# Current Federal Tax Developments

Week of February 28, 2022

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CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF FEBRUARY 28, 2022
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# SECTION: 401
# PROPOSED REGULATIONS ISSUED ON SECURE ACT CHANGES

## Citation: REG-105954-20, Federal Register Vol. 87, No. 37, 2/24/22

Proposed regulations[1] dealing with changes made in the SECURE Act to required minimum distributions were released by the IRS. The proposed regulations do have some surprises for taxpayers, some not very welcome while others are fairly favorable.

Jeff Levine, CPA/CVA, CFP has a long Twitter thread in which he discusses these proposed regulations.[2]

We will be using his very useful summary as a guide to the key issues for this new set of proposed regulations.

### Effective Date

The regulations provide for a proposed effective date for tax years beginning and transactions taking place on or after January 1, 2022.[3]

### Non-Designated Beneficiaries for Inherited IRAs

The SECURE Act made significant changes to rules related to inherited IRAs. However, the biggest changes were made to distributions to designated beneficiaries.

Non-designated beneficiaries are, generally, entities other than individuals such as charities, decedent's estates, and trusts (other then conduit trusts where we are allowed to "look through" the trust to determine ultimate living beneficiaries).

For non-designated beneficiaries the rules remain much the same as they were prior to the SECURE Act. If the covered employee/IRA holder dies before he/she reaches their required beginning date, then the balance of the plan must be distributed within the same 5-year period as before.[4] If the covered employee/IRA holder dies after reaching his/her required beginning date, then the remaining balance must be distributed per

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[1] REG-105954-20, *Federal Register Vol. 87, No. 37,* February 24, 2022, p. 10504, https://www.govinfo.gov/content/pkg/FR-2022-02-24/pdf/2022-02522.pdf (retrieved February 27, 2022)

[2] Jeff Levine CPA/CVA, CFP, Twitter Thread, February 23, 2022, https://twitter.com/CPAPlanner/status/1496654100792029184?s=20&t=aDl3ZzWBzRIVA5VlgVPt4Q (retrieved February 27, 2022)

[3] REG-105954-20, *Federal Register Vol. 87, No. 37,* February 24, 2022, p. 10521

[4] Proposed Reg. §1.401(a)(9)-3(c)(5)

IRC §401(a)(9)(B)(i) using the now deceased person's remaining life expectancy at the date of death (as absurd as that sounds).

## Designated Beneficiaries Other Than Eligible Designated Beneficiaries

Prior to the SECURE Act, federal law divided beneficiaries into two classes, one of which being the non-designated beneficiaries described in the prior section and designated beneficiaries. Designated beneficiaries included all individuals as well as trusts with specific provisions outlined in the regulations that allowed looking at living trust beneficiaries.

Under the SECURE Act the category of designated beneficiaries is further subdivided to create a special class known as *eligible designated beneficiaries* we will discuss later. In this section, we consider the general class of designated beneficiaries who aren't offered the options granted to those classes of beneficiaries that are part of the eligible designated beneficiary category, which we'll refer to as *non-eligible designated beneficiaries*.

The non-eligible designated beneficiaries will make up the largest group for non-spouse beneficiaries, becoming in many ways the default class of beneficiaries.

### *Death Before Reaching Required Beginning Date*

In the case of an inherited plan interest or IRA where the original beneficiary had not reached his/her required beginning date before passing away, the non-eligible designated beneficiary must take all funds from the account by the end of the 10th year following the year the original account interest holder passed away.[5]

There is no requirement that any amount be taken in any particular year, so long as all funds are withdrawn from the account by the end of the 10th year. Essentially, these are the same rules as under the 5-year distribution rules except a non-eligible designated beneficiary gets 10 years rather than 5 years to take the funds out.

Prior to the SECURE Act designated beneficiaries could be offered an option to (or even be required to) take distributions based on the primary designated beneficiary's life expectancy beginning in the year following the year of death. The SECURE Act was enacted specifically to remove this option which was used to create stretch IRA plans.

### *Death After Reaching Required Beginning Date*

After the passage of the SECURE Act, many commentators believed that the rules would be identical for non-eligible designated beneficiaries even if the original beneficiary had reached his/her required beginning date except for the need to assure

[5] Proposed Reg. §1.401(a)(9)-3(c)(3)

the required minimum distribution for the decedent was taken before the end of year of the death if it hadn't been taken before the date of death.

