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Tax Pros Can’t Shield Taxpayers From Accuracy-Related Penalties

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A US Tax Court decision highlights that taxpayers must review their returns for accuracy, as advice from tax professionals doesn’t preclude penalties due to negligence or disregard, say Marcum’s Kristina Lebron Vega and Ashlie Forum.

While many might view their annual obligation around tax filing as mundane or inconsequential, taxpayers must take heed of their exposure before accepting or signing, regardless if returns are self-prepared or completed by a professional.

As the US Tax Court’s September decision in *Johnson v. Commissioner* underscores, consequences are real for taxpayers who are presumed to possess specialized knowledge in their respective industries, but fail to notice inaccuracies or incompleteness in their returns.

The IRS can impose a penalty related to negligence or disregard of the rules and regulations, and reliance on advice from a tax professional doesn’t protect taxpayers from such penalties.

Facts of ***Johnson v. Commissioner***

The petitioner, John Johnson, was engaged in the business of buying, selling, and leasing property for more than 50 years. Due to his experience in the real estate industry, the IRS expected him to review and determine inconsistencies on the tax return that was prepared by a professional service provider—to avoid being subject to the accuracy-related penalty.

In cases of negligence or disregard of rules or regulations, the accuracy-related penalty is 20% of the portion of the underpayment of the tax resulting from the negligence or disregard.

In this case, the errors on tax returns for the years under review led to approximately $1 million in tax deficiencies and $200,000 in accuracy-related penalties. The taxpayer acknowledged the multiple errors, but disputed the assessment of the accuracy-related penalty.

Incorrect depreciation deduction. In 2006, the taxpayer purchased a commercial property for approximately $4.1 million. Commercial real estate property must be depreciated over a 39-year life.

However, the filed return depreciated the commercial real estate over a seven-year life. The depreciation taken over the years was approximately $2.1 million using the seven-year life. If the correct 39-year life had been applied, the depreciation expense would have totaled about $600,000. The taxpayer took accelerated deductions over the years in question of $1.5 million.

Incorrect documentation for charitable deductions. Recently, additional scrutiny has been placed on the proper completion of Form 8283 for deduction of noncash charitable donations. The IRS has provided detailed guidance that taxpayers and tax professionals can reference.

The taxpayer claimed $152,500 in charitable contributions for a building and fencing. He didn't properly report the deduction because he failed to obtain a qualified appraisal to attach to the form, failed to sign the form, didn't submit written acknowledgment from the donation recipient, and didn't clearly identify the donated property.

Mortgage interest deduction reported twice. The taxpayer deducted $44,800 of mortgage interest as a personal itemized deduction on Schedule A and as a business deduction on Schedule E, deducting the mortgage interest expense twice.

Under-reporting of social security income. The taxpayer reported social security income of $30,800. The actual amount of social security income should have been $35,500.

Analysis

Per Section 6662(c) of the tax code, negligence includes any failure to make a reasonable attempt to comply with the provisions, and disregard includes careless, reckless, or intentional disregard. If the taxpayer shows reasonable cause for underpayment and acted in good faith, no accuracy-related penalty may be imposed.

In this case, the taxpayer contended a reliance on a certified public accountant should qualify for a reasonable cause and good-faith exception. Reasonable cause requires the taxpayer to exercise ordinary business care and prudence as to the disputed items.

The determination of reasonable cause must be "made on a case-by-case basis, taking into account all pertinent facts and circumstances." The most essential factor in this determination is the "extent of the taxpayer's effort to assess the taxpayer's proper tax liability."

Reasonable reliance on the advice of an independent, competent professional on the tax treatment of an item may meet the requirement of ordinary business care and prudence. The taxpayer's education and business experience are relevant to the determination of whether the taxpayer's reliance on professional advice was reasonable and in good faith.

For a taxpayer to reasonably rely on the advice of a professional, they must pass three tests: The adviser must be a competent professional with sufficient expertise to justify reliance, they must provide all necessary and accurate information to the adviser, and must rely in good faith on the adviser's judgment.

The taxpayer passed the first two tests but not the third, according to the court. For such reliance to exist, the taxpayer would have had to establish that his CPA communicated advice. The taxpayer didn't prove that his CPA told him the seven-year depreciation schedule was applicable or that the mortgage interest deduction could be claimed twice.

The taxpayer contended he was entitled to the reasonable cause and good faith exception merely because his CPA prepared the returns. The court found that "the mere fact that a certified public accountant has prepared a tax return does not mean that he or she has opined on any or all of the items reported therein."

Taxpayers have a nondelegable duty to review the return for accuracy before filing. The taxpayer, a sophisticated real estate professional, wouldn't have missed the duplicate interest deductions, overstated depreciation, or lack of qualified appraisal if he had reviewed the returns. The court found that the taxpayer had failed to carry his burden of establishing reasonable cause.

While this case concerns expertise in real estate, taxpayers with specialized knowledge in any industry should learn from these findings to protect their reputations and safeguard their financial interests.

The case is Johnson v. Commissioner, T.C., No. 12676-20., 9/13/23.

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Author Information

Kristina Lebron Vega is a supervisor in Marcum's tax and business services division, supporting the firm's real estate tax and business enterprise tax specialty groups.

Ashlie Forum is partner in Marcum's tax and business services division and is the firm's real estate and construction industry leader in the southeast.

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