But I Relied On My Accountant! The Scope of the Reasonable Cause Defense to Penalties

By Larry A. Campagna, Caroline D. Ciraolo and Ellis L. Reemer

Larry A. Campagna, Caroline D. Ciraolo and Ellis L. Reemer examine the scope of the reasonable case defense to penalties.¹

Practitioners have seen an increase in the imposition of penalties and a corresponding increase in clients seeking penalty abatement. Taxpayers who seek relief from penalties often plead reliance on their tax advisors as their reasonable cause defense. While many penalties may be abated or eliminated based on “reasonable cause,” recent cases have narrowed the ability of taxpayers to demonstrate the reasonableness of their reliance on tax advice. This article addresses claims for relief based on reasonable cause, in particular, reasonable cause based on a taxpayer’s reliance on professional advice.

The Statutes, Regulations, and Manual

The Internal Revenue Manual sets forth the IRS’s policy on penalties.² Simply stated, penalties are used to enhance voluntary compliance by demonstrating the fairness of the tax system to compliant taxpayers and increasing the cost of noncompliance. IRS Examiners and their managers³ are advised to consider the applicability of penalties in each case, and fully develop the penalty issue when the initial consideration indicates that penalties should apply. Full development of the penalty issue is important for the IRS Appeals office to sustain a penalty and for Counsel to successfully defend that penalty in litigation.

The IRS has established four primary categories for penalty relief, including: (1) reasonable cause; (2) statutory exceptions; (3) administrative waivers;⁴ and (4) correction of service error.⁵ The most common defense asserted by taxpayers is under Section 6664(c), the reasonable cause defense. “No penalty may be imposed under [Code Sec.] 6662 with respect to any portion of an underpayment upon a showing by the taxpayer that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion.”⁶ Reasonable cause is based on all relevant facts and circumstances.⁷ A taxpayer must establish that it exercised ordinary business care and prudence in determining its tax obligations, but nonetheless failed to comply with those obligations.⁸

The Penalty Handbook (Part 20 of the Manual) sets forth various examples of reasonable cause, but any reason that establishes that despite the exercise of ordinary business care and prudence in determining its tax obligations, but nonetheless failed to comply with those obligations,⁹

The IRS views the most important factor in determining reasonable cause to be a taxpayer’s effort to report the...
proper tax liability. Any other factors considered include
the taxpayer’s experience, knowledge, education and
the taxpayer’s reliance on the advice of a tax advisor.

When considering a claim of reliance on the advice of
a tax advisor, the IRS will consider, among other things,
the nature of the tax investment, the complexity of the tax
issues, the competence of the tax advisor, the education
of the taxpayer and the quality of the opinion relied
upon to determine whether the reliance was reasonable
and whether the taxpayer acted in good faith. The
taxpayer should be prepared to provide the following information:
1. Was the advice in response to a specific request?
2. Did the advice reasonably rely on the advice?
3. Reliance on a professional tax advisor generally relates
to claims for abatement of the accuracy-related or fraud
penalty. However, there are limited circumstances
where reliance on an advisor can serve as grounds to
abate other types of penalties. For example, if a tax
professional advises a taxpayer that he does not have a
filing obligation based on the taxpayer’s income or status,
and the taxpayer relies in good faith that advice, such
reliance may serve as grounds to abate the failure to
timely file or pay penalties under Code Sec. 6651(a).

Reliance on a tax opinion provided by a tax advisor must
be objectively reasonable in order to justify abatement
based on reasonable cause. The taxpayer must supply
the advisor with all the necessary information, and the
advice must be based on all pertinent facts, circumstances
and the law as it relates to those facts and circumstances.
If the advisor suffers from a conflict of interest or lack of
expertise that the taxpayer knew or should have known
about, the taxpayer might not have acted reasonably in
relying on that advisor.

The advice that forms the basis of a taxpayer’s reasonable
cause defense may not be based on unreasonable
factual or legal assumptions (including assumptions as
to future events) and may not unreasonably rely on the
representations, statements, findings or agreements of the
taxpayer or any other person. In addition, the advice
may not be based on an assumption that the transaction
has a business purpose other than tax avoidance. A
taxpayer may not rely on an opinion or advice that a
regulation is invalid without adequately disclosing such
position to the IRS.

“Advice” can be any communication setting forth an
analysis or conclusion by a person other than the taxpayer
and on which the taxpayer relied in preparing the return.
To determine whether a taxpayer reasonably relied on
the advice, the taxpayer must produce the opinion. Any
claim of privilege to prevent the disclosure of the opinion
will result in a denial of the claim for abatement.