However, remember that bit at IRC §401(a)(9)(B)(i) we mentioned earlier. Well IRC §401(a)(9)(B) reads as follows:

> (B) Required distribution where employee dies before entire interest is distributed
>
> > (i) Where distributions have begun under subparagraph (A)(ii)
> >
> > A trust shall not constitute a qualified trust under this section unless the plan provides that if--
> >
> > > (I) the distribution of the employee's interest has begun in accordance with subparagraph (A)(ii), and
> > >
> > > (II) the employee dies before his entire interest has been distributed to him,
> >
> > the remaining portion of such interest will be *distributed at least as rapidly as under the method of distributions being used under subparagraph (A)(ii) as of the date of his death.*

The IRS proposed regulations read this provision of the law, which was not changed by the SECURE Act, as requiring distributions to be made during each of the first nine years following the year of death using the calculated required minimum distribution used under pre-SECURE Act law and regulations,[6] followed by a required distribution of the remaining balance in year 10.

The IRS explains in the preamble to the proposed regulations:

> Section 401(a)(9)(B)(i) provides rules that apply if an employee dies after benefits have commenced. While the 5-year rule under section 401(a)(9)(B)(ii) (expanded to a 10-year rule in certain cases by section 401(a)(9)(H)(i)(I)) generally applies if an employee dies before the employee's required beginning date, section 401(a)(9)(H)(i)(II) provides that section 401(a)(9)(B)(ii) applies whether or not distributions have commenced. Accordingly, if an employee dies after the required beginning date, distributions to the employee's beneficiary for calendar years after the calendar year in which the employee died must satisfy section 401(a)(9)(B)(i) as well as section 401(a)(9)(B)(ii). In order to satisfy both of these requirements, these proposed regulations provide for the same calculation of the annual required minimum distribution that was adopted in the existing

[6] Proposed Reg. §1.401(a)(9)-5(d)

regulations but with an additional requirement that a full distribution of the employee's entire interest in the plan be made upon the occurrence of certain designated events (discussed in section I.E.3.c. of this Explanation of Provisions).[7]

## Designated Beneficiaries Who Are Eligible Designated Beneficiaries

Certain designated beneficiaries retained the right to, at least for a period of time, continue to take distributions using their life expectancies. These beneficiaries, referred to as *eligible designated beneficiaries* under the law, are:

- Minor children of the decedent
- Individuals who are disabled
- Persons who are chronically ill
- Persons not more than 10 years younger than the deceased individual and
- Surviving spouses.

### *Minor Children*

Under the SECURE Act, a minor child of the decedent is an eligible designated beneficiary if the child had not reached the age of majority by the time of the employee's death. That child has a limited time during which he/she is an eligible designated beneficiary, with the status ending as of the date the child attains the age of majority. At that time the balance must be distributed within 10 years after the child attains the age of majority.[8]

But a key question was what was meant by this rule for *age of majority*? The proposed regulations provide that attaining the age of majority takes place on the child's 21st birthday.[9]

### *Disabled Individuals*

The proposed regulations provide separate definitions of a *disabled individual* depending on whether the individual has or has not attained age 18 as of the death of the original interest holder in the account. As well, the proposed regulations provide a safe harbor based on a social security determination of disability.

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[7] Preamble to the Proposed Regulations Section I.E.3.a, REG-105954-20, *Federal Register Vol. 87, No. 37,* February 24, 2022

[8] IRC §401(a)(9)(E)(iii)

[9] Proposed Reg. §1.401(a)(9)-4(e)(3)

For an individual who is 18 or older, the proposed regulations provide the following definition of disabled:

> An individual who, as of the date of the employee's death, is age 18 or older is disabled if, as of that date, the individual is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or to be of long-continued and indefinite duration.[10]

For younger beneficiaries, the proposed regulations provide the following definition:

> An individual who, as of the date of the employee's death, is not age 18 or older is disabled if, as of that date, that individual has a medically determinable physical or mental impairment that results in marked and severe functional limitations and that can be expected to result in death or to be of long-continued and indefinite duration.[11]

Finally, the proposed regulations provide the following safe harbor definition of disabled based on social security rules:

> If the Commissioner of Social Security has determined that, as of the date of the employee's death, an individual is disabled within the meaning of 42 U.S.C. 1382c(a)(3), then that individual will be deemed to be disabled within the meaning of this paragraph (e)(4).[12]

The proposed regulations also provide rules for mandatory documentation that must be provided to the plan administrator in the year following the year of death for a beneficiary to meet these qualifications.[13]

