APPEALS
TECHNICAL GUIDANCE PROGRAM
APPEALS SETTLEMENT GUIDELINES

ISSUE: Home-Based Business

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SETTLEMENT POSITION
HOME BASED BUSINESS

ISSUES

1. Are the deductions claimed ordinary and necessary expenses incurred during the taxable year in carrying on a trade or business or for-profit activity?

2. Does the accuracy-related penalty under IRC §6662 apply to any portion of the underpayment?
STATEMENT OF ISSUE #1

Are the deductions claimed ordinary and necessary expenses incurred during the taxable year in carrying on a trade or business or for-profit activity?

BACKGROUND

Many taxpayers inappropriately attempt to characterize personal expenses as the business expenses of a home-based business. These personal expenses are not deductible. There are three common situations.

? Scenario #1: Taxpayers purchase or develop a promoted scheme that advises them how to create the appearance of having a legitimate business (home-based or otherwise) primarily for the purpose of deducting personal living or family expenses on their individual income tax returns. The purported business activity is no more than an attempt to create the appearance of having a business where none actually exists.

? Scenario #2: Taxpayers participate, as a promoter, investor, or marketer, in a pyramid scheme that advises how to deduct personal living or family expenses on their individual income tax returns. The purported business activity (pyramid scheme) claims to provide income potential from selling the promotional packages, but is motivated solely by tax avoidance. The purported business activity is no more than an attempt to create the appearance of having a business where none actually exists.

? Scenario #3: Taxpayers are involved in a legitimate business (home-based or otherwise). In this situation, the promoters advise taxpayers to erroneously deduct personal living expenses.

Home-based business schemes have proliferated due to promotion by a number of tax advisors. The home-based business scheme continues to expand by utilizing flow-through entities such as partnerships and S corporations to conceal improper deductions and create the appearance of a legitimate business activity. The losses from the flow-through entities may include improper losses due to basis limitations.

The typical home-based business scheme is a classic substance versus form situation. Generally, the scheme involves any one or combination of the following:

? Deducting all or most of the cost of maintaining a personal residence. The promoters claim the “exclusive use” restriction of IRC §280A can be avoided by placing business-related items in a room of the house. The promoter attempts to use the IRC §280A(c)(2) exception for storage use (storage on a regular basis of inventory or product samples). For example, the promoter claims if a poster, calendar, desk, file cabinet, telephone, or other business-related item is placed in...
the room, it secures its business status without regard to the fact that the room is a kitchen, bathroom, child’s bedroom, etc.

? Paying children and/or family members up to $4,250 for household duties that are not ordinary and necessary to the operation of the business (e.g., disposing of trash, mowing the lawn, answering telephones, washing cars). Also, the payments may be excessive for the services performed.

? Deducting education expenses up to $5,250 per year per family member by claiming an Education Assistance Program for family members wrongfully claimed as employees or without regard to IRC §127 which requires that no more than 5% of such benefits be for an owner or their family member.

? Deducting excessive car and truck expenses when the vehicle was used for both personal and business use. The promoters claim a business purpose for every trip, whether it is to commute to a regular job, the grocery store, golf course, church, etc. The taxpayer argues that there is always the potential of recruiting new clients.

? Deducting personal furniture, home entertainment equipment, children’s toys, etc.

? Deducting personal travel, meals, and entertainment under the guise that since everyone is a potential client, these are deductible, not personal, expenses.

? Deducting 100% of personal medical expenses merely by “employing” a family member who is not a bona fide employee and creating a medical reimbursement plan.

Taxpayers in these schemes are advised by promoters to maintain detailed records of all expenses incurred. In addition to selling the scheme, some promoters also offer audit insurance for an additional fee.

Home-based business schemes reduce tax liability by taking a tax position that is not supported by tax law or by misinterpreting the law. Therefore, these schemes are considered to be abusive and a detriment to voluntary compliance. The IRS has taken a series of actions to warn taxpayers and tax preparers against using these schemes and to stop the activities of promoters who market them.

Rev. Rul. 2004-32, 2004-12 I.R.B. 621, emphasizes to taxpayers, promoters, and return preparers who assist taxpayers with home-based business schemes, that they cannot avoid income tax by claiming otherwise nondeductible personal, living or family expenses as business deductions. Personal expenses are simply not deductible whether or not incurred in a purported home-based business context.

Courts have enjoined promoters who market frivolous tax avoidance schemes that utilize these frivolous arguments. Four major promoters were enjoined by the courts from carrying on some aspects of their promotion:

? Daniel Gleason of Franklin, TN: On 08-25-2004, Gleason, individually and dba Tax Toolbox, Inc. (TTB) and My Taxman Inc. was ordered to stop promoting, marketing,


? Michael C. Cooper, doing business in a number of capacities, including Renaissance, TTP, Inc., was temporarily enjoined by the State of Kansas from promoting a multi-level marketing scheme of selling home-based business packages. **Kansas v. Cooper**, District Court of Shawnee County, Case. No. 00-C-1394, May 15, 2001.


**COMPLIANCE POSITION**

The deductions are disallowed because the purported legitimate business (home-based or otherwise) is a sham. The claimed expenses are personal in nature despite the alleged business context.  

1 Occasionally a business purpose argument is raised and consideration is given as to whether or not the activity is one engaged in for profit.

Where the alleged business is a sham, purported income (if insubstantial) is often disregarded by Compliance. In cases where the taxpayer has a legitimate business but has utilized home based business schemes to add personal expenses to legitimate ones, Compliance generally focuses on disallowing specific expenses rather than disregarding the entire activity.

**TAXPAYER POSITION**

Taxpayers argue that the reported business activity is legitimate or was engaged in for profit, and the claimed deductions were ordinary and necessary to carrying on the business activity.