In cases where the accuracy related penalty is not
imposed based on reasonable reliance on professional
advice, the Manual instructs examiners to contact the
taxpayer’s preparer, as authorized by Code Sec. 6103(k)
(6), to confirm that the advice was provided, and to
consider the applicability of the return preparer penalties
under Code Secs. 6694 and 6695.

The IRS will not impose the accuracy-related penalty
under Code Sec. 6662A with respect to any portion of
an understatement attributable to a reportable transaction
if it is shown that there was reasonable cause and the
taxpayer acted in good faith. A taxpayer seeking relief
under Code Sec. 6664(d)(1) must adequately disclose
the tax treatment of the item in accordance with Code
Sec. 6011 and regulations prescribed thereunder, must
establish that there is or was substantial authority for
the treatment, and establish a reasonable belief that the
treatment was more likely than not the proper treatment.

The failure of a taxpayer to adequately disclose a
reportable transaction is a strong indication that the
taxpayer did not act in good faith, but the taxpayer may
argue that the failure to disclose was based on the advice
of a tax advisor concluding that the transaction was not
reportable. The taxpayer’s reliance on such advice that
a transaction is not reportable must be reasonable and
made in good faith. In addition, the tax advisor must
be a “disqualified tax advisor” as defined by Code
Sec. 6664(d)(4)(B)(ii), and the opinion must not be a
disqualified opinion” as defined by Code Sec. 6664(d)
(4)(B)(iii).

A disqualified tax advisor includes a material advisor
within the meaning of Code Sec. 6111(b)(1) who
participates in the organization, management, promotion
or sale of the transaction or is related to any person who
so participates, is compensated directly or indirectly by
a material advisor with respect to the transaction, has a
fee arrangement with respect to the transaction that is
contingent on intended tax benefits being sustained, or
has disqualifying financial interest with respect to the
transaction. A disqualified opinion is one that is based
on unreasonable factual or legal assumptions, including
assumptions as to future events, unreasonably relies
on representations, statements, findings or agreements of
the taxpayer or any other person, does not identify
and consider all relevant facts, or fails to meet other
requirements established by the IRS.

To establish a reasonable belief, a taxpayer must show
that his or her belief is based on the facts and the law that
IRM Exhibit 20.1.5-7

<table>
<thead>
<tr>
<th>Circumstances that may indicate reasonable cause and good faith:</th>
<th>Circumstances that may not indicate reasonable cause and good faith:</th>
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<tbody>
<tr>
<td>Honest misunderstanding of fact or law that is reasonable given the experience, knowledge, sophistication and education of taxpayer.</td>
<td>Lack of significant business purpose.</td>
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<tr>
<td>An isolated computational or transcription error.</td>
<td>Reliance on advice of a tax advisor or appraiser who the taxpayer knows or should have known lacked sufficient expertise or lacked independence.</td>
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<tr>
<td>Reliance on erroneous information reported on Forms W-2, 1099, etc., provided that the taxpayer did not know or have reason to know that the information was incorrect.</td>
<td>Taxpayer agreed with the organizer or promoter of the tax shelter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter.</td>
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<tr>
<td>Reliance on advice of a tax advisor or appraiser who does not suffer from a conflict of interest or lack of expertise.</td>
<td>Claimed tax benefits are unreasonable in comparison to the taxpayer’s investment in the tax shelter.</td>
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exist at the time the return at issue is filed, and that the belief relates solely to the taxpayer’s chance of success on the merits of such treatment, and not on the chance that the return will not be selected for audit, that the issue will not be raised in any future proceeding, or that the issue will be subject to settlement.30

There is no reasonable cause exception for the penalty under Code Sec. 6707A with respect to a listed transaction set forth in Code Sec. 6662(b)(6). If a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the accuracy-related penalty applies to that portion of the understatement unless the reasonable cause and good faith exception applies.31 A corporation's legal justification may be taken into account in establishing reasonable cause and good faith, but only if there is substantial authority within the meaning of Reg. § 1.6662-4(d) for the treatment of the item and the corporation reasonably believed, when the return was filed, that the treatment was more likely than not the proper treatment.32

The reasonable belief standard is generally met if:
1. The corporation analyzed pertinent facts and relevant authorities to conclude in good faith that there would be a greater than 50-percent likelihood (“more likely than not”) that the tax treatment of the item would be upheld if challenged by the IRS; or
2. The corporation reasonably relied in good faith on the opinion of a professional tax advisor who analyzed all the pertinent facts and authorities, and who unambiguously states that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by IRS.

The comparison chart above, IRM Exhibit 20.1.5-7, is provided in the IRM Penalty Handbook.

