

Overcoming Accuracy-Related Penalties With Reasonable Cause

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In this article, the authors review a recent case involving the accuracy-related penalty, and they use their machine-learning algorithm to explore the odds of success for taxpayers using a reasonable cause and good faith defense in similar cases.

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I. Introduction

According to the national taxpayer advocate's annual reports to Congress, the most litigated

federal tax issue in recent years has been the application of the accuracy-related penalty (ARP).¹ Section 6662 imposes an ARP on persons who have underpaid their income tax in specific circumstances, the most frequently litigated being underpayments attributable to negligence or disregard of rules² and underpayments that exceed a computational threshold — called a substantial understatement.³

Taxpayers will succeed in removing or reducing an ARP if they can establish that they acted with “reasonable cause and good faith” as set forth in section 6664. We will refer to this as the “reasonable cause defense.” In one report, the national taxpayer advocate found that although the underlying tax deficiency (or portions thereof) was upheld in all cases they reviewed in 2017, there was a greater than 20 percent overall success rate for challenging an ARP imposed under section 6662(b)(1) and (2), attributable to the taxpayer having shown “a reasonable and good faith attempt to ascertain the correct amount of tax due.”⁴

Moreover, presenting complete and accurate records and proving a reasonable reliance on a competent tax professional strengthened a taxpayer's reasonable cause defense considerably. In those 2017 cases, the taxpayer was wholly or partially successful 32 percent of the time.⁵

The ARP and the applicability of the reasonable cause defense appear poised to

¹ Taxpayer Advocate Service, “2013 Annual Report to Congress,” at 339 (accessed Mar. 7, 2023); TAS, “Annual Report to Congress 2017” (accessed Mar. 7, 2023).

² Section 6662(b)(1).

³ Section 6662(b)(2).

⁴ TAS, “Annual Report to Congress 2017,” *supra* note 1, at 371.

⁵ *Id.* at 375.

continue to be the most litigated tax issue each year. Blue J Tax catalogs over 1,500 federal tax cases involving ARPs and the reasonable cause defense litigated since 1990. In a quarter of those decisions, the taxpayer prevails regarding reasonable cause.

But Blue J can reveal more than summary statistics. Blue J uses machine-learning techniques to identify the factors driving the availability of the reasonable cause defense for taxpayers. These insights can help users raise a stronger defense to the ARP by positioning their cases in the most effective way possible. We are pleased hereby to offer the machine-learning guide to overcoming ARPs with the reasonable cause defense.

To animate our machine-learning analysis of the reasonable cause defense, we will scrutinize the ongoing litigation in *Soni*.⁶ Blue J predicts with 88 percent confidence that the taxpayer's reasonable cause defense against the ARP will not be successful in the appeal. Our principal findings emphasize the importance of maintaining complete and accurate financial records and relying on competent tax professionals.

II. Background

A. Factual Background

Om and Anjali Soni are a married couple who file a joint federal income tax return; they have lived together in the United States since their marriage in 1978. Om immigrated to the United States before 1973 to pursue his education, obtaining master's degrees in chemical engineering and engineering sciences, as well as an MBA.

Early in his career, Om gained experience working at several *Fortune* 500 companies. He proceeded to found seven businesses, which combined to employ thousands of staff and generate nearly \$100 million in annual revenue. Om was the owner and CEO of Sonix Medical Resources (Sonix), a corporation that managed the finances of those businesses and handled Om's personal financial matters, including the preparation of his personal tax returns and management of his bank accounts.

⁶*Soni v. Commissioner*, T.C. Memo. 2021-137.

The Soni family had a friend, Mr. Shah, who operated a restaurant owned by an S corporation, Beauville Corp. (Beauville). According to Om's testimony submitted to the Tax Court, Shah experienced financial trouble, and Om provided him with checks worth about \$500,000. At Shah's request, Om obtained a majority financial stake in Beauville. Om claimed that he had kept copies of the checks provided to Shah and a statement from Shah but said that he had not documented the transactions according to standard business practices because their business dealings "were based on trust."

