The Accuracy Related Penalty (AKA IRS Negligence Penalty)

The substantial tax understatement penalty is just what it sounds like. It is a **penalty for understatement of tax**. It is also referred to as the "IRS negligence penalty" or "tax negligence penalty."

This is one of the many penalties the IRS can impose. This penalty is imposed only if you file a tax return. It is imposed by the IRS–usually as a result of an IRS audit of your tax return.

An understatement of tax can include understating income, such as failing to report items of income that the IRS discovers. This can also include overstating tax deductions that the IRS disallows based on the accuracy of a deduction. It can include overstating tax basis that the IRS adjusts. It can also include using an incorrect value in reporting an asset that is sold.

It's important to note that this penalty is applied regardless of whether or not you intentionally misrepresented your income, deductions, etc. Once the penalty is imposed, it is up to you to take action to remove it. Note: If you are looking for **how to remove the accuracy penalty**, skip to the bottom of this article.

What is the IRS Negligence Penalty?

How is Accuracy-Related Penalty Calculated?

The penalty is set out in Tax Code 6662. Section 6662 says that the penalty is 20 percent of the portion of the underpayment that is attributable to:

1. Negligence or disregard of the rules or regulations,
2. Substantial understatement of income tax,
3. Substantial valuation misstatement,
4. Substantial overstatement of pension liabilities,
5. Substantial estate and gift tax valuation understatement (inconsistent estate tax basis),
6. Disallowed of claimed tax benefits due to economic substance, or
7. Undisclosed foreign financial asset understatements.

We'll address the first three of these in more detail below, as the first three are the most common (the economic substance rationale is caused by reason of a

transaction lacking economic substance, which the IRS has started raising for business taxpayers).

The reference to "portion" is key to understanding this penalty. If you have two errors on your tax return and only one is due to negligence, etc., then the penalty is only computed based on the tax due to that portion.

In addition to 20 percent of these amounts, Section 6601 allows the IRS to charge interest in the penalty. Interest starts to accrue from the return due date and runs until the correct amount of tax and penalties are paid.

This penalty cannot be imposed for the same portion of an understatement that a fraud penalty or a reportable transaction penalty was imposed. This prevents the IRS from assessing double penalties for the same portion of the understatement.

What is an underpayment?

The accuracy-related penalty only applies if there is an "understatement." To find what counts as an "understatement" we have to read Sec. 6664.

Section 6664 says that the term "underpayment" means the amount by which the tax imposed exceeds the excess of:

1. the sum of the amount shown as tax by you on your tax return, over,
2. the amount of any abatement, credit refund, or other repayments.

For example, if the IRS determines that your tax liability is $20,000, but you only reported $10,000 of tax on your tax return and are entitled to a $2,000 research tax credit, then your understatement would be $12,000. The penalty would be $2,400.

What is negligence or disregard of the regulations?

The term "negligence" is usually defined as failure to take proper care in doing something. Our tax laws have a similar definition.

The term "negligence" in our tax laws is a failure to make a reasonable attempt to comply with our tax laws.

The term "disregard" includes careless, reckless, or intentional disregard.

The regulations provide further clarification. Regulation 1.6662-3 says that negligence includes any failure to keep proper books or records or to substantiate tax items correctly.

The regulations suggest that you are negligent if you fail to include income on your tax return if the income was reported on a Form 1099, Schedule K-1, etc. They also say that negligence includes failure to make reasonable inquiries about "too good to be true" tax deductions, credits, etc. where the principal purpose is the avoidance of tax.

What is a substantial understatement of income tax?

An understatement is "substantial" if the understated tax is the greater of (1) 10 percent of the tax determined by the IRS or (2) $5,000.
The $5,000 is increased to $10,000 for corporations. There is also a limit of $10 million in case of a corporation.

What is a substantial valuation misstatement?

The "substantial valuation misstatement" involves an incorrect value of any property. This valuation has to be included in a position that is reported on your tax return.
The Internal Revenue Code says that a valuation misstatement is "substantial" if:

1. the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be), or
2. (i)the price for any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of such price, or (ii)the net section 482 transfer price adjustment for the taxable year exceeds the lesser of $5,000,000 or 10 percent of the taxpayer's gross receipts.

This usually comes up in real estate and business sales and, as noted, for net increases due to transfer pricing disputes.
This is not as common as negligence and substantial understatement penalties described above.

When is Accuracy-Related Penalty Assessed?

The term "assessed" refers to the IRS recording an amount on its books and records. This includes recording the accuracy-related penalty on your IRS tax account.
Once the penalty is assessed, the IRS is authorized to begin trying to collect the penalty from you.
The accuracy-related penalty is usually assessed by the IRS after it makes an adjustment to your tax account. This almost always involves an IRS audit of a tax return that you filed.
IRS auditors will typically impose this penalty as a matter of course if you owe a tax over $5,000 (or $10,000 for corporations) as a result of the audit.
The penalty may not be finally assessed until you exhaust your administrative appeals remedy or file (or fail to file) a tax court petition.

Defenses to the Tax Negligence Penalty

No penalty if no understatement

One way to avoid the accuracy penalty is to show that there is no understatement. This can be done by challenging the IRS's position. This can include challenging the position by filing a refund claim, filing a protest to dispute the tax with the IRS Office of Appeals, or filing a tax court petition.

No penalty if substantial authority

It can also be done by showing that there was substantial authority for the position (note: this does not apply for tax shelters). Substantial authority means the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary positions.

Authority includes the Internal Revenue Code, regulations (proposed, temporary, and final), court cases, and revenue rulings and revenue procedures. It even includes IRS information and press releases and IRS guidance, such as technical advice memoranda.