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1 Compliance’s position is further indicated by Publication 4035 (published 08-2003, this document cautions the public about promoters who are selling the concept that taxpayers can operate any type of unprofitable “business” out of their home and claim personal expenses as business expenses); IR 2002-13 (IRS News Release dated 02-02-2002), warns taxpayers to be aware of home-based business tax avoidance schemes).
DISCUSSION

LEGAL ANALYSIS

IRC §162 allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. A bona fide business must truly exist prior to claiming expenses. An expense may qualify as ordinary and necessary if it is appropriate and helpful in carrying on a trade or business, is commonly and frequently incurred in the type of business conducted by the taxpayer, and is not a capital expenditure.2

A trade or business expense deduction under IRC §162, however, is not permitted with respect to a taxpayer’s residence unless specifically permitted in limited circumstances by IRC §280A. IRC §280A provides that in order for allocable expenses to be deductible, the portion of the taxpayer’s residence must be used exclusively by the taxpayer on a regular basis as a principal place of business for the taxpayer’s trade or business, or to meet or deal with patients, clients or customers in the normal course of the taxpayer’s trade or business. IRC § 280A also allows for deduction of expenses associated with a separate structure not attached to the dwelling unit, if it is used exclusively on a regular basis in the taxpayer’s trade or business. If the taxpayer is an employee, the exclusive and regular use of a portion of the taxpayer’s residence must be for the convenience of the taxpayer’s employer before any expenses relating to that part of the taxpayer’s residence may be deducted. Additionally, IRC § 280A may allow deductions if the residence is used on a regular basis for storage of inventory or product samples if certain conditions are met. The deduction is limited to the income from the business, so the deduction cannot be used to offset other income.

IRC §183(b) limits the deductions for an activity not engaged in for profit to the sum of (a) the deductions which would be allowable without regard to whether or not the activity was engaged in for profit, and (b) a deduction equal to the amount of the deductions which would be allowable for the activity if it were engaged in for a profit, but only to the extent that the gross income derived from the activity for the taxable year exceeds the deductions allowable under (a). Treasury Regulation §1.183-2(b) identifies nine relevant factors to consider in determining whether an activity is engaged in for profit.

IRC §262 prohibits the deduction of personal, family and living expenses, except as otherwise expressly provided by the Internal Revenue Code. Medical expenses, for example, are deductible only if the specific requirements of IRC §213 are satisfied. Similarly, the provisions of IRC §163(h) govern when an individual taxpayer (not engaged in a trade or business) may deduct interest on a mortgage or home equity loan. IRC §163(h)(2) and §163(h)(3).

Applying the Law to the Taxpayer’s Facts and Circumstances:

The first step in determining the proper tax treatment of expenses not involving the home and giving rise to the losses reported on the Schedule C (or flowing through from a partnership or S corporation) is to decide whether or not the activity is a bona fide business. In determining if a transaction is a “sham,” courts consider whether there is economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that are meaningless. A key factor to this determination is a factual assessment of whether the transaction is entered into for profit with a reasonable prospect of economic gain. The following court cases may assist in making the determination on whether the activity is a sham:

? In **Frank Lyon Co. v. Commissioner**, 435 U.S. 561 (1978), the Supreme Court defined the criteria for determining whether or not a transaction was a sham. The court stated that in order to be recognized for tax purposes, there needs to be an economic substance which is compelled or encouraged by business or regulatory realities, and is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels.

? In **Collins v. Commissioner**, 857 F.2d 1383 (9th Cir. 1988), the court did not inquire into a transaction’s primary objective until it determined that the transaction was bona fide and not a sham. The standard used by the court to determine if a sham exists is whether the transaction had any practical economic effects other than the creation of income tax losses.

? In **Knetsch v. Commissioner**, 364 U.S. 361 (1960), the court stated, “Tax avoidance is a dominating motive behind scores of transactions. It is plainly present here.” The court determined there was nothing of substance to be realized by the taxpayer from the transaction beyond a tax deduction.

? In **Rose v. Commissioner**, 868 F.2d 851 (6th Cir. 1989), the court upheld the disallowance of deductions claimed by taxpayers who had purchased reproduction masters of Picasso originals because the taxpayers had no honest profit motive and their venture was completely void of economic substance and motivated by tax considerations.

? In **Mahoney v. Commissioner**, 808 F.2d 1219 (6th Cir. 1987), the transactions were shams as they lacked any purpose other than generating tax losses. The court concluded that if a transaction is a sham, then there is no need to analyze if the “entered into for a profit” element of IRC §183 or “trade or business” element of IRC §162 is satisfied.

? In **Jackson v. Commissioner**, 966 F.2d 598 (10th Cir. 1992), the court determined that in making the determination of whether a transaction is a sham, the fact that an individual believes in the genuineness of the business opportunity is not sufficient to create economic substance. One of the factors cited by the court to support its sham determination was that the documents describing the benefits of the transactions emphasized the tax benefits. The Tax Court had held (T.C. Memo. 7

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that the transaction underlying the deduction was a sham, not recognizable for tax purposes and the taxpayer was unable to deduct the money paid for the participation in the scheme.

In *Manley v. Commissioner*, T.C. Memo. 1983-558, the court disallowed deductions of claimed personal and living expenses and imposed both the negligence penalty and a penalty under IRC §6673 for advancing frivolous arguments.

If a bona fide business appears to exist, the second step in the analysis is to decide whether or not the taxpayer meets the burden of proof for ordinary and necessary expenses paid or incurred during the taxable year in carrying on the trade or business. Even though taxpayers in these schemes are advised to maintain detailed records of all expenses incurred, the existence of such records alone do not provide evidence to support the requirement that expenses be “ordinary and necessary” in relation to a legitimate business activity and satisfy any other deductibility requirements under IRC §274.

