Avoiding IRS Accuracy Penalties for a Substantial Underpayment of Tax

Jan 27, 2026

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There are over 150 types of penalties in the Internal Revenue Code (IRC). One frequent penalty that the Internal Revenue Service (IRS) asserts is the accuracy penalty under IRC Section 6662. As advisors and clients prepare for tax planning in 2026 and file 2025 tax returns, both parties should be aware of the general rules for IRC Section 6662 penalties and how to avoid them. Failing to do so can result in 20% (or even 40%) penalties on the amount of tax due. This article describes methods to avoid a substantial understatement penalty, which is a common type of accuracy penalty.[1] In addition, this article outlines a recent Tax Court memorandum where a taxpayer did not have substantial authority and faced such accuracy penalties.

As detailed below, taxpayers should either have: (i) a reasonable basis for the position and adequately disclose it; or (ii) substantial authority for the position based on sources identified in Treasury Regulation § 1.6662-4(d)(3)(iii).[2]

Common IRC Section 6662 Provisions

Accuracy penalties under IRC Section 6662 can apply when a taxpayer has filed a tax return, but the IRS alleges that an increased amount of tax is due (e.g., there is an understatement of income tax), and no relief provision is available.

The amount of the accuracy penalty under IRC Section 6662 is generally calculated at 20% of the amount of tax due, but the IRS can increase accuracy penalties to 40% in certain instances.[3] Further, the IRS can impose civil penalties (under different IRC sections) of up to 75% in the instance of fraud.

Under IRC Section 6662, the IRS may allege, among other possibilities, that the understatement of tax was due to either: (i) negligence or disregard of the rules or regulations; or (ii) a substantial understatement of income tax. See IRC Section 6662(b)(1) and (2).

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First, IRC Section 6662(c) defines "negligence" to include any "failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return." Treasury Regulation § 1.6662-3(b)(1)(ii) adds color to that by stating:

A taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a tax return which would seem to a reasonable and prudent person to "be too good to be true" under the circumstances.

Treasury Regulation § 1.6662-3(b)(2) provides an explanation of what it means to "disregard rules or regulations," but this article does not focus on the many definitions therein.

Second, IRC Section 6662(b)(2) states that accuracy penalties apply to substantial understatements of income tax. IRC Section 6662(d) defines "substantial understatement" to mean (for individuals) that the understatement income tax ***exceeds the greater*** of: (i) 10% of the tax required to be shown on the return; or (ii) $5,000.

For corporations, by comparison, there is a substantial understatement if the understatement ***exceeds the lesser*** of: (i) 10% of the tax required to be shown on return—or, if greater, $10,000—or (ii) $10,000,000.

So, for most individuals, the IRS can assert a 20% accuracy penalty for the understatement of income tax whenever the understatement of income tax due exceeds $5,000.

How to Avoid Accuracy Penalties for a Substantial Understatement

Because of the low threshold in the definition of "substantial understatement" regarding an individual's tax due, it is frequently the case that the IRS will assess the 20% accuracy penalty by alleging a substantial understatement.

In this setting, taxpayers have two options to defend against the accuracy penalty (other than a "reasonable cause" defense). A

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taxpayer must either: (i) have a reasonable basis for the position ***and*** adequately disclose the relevant facts; or (ii) have substantial authority for the tax position.

Reasonable Basis and Adequate Disclosure

A "reasonable basis" means:

> . . . [A standard that is] significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in [Treasury Regulation] § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in [Treasury Regulation] § 1.6662-4(d)(2). (See [Treasury Regulation] § 1.6662-4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty.) . . .
>
> Treasury Regulation § 1.6662-3(b)(3).

So, a taxpayer needs one or more primary authorities listed in Treasury Regulation § 1.6662-4(d)(3)(iii),taking into account the authority's relevance and persuasiveness. These primary authorities include, but are not limited to, the following:

- Applicable provisions of the IRC and other statutory provisions
- Proposed, temporary and final regulations construing such statutes
- Revenue rulings and revenue procedures
- Tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties

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- Court cases
- Congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers
- General explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book)
- Certain private letter rulings
- Certain actions on decision, technical advice memoranda, and general counsel memoranda
- IRS information or press releases
- Notices, announcements, and other administrative pronouncements published by the IRS in the Internal Revenue Bulletin.

Of note, conclusions reached in treatises, legal periodicals, legal opinions, or opinions rendered by tax professionals are not primary authority. Instructions on tax forms are also not primary authority.

Further, in determining legal precedent/court cases, the legal precedent of the U.S. Court of Appeals where the taxpayer resides is controlling precedent. See Treasury Regulation § 1.6662-4(d)(3)(iv)(B).

Adequate disclosure, assuming the position needs to be disclosed (i.e., some positions listed in revenue procedures do not need to be disclosed), is effectuated by completing and attaching IRS Form 8275 or 8725-R (the latter is for a position contrary to a treasury regulation) to the relevant income tax return. Disclosure is adequate only if it meets the methods of disclosure under Treasury Regulation § 1.6662-3(c)(2), which references rules under Treasury Regulation § 1.6662-4(f). Critically, these regulations mostly require the taxpayer to complete the Form 8275 or 8275-R. Form 8275 does not simply require the taxpayer to explain a deduction.

