

Penalty Abatement:

Framework for the Reasonable Cause and Good Faith Defense

The reasonable cause and good faith exception under IRC § 6664(c) is the statutory basis for avoiding accuracy-related penalties under IRC § 6662 and fraud penalties under IRC § 6663 [1]. The core of the exception is stated in IRC § 6664(c)(1): "No penalty shall be imposed under section 6662 or 6663 with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion".

The determination is not a simple checklist but a holistic evaluation of all relevant facts and circumstances, with the taxpayer bearing the burden of proof.

1. The Overarching Standard: Taxpayer's Effort and Sophistication

A crucial point is the general standard articulated in the Treasury Regulations. The determination of reasonable cause and good faith is made on a case-by-case basis, and "generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability" [2].

Furthermore, the taxpayer's own attributes are central to the analysis. An honest misunderstanding of fact or law can be considered reasonable, but only "in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer" [2]. This means a taxpayer's sophistication is a key factor. Courts often hold highly educated or experienced professionals to a higher standard, making it more difficult for them to claim reasonable reliance, especially if a transaction's tax benefits seem "too good to be true".

2. Advisor Competence and Independence

The regulations specify that reliance may not be reasonable if the taxpayer "knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law" [2].

- **Competence:** The advisor's competence is judged on their expertise in the specific tax matter at issue. In *Rawls Trading LP*, the court found a CPA competent to advise on a complex short-sale transaction based on his credentials and experience, even though the IRS argued he was wrong on the law. The court noted that a taxpayer cannot be expected to know if an otherwise qualified advisor lacks knowledge in a specific area.
- **Independence:** The advisor must not have a conflict of interest. For example, advice from a promoter of a tax shelter is generally not considered objective, and reliance on it is often deemed unreasonable. In *Rawls*, the court distinguished between a law firm that

was a promoter and a CPA who was merely referred to the taxpayer by the promoter, finding the CPA to be independent.

3. Quality and Form of the Advice

- **Form of Advice:** While written advice is best practice, it is not a strict requirement. Treasury Regulation § 1.6664-4(c)(2) defines advice broadly as "any communication...setting forth the analysis or conclusion of a person, other than the taxpayer...Advice does not have to be in any particular form" [2].
- **Substance of Advice:** The advice itself must be based on sound reasoning. According to Treasury Regulation § 1.6664-4(c)(1)(ii), the advice "must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person" [2].

4. Full Disclosure of Information

The defense is undermined if the taxpayer fails to provide the advisor with all necessary and accurate information, however, the court in *Rawls* noted that it is the advisor's responsibility to know what questions to ask, and a taxpayer may not be at fault if the advisor fails to make sufficient inquiries.

Purpose and Critical Limitations

1. The Non-Delegable Duty to File

A significant limitation to this defense, established by the Supreme Court in *United States v. Boyle*, is that a taxpayer's duty to file a tax return on time is a non-delegable duty. A taxpayer cannot blame an agent or advisor for missing a clear and fixed filing deadline. The reasonable cause defense is more applicable to substantive tax positions rather than the ministerial act of filing.

2. Waiver of Attorney-Client Privilege

A taxpayer who asserts the reasonable cause defense by claiming reliance on the advice of an attorney puts the nature of that advice at issue. Consequently, courts have held that this action waives the attorney-client privilege for all communications and documents related to the advice. The IRS is then entitled to review those communications to assess the taxpayer's state of mind and the reasonableness of the reliance. This was the holding in cases like *Eaton Corp. v. Commissioner* and *Ad Investment 2000 Fund LLC v. Commissioner*. This is a significant risk that taxpayers must consider before raising the defense.

3. Special Rules for Certain Transactions

The general reasonable cause exception does not apply to all underpayments. IRC § 6664(c)(2) and (d) establish stricter requirements or disallow the defense entirely for certain transactions, such as:

- Transactions lacking economic substance (as described in IRC § 6662(b)(6)).
- Certain undisclosed foreign financial asset understatements.
- Reportable transaction understatements, which have their own heightened reasonable cause standard requiring adequate disclosure, substantial authority, and a reasonable belief that the treatment was more likely than not proper [1].

Critical Cases Addressing Reliance on a Tax Professional

Your document would be greatly strengthened by referencing the cases that have defined the contours of this defense.

- ***United States v. Boyle, 469 U.S. 241 (1985)***: This landmark Supreme Court case established that to show reasonable cause, a taxpayer must demonstrate they exercised "ordinary business care and prudence." Crucially, it held that the duty to file a timely return is non-delegable, and reliance on an agent to file is not reasonable cause for a late filing [3], [4ae05edd-ffcf-58f3-98ff-7eb7815bcd9]. The Court distinguished between relying on an agent for the ministerial task of filing versus relying on an attorney's advice on a substantive question of tax law, finding the latter to be reasonable [4].
- ***Neonatology Associates, P.A. v. Commissioner, 115 T.C. 43 (2000)***: This Tax Court case is widely cited for its three-prong test to prove reasonable reliance on a professional:
 1. The adviser was a competent professional with sufficient expertise to justify reliance.
 2. The taxpayer provided necessary and accurate information to the adviser.
 3. The taxpayer actually relied in good faith on the adviser's judgment [5]. The case also stands for the principle that reliance is not in good faith if the taxpayer knew the transaction was "too good to be true," particularly for sophisticated taxpayers [6].
- ***Haywood Lumber & Mining Co. v. Commissioner, 178 F.2d 769 (2d Cir. 1950)***: This is a taxpayer-friendly ruling holding that when a taxpayer selects a competent tax expert, supplies them with all necessary information, and requests the preparation of proper returns, the taxpayer "has done all that ordinary business care and prudence can reasonably demand." The taxpayer is not required to second-guess the expert or inquire about the applicability of specific legal principles [3].

- ***Litman v. United States, 90 Fed. Cl. 257 (2007)***: This case provides a modern example of a successful reasonable cause defense. The taxpayers demonstrated their good faith and effort to assess their proper tax liability by commissioning two separate appraisals for their restricted stock, relying on the more conservative of the two, and having their accounting firm (KPMG) review the chosen appraisal for reasonableness before filing their return. This extensive effort was key to the court's finding of reasonable cause [4].
- ***Rawls Trading LP v. Commissioner, T.C. Memo. 2012-340***: In this son-of-BOSS tax shelter case, the court still found the taxpayer had reasonable cause by relying on his CPA (who was not a promoter). The court emphasized that the taxpayer provided all information and that it was the CPA's job to ask the right questions. It also affirmed that an advisor can be considered competent even if their advice is ultimately incorrect, and a taxpayer is not required to seek a second opinion or monitor the expert's work.

Cited sources:

[1] Sec. 6664 Definitions and special rules: <https://app.askbluej.com/source/c5212f99-106a-55a5-9535-113e1c15ccc3>

[2] Sec. 1.6664-4 Reasonable cause and good faith exception to section 6662 penalties.:
<https://app.askbluej.com/source/5eb1b87a-d2ed-54a0-a5ec-6ef52ba6c236>

[3] TAM 201423035: <https://app.askbluej.com/source/52a0fefc-fdd0-50db-8c01-6db08e00c0df>

[4] Litman, David S., et al. v. United States, 78 Fed. Cl. 90 (2007):
<https://app.askbluej.com/source/68aa744f-23f4-5a3c-9262-0286d185b0a5>