6694(a) preparer penalties as a matter of public policy.

Taken together, the above body of literature has served to explicate the structure of, and articulate the parameters surrounding, the accuracy-related penalty regime of the Internal Revenue Code. This paper will add to this body of knowledge by: (a) drawing from the body of case law set forth in all of the annual reports to date made by the United States Taxpayer Advocate, that is, the reports to Congress from 2009 through 2015; (b) examining this body of case law to discover the types and categories of authorities that courts have acknowledged and affirmed as being substantial authority under Code § 6662(d)(2)(B) for purposes of penalty relief even when taxpayers have been unsuccessful in appealing their underlying tax positions; and (b) examining this body of case law to discover the factors that courts have emphasized while granting Internal Revenue Code § 6664(c) reasonable cause relief. In doing so, this paper will effectively expand and update the earlier case analysis performed by Knight and Knight (2013).

RECOGNITION OF SUBSTANTIAL AUTHORITY UNDER CODE § 6662(d)(2)(B)

As noted above 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. Treasury regulations provide that this standard can be met if the taxpayer's position reasonably relies on one or more of the substantial authorities listed in Treas. Reg. § 1.6662-4(d)(3)(iii). These can include information such as sections of the IRC; proposed, temporary, or final regulations; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; and congressional intent as reflected in committee reports. Absent from this list are opinions, analyses, articles and treatises published by non-governmental journals and other scholarly outlets, such as the journal Accounting and Taxation, irrespective of the quality, extent of research, insightfulness, credibility or expertise that might be demonstrated by such efforts.

In the seven annual reports to Congress made by the United States Taxpayer Advocate from 2009 to 2015, a total of 846 accuracy-related penalty court opinions were identified (Taxpayer Advocate Service, 2015, 2014, 2013, 2012, 2011, 2010, 2009). Of these, 631 were identified by the Taxpayer Advocate as having been decided in favor of the Internal Revenue service; 161 were identified as having been decided in favor of the taxpayer(s); 53 were identified as split decisions; and one case was remanded to the lower court for further proceedings. Many of the 53 cases identified as split decisions involved penalty relief for some, but not all, of the accuracy-related penalties assessed by the Internal Revenue Service.

As we examined the opinions in the 846 cases listed by the Taxpayer Advocate, we observed that 22 cases specifically addressed in some detail the issue of whether the assessed accuracy-related penalties should be reduced by the portion attributable to items for which the taxpayer(s) had proffered substantial authority pursuant to Internal Revenue Code § 6662(d)(2)(B). In 18 of these 22 opinions, the courts concluded that the authorities referenced by the taxpayer(s) did not meet the standard for substantial authority. However, the courts decided in four cases that the authority relied upon was substantial and qualified the taxpayer(s) for penalty relief; two of those four cases were separate proceedings involving the same taxpayer and many of the same issues. These four cases involving three taxpayers are discussed below.

The first of the four substantial authority cases referenced by the Taxpayer Advocate was NPR Investments, LLC v. United States (2010). NPR involved three attorneys whose law firm had invested in a foreign currency exchange tax shelter scheme in connection with one of their clients. The attorneys obtained a tax opinion from a prominent tax attorney; the opinion provided an analysis of extant case law and concluded that the case law strongly supported the reporting position taken by the three attorneys in regard to the foreign currency tax benefits. The taxpayers appealed the IRS's denial of their claimed tax shelter benefits, and the trial court upheld the government on this issue. The trial court also reviewed the taxpayers' assertion that substantial authority supported their position for purposes of a relief from the accuracy-related penalties assessed by the government. On this issue, the trial court ruled that acted reasonably and in good faith in relying on their tax advisors' advice with respect to their investments in the underlying transactions. On appeal by the government, the Fifth Circuit applied its own critical analysis to the authorities relied upon by the taxpayers and overturned the trial court's grant of penalty relief to the taxpayers (NPR Investments, LLC v. United States, 2014).

Two of the four substantial cases identified by the Taxpayer Advocate involved the same taxpayer, a partnership known as Castle Harbor, and the same underlying set of facts. Castle Harbor had been formed by General Electric Capital Corporation, the owner of a fully depreciated fleet of aircraft leased to commercial carriers. General Electric Capital Corporation had hoped to use Castle Harbor as a vehicle for raising cash from certain Dutch banks by assigning income to the banks (which were not subject to U.S. taxation. The Internal Revenue Service challenged this arrangement by reallocating taxable time back to General Electric Capital Corporation and away from the Dutch banks. An early court proceeding in the matter (TIFD III-E Inc. v. United States, 2004), which was later overturned (TIFD III-E, Inc. v. United States, 2006), had concluded that the taxpayers had properly interpreted the statutory and case law when they allocated taxable income to the Dutch banks.