A taxpayer who claims a business expense deduction has the burden of proof. Deductions are strictly a matter of legislative grace, and petitioners bear the burden of proving that they are entitled to the deductions claimed. *Hawthorne v. Commissioner*, T.C. Memo. 1999-31 (citing *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84, 117 L.Ed.2d 226, 112 S. Ct. 1039 (1992)). This includes the burden of substantiating the amount and purpose of the item claimed. IRC §6001 imposes a broad recordkeeping responsibility on all taxpayers, requiring them to maintain adequate records to substantiate the liability. IRC §6001 gives the Service authority to require whatever records it deems necessary. If the taxpayer proves that some part of an expenditure was made for deductible purposes, and when the record contains sufficient evidence for a reasonable allocation, the Service may allocate a portion (supported by the record) of the expenditure to the deductible business purpose. *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

*Cohan* may allow the Service to accept an estimate of some expenses but not others. Substantiation is more stringent for travel, meals and entertainment, gifts, and “listed property” as defined in IRC §280F(d).3 IRC §274(d) disallows deductions for traveling expenses, gifts, and meals and entertainment, as well as for “listed property,” unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the

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3 Section 280F(d)(4) defines listed property.

(A) In general. Except as provided in subparagraph (B), the term “listed property” means-
(i) any passenger automobile,
(ii) any other property used as a means of transportation,
(iii) any property of a type generally used for purposes of entertainment, recreation, or amusement,
(iv) any computer or peripheral equipment (as defined in section 168(i)(2)(B)),
(v) any cellular telephone (or other similar telecommunications equipment), and
(vi) any other property of a type specified by the Secretary by regulations. …

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taxpayer’s own statement: (1) the amount of the expense; (2) the time and place of the expense; (3) the business purpose of the expense; and (4) the business relationship to the taxpayer of the persons involved in the expense.

SETTLEMENT GUIDELINES FOR ISSUE #1

Whether the claimed business activity is a sham or whether the claimed deductions on the Schedule C, Profit or Loss from Business, are ordinary and necessary business expenses incurred during the taxable year in carrying on a trade or business or for profit activity is made on a case-by-case basis depending on the specific facts and circumstance of each case.

Scenario #1: If the activity is determined to be a sham, it will be disregarded for federal tax purposes. When the transaction is disregarded, determine the proper tax treatment of (a) the gross receipts, (b) the expenses, (c) the business use of the home expenses, and (d) the individual tax return preparation expenses as follows:

(a) Gross Receipts: The gross receipts from a sham or pyramid scheme are not business income. The gross receipts are reclassified as “Other Income” and it is not self-employment income. It is possible the taxpayer may claim the gross receipts are fictitious or that Compliance will choose to disregard them. If it is determined the gross receipts lack economic reality, disregard the gross receipts by not reclassifying the gross receipts as “Other Income.”

(b) Expenses: All expenses (deductions from receipts) are disallowed in full.

(c) Business Use of the Home Expenses: If there are expenses deductible under IRC §163 or §164 such as mortgage interest and property taxes, allow them on Schedule A of the Form 1040.

(d) Individual Tax Return Preparation Expenses: If there is an expense deductible under IRC §212 for individual income tax preparation fees allocable to the individual Form 1040 and Schedules A and B, allow it on Schedule A of the Form 1040 as an itemized deduction subject to the 2% Adjusted Gross Income limit.

In Jackson v. Commissioner, 966 F.2d 598 (10th Cir. 1992), the court held the sham nature of the transaction prevents it from being recognized for tax purposes. The taxpayers were unable to deduct the very funds that enabled their participation in the scheme. Even though payments were made to insiders and real money changed hands, the payments were without economic substance.
In non-sham cases, consider IRC §183, which allows deductions for some expenses in an activity not engaged in for profit and not meeting the IRC §162 or §212 requirements. IRC §183(b) allows the following deductions for an activity not engaged in for profit: (a) the deductions which would be allowable without regard to whether the activity was engaged in for profit; and (b) a deduction equal to the amount of the deductions which would be allowable for this activity if it were engaged in for a profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable under (a). The gross receipts are reclassified as “Other Income” and it is not self-employment income. Allow the expenses, up to the amount of gross receipts, on Schedule A of the Form 1040 as a Miscellaneous Itemized Deduction, subject to 2% Adjusted Gross Income reduction. Treasury Regulation §1.67-1T.

Scenario #2: If the pyramid scheme involves selling the tax avoidance scheme, it will be disregarded for federal tax purposes. When the transaction is disregarded, refer to Scenario #1 to determine the proper tax treatment of (a) the gross receipts, (b) the expenses, (c) the business use of the home expenses, and (d) the individual tax return preparation expenses.

Scenario #3: If the activity is a legitimate business (home-based or otherwise) deducting fabricated or personal living expenses, consider the individual expenses and disallow those which the taxpayer cannot show to be ordinary and necessary to the business activity.

The following examples illustrate fact patterns associated with the home-based business cases:

Example 1. T, an individual, received advice from P, a friend who is not a tax professional but who sells the tax avoidance and audit assistance packages, as to how T might reduce Federal tax obligations. P advised T that, for a nominal fee, T could receive tax benefits which virtually eliminate Federal tax liability. P also named the promoters who had credentials in tax. Without further inquiry, T purchased the packages and claimed the tax savings benefits by creating a fictitious home-based business claiming to be a “consultant” and selling the promotional packages (such as Renaissance or those offered by “The Tax People”). T reports the sale of a couple of promotional packages and deducts personal expenses such as commute, meals, and entertainment. T claims he is always seeking potential clients when he leaves his home. T also deducts business use of his home claiming he places promotional material in the rooms for visitors to view when they visit. T keeps books and records reconciling to the deductions on the tax return as required by the promoter. T reports Schedule C losses. In this case, T’s home-based business is a sham created for purposes of generating Schedule C losses to offset income.