In 2004 the Sonis' tax returns were prepared by Ralph Crisci, a partner at an external accounting firm, in coordination with the internal accounting departments of Om's businesses. The tax records and the returns were maintained by those accounting departments, which gave the outside accountants the information to prepare the Sonis' personal returns. Also, Om employed Alan Grossman, a CPA, to provide information to Crisci regarding the Sonis' investment in Beauville.

The Sonis' 2004 return claimed a \$1.78 million flow-through loss deduction from Beauville, which reduced their total income from \$2.28 million to about \$390,000, resulting in a claimed \$73,470 refund. According to the government's brief on appeal, Crisci had conferred regularly with both Om and Grossman while preparing the return, and he relied on representations from them that the \$1.78 million deduction could be substantiated. Crisci testified that he had expressed concern about the loss to Om, but Om "was sophisticated with respect to tax matters," and Om had indicated he felt comfortable claiming the loss "based on Mr. Grossman's advice." During those conversations, Crisci warned Om that supporting documentation would be required to substantiate such a large loss to the IRS.

B. IRS Examination

Upon examination, the IRS issued a statutory notice of deficiency of \$642,629, finding that the Sonis' actual liability should have been \$977,321. The difference was primarily attributable to the large and unsubstantiated \$1.78 million flow-through loss that Soni claimed regarding the

investment in Beauville, which the IRS disallowed. The IRS also assessed a 20 percent ARP under section 6662(a) for the underpayment, as well as late-filing penalties under section 6651(a)(1).

During the examination of the 2004 return and in response to the disallowance of the \$1.78 million flow-through loss, Om claimed that Sonix had copies of checks made out to the Shahs both in “safes on premises, off premises,” and scanned into Sonix’s computer system. However, Om was unable to produce any of this evidence to substantiate the loss, and the case proceeded to the Tax Court.

C. Accuracy-Related Penalty

Section 6662(a) imposes a 20 percent ARP to underpayments of federal tax caused by specified situations described in paragraph (b) of that section. Paragraph (b)(1) provides that the ARP applies when an underpayment is attributable to negligence or disregard of rules or regulations that causes an underpayment of tax.⁷ Paragraph (b)(2) applies the ARP to any substantial understatement of income tax.⁸ Additional circumstances that will cause an underpayment to be subject to the ARP are described in paragraphs (b)(3) through (9).⁹

For the purposes of section 6662(b)(1), “negligence” is defined as “any failure to make a reasonable attempt to comply with the provisions of this title, and the term ‘disregard’ includes any careless, reckless, or intentional disregard.”¹⁰ As illustrated by the government’s position in *Soni*¹¹ and as set out in reg. section 1.6662-3(b)(1), strong indicators of negligence include keeping inadequate books and records or failing to

substantiate transactions that gave rise to the underpayment being assessed.¹²

Section 6662(d)(1) and reg. section 1.6662-4(b) provide guidelines for calculating whether an underpayment is substantial. For individuals, S corporations, and personal holding companies, an understatement is considered substantial if it exceeds the greater of 10 percent of the tax that must be shown on the return for the taxable year or \$5,000.¹³ For corporations other than S corporations and personal holding companies, an understatement is substantial if it exceeds the lesser of 10 percent of the tax required to be shown on the return for the tax year (or, if greater, \$10,000) or \$10 million.¹⁴

Although the IRS may impose the ARP for multiple types of underpayments described in section 6662(b), the penalties are not stackable.¹⁵ For example, if the underpayment being assessed is attributable to both negligence and a substantial understatement of income tax, the maximum ARP is 20 percent of the underpayment.¹⁶

Depending on which section 6662(b) circumstance has led to the underpayment, a taxpayer may have one or more potential defenses to the ARP, including the reasonable cause defense set forth in section 6664.