Other limits to the reasonable cause exception include any portion of an underpayment that is attributable to one or more transactions listed in Code Sec. 6662(b)(6) (accuracy-related penalty for transaction lacking economic substance under Code Sec. 7701(o)).33 Code Sec. 6664(c)(3) also provides that where the underpayment is attributable to substantial or gross valuation overstatement with respect to charitable deduction property, the reasonable cause defense does not apply unless:
1. The claimed value of the property was based on a qualified appraisal made by a qualified appraiser; and
2. The taxpayer made a good faith investigation of the property’s value.34

Summaries of Recent Decisions

In 106 Ltd.,35 the U.S. Tax Court’s review was limited to whether the taxpayer sufficiently established reasonable cause and good faith based on its reliance on tax professionals to negate the 40-percent gross valuation misstatement penalty. The case involved a Notice 2000-44 transaction involving foreign currency options that resulted in an overstatement of basis in partnership assets by $3 million and a corresponding reduction in the tax matter partner’s individual federal tax liability. The court rejected the reliance defense, based on: (1) taxpayer’s business sophistication and experience; (2) the sloppy opinion letter describing a different transaction; and (3) fact that advisors were also promoters of the transaction. Citing Countryside Ltd. P’ship,36 the court acknowledged that a tax advisor is not a promoter of a transaction when he or she: (1) has a long-term and continual relationship with the client; (2) does not give unsolicited advice regarding the tax shelter; (3) advises only within their field of expertise (and not because of their regular involvement

JOURNAL OF TAX PRACTICE & PROCEDURE 53
in the transaction being scrutinized); (4) follows their regular course of conduct in rendering their advice; and (5) has no stake in the transaction besides his customary compensation for services rendered. The court's decision was affirmed on appeal.

In *Bemont Investments, LLC*, the IRS imposed accuracy-related penalties with respect to adjustments arising from a tax shelter transaction. The Fifth Circuit recognized that "[r]eliance on the advice of a professional tax adviser does not necessarily demonstrate reasonable cause and good faith; rather, the validity of this reliance turns on "the quality and objectivity of the professional advice which they obtained." The court rejected the reliance defense, finding that the professional advisor involved "was no more than a 'puppet'" and "rendered no real independent or objective advice...[he] said what he was paid to say."

In *Southgate Master Fund, LLC*, the IRS imposed accuracy-related penalties based upon its disregard of the taxpayer's transaction for lack of economic substance. The district court disagreed, finding that while the adjustments were proper, the taxpayers established a reliance defense to negate the penalties. The Fifth Circuit affirmed, holding that the taxpayers relied on "qualified tax advisors not burdened by any conflict of interest" and the taxpayers "knew, or had reason to know, were unlikely to be true;" and the IRS unequivocally warned taxpayers regarding the impropriety of COBRA deals.

In *American Boat Co., LLC*, the Seventh Circuit found the taxpayer's reliance was justified because it did not know that the tax attorney upon whom it relied had a disqualifying conflict of interest. The taxpayer did not approach the attorney seeking a tax shelter, but rather to set up a trust and reorganize business entities. In addition, the taxpayer paid the attorney flat fees, not a percentage of fees based on the tax benefits, the taxpayer was attempting to maximize profits and minimize tax and two reputable accounting firms reviewed and did not object to the transaction.

In *Neonatology Associates, P.A.*, the court applied a three-prong test to establish (by a preponderance of the evidence) reasonable reliance sufficient to negate an accuracy-related penalty: (1) the advisor must be a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer must have given the advisor the necessary and accurate information; and (3) the taxpayer must have actually relied in good faith on the advisor's judgment. The court noted that reliance may be unreasonable when it is placed on insiders, promoters or their offering materials, or when the person relied upon has an inherent conflict of interest of which the taxpayer is or should be aware.

In *Woods*, partnerships sought relief from accuracy-related penalties arising from their participation in Currency Options Bring Reward Alternatives (COBRA) transactions. The court found that while Woods was not a "tax specialist," his knowledge of business in general and accounting in particular was both broad and deep, he was aware that the COBRA transactions were for the sole purpose of generating large paper losses for tax purposes, and that tax shelter entities were required to have a business purpose and economic substance. The court held that reliance on the accounting firm and two law firms involved was not reasonable because there was "an inherent conflict of interest which was too obvious to be ignored;" the COBRA tax benefit was "too good to be true;" and the IRS unequivocally warned taxpayers regarding the impropriety of COBRA deals.

In *NPR Investments, LLC*, the taxpayers acted with reasonable cause and in good faith in relying on their tax advisors’ advice with respect to investments in transactions that turned out to be tax shelters. The district court found that, at every step, the taxpayers followed the advice of the people upon whom they relied and were unaware that the transaction constituted a tax shelter. The district court’s decision is currently on appeal.