Example 2. T, an individual, has a legitimate sole proprietorship. T changes tax preparers for the purpose of the tax saving benefits offered by P, the home-based business promoter. T deducted inflated business expenses and/or personal
expenses, including education expenses for the children, medical reimbursement plan, and personal commute. Although T is involved in a bona fide business, the inflated and/or personal deductions are disallowed.

Attachment 1 is a decision guide which will assist in determining the appropriate settlement for issue #1.
STATEMENT OF ISSUE #2

Does the accuracy-related penalty under IRC §6662 apply to any portion of the underpayment?

BACKGROUND

Refer to the background discussion under Issue #1.

COMPLIANCE POSITION

Compliance asserts the accuracy-related penalty under IRC §6662 for negligence or disregard of rules or regulations and/or a substantial understatement of income tax in appropriate cases.⁵

TAXPAYER POSITION

Taxpayers defend against the imposition of the accuracy-related penalty by either making arguments specific to the relevant component of the penalty (discussed below) or by arguing that the reasonable cause and good faith exception applies because they relied on the advice of a preparer/promoter.

DISCUSSION

LEGAL ANALYSIS

IRC §6662 imposes an accuracy-related penalty in an amount equal to 20% of the portion of an underpayment attributable to, among other things:

(1) negligence or disregard of rules or regulations,⁶
(2) any substantial understatement of income tax,⁷
(3) any substantial (or gross) valuation misstatement under chapter 1.⁸

⁵ Compliance position on penalties is indicated in the Accuracy-Related Penalties for Taxpayers Involved in Tax Shelter Transactions Audit Technique Guide (ATG). It focuses primarily on the Negligence or Disregard of Rules or Regulations, Substantial Understatement and Substantial Valuation Misstatement components of the accuracy-related penalty that are most likely to apply in examinations relating to tax shelters. The ATG describes “schemes or scams” as some of the easiest abusive tax shelters to detect. They generally fall under the “too good to be true” category. These transactions are clearly unallowable or have no existing basis in law. The ATG categorizes home-based business schemes as tax shelters.

⁶ IRC §6662(b)(1).
⁷ IRC §6662(b)(2).
⁸ IRC §6662(b)(3).
The penalty applies only when a tax return is filed. There is no stacking of the accuracy-related penalty components. The maximum accuracy-related penalty imposed on any portion of an underpayment is 20% (40% in the case of a gross valuation misstatement), even if that portion of the underpayment is attributable to more than one type of misconduct (e.g., negligence and substantial valuation misstatement).

For purposes of IRC §6662, the term "underpayment" is defined as the amount by which any tax imposed exceeds the excess of the sum of the amount shown as the tax by the taxpayer on his return, plus amounts not so shown previously assessed (or collected without assessment), over the amount of rebates made.

Negligence or Disregard of Rules or Regulations

Negligence is any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code and includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly. Negligence includes the failure to exercise due care or the failure to do what a reasonable and prudent person would do under the circumstances. Negligence is strongly indicated when a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be “too good to be true” under the circumstances. A return position is not attributable to negligence if there is a reasonable basis for that position. For this purpose, “reasonable basis” requires a more than colorable claim. The position must be based on one or more of the authorities described in the section below entitled “Substantial Authority.”

Disregard includes any careless, reckless, or intentional disregard of rules or regulations. Treas. Reg. §1.6662-3(b)(2) defines “rules or regulations,” “careless,” “reckless,” and “intentional” as follows:

“Rules or regulations” include the provisions of the Internal Revenue Code, temporary or final Treasury regulations issued under the Code and revenue rulings or notices (other than notices of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin.

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9 IRC §6664(b).
10 Treas. Reg. §1.6662-2(c).
11 IRC §6664(a)(1),(2); Treas. Reg. §1.6664-2(a)(1),(2).
12 IRC §6662(c); Treas. Reg. §1.6662-3(b)(1).
14 Treas. Reg. §1.6662-3(b)(1).
15 IRC §6662(c); Treas. Reg. §1.6662-3(b)(2).
A disregard of rules or regulations is “careless” if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is contrary to the rule or regulation.

A disregard is “reckless” if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe.

A disregard is “intentional” if the taxpayer knows of the rule or regulation that is disregarded.

Courts have upheld penalties due to negligence in the following cases:

Penalty sustained where business and personal expenses were commingled:

? In **Loftus v. Commissioner**, T.C. Memo. 1992-266, the court imposed the accuracy-related penalty, finding that the taxpayer was negligent when he commingled business and personal funds and then failed to provide correct information to the return preparer.

Penalty sustained against sham transactions

? In **Sandvall v. Commissioner**, 898 F.2d 455 (5th Cir. 1990), the court imposed negligence and substantial understatement penalties on taxpayers who utilized a foreign-based sham trust. The taxpayers failed to cooperate with the IRS and refused to present the requested documentation which would substantiate their claimed deductions.

? In **Neely v. Commissioner**, 85 T.C. 934 (1985), the Tax Court determined the taxpayers failed to show they acted reasonably and prudently and exercised due care. An ordinarily prudent person should reasonably have known that the appraisals were in substantial variance with the actual fair market value. Id. at 948.

? In **Anderson v. Commissioner**, 62 F.3d 1266 (10th Cir. 1995), the court of appeals held the taxpayers were "negligent" for failing to discover that their marine dry cargo container investment was a sham.

? In **Allen v. Commissioner**, 925 F.2d 348 (9th Cir. 1991), aff'g 92 T.C. 1 (1989), the court determined the taxpayers were negligent for not having investigated the arrangement which purportedly allowed them a tax deduction 10 times greater than their own cash outlay and generated tax savings of almost double the amount of their outlay.