1. Reasonable cause and good faith.

Section 6664(c) provides that taxpayers will not be subject to the ARP in section 6662 if they had reasonable cause for the underpayment and they acted in good faith. According to reg. section 1.6664-4, whether a taxpayer acted with reasonable cause and in good faith requires a case-specific analysis that considers all relevant facts and circumstances. In general, the most important consideration is the extent of the taxpayer’s effort to properly calculate the tax

⁷ See also reg. section 1.6662-3.

⁸ See also reg. section 1.6662-4.

⁹ Section 6662(b)(3)-(9) imposes the ARP on the portion of any underpayment that is attributable to any substantial valuation misstatement; any substantial overstatement of pension liabilities; any substantial estate or gift tax valuation understatement; any disallowance of claimed tax benefits by reason of a transaction lacking economic substance; any undisclosed foreign financial asset understatement; any inconsistent estate basis; or any overstatement of qualified charitable contributions (deduction provided in section 170(p)).

¹⁰ Section 6662(c).

¹¹ *Soni*, T.C. Memo. 2021-137.

¹² See also *Olive v. Commissioner*, 139 T.C. 19 (2012) (accuracy-based penalty where taxpayer failed to maintain adequate records to substantiate deductions).

¹³ Section 6662(d)(1)(A).

¹⁴ Section 6662(d)(1)(B).

¹⁵ Reg. section 1.6662-2(c).

¹⁶ Section 6662(a). The penalty can increase to 40 percent if any portion of the underpayment is attributable to a “gross valuation misstatement” (section 6662(h)); an undisclosed noneconomic substance transaction; or an undisclosed foreign financial asset understatement. The penalty can increase to 50 percent in the case of an overstatement of qualified charitable contributions.

liability. The factors used to measure a taxpayer's efforts generally include the knowledge and experience of the taxpayer, good-faith efforts of the taxpayer, and whether the taxpayer reasonably relied on the advice of a tax professional.

a. Education, experience, and knowledge of the taxpayer.

Reg. section 1.6664-4(b)(1) provides that "circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge and education of the taxpayer." To determine what is reasonable in a taxpayer's situation, the taxpayer's level of education, work experience, and tax-specific knowledge will be considered.¹⁷ The complexity and ambiguity of the tax issue related to the underpayment and the taxpayer's ability to comprehend the issue will also inform the determination.¹⁸

b. Good-faith efforts.

Taxpayers may demonstrate good faith by showing they were careful in the research and preparation of their transaction and tax return. For example, a mistake that was an isolated computational or transcriptional error would be consistent with this determination.¹⁹ Of great importance in evidencing good-faith efforts is the maintenance of adequate records and attempts to verify the accuracy of one's tax return.²⁰ Failure to do so will detract from the taxpayer's credibility in raising a reasonable cause defense because it undermines the assertion of a reasonable attempt to comply with the requirements of the law.

c. Reasonable reliance on others' advice.

Demonstrating reliance on a tax professional can affect a taxpayer's reasonable cause defense. The court in *Neonatology Associates* sets forth a

three-prong test in considering whether reliance is reasonable²¹:

- the adviser being relied on has to be a competent professional who has sufficient expertise to justify reliance;
- the taxpayer must have provided necessary and accurate information to the adviser; and
- the taxpayer must have actually relied in good faith on the adviser's judgment.

For a taxpayer to claim reliance on the advice of a tax professional, the advice relied on must be substantive and not limited to the tax professional merely preparing the tax return.²² Moreover, the adviser must have the complete information necessary to advise on the issue. In particular, the taxpayer may not rely on advice that is based on unreasonable factual or legal assumptions or advice that unreasonably relies on representations of the taxpayer.²³

D. Tax Court Opinion and Appeal

At the proceeding before the Tax Court, the Sonis claimed that they had relied on tax professionals in claiming the \$1.78 million loss in Beauville. However, the Tax Court sustained the deficiency and penalties, citing Crisci's testimony that he was concerned about the Sonis' basis for the claimed loss from Beauville; in fact, Crisci had ultimately included the loss on the return based on Om's repeated assertions that it was legitimate. The Tax Court noted Crisci's warning to Om that the IRS would require "proof" of such "a large loss" and Om's subsequent inability to produce that evidence. The court also noted that, although the Sonis did not claim reliance on any specific advice of Grossman, "reliance on advice must be objectively reasonable."

