# Tax Return Positions, Penalties, and Penalty Defenses

# Panelists

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# Learning Objectives

- Understand the hierarchy of confidence levels for return positions and what authorities support each type of position
- Identify common accuracy-related penalties asserted by the IRS
- Understand defenses for each type of penalty

# Confidence Levels for Tax Return Positions

# Summary of Confidence Levels

Will

Should

More Likely Than Not

Substantial Authority

Realistic Possibility of Success

Reasonable Basis

Below Reasonable Basis/Frivolous

# "Will"

- At least 90% confidence
- "Will" is not defined by law, but is generally considered a virtually certain position
- "Will" level positions typically have strong textual support in the law and/or clear application of relevant case law

# “Should”

- At least 70% confidence
- “Should” is not defined by law, but is generally considered a position supported by the preponderance and weight of favorable authorities
- “Should”-level positions may involve more room for interpretation than “will”-level positions
- However, these positions have strong support in text, case law, or administrative guidance to resolve any uncertainties

# "More Likely Than Not"

- Greater than 50% level of confidence
- Regulations discuss the "more likely than not" standard in the context of various penalty defenses. Treas. Reg. 1.6662-4(d)(3)(ii), -4(f)(2)(B), -4(g)(4)
- Taxpayer must <u>reasonably believe</u> that the tax treatment is more likely than not the proper tax treatment
- Taxpayer's analysis must be based on <u>pertinent facts and authorities</u>
- The probability of being selected for an audit is not relevant
- Analogous to the "more likely than not" standard used for financial reporting purposes under FIN 48

# *Less than* "More Likely Than Not"

- "Substantial Authority"
  - At least 40% confidence
  - "Substantial Authority" is an <u>objective standard</u> and requires the <u>weight of authorities</u> supporting the treatment be <u>substantial</u> in relation to the weight of contrary authorities
  - Described by Treas. Reg. 1.6662-4(d)(2)

# What Authorities Count?

- Internal Revenue Code
- proposed, temporary and final regulations construing such statutes
- revenue rulings and revenue procedures
- tax treaties and Treasury Department and other official explanations of such treaties
- court cases
- congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers
- General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book)
- private letter rulings and technical advice memoranda issued after October 31, 1976
- actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin)
- Internal Revenue Service information or press releases
- notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin.

Treas. Reg. 1.6662-4(d)(3)(iii)

# *Less than* "More Likely Than Not"

- "Realistic Possibility of Success"
  - At least 33% confidence
  - A reasonable and well-informed analysis of the law and facts by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one-in-three (or greater) likelihood of being sustained on its merits
  - Based on AICPA SSTS No. 1

# *Less than* "More Likely Than Not" (cont'd)

- "Reasonable Basis"
  - At least 20% confidence
  - If a return position is reasonably based on one or more authorities, it will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard
  - Described by Treas. Reg. 1.6662-3(b)(3)

# Know Your Audience

- Which authorities are most relevant may depend on the IRS function that is handling the issue, which could be:
  - Service Center
  - Exam
  - Exam specialists
  - Appeals
  - IRS Counsel
  - IRS National Office

# Accuracy-Related Penalties & Defenses

# Summary of Accuracy-Related Penalties

| | Minimum Level of Authority for Defense | Adequate Disclosure? |
|---|---|---|
| Negligence (Treas. Reg. 1.6662-3) | Reasonable Basis | Not Necessary |
| Disregard of rules and regulations (Treas. Reg. 1.6662-3) | Reasonable Basis | Necessary |
| Substantial understatement (Treas. Reg. 1.6662-4) | Substantial Authority | Not Necessary |
| | Reasonable Basis | Necessary |
| Valuation misstatement (IRC 6662(e)) | Must have Reasonable Cause | Not a defense |

- Reasonable cause (IRC 6664) can be a defense to all penalties
- Special rules for substantial understatements attributable to tax shelters