Part II of the instructions requires that:

Your disclosure statement must include a description of the relevant facts affecting the tax treatment of the item. To

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satisfy this requirement, you must include information that can reasonably be expected to apprise the IRS of the identity of the item, its amount, and the nature of the controversy or potential controversy. Information concerning the nature of the controversy can include a description of the legal issues presented by the facts.

Failing to do this would likely mean the Form 8275 was incomplete and would subject the taxpayer to the 20% accuracy penalty for failure to adequately disclose the position.

Substantial Authority

Treasury Regulation § 1.6662-4(d)(2) describes "substantial authority." It is a standard less stringent than the "more likely than not" standard, yet more stringent than the "reasonable basis" standard.

The possibility that a return will not be audited or is unlikely to be raised is not relevant for substantial authority, and tax practitioners are prohibited from advising this. See Treasury Regulation § 1.6662-4(d)(2).

Further, there is substantial authority for the tax treatment of an item only if the weight of authorities supporting the treatment is substantial in relation to the weight of authorities supporting the contrary treatment. See Treasury Regulation § 1.6662-4(d)(3). The weight accorded to the authority is dependent on its relevance and persuasiveness. The types of authorities to be relied on are those listed above in the "Reasonable Basis" section.

So, to have substantial authority, the taxpayer must weigh the relevant authorities listed and determine if the weight of authorities in favor of the position is substantial relative to the weight of the authorities against the position. If the taxpayer meets the "substantial authority" standard, even though the taxpayer does not meet the "more likely than not" standard, the taxpayer can successfully defend against the accuracy penalty under IRC Section 6662.

Case in Point: *Root v. Commissioner*

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As a good example of the application of accuracy penalties and substantial authority, in *Root v. Commissioner*, the IRS challenged the taxpayers' use of net operating losses. T.C. Memo 2025-51. The IRS argued that the taxpayers had not yet engaged in a trade or business and therefore had not incurred business losses, and also imposed accuracy penalties under IRC Section 6662.

To make the trade or business determination, the Tax Court analyzed three factors, which were whether the taxpayer had: (i) undertaken an activity intending to earn a profit; (ii) regularly and actively engaged in the activity; and (iii) actually commenced business activities. *Id.* at 9. The last factor requires that the business begins to function as a going concern and performs the activities for which it was organized. *Id*.

In *Root v. Commissioner*, the taxpayers wanted to start a business that involved building a lodge on their property where folks could spend time outdoors and sleep overnight. The taxpayers would presumably charge customers rent or other fees to do so.

The taxpayers engaged an architectural firm and spent considerable funds to build a lodge on the property. *Id*. at 3. Unfortunately, prior to completion, the taxpayers abandoned the business/project because of structural deficiencies in the fireplace, foundation issues, defects in the window installations that caused flooding, and wild animals inhabiting the lodge. *Id*. at 2–4. The taxpayers never rented the lodge to a customer prior to abandonment. *Id*. at 12. Nonetheless, the taxpayers took the position that their expenses were business expenses that created losses. The taxpayers filed amended returns reflecting this tax position. *Id*. at 6–7.

Because no customers had rented the lodge, the Tax Court ruled that the third factor had not been met. For this reason, among others, a business had not begun, and the Tax Court disallowed the losses. *Id*. at 17–18.

The taxpayers cited various cases as substantial authority for their tax position to avoid accuracy penalties. When the Tax Court reviewed such authority, the cases cited did not support the taxpayers (some were favorable to the IRS). *Id.* at 13–14. Accordingly,

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the Tax Court found there was not substantial authority based on the cases cited, and the taxpayers were subject to accuracy penalties. *Id*. at 18–19.

Proper planning and support could have saved the taxpayers from paying such penalties.

Key Takeaways

A reasonable basis with adequate disclosure, or substantial authority, should provide a taxpayer with a defense to accuracy penalties under IRC Section 6662 for a substantial underpayment of taxes. As practitioners and taxpayers engage in tax planning transactions for 2026, or get ready to file 2025 tax returns, they should ensure that they have the proper authority on hand. Doing so would save them time and money if the IRS asserts penalties for a substantial underpayment.

Should you have any questions or comments on these topics, please contact the authors or any attorney with the firm's Tax Practice Group. You can also visit our Tax Law Defined® Blog for more insight into the latest developments in federal, state and local tax planning and tax administration.

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[1] The information provided in this article does not constitute legal advice (and should not be relied on by any individual or entity as such) and does not create an attorney-client relationship. Its intention is to merely be informative and help advisors and taxpayers understand the law and the options therein. This article is limited in scope only to the items described herein (*e.g.*, it does not cover requirements to avoid penalties for tax shelters or reportable transactions, preparer penalties, or accuracy penalties that lead to a 40% penalty, among others). This article also does not discuss legal standards guiding practitioners or preparers under the IRC, Circular 230, or the AICPA rules, among others.

[2] Note that under the first test, a taxpayer must have a reasonable basis and adequately disclose the position—disclosure alone is insufficient. Further, IRC Section 6664 provides a "reasonable cause" defense to IRC Section 6662 penalties if taxpayers meet a "facts and circumstances" test. This test analyzes several factors,

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and generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. This article does not explore such defense, but a subsequent Tax Law Defined® publication is forthcoming on the topic.

[3] *E.g.*, undisclosed transactions lacking economic substance, undisclosed foreign financial assets, and gross valuation misstatements. See IRC Sections 6662(i), (j), and (h) respectively.

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