The Sonis have appealed the Tax Court's decision. To succeed on this appeal and avoid the imposition of an ARP under section 6662 for an understatement of tax that was both substantial and attributable to negligence, they must

¹⁷ Reg. section 1.6664-4(b)(1).

¹⁸ *Id.*

¹⁹ Reg. section 1.6664-4(b)(2).

²⁰ *Id.*

²¹ *Neonatology Associates PA v. Commissioner*, 115 T.C. 43 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

²² *Russian Recovery Fund Ltd. v. United States*, 851 F.3d 1253 (Fed. Cir. 2017).

²³ Reg. section 1.6664-4(c)(1)(ii).

demonstrate reasonable cause. Blue J predicts that they will be unable to do so.

III. Machine-Learning Analysis

A. Predicting Chances of Success

The reasonable cause defense to ARPs is a complex area that requires a thorough and contextualized examination of the relevant factors. Tax professionals can benefit from using Blue J Tax's machine-learning software to help them analyze the joint effect of these factors. By applying Blue J's algorithm, users can gain valuable insights into a taxpayer's likelihood of success in a reasonable cause defense, ultimately helping to mitigate the overall risk for taxpayers.

The predictive technology developed by Blue J guides users to enter the most relevant details of their case. Blue J's algorithm then analyzes prior case law on which it has been trained to predict the likelihood of a court accepting a taxpayer's reasonable cause defense based on the provided facts and circumstances. Blue J also provides a confidence level for its prediction.

Blue J's algorithm conducts a multifactorial analysis that draws conclusions from the circumstances regarding the taxpayer's good-faith efforts. The algorithm considers over 21 different crucial factors and is trained on a data set of over 1,500 previous opinions. Blue J's predictions consider and weigh the factors that judges refer to and rely on in their decisions, while considering the entire body of accumulated case law on the subject. Blue J's analysis reveals that, in almost three-quarters of the relevant cases in Blue J's system, the taxpayer was not successful in asserting a reasonable cause defense.

Based on the Tax Court's characterization of the underlying factual circumstances, Blue J predicts with 88 percent confidence that the taxpayers will be unsuccessful in raising a reasonable cause defense on appeal.²⁴

²⁴This also assumes that the taxpayers are unable to obtain a favorable review of arguments they are appealing regarding their liability for the underlying tax.

B. Issues in Dispute Regarding the ARP

Based on the Tax Court opinion and the parties' submissions on appeal, the dispute over the ARP focuses on whether the Sonis' failure to keep proper records disentitles them from using the reasonable cause defense. The Tax Court found that their failure to keep proper records was negligent and precluded them from using their tax adviser or tax preparer as a "shield."

The Sonis attempted to show reliance on an adviser, which would require them to prove that (1) the adviser was a competent professional; (2) they provided the adviser with the necessary and accurate information to provide the advice; and (3) they actually relied in good faith on the adviser's judgment, as set out in *Neonatology Associates*.²⁵

In their appeal brief, the Sonis do not dispute their failure to properly keep or provide records. However, they argue that a failure to maintain proper records should not necessarily be equated with negligence under section 6662(b)(1) and (c), which requires a failure to make a reasonable attempt to comply with the provisions of the tax code. The Sonis claim that they relied on Grossman and Crisci as their accountants, and that their assistance shows that they unquestionably relied on tax professionals in reaching their conclusion. They assert that the Tax Court's imposition of the ARP despite that reliance is based on the finding that they did not keep proper records.