A later court proceeding in the same district court (TIFD III-E Inc. v. United States, 2009) resulted in a less favorable interpretation of the statutory and case law, but acknowledge that the earlier favorable ruling in 2004 constituted substantial authority for purposes of penalty relief under Internal Revenue Code § 6662(d)(2)(B). This ruling in regard to the accuracy-relief penalties was overturned on appeal (TIFD III-E Inc. v. United States, 2012), but on remand the same district court ruled that even if the substantial authority exception did not apply, the Internal Revenue Code § 6662(d)(2)(B) provision for penalty abatement if there is proper disclosure and a reasonable basis (even without substantial authority) applied (TIFD III-E Inc. v. United States, 2014). The two pro-taxpayer rulings (i.e., the 2009 and 2014) rulings were cited by the Taxpayer Advocate, along with the 2012 pro-government ruling. A later reversal of the 2014 pro-taxpayer ruling, TIFD III-E Inc. v. United States (2015) occurred after the cutoff date for the Taxpayer Advocate's 2015 annual report.

Southgate Master Fund v. United States (2009) was the fourth case in which penalty-abating substantial authority was recognized, as acknowledged by the Taxpayer Advocate. In that case, the taxpayer claimed capital losses that appeared to fall within a literal reading of the Internal Revenue Code, but the court ruled that the transaction that created the high basis in the stock transaction lacked economic substance and therefore must be disregarded for tax purposes. However, the court also ruled that the taxpayer's literal interpretation of the statute, as articulated and elaborated in two tax opinions obtained by the taxpayer, constituted substantial authority. As noted by the Taxpayer Advocate, this ruling was affirmed on appeal to the Fifth Circuit (Southgate Master Fund v. United States, 2011).

RECOGNITION OF REASONABLE CAUSE UNDER CODE § 6664(c)

Pursuant to Internal Revenue Code § 6664(c) the accuracy-related penalty does not apply in situations where it is determined that the taxpayer acted with reasonable cause and in good faith. A reasonable cause determination requires that all of the pertinent facts and circumstances be taken into account. Generally, the most significant and persuasive factor is the extent to which the taxpayer made an effort to determine the proper tax liability. Our examination of the 846 court listed by the Taxpayer Advocate revealed that 169 cases were decided in favor of taxpayers who were able to make a good faith showing of reasonable cause as allowed by Internal Revenue Code § 6664(c). We have selected a few exemplary cases that reflect the reasoning the courts have applied in these 169 cases.

The first of these cases is Price v. Commissioner (2014), involving an auto dealer who engaged in a side activity which consisted of breeding, boarding, training, hauling, and showing of horses. The Internal Revenue Service objected to the auto dealer's attempt to offset auto dealership profits with losses from the horse activity, insisting that these were separate undertakings. When the taxpayer appealed the matter, the United States Tax Court agreed with the Internal Revenue Service that the two undertakings did not share organizational and economic overlap, that any economic benefit between the two activities was directed from the horse activity to the dealership for the convenience of the auto dealer, and that the activities were wholly dissimilar. The Tax Court did however waive the accuracy-related penalties that had been assessed by the Internal Revenue Service. In doing so, the Tax Court observed that the auto dealer had hired a certified public accountant and had consulted the accountant about the various tax issues. The taxpayer had also taken the horse activity seriously, even though the activity did not qualify as a trade or business for tax purposes.

In Humphrey, Farrington & McClain, P.C. v. Commissioner (2013), a litigation law firm that represented plaintiffs on a contingent fee basis in cases involving tobacco, toxic-substance exposure, products liability, false advertising, consumer antitrust, securities fraud, medical malpractice, and ERISA benefits. The firm attempted to deduct on a cash basis pre-litigation and trial-related expenditures such as court-filing fees, court reporters, expert witnesses, depositions, medical records, medical examinations, travel, phone calls, faxes, and photocopying. The law firm created an internal classification system that attempted to account for the relative risks of losing its cases, and used this system to determine whether to claim deductions for the advanced expenses. It did not claim deductions for all of the advanced expenses: For example, it capitalized some of the advanced expenses in the net-fee category. The Internal Revenue Service denied the immediate deductions for all of these expenditures, irrespective of the law firm's classification system, contending that all of them were more in the nature of nondeductible loans (at least until each respective case is resolved in one way or another). The Internal Revenue Service also assessed accuracy-related penalties. When the law firm appealed the matter to the Tax Court, the tax deficiencies were upheld but the penalties were waived on the basis of reasonable cause. In arriving at this conclusion, the Court made note of the efforts to which the law firm went in their efforts to distinguish what they believed to be properly deductible expenditures, from expenditures they believed ought to have been capitalized.