In *Nevada Partners Fund, LLC*, the IRS imposed accuracy-related penalties based on its disregard of a multi-tiered “Family Office Customized” structure (FOCus), which was presented to the taxpayers by a large accounting firm and other law firms as a means to reduce federal tax on the sale of business property. In response to the partnerships’ reliance defense, the court held that while reliance on professionals can be viewed as sufficient in some situations, here, the taxpayers’ sophistication and reliance on erroneous assumptions set forth in the opinions did not warrant a finding of reasonable cause.

In *Klamath Strategic Inv. Fund, LLC*, the Fifth Circuit held that while a partner may not raise individual defenses during a partnership-level proceeding, in determining penalties at the partnership level a court may consider reasonable cause and good faith defenses of the partnership. The court affirmed the district court’s finding that the partnership relied in good faith on the advice of qualified accountants and tax attorneys and therefore, no penalties should apply.
In Long Term Capital Holdings, the IRS imposed accuracy-related penalties based on its adjustments arising from transactions that lacked economic substance. Taxpayers disputed the penalties based on reliance on advice provided by Shearman & Sterling and King & Spalding (K&S). The court disagreed, finding that Long Term did not receive the K&S opinion until after the return was filed. Taxpayers also failed to prove that the opinion was based on all pertinent facts and circumstances and did not unreasonably rely on unreasonable factual assumptions.

In Murfam Farms, LLC, the IRS imposed accuracy-related penalties based on the partnerships’ participation in COBRA transactions. The partnerships conceded lack of economic substance, but disputed penalties based on their reliance on an opinion regarding the transaction issued by a large accounting firm. The court noted that, to negate penalties, reliance must be reasonable in light of the particular facts and circumstances. The court found the partnerships’ reliance unreasonable based on the experience of the partnerships, the imputed knowledge of their executives, and the inherent conflict of interest of the accounting firm cause by the fee structure of the COBRA transaction.

In Allison III, the taxpayers purchased interests in a limited partnership in the recycling industry on the advice of an investment manager and a CPA. The IRS determined adjustments and imposed accuracy-related penalties. The court noted that while reliance on the advice of accountants and attorneys could clearly qualify taxpayers for the reasonable cause exception to certain penalties, the analysis was slightly different for reliance on investment advisors. Whether the reliance on such advice is sufficient to establish reasonable cause and good faith will depend on the sophistication of the taxpayer and the advisor, the knowledge of the advisor in regard to a particular transaction, and whether the advisor has any conflict of interest. Under the particular facts of this case, the court found “reasonable cause” and abated the penalties.

In Woodsum, the taxpayer received and provided to his tax return preparer a Form 1099-MISC reflecting $3.4 million from a swap transaction. The income was not reported on the return and the IRS imposed an accuracy related penalty. The court rejected the taxpayer’s reliance defense because the reliance was not on tax “analysis” or “conclusion,” which was required to establish reliance on tax advice. The court acknowledged that a taxpayer is not required to duplicate the efforts of the return preparer to avoid computational or transcription errors, but where the income omitted is straightforward and substantial, a cursory review of the return would have revealed the deficiency.

In Seven W. Enterprises, Inc., the IRS imposed accuracy-related penalties on the corporation for several years. The court found that the corporation acted with reasonable cause and in good faith when it relied on the advice of an independent, outside advisor, but that when that same advisor became employed by the business, the advice was no longer independent and could not be used to avoid penalties. The court cited Reg. §1.6664-4(c)(2), noting that an employee of the taxpayer is not considered a person “other than the taxpayer” and therefore, the reliance on the employee did not establish reasonable cause with respect to the accuracy related penalty. The court offered the following disclaimer: “We need not, and do not, opine as to whether reliance on an in-house professional tax advisor may establish reasonable cause in other circumstances.”

In Canal Corporation, the court found that a leveraged partnership transaction was a disguised sale, and that the parent corporation was liable for the tax on the gain and the substantial understatement penalty. The court found that the taxpayer’s reliance on PWC’s “should” opinion (the highest level of assurance that PWC offers its tax clients) was not reasonable because PWC: (1) received a flat fee of $800,000 for the opinion, which was disorganized, incomplete and filled with typographical errors; (2) helped plan the transaction and draft some of the documents; and (3) made unreasonable assumptions. As a result, PWC had an inherent conflict and reliance on its opinion could not be reasonable. The facts and circumstances suggested a quid pro quo arrangement rather than a true tax advisory opinion.

