IRS TAX AUDITS:
TAXPAYER GOOD FAITH MISINTERPRETATION OF THE LAW

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In December 2016 Gary was interviewed by California CEO Magazine and RCBNNews.org on the subject of Criminal Tax Evasion and IRS Tax Audits: Civil and Criminal Issues. This 4 part series, which has been published by Lorman Education, can be viewed below:

Criminal Tax Evasion - Part 1
Criminal Tax Evasion – Part 2
Criminal Tax Evasion – Part 3
Criminal Tax Evasion – Part 4

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IRS Tax Audits: Taxpayer Good Faith Misinterpretation of the Law

By Gary S. Wolfe

Under the case, Mortensen v. Commr. 440 F.3d 375, 385 (6th Cir. 2006), it was held that reasonable minds could differ over tax reporting. In the US Supreme Court case of United States v. Bishop, 412 US 346, 360, 36 L.Ed. 2d 941, 93 S.Ct. 2009 (1973) the Supreme Court stated:

"In our complex tax system, uncertainty often arises among taxpayers who earnestly wish to follow the law… It is not the purpose of the law to penalize frank difference of opinion or innocent errors made despite the exercise of reasonable care". 412 US at 360-361. See: Spies v. United States 317 US 492, 496, 87 L.Ed 418, 63 S.Ct. 364 (1943).

In the Mortensen, Bishop and Spies cases the United States complex system of tax law was held by the Courts to be a reasonable basis for a good faith misinterpretation of a taxpayer's legal duties in the wrong application of the tax law. The essence of the Courts' rulings was that a misunderstanding or lack of knowledge of the law or facts militates against a finding of willfulness.

There is a long line of cases in the United States that side with the taxpayer for a good faith misunderstanding of the law. It has been held that "Willfulness" is a voluntary, intentional violation of a known legal duty. A good faith misunderstanding of the law, whether or not objectively reasonable, negates willfulness. See: Cheek v. United States 498 US 192, 200-202, 112 L. Ed. 2d 617, 11 S. Ct. 604 (1991); United States v. Bishop (cited above), United States v. Pensyl 387 F. 3d 456, 458-460 (6th Cir. 2004).

The complexities of the Internal Revenue Code and the massive case law interpreting the Code (along with the US Treasury Regulations, Revenue Rulings et al) result in the understanding that the complexities involved in the interpretation of the relevant tax laws may subject the taxpayer to a misinterpretation of the tax law. As these cases hold a taxpayer is not required to be perfect for this would be an unrealistic expectation. Even tax specialists cannot be expected to be perfect.

As stated in the Mortensen case, reasonable minds can differ over tax reporting. The US Congress was concerned that taxpayers would participate in the audit lottery (ie. the risks of being audited) and take questionable positions on their tax returns in hopes of not being audited. H.R. REP. No.101-247, 1388 (1989). H.R. Rep. No. 101-247, as reprinted in 1989 U.S.C.C.A.N. 1906, 2858.

Congress legislation requires that taxpayers have an obligation to submit tax returns that reflect correct amounts of income. IRC Sec. 6662 imposes a penalty for substantial understatement of income (See IRC 6662 (b). However, the relevant statutes provide for several defenses to penalties including "reasonable cause" and "good faith defense" (see IRC 6664 (c)

Treasury Regulation 1.6664-4(b) (1) provided clarification on reasonable cause and good faith, which states "the most important factor is the taxpayer's effort to assess the taxpayer's proper tax liability". In addition, Courts take into account all the relevant facts and circumstances to make a determination of "reasonable cause" and "good faith" such as the taxpayer's experience, knowledge, sophistication, and education and whether the taxpayer relied on a tax professional.

The key issue is whether the taxpayer made an effort to assess their proper tax liability. So if the taxpayer made a mistake in their interpretation of the tax law but made "an effort" to assess their proper tax liability for example by engaging a qualified tax advisor who is an expert on federal tax law (e.g. a tax attorney) and then relied on the professional tax advisor (i.e. tax attorney) in the preparation and filing of the relevant tax return to report the income the taxpayer may then satisfy the "reasonable cause" and "good faith" exception because the taxpayer believed that the tax professional had knowledge in the relevant areas of the tax law. (See: United States v. Boyle 469 U.S. 241, 251 (1985).

Under Boyle the US Supreme Court held that a taxpayer is entitled to rely on the advice of a tax attorney since "it is unrealistic for taxpayers to recognize errors in the substantive advice of an attorney." In addition Boyle stated: "

to require the taxpayer to challenge the attorney would nullify the purpose of seeking the advice of a presumed expert in the first place".