Penalty sustained on deductions of unallowable expenses

? In **Manley v. Commissioner**, T.C. Memo. 1983-558, the Tax Court disallowed deductions of claimed personal and living expenses and imposed both the accuracy-related penalty and a penalty under IRC §6673 for advancing frivolous arguments.
In **Elliott v. Commissioner**, 90 T.C. 960, 974 (1988), the Tax Court found the taxpayers involved in an Amway distributorship were liable for penalties when their records were kept in a cursory and sloppy fashion.

In **Marcello v. Commissioner**, 380 F.2d 499 (5th Cir. 1967), aff’g in part and remanding in part 43 T.C. 168 (1964), the court of appeals held that the taxpayers had negligently understated taxable income when they failed to keep books and documents necessary to form a rational basis for the income reported and expenses deducted. Negligence is the lack of due care or the failure to do what a reasonable and ordinarily prudent person would do under the circumstances.

### Substantial Understatement

For individual taxpayers, a substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10% of the tax required to be shown on the return or $5,000.\(^\text{16}\) An “understatement” is defined as the excess of the tax required to be shown on the return over the tax actually shown on the return, less any rebate.\(^\text{17}\)

For purposes of determining the amount of the understatement, for items not attributable to a “tax shelter” (defined below), the understatement is reduced by the understatement attributable to any item (1) for which there is or was substantial authority for the tax treatment; or (2) for which the taxpayer has adequately disclosed the relevant facts affecting the tax treatment and for which there is a reasonable basis for the taxpayer’s tax treatment.\(^\text{18}\) For an understatement attributable to a tax shelter of a noncorporate taxpayer, the understatement is reduced only if there was substantial authority for the tax treatment of the item and the taxpayer reasonably believed that the tax treatment was more likely than not the proper treatment.\(^\text{19}\)

### Substantial Understatement – Tax Shelters

For purposes of the substantial understatement component of the accuracy-related penalty, a tax shelter is defined as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income

\(^{16}\) IRC §6662(d)(1).

\(^{17}\) IRC §6662(d)(2)(A).

\(^{18}\) IRC §6662(d)(2)(B).

\(^{19}\) IRC §6662(d)(2)(C)(i). For taxable years ending after October 22, 2004, neither corporate nor noncorporate taxpayers can reduce the amount of the understatement attributable to a tax shelter item. Thus, this component of the accuracy-related penalty would apply unless the taxpayer acted with reasonable cause and good faith, discussed below. See the American Jobs Creation Act of 2004 ("AJCA"), P.L. 108-357, sec. 812.
Typical of tax shelters are transactions structured with little or no motive for the realization of economic gain, and transactions that utilize the mismatching of income and deductions, or the mischaracterization of the substance of the transaction. Special rules apply when an item of a noncorporate taxpayer is attributable to a tax shelter. The amount of the understatement is not reduced for items that are disclosed. In addition, the total amount of the understatement is reduced by amounts for which there was substantial authority only if the taxpayer reasonably believed the tax treatment of such item was more likely than not the proper treatment. “Substantial authority” is an objective standard, and involves an analysis of the law and the application of that law to the relevant facts. It is a more stringent standard than “reasonable basis” (which must be based on one or more authorities) but less stringent than a 50 percent likelihood of the position being upheld. In determining whether there is substantial authority for a position, only the following items are considered authority: (1) the Code and other statutes; (2) proposed, temporary, and final regulations; (3) revenue rulings and revenue procedures; (4) tax treaties and official explanations of those treaties; (5) court cases; (6) congressional intent as reflected in certain committee reports; (7) certain private letter rulings, technical advice memoranda, and general counsel memoranda; (8) IRS information or press releases; and (9) notices, announcements, and other administrative pronouncements published in the Internal Revenue Bulletin. We do not think taxpayers will be able to establish that there is or was any authority – let alone “substantial” authority – for the position that personal expenses are deductible.

A noncorporate taxpayer is considered to have reasonably believed that the tax treatment of an item is more likely than not the proper tax treatment if (1) the taxpayer analyzes the pertinent facts and authorities and, based on that analysis, reasonably concludes, in good faith, that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if the Service challenges it, or (2) the taxpayer reasonably relies, in good faith, on the opinion of a professional tax advisor, which clearly states (based on the advisor’s analysis of the pertinent facts and authorities) that

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20 IRC §6662(d)(2)(C)(iii).
22 IRC §6662(d)(2)(C)
23 IRC §6662(d)(2)(C)(i). For taxable years ending after October 22, 2004, neither corporate nor noncorporate taxpayers can reduce the amount of the understatement attributable to a tax shelter item. Thus, this component of the accuracy-related penalty would apply unless the taxpayer acted with reasonable cause and good faith, discussed below. See AJCA, P.L., 108-357, sec. 812.
25 Treas. Reg. §1.6662-3(b)(3).
27 Treas. Reg. §1.6662-4(d)(3)(iii). This regulation also notes when certain items are no longer considered to be authority.
the advisor concludes there is a greater than 50 percent likelihood the tax treatment of the item will be upheld if the Service challenges it.\textsuperscript{28}

In no event will a taxpayer be considered to have reasonably relied in good faith on the opinion of a professional tax advisor unless the requirements of Treas. Reg. §1.6664-4(c)(1) are met. Refer to “Reliance On The Advice Of Others,” below.

**Reasonable Cause and Good Faith Exception**

The IRC §6662 penalty does not apply to any portion of an underpayment if the taxpayer had reasonable cause for that portion and if the taxpayer acted in good faith with respect to that portion.\textsuperscript{29}

Reasonable cause and good faith are determined on a case-by-case basis, taking into account all pertinent facts and circumstances. Generally, the most important factor is the extent of the taxpayer’s effort to assess the taxpayer’s proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. Reasonable cause and good faith are not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice, or other facts may constitute reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.\textsuperscript{30} Refer to “Reliance On The Advice Of Others,” below.

