ARONBERG GOLDGEHN

Business Litigation Alert

October 19, 2017

Defending Against IRS Tax Penalties

By Nathan H. Lichtenstein and Mark D. Anderson

The Internal Revenue Code contains more than 150 penalties that can be assessed against taxpayers and tax return preparers. Some of them are found in Code Section 6662, which authorizes the IRS to impose an accuracy related penalty equal to 20 percent of any substantial understatement of income tax. For an individual, an understatement of tax is deemed substantial if it exceeds the greater of $5,000 or 10 percent of the tax. In addition, a 40 percent penalty applies where an understatement results from undisclosed transactions that lack economic substance.

And the IRS is getting more aggressive about asserting penalties. The number of accuracy related penalties assessed against individual taxpayers increased from 58,366 in 2005 to 553,184 in 2015. That is nearly a 1,000 percent increases over the past decade.

One of the defenses to the imposition of an accuracy related penalty is the "reasonable-cause exception." A taxpayer is not liable for the accuracy related penalty imposed by Section 6662 (or the fraud penalty imposed by Section 6663) if there was a reasonable cause and the taxpayer acted in good faith. The 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 the pertinent facts and circumstances. Generally, the most important factor is the extent of the taxpayer's effort to determine the proper tax liability. This question often revolves around whether the taxpayer reasonably relied on the advice of a third party. IRC Regulation Section 301.6664-4(c) provides that "Reliance on . . . the advice of a professional tax advisor . . . does not necessarily demonstrate reasonable cause and good faith . . . Reliance on . . . professional advice . . . however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith." Equally important is the "experience, knowledge, and education of the taxpayer."

A taxpayer can avoid a liability for accuracy related penalties where he has relied on the advice of a tax professional, even if that advice turns out to be erroneous. To establish reasonable reliance on the advice of the tax professional, the taxpayer must show (a) the taxpayer used a competent tax professional who had sufficient expertise to justify reliance, (b) the taxpayer provided all the necessary information to that professional, and (c) the taxpayer in good faith relied on the advice. It is also important that the tax professional should not be the one promoting the transaction, or otherwise be involved in structuring the transaction or compensated out of the transaction.

There has been a great deal of litigation relating to determining whether reasonable reliance exists. Often, the taxpayer's education, sophistication and business experience are considered in determining whether the taxpayer's reliance on advice was reasonable. For example, a professional football player was found to have

© 2017 Aronberg Goldgehn. All rights reserved. The above material is intended for general information and promotional purposes, and should not be relied on or construed as professional advice. Under the Illinois Rules of Professional Conduct, the above information may be considered advertising material. The transmission of this information is not intended to create, and receipt of it does not create, a lawyer-client relationship.

reasonably relied on his tax advisor when investing in a horse-breeding tax shelter (W.T. Romanowski, 104 TCM 1379), while a business owner with an MBA who had invested in the same horse-breeding tax shelter did not reasonably rely in good faith on the advice of his tax advisor (W.G. Pederson, 105 TCM 1365).

The Takeaway

When considering an investment in a tax shelter, seek out the advice and opinion of a competent and independent tax professional.

If you have any questions about this article, please contact the authors listed below or the Aronberg Goldgehn attorney with whom you normally consult:

Nathan H. Lichtenstein
312.755.3148
nlichtenstein@agdglaw.com

Mark D. Anderson
312.755.3163
manderson@agdglaw.com