Therefore, the issue on appeal comes down to whether the Sonis can rely on their tax advisers as a defense against the ARP. The government argues that the Sonis did not reasonably rely on their advisers, while the Sonis assert that they did. While the failure to keep proper records is a factor in the analysis, an examination of the relevant factors using machine learning will reveal that the dispute, in fact, centers on whether the Sonis provided necessary and accurate information and relied in good faith on their advisers' judgment.

²⁵*Neonatology Associates*, 115 T.C. 43, *aff'd*, 299 F.3d 221.

Impact of Documentation and Information on Reasonable Cause Defense

	System for Documentation	Complete Records	Information Provided	Taxpayer's Tax Expertise	Result
Base Case	Yes	No	Incomplete information	Low	88% unsuccessful defense
Scenario 2	Yes	Yes	Incomplete information	Low	71% unsuccessful defense
Scenario 3	No	No	Incomplete information	Low	92% unsuccessful defense
Scenario 4	Yes	No	Complete information	Low	82% successful defense
Scenario 5	Yes	No	Incomplete information	High	92% unsuccessful defense

C. Using Machine Learning to Quantify Positions

Blue J's algorithm differentiates between maintaining complete records and providing complete records to a tax adviser as distinct elements in determining whether a taxpayer relied on the adviser. To achieve this, the algorithm breaks down the documentation inquiry into three distinct components by evaluating: (1) whether the taxpayer had an adequate documentation system; (2) whether the taxpayer's records were complete; and (3) in cases in which the taxpayer claims to have relied on an adviser, whether the full documentation was provided to the adviser to enable them to offer the opinion or advice on which the taxpayer relied.

The results in the table indicate that the factors in the algorithm can operate independently of each other and that the algorithm does not assign static weights to individual factors. Rather, the algorithm adapts these factors dynamically based on how they have been interpreted by the courts.

In the base case of taxpayers who had a documentation system but incomplete records and failed to provide complete information to the tax adviser or preparer, the algorithm predicts with 88 percent confidence that the taxpayers would not succeed in their reasonable cause defense.

In Scenario 2, in which taxpayers have complete records but did not provide them to the tax adviser, the algorithm still predicts that the taxpayers would not succeed in their defense, but with less confidence: 77 percent.

In Scenario 3, in which taxpayers have no documentation system, the algorithm predicted a 92 percent unsuccessful defense, compared with the base case.

In Scenario 4, in which taxpayers have incomplete records and yet provided enough information to the tax adviser, the algorithm predicted an 82 percent successful defense.

These results suggest that the most critical factor is whether taxpayers provided sufficient documentation with all the necessary information for the adviser to render the advice or opinion. This is because the reasonable cause defense hinges heavily on the taxpayer's *reliance* on tax professionals. Naturally, it is challenging for taxpayers to claim such reliance when they have not provided the necessary information for the adviser to offer a proper opinion.

The weighting of the factors relating to the parties' submissions reveals that the government is challenging the taxpayers' claim of "unquestionable reliance on tax professionals" by questioning the objective reasonableness of their reliance. The government's challenge is based on two facts: first, that the taxpayers did not heed the warning given by Crisci, and second, that the taxpayers did not cite any specific communications from Grossman on which they relied.

Thus, the taxpayers could directly address the government's rebuttal and provide an explanation for why the information they provided was sufficient for Grossman and Crisci to render a complete opinion. That would require

them to provide more specific details instead of a blanket assertion of reliance on tax professionals. For example, did Grossman say that the records were unnecessary based on a paper trail established by counterparties?

D. Using Blue J's Cataloging Method

Blue J's cataloging method offers an additional advantage to tax professionals in evaluating the relative importance of the factors considered in a predictive algorithm. In addition to the predictive algorithm, machine learning involves the process of collecting data from raw, unstructured case data and transforming it into structured data to train the model and develop the algorithm. This results in a comprehensive catalog of all relevant factors and metadata for every case in the system. The cataloging perspective provides users with a bird's-eye view of the factors, enabling them to analyze and evaluate their relative importance.