For a taxpayer to have reasonable cause, the taxpayer must have exercised ordinary business care and prudence regarding their tax affairs. The following cases indicate that the most important factor is the extent of the taxpayer’s effort to assess the proper tax liability:

- In **Collins v. Commissioner**, 857 F.2d 1383 (9th Cir. 1988), the court was unconvinced that the taxpayers acted reasonably when they failed to investigate and simply relied on offering circulars and the advice of their accountant, who had no first-hand knowledge about the mining venture. The court found that the high write-offs and the risk of audit should have alerted taxpayers that their deductions were questionable at best.
- In **Larson v. Commissioner**, T.C. Memo. 2002-295, the taxpayers reported a very small amount of nonemployee compensation in comparison to the amount of work performed. The court found that the taxpayers did not have reasonable

\textsuperscript{28}Treas. Reg. §1.6662-4(g)(4).
\textsuperscript{29}IRC §6664(c)(1).
\textsuperscript{30}Treas. Reg. §1.6664-4(b)(1).
cause or act in good faith when they reported only the $1,891 that was shown on a misprinted Form 1099, rather than the $21,891 that they were actually paid. Taking into account the taxpayers’ experience, knowledge and education, the taxpayers should have attempted to ascertain why the amount of nonemployee compensation was so small.

Reliance On The Advice Of Others

In no event will a taxpayer be considered to have reasonably relied in good faith on the opinion of a professional tax advisor unless the following requirements of Treas. Reg. §1.6664-4(c)(1) are met:

**Facts and circumstances; minimum requirements.** —All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. For example, the taxpayer’s education, sophistication and business experience will be relevant in determining whether the taxpayer’s reliance on tax advice was reasonable and made in good faith. In no event will a taxpayer be considered to have reasonably relied in good faith on advice (including an opinion) unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied, however, will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

(i) **All facts and circumstances considered.** —The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer’s purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.

(ii) **No unreasonable assumptions.** —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. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer’s purposes for entering into a transaction or for structuring a transaction in a particular manner.
(iii) Reliance on the invalidity of a regulation.—A taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith unless the taxpayer adequately disclosed, in accordance with §1.6662-3(c)(2), the position that the taxpayer is questioning the validity of the regulation.

Reasonable reliance, in good faith, upon a tax opinion provided by a professional tax advisor is a defense to the accuracy-related penalty. The reliance itself, however, must be objectively reasonable in the sense that the taxpayer supplied the professional with all the necessary information to assess the tax matter and that the professional himself does not suffer from a conflict of interest or lack of expertise that the taxpayer knew of or should have known about. The following cases illustrate this point:

? In *Long Term Capital Holdings v. United States*, 330 F.Supp.2d 122 (D. Conn. 2004), an investment partnership lacked good faith when it claimed certain tax losses arising from a complex transaction. The taxpayer did not meet the reasonable cause and good faith exception to the accuracy-related penalty because it could not show reasonable and good faith reliance on the opinion of its tax advisor. The taxpayer could not show that it received the advice before it filed its tax return for the year at issue. The court noted that even if it assumed the taxpayer timely received some form of “opinion,” there was an inadequate evidentiary basis for accurately determining what that opinion consisted of and what substantive analysis under girded it.

? In *Peete v. Commissioner*, T.C. Memo. 2004-31, the Tax Court imposed the accuracy-related penalty against a taxpayer who, on the basis of advice of his tax advisor, deducted personal and living expenses as purported business expenses related to recruiting participants in a tax avoidance pyramid scheme run by “The Tax People.” The taxpayer also deducted fictitious expenses for which there was no substantiation. While the taxpayer believed this may have been too good to be true, he did not take steps to investigate what he was told. The court found that the taxpayer had not relied on an independent, competent tax professional.

? In *Neonatology Associates, P.A. v. Commissioner*, 115 T.C. 43 (2000), aff’d, 299 F.3d 221 (3d Cir. 2002) (citing *Ellwest Stereo Theatres of Memphis, Inc. v. Commissioner*, T.C. Memo. 1995-610), the Tax Court found that the taxpayer did not establish reasonable and good faith reliance on the advice of its tax advisor because it could not prove by a preponderance of the evidence that:

1. The advisor was a competent professional who had sufficient expertise to justify reliance;
2. The taxpayer gave the advisor the necessary and accurate information; and
3. The taxpayer actually relied in good faith on the advisor’s judgment.

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31 Treas. Reg. §1.6664-4(c).
It is well established that taxpayers generally cannot "reasonably rely" on the professional advice of a tax shelter promoter. See Neonatology Associates, P.A. v. Commissioner, 299 F.3d 221, 233-34 (3d Cir. 2002). Such reliance is especially unreasonable when the advice would seem to a reasonable person to be "too good to be true" as found in the following cases:

? In **Rybak v. Commissioner**, 91 TC 524, 565 (1988), the Tax Court sustained the negligence penalty where the taxpayers relied only upon advice of persons who were not independent of the promoters.

? In **Gilmore Goldman v. Commissioner**, 39 F.3d 402 (2d Cir. 1994), aff’g T.C. Memo. 1993-480, the court determined that the appellants could not have reasonably relied for professional advice on someone they knew to be burdened with an inherent conflict of interest. The appellants’ tax advisor was a sales representative for the limited partnership, had no knowledge of the industry involved, and did not make any independent inquiries regarding the partnership.

? In **Neonatology Associates, P.A.**, 115 T.C. at 98, the Tax Court stated that "[r]eliance may be unreasonable when it is placed upon insiders, promoters, or their offering materials, or when the person relied upon has an inherent conflict of interest that the taxpayer knew or should have known about."

? In **Pasternak v. Commissioner**, 990 F.2d 893, 903 (6th Cir. 1993), aff’g Donahue v. Commissioner, T.C. Memo. 1991-181, the court determined that taxpayers could not escape the negligence penalty by relying on promoters or their agents.