The case of G.D. Parker, Inc. v. Commissioner (2012) involved various disputes between the taxpayer and the Internal Revenue Service, including a conflict over whether the taxpayer was entitled to a capital loss and related capital loss carryovers arising from the sale of stock. Although the Tax Court issued a memorandum opinion supporting the government's position in regard to the capital loss and carryovers, the court also granted reasonable cause relief from the imposition of accuracy-related penalties. The court concluded that the advice received by the taxpayer from its accountants took into account all of the facts and circumstances of the transactions and the law as it related to those facts and circumstances. The court also expressed its belief that the advice was based on unreasonable factual or legal assumptions, and that it was reasonable for the taxpayer to rely on its accountants in deducting the capital loss and related carryovers.

Finally, Esgar Corp. v. Commissioner (2012) involved the Internal Revenue Service's challenge of the charitable contribution deduction taken by the taxpayers as a result of its donation of a conservation easement to the State of Colorado. In particular, the government challenged the value of the underlying land, insisting that the highest and best use, and the use on which value was properly established, was agricultural, not the more valuable gravel extraction use on which the taxpayers had relied. The Tax Court agreed with the government's position in regard to the valuation and related deductibility of the conservation easement, but set aside the Internal Revenue Service's assessment of accuracy-related penalties based on reasonable cause. The Court agreed with the taxpayers that they had made a good faith investigation by relying on their adviser and his accounting firm, by obtaining a core sampling report of the underlying valuable gravel reserves, and by obtaining a qualified appraisal from a qualified appraiser.

CONCLUSION

In this paper, we set out to discover the extent to which arguments about reliance upon substantial authority, and, alternatively, arguments about reasonable efforts to comply with the tax rules, have served to provide relief from the imposition of accuracy-related tax penalties. Our study involved the legal case study methodology as we investigated accuracy-related penalties cases compiled by the United States Taxpayer Advocate. Those reported court opinions provided a helpful body of common law that permitted our analysis of the manner in which such penalties are waived by the courts.

Our study revealed that only a handful of such reported cases have involved a successful appeal of the assessment of accuracy-related penalties based on the objective analysis of substantial authorities under Internal Revenue Code § 6662(d)(2)(B), and most of these were overturned on appeal. On the other hand, taxpayers who relied on the somewhat lower and more subjective standard of reasonable cause under Internal Revenue Code § 6664 appeared to have fared better. Courts waived accuracy-related penalties in a significant number of cases when the courts believe that the taxpayers had made rigorous and significant efforts to ensure that the reported tax positions were reasonable and credible. These efforts have included accounting and record-keeping procedures that reflect an effort to distinguish between proper and improper tax reporting positions, consultation with tax professionals and other experts, and other good-faith efforts to allow their tax returns to reflect income clearly.

These cases also provide a basis for an inference that taxpayer efforts to point the government and the courts to court cases, rulings and other authorities – in an effort to avoid accuracy-related penalties – are likely to be more successful if those arguments are framed in a particular way. To the extent that they are framed as a sort of "tax research battle" wherein the legal authorities relied upon by the taxpayer are compared to opposing legal authorities relied upon by the government, the taxpayer appears to be disadvantaged. But to the extent that these tax authorities are framed in terms of professional advice relied upon in good faith by the taxpayer, the focus shifts from the underlying objective weight of the authorities to the more subjective extent to which the taxpayer appears to have reasonably relied upon such authority.

This paper has modeled a methodology for comparing the relative value of a reliance upon an Internal Revenue Code § § 6662(d)(2) substantial authority defense, with a reliance upon an Internal Revenue Code § 6664 reasonable cause defense as a waiver-abatement strategy. Future research might be conducted in order to do a more thorough and comprehensive analysis of the more than 100 cases reported by the Taxpayer Advocate that successfully employed a reasonable cause argument. Since the reasonable cause argument has been shown here to be more successful, as a general rule, than the substantial authority argument, both taxpayers and the U.S. government would benefit from a more detailed analysis of the various factors that contribute to the articulation of compelling and relevant reasonable cause defenses under Internal Revenue Code § 6664.

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