In Dunlap, the IRS disallowed deductions for charitable contributions of facade easements, finding that the easements lacked any value, and imposed accuracy-related penalties. Although the court affirmed the adjustments, and in doing so rejected the taxpayers’ independent appraisal and opinion letter from counsel, it held that the taxpayers acted with reasonable cause and in good faith based on their retention of a qualified appraiser and adequate disclosure of the transaction on Form 8283.

In Blum, the court held that the taxpayers were not entitled to deduct certain capital losses claimed from their participation in an Offshore Portfolio Investment Strategy (OPIS) transaction because the OPIS transaction lacked economic substance and, therefore, must be disregarded for tax purposes. The court rejected the taxpayers’ reasonable cause defense to the penalty imposed because the opinion from the large accounting
firm was based on the taxpayer’s misrepresentation regarding his review of the underlying economics of the transaction, and the fact that the opinion was finalized after the filing of the return. Finally, the accounting firm’s role as a promoter of OPIS prevented reasonable reliance.

In *Rovakat, LLC*, the Service imposed accuracy-related penalties on a TEFRA partnership notwithstanding its reliance on three different tax opinions. The court agreed, noting that the opinions were obtained through the partnership’s counsel at Sidley Austin, and from a firm that specifically prepared the tax opinions for the transaction at issue. There was no contact between the tax matters partner and the attorneys rendering the opinions; instead, the partner relied on the promoter of the transaction to obtain the opinions. Finally, the court cited the material misrepresentations of fact and numerous disclaimers in two of the opinions. Once again, the court found the transaction “too good to be true.”

In *Gustashaw*, the IRS imposed an accuracy-related penalty. The taxpayer asserted a reasonable cause and good faith defense, arguing that he reasonably relied on advice provided by the law firm of Brown & Wood, as well as advice from his CPA. The court rejected the defense, noting that the law firm worked for the promoters and as a result, had an inherent conflict of interest, and the CPA only opined as to Brown & Wood’s reputation and the quality of its tax opinion. The court also noted that the taxpayer had no engagement agreement with Brown & Wood, never met with a Brown & Wood attorney and did not directly compensate the law firm for its services. Turning to the tax opinion, the court found that it failed to properly represent and address the facts and circumstances of the transaction at issue. In sum, the court found that the transaction was “too good to be true.” The case is currently on appeal.

In *Fletcher*, the IRS imposed accuracy-related penalties against investors in a sheep and cattle breeding partnership based on computational adjustments to flow through losses reported on their individual returns. The taxpayers disputed the penalties on the grounds of reasonable cause and good faith, based on their farming experience and reliance on advice of their CPA and H&R Block. The taxpayers were high school graduates with no training or experience in accounting or tax return preparation. The court held the taxpayers liable for the penalties, noting that their CPA warned them against the investment, they lacked any evidence of independent professional advice, and instead, relied on the advice of a tax-preparation company connected with the promoters of the partnerships.

In *Robucci*, the IRS imposed accuracy-related penalties against a doctor who, with his CPA, created an entity structure to run his psychiatry practice. The court noted that no steps had been taken to properly recognize or operate the corporate structure, and that the entity lacked any business purpose. It held that doctor’s reliance on the CPA was not in good faith based its belief that the transaction was “too good to be true.”

**Divining Meaning from the Case Law**

Clearly, the courts continue to address numerous challenges to penalties based on reliance on professional advice. A review of these opinions reveals some common themes, including:

- **Inherent conflicts of interest**—Commonly found in tax shelter cases, conflicts arise when the advice is rendered by tax professionals with a connection to the transaction at issue. The dual role of the advisor-promoter renders such individuals incompetent to render independent tax advice.

- **Inadequate disclosure by the taxpayer to the advisor**—Reasonable cause defenses have been rejected in these cases where the taxpayer did not sufficiently explain certain facts to the qualified tax professional in order for that professional to form a sound opinion.

- **Inadequate qualification of the advisor**—The IRS has challenged the claim of reliance on the basis that the tax professional was not qualified. This may occur where the taxpayer uses a seasonal return preparer lacking any accounting or tax background to prepare a more complex individual or business return.

- **Actual reliance in good faith**—The IRS has challenged taxpayers’ actual reliance on the professional advice provided based on, among other things, the education, experience and/or sophistication of the taxpayer, or the taxpayer’s knowledge of the advisors inherent conflict of interest.

Taxpayers generally have been expected to ascertain the independence and qualification of their advisors, and are expected to provide the tax advisor with all the relevant facts. The reasonable cause defense requires these steps even of relatively uneducated taxpayers, although the cases demonstrate occasional leniency for unsophisticated taxpayers.
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