? In **Roberson v. Commissioner**, 98-1 USTC ¶50,269 (6th Cir. 1998), aff’g T.C. Memo. 1996-335, the court, in an unpublished opinion, affirmed the Tax Court’s determination that the taxpayer acted negligently and sustained the imposition of the accuracy-related penalty. The Tax Court rejected Roberson’s claim of reasonable reliance on a tax preparer who had no knowledge of or expertise in the music industry and made no investigation of the bona fides of the investment.

? In **Gilmore & Wilson Construction Co. v. Commissioner**, 99-1 USTC ¶50,186 (10th Cir. 1999), aff’g Est. of Hogard v. Commissioner, T.C. Memo. 1997-174, the court, in an unpublished opinion, affirmed the Tax Court determination that the taxpayer was liable for the negligence penalty in a plastics recycling case. The Tax Court found that reliance on an advisor with no expertise in plastics recycling, and who would receive a commission on the taxpayer’s investments from the promoter, was unreasonable.

The taxpayers retain a duty to file an accurate return and generally are required to review their return before signing it. **Metra Chem Corp. v. Commissioner**, 88 T.C. 654, 662 (1987) (citing **Pritchett v. Commissioner**, 63 T.C. 149 (1975)).

The facts in most of these cases indicate the taxpayer should have known or had reason to know there was no reasonable basis for the advice. In general, home-based business schemes involve a classic substance versus form situation. The home-based business scheme purportedly reduces tax liability by taking a tax position that is not supported by tax law or misinterprets the law.

**Applying the Law to the Taxpayer’s Facts and Circumstances:**

Whether the accuracy-related penalty applies to the underpayment attributable to the legitimate business (home-based or otherwise) activity must be determined on a case-by-case basis and will depend on the specific facts and circumstance of each case. The development of the facts and circumstances is the responsibility of Compliance.

The Service has the “burden of production in any court proceeding with respect to the liability of any individual for any penalty.” 32 Once the Commissioner determines that the negligence or substantial understatement component of the accuracy-related penalty is appropriate, the taxpayer bears the burden of proving the absence of negligence or the absence of a substantial understatement.33

Appelles believes the accuracy-related penalty will apply in the majority of these cases, because in most cases, the taxpayer will not have had a bona fide business. Further, in most cases, the taxpayer will have failed to inquire beyond the promotional materials as to the details of the scheme, the individuals with whom the taxpayer was doing business, and the implications of the scheme. Given this fact pattern, the cases cited above and Rev. Rul. 2004-32 support the imposition of the penalty under IRC §6662.

Taxpayers against whom an accuracy-related penalty for the substantial understatement of income tax is determined will need to establish first that the understatement is not attributable to a tax shelter item. As noted above, for this purpose, a tax shelter is an investment plan or arrangement a significant purpose of which is the avoidance or evasion of federal income tax. The typical home-based business scheme either creates the appearance of a home-based business or uses a legitimate home-based business for the purpose of deducting otherwise nondeductible expenses – in other words, for avoiding federal income tax. In most, if not all, of these

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cases, any understatement of income tax will be attributable to a tax shelter item within the meaning of IRC §6662(d).

If the understatement of income tax is attributable to a tax shelter item, the taxpayer will have to establish that there was substantial authority for the tax treatment of the item, either currently or at the time the return was filed. Taxpayers will be unable to establish that there is or was substantial authority for deducting these personal expenses.

To avoid the imposition of the negligence component of the accuracy-related penalty, taxpayers will have to show either that there was a reasonable basis for their tax treatment of the item in question or that they made a reasonable attempt to ascertain the correctness of the deductions. To establish a reasonable basis, taxpayers will have to show that there is at least one authority that supports their position; generally, there is no such authority. Therefore, these taxpayers will have to show that they made a reasonable attempt to ascertain the correctness of their deductions, most likely by relying on their tax advisors. These arguments will be similar to the arguments for the reasonable cause and good faith exception based on reliance of a tax advisor.

Taxpayers who received advice about the scheme will generally assert that the reasonable cause and good faith exception applies because they reasonably relied on the advice of a tax professional. In most instances, characteristics are present indicating that full sustention of the accuracy-related penalty is appropriate.

Court cases in favor of conceding the penalty based on reliance on an advisor:

- In *Reile v. Commissioner*, T.C. Memo. 1992-488, the taxpayers, who lacked investment experience and relied on an accountant who owned a financial and accounting firm, were not liable for penalties. The court found that the taxpayers acted reasonably and relied in good faith on the advice of an accountant, who was an acquaintance and fellow “temple recommend holder;” the taxpayers were not expected to “outguess” their accountant.

- In *Haman v. Commissioner*, 500 F.2d 401, 403 (9th Cir. 1974) (per curium), the court determined that imposition of the negligence penalty was not warranted where a taxpayer was misguided, unsophisticated in tax law, and acted in good faith without negligence and without ‘intentional disregard’ of applicable rules and regulations when deducting business expenses.

**SETTLEMENT GUIDELINES FOR ISSUE #2**

As noted above, the accuracy-related penalty should be asserted in all business (home-based or otherwise) cases where the taxpayer participated in a scheme that the taxpayer knew or should have known to be tax-avoidance in nature, or when the reasonable cause and good faith exception of IRC §6664 does not apply. Appeals
believes that fact patterns and the trend in litigation indicate a strong position for penalties in the majority of these cases, as long as these fact patterns have been fully developed.

On the other hand, where fully developed facts clearly establish that a taxpayer has met the reasonable cause exception (as discussed above), the IRC §6662 penalty should not be imposed.
Settling Home-Based Business Cases

Decision Guide – Issue #1

Are the deductions claimed from the home-based activity ordinary and necessary business expenses incurred during the taxable year in carrying on a trade or business or for profit activity?

1. Did the taxpayer purchase or develop a scheme to create the appearance of having a legitimate business (home-based or otherwise) primarily for the purpose of deducting personal living or family expenses on the individual income tax return?