One has to weigh these rulings to determine whether there is substantial authority. The taxpayer's belief is not relevant to this analysis. Regulation Sec. 1.6662(d)(2)(B) provides more details about this topic, as there are instances when the authorities for a tax issue are not clear.

No penalty if adequate disclosure

There is no accuracy penalty for positions disclosed on tax returns. This requires the relevant facts to be included on your timely-filed tax return (timely-filed is considered with regard to extensions, so extended tax returns count). This is why many taxpayers opt to include various attachments and statements with their tax returns.

You disclose the position and facts on Form 8275 or 8275-R (or a Schedule UTP if you are a large corporation). This form has to be attached to your income tax return.

Disclosure does not help if you do not have a reasonable basis for the position, you do not keep adequate books and records for the position, or the position involves a tax shelter. The IRS will impose Sec. 6662 penalties in these cases.

Revenue Procedure 2012-51 addresses unreasonable positions. It should be consulted if there is a question as to whether you have a reasonable basis for your position.

No penalty if reasonable cause – Sec. 6664

The IRS is not to impose accuracy penalties for the portion of understatements for which you have reasonable cause.

The term reasonable cause is not defined. The courts have filled this gap.

Since the IRS often removes penalties in many cases that warrant it (as explained below), most cases that end up going to court and are fully litigated do not have very good facts. This, coupled with the rule that the taxpayer has the burden of proof once penalties have been assessed, has resulted in a body of case law in which the IRS prevailed in most of the cases. This negative taint should not dissuade you from pursuing the **affirmative defense of reasonable cause**.

There are several theories that support a reasonable cause defense. The primary theory is reliance on a tax advisor. This theory says that you should not be liable for penalties if you hired a competent professional tax advisor, the competent professional was provided with all of the relevant information, and they provided tax advice that turned out to be wrong. This reliance on the advice of a competent professional defense is commonly accepted by the IRS and the courts (it has even been accepted for bookkeepers as competent advisors and tax advisors who have questionable track records).

There are other court cases where accuracy-related penalties have not been imposed when the taxpayer made an honest mistake. This theory says that you do not have the tax knowledge, sophistication, sufficient expertise, etc. to fully understand that your tax position was incorrect. This type of case often involves more complex areas of the law, such as the reporting of retirement distributions, business transactions, etc. and obscure tax reporting forms.

Health and other circumstances beyond your control may also suffice. This theory says that you lacked the requisite mental or physical ability to file an accurate tax return.

While not necessarily a reasonable cause defense, we have also had some luck in arguing that penalties create a financial hardship. We have not had luck with this argument by submitting penalty abatement letters or refund claims. Instead, we have submitted it as part of an offer-in-compromise based on effective tax administration.

We have not had good luck with “good faith” types of arguments as stand-alone arguments The phrase “good faith” usually accompanies the phrase “reasonable cause,” but this should be viewed as a requirement to show reasonable cause. Requests for penalties to not be imposed or abated if they are already imposed should cite and explain the facts for good-faith (and maybe not discuss facts showing bad faith), but should really be premised on another theory.

How to Avoid an Accuracy-Related Penalty

Why is accuracy important when filing an income tax return?

The short answer is that the accuracy-related penalty can be avoided with taxes filed correctly. The proper treatment of tax positions does not trigger taxes. But tax is never this easy….

Using the accuracy-related penalty to your advantage

This penalty can also be avoided by ensuring that possible adjustments result in less than $5,000 of tax (or $10,000 in the case of a corporation). This threshold can be used to your advantage, in some cases.

For example, you may be able to take an unreasonable position penalty-free up to this threshold amount. If a taxpayer is in the 30 percent tax bracket, the taxpayer might be able to take a $16,000 deduction and not worry about this penalty. Taxpayers who do this are said to be "**playing the audit lottery**" as they wait to see if the IRS audits their returns. If the IRS does, the taxpayer will just be out the tax they would have already paid (plus a small amount of failure to pay penalties and interest). If the IRS does not audit the tax return, the taxpayer wins the bet. The IRS audit rate is notoriously low, which ensures that the taxpayer who plays this lottery is likely to win.

How to Remove an Accuracy-Related Penalty

Can IRS waive an accuracy-related penalty?

Yes, the IRS can waive the accuracy-related penalty. This is common.

For example, it is common–and sometimes advisable–to ask the IRS auditor to waive this penalty in exchange for agreeing to pay tax on another item. This trading of the penalty for tax can save you money in some situations.

Does an accuracy-related penalty qualify for a first-time abatement?

No. The IRS first time abate policy does not work for this penalty. The IRS only applies this policy for taxpayers who have penalties that are based on acts that do not involve the calculation of tax on a return, such as the failure to file and failure to pay penalties. The act of not timely paying or filing qualify for this policy. The act of understating tax on a return does not.

How to get accuracy-related penalties abated?

You can get accuracy-related penalties removed by showing that there is no understatement or that it is below the minimum tax threshold of $5,000 (or $10,000 in the case of a corporation).

Alternatively, you can get an accuracy-related penalty abated by trying to negotiate with the IRS agent, as noted above.

You can also get the penalty abated by submitting a written penalty abatement request or filing a claim for a refund for the penalty. The penalty abatement letter

and refund claim denial should entitle you to have the IRS Office of Appeals consider the penalty. Appeals will often agree to remove or reduce the penalty. These penalties are subject to the manager's approval rules. Thus, the request may be based on the IRS not first obtaining manager approval before imposing the penalties.

If the time period has not expired, you can also ask the U.S. Tax Court to abate the penalty. These requests are usually based on arguments as to reasonable cause. This is usually the last effort to remove the penalty given that the courts have a mixed record when it comes to abating accuracy-related penalties.