

BASIC RETURN POSITION TAXPAYER PENALTIES

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I. ACCURACY-RELATED PENALTY (IRC SECTION 6662)

A. Basics

- Encompasses a number of different penalties
- For example, negligence: any failure to make a reasonable attempt to comply
- For example, substantial understatement: penalty applies in case of individual if understatement of income tax is substantial (exceeds the greater of 10% of the tax required to be shown on the return or \$5,000)
- Penalty is 20% of the portion of the underpayment that is attributable to the prohibited conduct

B. Defenses

- Substantial authority (about 40% chance of prevailing on merits)
 - Weight of authorities supporting the treatment must be substantial in relation to authorities supporting contrary positions
 - Authorities include Code, Regs, court cases, rulings, legislative history
 - Authorities do not include treatises, legal periodicals and tax opinions
- Adequate disclosure (Form 8275) so long as reasonable basis (about 20% chance of success)
- Reasonable cause (e.g., reliance on tax advisor's advice)
 - Most important factor is extent of taxpayer's effort to determine proper treatment
- One exception: when tax shelter involved (i.e., tax avoidance is significant purpose), individuals need substantial authority and reasonable belief that more likely than not the proper treatment

C. Procedural Issues

- Routinely asserted by revenue agents
- Agents supposed to consider in every audit
- Not supposed to be a bargaining chip in negotiations
- IRS penalty policy has stiffened in recent years

- Conflict of interest potential: reliance on tax advisor argument
- Pretty much automatic if Form 1099 sent

II. FRAUD PENALTY (IRC SECTION 6663)

A. Basics

- Penalty is 75% of the portion of underpayment attributable to fraud
- Intent to cheat required; negligence does not suffice
- Reserved for egregious circumstances
- Burden of proof on IRS by clear and convincing evidence
- Examples: substantial amounts of unreported income or large, bogus deductions
- Some agents reluctant to assert because of severity

B. Miscellaneous

- Difficulty of distinguishing between civil fraud and criminal fraud: no bright line test
- Not dischargeable in bankruptcy
- Compare: fraudulent failure to file penalty