Recall that in about three out of four of the decisions, the taxpayer was unsuccessful in raising a reasonable cause defense. It is important to note that in cases in which taxpayers did not keep complete records, they were historically unsuccessful in raising a reasonable cause defense in almost nine out of 10 decisions. However, that does not mean that failing to keep proper records should automatically disqualify the taxpayers from raising a reasonable cause defense (which the taxpayers correctly pointed out in their appeal submissions). But the data also reveal that a failure to provide the adviser with all the information and records is *almost determinative* of the outcome and effectively renders the taxpayer ineligible to raise the reasonable cause defense.

Thus, while recordkeeping is not necessarily determinative, the cataloging perspective shows that providing the tax professional with all the necessary information and records is crucial to the success of a reasonable cause defense.

E. Taxpayer Education and Experience

Apart from the issue of documentation, there appears to be a minor discrepancy regarding the taxpayer's education, experience, and knowledge. In their appeal, the taxpayers attempted to downplay Om's familiarity with taxation by arguing that he had little to no knowledge of the subject and relied on others for his tax filings.

However, the government's characterization of Om paints a different picture, portraying him as sophisticated when it comes to tax matters. The Tax Court took note of Om's impressive educational background. Further, Om's professional experience includes working for *Fortune* 500 companies and establishing several successful businesses, all of which had sizable accounting and finance departments.

The algorithm considers the taxpayer's education, experience, and knowledge by asking about their work experience, tax experience, and highest level of education. While the taxpayer's work experience and education level are fixed, the taxpayer's familiarity with tax matters is subject to debate. This factor's significance is explored in Scenario 5, in which the algorithm assumes that the taxpayer possessed the educational requirements necessary to qualify as a tax professional. Even if the taxpayer's work experience and education provided them with the required tax knowledge, the algorithm's confidence would change only marginally, with a 92 percent confidence level that the taxpayer would be unsuccessful in a reasonable cause defense.

IV. Conclusion

The use of machine-learning models such as Blue J's algorithm can provide tax professionals with valuable insights into the application of ARPs and the likelihood of success in a reasonable cause defense on appeal. This approach allows professionals to identify the significant factors that affect the defense, ultimately helping to minimize overall risk for taxpayers.

It is worth noting that the importance of proper documentation has been a recurring theme in previous installments of Blue J Predicts, such as our previous predictions of the *Aspro* and *Skolnick* appeals.²⁶ However, this installment adds a unique twist to the discussion by highlighting the crucial role that *providing* documentation to tax advisers (and not merely possessing it) plays

²⁶ See Benjamin Alarie and Christopher Yan, "Disguised Distributions and Management Fees: *Aspro* Revisited," *Tax Notes Federal*, May 30, 2022, p. 1401; and Alarie and Kathrin Gardhouse, "Situational Awareness: Accurate Financial Recordkeeping and Business Deductions," *Tax Notes Federal*, Aug. 1, 2022, p. 713.

in the success of a reasonable cause defense. This underscores the importance of providing accurate documents to tax professionals when seeking to rely on their advice. Taxpayers can leverage legal technology to identify relevant practices and develop solid documentation at the tax planning stage to avoid scrutiny from tax authorities.

Moreover, Blue J's algorithm reveals that a successful reasonable cause defense depends on not only keeping complete records but also providing complete documentation to tax advisers. The algorithm's dynamic approach to weighting the relevant factors based on the court's interpretations provides a significant advantage for tax planning and defense strategies. Taxpayers can use this technology to predict the outcomes of their tax positions and develop sound strategies that reduce the likelihood of ARPs.

Using machine learning to predict outcomes in legal areas with a substantial body of case law and fact-intensive inquiries can provide a significant advantage in tax planning and defense strategies. By taking proactive steps to document transactions and relying on tax professionals, taxpayers can effectively navigate the complex tax landscape and minimize their exposure to penalties. ■

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