# Negligence & Disregard of Rules

- Penalty: 20% of underpayment
- Definition:
    - "Negligence" means any failure to make a reasonable attempt to comply with the provisions of the Code
    - "Disregard" means any careless, reckless, or intentional disregard

Treas. Reg. 1.6662-3

# Negligence & Disregard of Rules

- Defenses:
    - There is no negligence if a position has *at least* a "reasonable basis," regardless of disclosure
    - There is no disregard of rules if a position has *at least* a "reasonable basis" *and* the taxpayer adequately disclosed the position (i.e., Form 8275 or Form 8275-R)
    - Reasonable cause under IRC 6664(c)

Treas. Reg. 1.6662-3

# Substantial Understatement

- Penalty: 20% of underpayment
- Definition:
  - "Substantial" means the understatement of income tax exceeds the greater of $5,000 or 10% of correct tax
  - For C corps, "substantial" means the understatement of income tax exceeds the lesser of $10M or 10% of correct tax

Treas. Reg. 1.6662-4

# Substantial Understatement

- Defenses:
  - There is no substantial understatement if a position has *at least* "substantial authority," regardless of disclosure
  - If a position only has a "reasonable basis," there must also be adequate disclosure of the position
  - Exceptions do not apply to tax shelters (significant purpose of Federal income tax avoidance or evasion)
  - Reasonable cause under IRC 6664(c) (but certain special rules apply for tax shelters)

Treas. Reg. 1.6662-4

# Valuation Misstatements

- Penalty: 20% for "substantial valuation misstatement" and 40% for "gross valuation misstatement"
- Definition:
  - "Substantial" means the value (or adjusted basis) of any property claimed on any return is 150 percent or more of the amount determined by the government
  - "Gross" substitutes 200% for 150%
  - Special rules for transfer pricing

IRC 6662(e), (h), Treas. Reg. 1.6662-5

# Valuation Misstatements

- Defenses:
  - Reasonable cause under IRC 6664(c)
  - There is no disclosure exception to this penalty

IRC 6662(e), (h), Treas. Reg. 1.6662-5

# Reasonable Cause (IRC 6664(c))

- No accuracy-related penalties are imposed if it is shown that:
  - there was a reasonable cause for such portion and
  - the taxpayer acted in good faith with respect to such portion
- Special rules apply to substantial underpayment penalty attributable to a tax shelter

# Reasonable Cause (IRC 6664(c))

- What is “reasonable cause”?
  - Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability
  - Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer.

Treas. Reg. 1.6664-4; see also IRM 20.1 (Penalty Handbook), specifically IRM 20.1.1.3.2 discussing reasonable cause

# Reasonable Cause (IRC 6664(c))

- What is "reasonable cause"? (*continued)*
  - An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith.
  - Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith.
  - Reliance on an information return, professional advice, or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.

Treas. Reg. 1.6664-4; see also IRM 20.1 (Penalty Handbook), specifically IRM 20.1.1.3.2 discussing reasonable cause

# Reasonable Cause (IRC 6664(c))

- Special rules for substantial understatement penalty attributable to tax shelter items
- Minimum requirements:
  - The position must have "substantial authority," <u>and</u>
  - The corporation must <u>reasonably believe</u> at the time the return was filed that the tax treatment of the item was <u>more likely than not</u> the proper treatment
- These minimum requirements, even if met, are not dispositive

Treas. Reg. 1.6664-4; see also IRM 20.1 (Penalty Handbook), specifically IRM 20.1.1.3.2 discussing reasonable cause

# Reasonable Cause (IRC 6664(c))

- Consider the privilege implications of asserting reliance on an advisor
- Even the "good faith" requirement can potentially lead to a privilege waiver when the taxpayer's state of mind is put at issue
  - Tax Court has found a privilege waiver when the IRC 6664(c) is asserted: *AD Inv. 2000 Fund LLC v. Comm'r*, 142 T.C. 248 (2014)

# Adequate Disclosure

- Treas. Regs. 1.6662-3(c) and 1.6662-4(f) describe “adequate disclosure:”
  - Disclosure on Forms 8275 (Disclosure Statement) and 8275-R (Regulation Disclosure Statement)
  - Commissioner may announce other methods via revenue procedure
  - Recurring items must be disclosed every year
  - For an item that is a carryback or carryover, the adequate disclosure must be made in the source year
- Schedule UTP
- Are Rev. Proc. 94-69 disclosures making a comeback?