   If yes…….. The activity is determined to be a sham, it will be disregarded for federal tax purposes.
   a. The gross receipts are reclassified as “Other Income” and it is not self-employment income;
   b. All expenses (deductions from receipts) are disallowed in full;
   c. If there are expenses deductible under IRC §163 or §164 such as mortgage interest and property taxes, allow them on Schedule A of the Form 1040;
   d. If there is an expense deductible under IRC §212 for individual income tax preparation fees allocable to the individual Form 1040 and Schedules A and B, allow it on Schedule A of the Form 1040 as an itemized deduction subject to the 2% Adjusted Gross Income limit;
   e. go to the next question as an alternative position;

   If no ……..Go to the next question.

2. Did the taxpayer participate, as a promoter, investor, or marketer, in a pyramid scheme that advises how to deduct personal living or family expenses on their individual income tax return. The purported business activity (pyramid scheme) claims to provide income potential from selling the promotional packages motivating the tax avoidance scheme.

   If yes…….. The activity is determined to be a sham, it will be disregarded for Federal tax purposes; refer to #1 above.

   If no ……..Go to the next question.

3. Is the taxpayer involved in a legitimate business but claiming personal living or family expenses or inflated business expenses on the individual income tax return?

   If yes……..Consider the individual expenses claimed and disallow those which the taxpayer cannot show to be ordinary and necessary;

   If no ……..Go to the question #1.
Penalty Settlement Decision Guide  
for use by Compliance under Delegation Order 4-25

When making the IRC §6662 penalty determination, consider using the table below based on the facts and circumstances of the case. No one factor alone is controlling nor is the weights of each factor the same. Consider all the factors while placing greater weight to objective facts rather than to the T/P’s mere statements.

<table>
<thead>
<tr>
<th>FACTS FOR T/P</th>
<th>FACTS FOR GOVERNMENT</th>
</tr>
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<tbody>
<tr>
<td>1. The T/P had a legitimate business for profit.</td>
<td>T/P’s activity is a sham with tax avoidance purpose.</td>
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<tr>
<td>2. The T/P relied in good faith on a credentialed advisor and/or tax preparer that was not associated or affiliated with the promoter’s home-based business tax savings package. The T/P disclosed all the facts and circumstances about the scheme to the preparer.</td>
<td>The T/P relied on a credentialed advisor, tax preparer, promoter who was associated or affiliated with the home-based business scheme which put the T/P on notice that the preparer was not independent of the promotion and/or stood to profit.</td>
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<td>3. The T/P had a history of using the tax preparer’s services for its business and/or personal tax return preparations. The tax preparer got involved with the HBB scheme and the T/P had no reason to doubt that there was reasonable basis for the advice for the deductions and was unaware of the preparer’s involvement with the scheme.</td>
<td>The T/P changed tax preparers for the purpose of the home-based business scheme. The T/P had no history of using the tax preparer and merely changed tax preparers for tax avoidance purposes.</td>
</tr>
<tr>
<td>4. The T/P was introduced to the tax avoidance and/or audit assistance package by a credentialed advisor that the T/P didn’t know was associated or affiliated with the promotion and stood to profit.</td>
<td>The T/P purchased the tax avoidance and/or audit assistance package from participants who were not independent of the promotion and stood to profit. The T/P knows the seller is not independent.</td>
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<tr>
<td>5. The T/P claimed an improper allocation of deductions such as an overstatement of the percentage of business use of an item or some personal items (not egregious). The T/P did not fabricate deductions.</td>
<td>The T/P fabricated the home-based business and/or deductions.</td>
</tr>
<tr>
<td>6. The T/P kept adequate books and records to substantiate deductions as is evident by the T/P’s efforts to separate personal from business deductions in order to arrive at the correct tax liability.</td>
<td>The T/P failed to keep adequate books and records to substantiate items properly. The T/P didn’t separate personal from business deductions in order to arrive at the correct tax liability.</td>
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<tr>
<td>7. The T/P presents strong supporting documentation to show reasonable cause for the T/P’s reliance on the scheme. The T/P inquired and investigated the scheme beyond the promotional material. This may include: inquiries made to IRS? IRS information? credentialed advisor not associated or affiliated with the tax savings package to whom all the facts and circumstances were disclosed</td>
<td>The T/P disregarded rules or regulations. Disregard includes any careless, reckless, or intentional disregard of rules or regulations. Under the circumstances, the scheme was “too good to be true”. The T/P failed to exercise due care or failed to do what a reasonable or prudent person would do under the circumstances to comply with the provisions of the Internal Revenue Code by failing to inquire and investigate the scheme beyond the promotional material.</td>
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<td>8. The T/P is unsophisticated, inexperienced, and lacked tax knowledge. The T/P didn’t know or have reason to know there was no reasonable basis for the tax position in the scheme. The T/P appears credible, sincere, and makes a good witness in his/her own behalf.</td>
<td>This scheme is not sophisticated or complex. A reasonable and prudent T/P should have known or had reason to know there was no basis for the advice. The T/P has sufficient sophistication, experience, education, and/or knowledge of taxation to have known the scheme was not bona fide and primarily for tax-avoidance.</td>
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<td>9. The amounts of the disallowed deductions are minimal.</td>
<td>The amounts of the disallowed deductions are egregious.</td>
</tr>
<tr>
<td>10. The nature of the deduction is not clearly of a personal nature such as an overstatement of the percentage of business use of an item.</td>
<td>The nature of the deductions is clearly of a personal nature. The type of deduction that an ordinary prudent individual should have known or had reason to know there was no reasonable basis for the advice.</td>
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<tr>
<td>11.</td>
<td>After receiving correspondence from the Service and/or the promoter informing the T/P of the abusive nature of the scheme, the T/P abandoned the scheme.</td>
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