So how does the taxpayer establish reasonable cause and a good faith effort? The taxpayer who recognizes the limitations of their tax expertise and decides to engage a competent tax attorney as an expert to guide them may then prove "reasonable cause" in the tax positions they take on their tax returns. Generally, reliance on a tax advisor may be considered reasonable when the taxpayer knew that the tax advisor possessed specialized knowledge in the relevant aspects of federal tax law (Treasury Reg. 1.6664-4(b)(1).

In the case Stanford v. Commr 152 F.3d 450 (5th Cir. 1998) the court held that "many intelligent investors hire independent experts to advise them particularly with respect to arcane matters of tax law". The key issue is whether the taxpayer understood the tax law. If not, they hired a skilled tax attorney who was well versed in the "arcane area of tax law" and then relied on the tax attorney's advice.

Case law has set forth a 3 prong approach to prove reasonable cause (especially where the taxpayer is asserting a defense against penalties under IRC Sec. 6662 which imposes a penalty for substantial understatements of income, among other penalties imposed for negligence, substantial valuation misstatements, and a variety of other types of understatements of income or overstatements of liabilities (IRC 6662 (b).

The case law 3 prong approach to prove reasonable cause requires the taxpayer to demonstrate the following:

1. The Advisor was a competent professional who had sufficient expertise to justify reliance;

2. The taxpayer provided necessary and accurate information to the advisor;

3. The taxpayer actually relied in good faith on the advisor's judgment

See Sklar, Greenstein & Scheer, P.C. v. Commr. 113 T.C. 135, 144-145 (1999) citing Ellwest Stereo Theatres of Memphis,Inc. v. Commr, T.C.M. 1995-610.

Generally, reliance on a tax expert (i.e. tax attorney) may be considered reasonable when the taxpayer knew that the tax advisor possessed specialized knowledge in the relevant aspects of the Federal tax law. In the case of Neonatology, P.A. v Commr. Taxpayer reliance on an insurance agent was found to be unreasonable because the insurance agent was not a tax professional and the taxpayers were sophisticated and should have known that the tax benefits discussed were “too good to be true”. See Neonatology 115 T.C. 43, 99 (2000) affirmed 299 F.3d 211 (3d Cir. 2002).

In the case of Stanford v. Commr 152 F3d 450 (5th Cir. 1998) the Court held that a taxpayer could rely on their tax advisor who was an expert in the relevant area of law. The Court ruled that the tax expert who advised the taxpayer was “diligent in reviewing the taxpayer’s business and tax records, and studying the statutes, case law, legislative history and regulations.

In Larson v. Commr TC Memo 2002-295, 84 TCM 608 (2002) the Court held that to satisfy the “reasonable cause” and “good faith” exception the taxpayer must provide necessary and accurate information to the tax advisor. In this case the taxpayer had reason to believe that the tax reported on the tax return was not accurate, and was not able to satisfy the “reasonable cause” and “good faith” exception as the “taxpayer should have made additional efforts to assess the proper amount of their tax liability.

In Woodsum v. Commr. 136 TC 585 (2011) the court held that the taxpayer must rely in good faith on the tax advisor’s judgment or advice. In this case, the Court held that the taxpayer’s reliance on the tax expert did not constitute reasonable cause. Here the tax return failed to include a $3.4m tax item and also substantially understated the tax liability.

In Woodsum, although the taxpayers provided the tax firm and other competent professionals with accurate information through more than a hundred information returns, the Court did not apply the reasonable cause exception because the tax professionals did not provide advice to the taxpayers.

Tax Advice as defined in Treas. Reg. section 1.6664-4(c)(2) constitutes analysis or the conclusions of a professional tax advisor. In Woodsum, the taxpayers did not provide evidence to show that a professional tax advisor's analysis or conclusions led to the omission of the item on the tax returns. Instead the taxpayers merely perpetuated a clerical mistake. The taxpayers failed to satisfy either reasonable cause or good faith as the taxpayers did not review the prepared return to ensure that the income items were included.

Taxpayers may rely on a tax expert (i.e. tax attorney) as long as the tax advisor had apparent expertise to justify their reliance, the taxpayer provided the necessary and accurate information and the taxpayer relied in good faith on the advice received from the tax advisor. The tax advisor must be licensed and have sufficient background, credentials and expertise to provide the advice requested by taxpayers.