# LEVELS OF CONFIDENCE FOR TAX RETURN POSITIONS

Purpose: To understand the relationship between the levels of confidence, disclosure, and potential penalties for preparers and taxpayers.

| Levels of Confidence[1] *(Percentages are approximate and represent relative levels of accuracy)* | Taxpayer Penalty | | | | Preparer Penalty | |
|---|---|---|---|---|---|---|
| | Negligence | Substantial understatement | Disregard of regs. | Tax shelter | Not a tax shelter | Is a tax shelter |
| **Will (at least 90%)**: While the term is not defined by law, this means a virtually certain position. Be cautious in using this term as it can relay a certain level of confidence.[2] | ✓ | ✓ | △ | ✓ | ✓ | ✓ |
| **Should (at least 70%)**: While not defined by law, the preponderance and weight of support is favorable. Be cautious in using this term as it can relay a certain level of confidence.[2] | ✓ | ✓ | △ | ✓ | ✓ | ✓ |
| **More Likely than Not (at least >50%)**: Reasonable belief that the tax treatment of an item at the time the return is filed is more likely than not the proper tax treatment (i.e., there is a greater than 50% chance it will be upheld if challenged by the IRS) based on an analysis of pertinent facts and authorities in the manner described in Regs. Sec. 1.6662-4(d)(3)(ii). *[Regs. Sec. 1.6664-4(f)(2)(B)]* | ✓ | ✓ | △ | ✓[3] | ✓ | ✓ |
| **Substantial Authority (at least 40%)**: An objective standard involving an analysis of the law and application of the law to the relevant facts. Substantial authority exists if the weight of the authority supporting the treatment is substantial in relation to the weight of the authority supporting contrary treatment. *[Regs. Sec. 1.6662-4(d)]* | ✓ | ✓ | △ | ⊘[3] | ✓ | △[4] |
| **Realistic Possibility of Success (at least 33%)**: A reasonable and well-informed analysis of the law and the facts by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one-in-three (or greater) likelihood of being sustained on its merits. *[AICPA SSTS No. 1]* | ✓ | △ | △ | ⊘ | △ | ⊘ |
| **Reasonable Basis (20%)**: If a position is based on one or more authorities, it will generally satisfy reasonable basis even though it does not satisfy the substantial authority standard (not merely arguable or not merely a colorable claim). *[Regs. Sec. 1.6662-3(b)(3); Joint Committee on Taxation Interest and Penalty Study (JCS-3-99)]* | ✓ | △ | △ | ⊘ | △ | ⊘ |
| **Below Reasonable Basis, including Frivolous (below 20%)**: A position that is patently improper with no plausible argument in support of the position. *[Not defined by statute or regulation]* | ⊘ | ⊘ | ⊘ | ⊘ | ⊘ | ⊘ |

✓ No disclosure is required.

△ No penalty with proper disclosure; see Forms 8275 or 8275-R.

⊘ Penalty with or without disclosure.

1. The level of confidence means the level of authority needed for either a taxpayer or a preparer to avoid the relevant penalty. See Regs. Sec. 1.6662-4(d)(3)(iii) and AICPA U.S. Federal Tax Law Hierarchy Quick Reference Chart.
2. In rendering tax advice for a return position, it's advisable to use the terminology in the Code and regulations to describe the level of confidence. Exercise care in using terms "should" or "will" because a client may misinterpret the meaning.
3. To avoid a penalty, a taxpayer must have substantial authority and establish a reasonable belief that the treatment meets the more likely than not standard.
4. See Notice 2009-5, Sec. 6694, and Sec. 6707A.

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