### *Chronically Ill Individual*

The proposed regulations give the following definition for a chronically ill individual:

> An individual is chronically ill if the individual is chronically ill within the definition of section 7702B(c)(2) and satisfies the documentation requirements of paragraph (e)(7) of this paragraph. *However, for purposes of the preceding sentence, an individual will be treated as chronically ill under section 7702B(c)(2)(A)(i) only if there is a certification from a licensed health care practitioner (as that term is defined in section 7702B(c)(4)) that, as of the date of the certification, the individual is unable to perform (without substantial assistance from another individual) at least 2 activities of daily living for an indefinite*

[10] Proposed Reg. §1.401(a)(9)-4(e)(4)(ii)

[11] Proposed Reg. §1.401(a)(9)-4(e)(4)(iii)

[12] Proposed Reg. §1.401(a)(9)-4(e)(4)(iv)

[13] Proposed Reg. §1.401(a)(9)-4(e)(7)

> *period which is reasonably expected to be lengthy in nature (and not merely for 90 days).*[14]

Note the mandatory requirement there be a certification from a licensed health care practitioner.

Similar documentation rules to those that apply for disabled individuals apply to the chronically ill individuals, requiring delivery of this information to the plan administrator in the year following the year of death.[15]

### *Beneficiary Not More Than 10 Years Younger Than Decedent*

The proposed regulations use the actual date of birth, not just the year of birth, to determine if the beneficiary is not more than 10 years younger than the decedent:

> Whether a designated beneficiary is not more than 10 years younger than the employee is determined based on the dates of birth of the employee and the beneficiary. Thus, for example, if an employee's date of birth is October 1, 1953, then the employee's beneficiary is not more than 10 years younger than the employee if the beneficiary was born on or before October 1, 1963.[16]

## Surviving Spouse and Delay Until Spouse's Required Beginning Date

The law had previously allowed a surviving spouse to treat a retirement account as his/her own and start benefits under his/her RMD at their required beginning date even if the spouse had already begun taking required distributions. However, some had worried that although the law moved this age to age 72 that spouses that had previously inherited their interest in years prior to the effective date of the SECURE Act might still be required to begin distributions at age 70 ½.

The proposed regulations provide for a single age 72 required beginning date for surviving spouses regardless of when they inherited their interest—that is, there is no special age 70 ½ rule for those who inherited funds earlier.[17]

## Can an Eligible Beneficiary Use the 10-Year Rule Rather than Their Life Expectancy

Another question that remained to be answered following the enactment of the SECURE Act changes was whether an eligible designated beneficiary could opt to use

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[14] Proposed Reg. §1.401(a)(9)-4(e)(5)

[15] Proposed Reg. §1.401(a)(i)-4(e)(7)

[16] Proposed Reg. §1.401(a)(9)-4(e)(6)

[17] Proposed Reg. §1.402(c)-2(j)(3)(iii)

the 10-year payout method rather than their own life expectancy. The regulations allow this *but* also allow a plan to bar the use of the life expectancy method.

The regulations, in describing optional plan provisions, provides:

> A defined contribution plan will not fail to satisfy section 401(a)(9) merely because it includes a provision specifying that the 10-year rule described in paragraph (c)(3) of this section (rather than the life expectancy rule described in paragraph (c)(4) of this section) will apply with respect to some or all of the employees who have an eligible designated beneficiary. Further, a plan need not have the same method of distribution for the benefits of all employees in order to satisfy section 401(a)(9).[18]

### Other Areas Covered

The proposed regulations have additional changes made to conduit trusts and the treatment of successor beneficiaries I don't have time to cover here during tax season. However, Jeff Levine's Twitter analysis will give you a good overview of these provisions and I suggest reading it if you have interests in these areas.[19]

For now, it's important to remember these are still proposed regulations, and that there may be significant changes made when final regulations are issued. But this gives us some ideas about how the IRS is thinking in this area.

## SECTION: 6011
## AICPA AND STATE CPA SOCIETIES ASK IRS TO DELAY REQUIREMENTS TO FILE SCHEDULES K-2 AND K-3

### Citation: "Concerns Regarding Schedules K-2 and K-3 Reporting," Letter from the AICPA and State CPA Societies, 2/24/22

The AICPA and the state societies of CPAs on February 24, 2022[20] sent a letter to Lisa Batchelder, Assistant Secretary (Tax Policy) Department of Treasury and IRS Commissioner Charles P. Rettig asking for a delay in the requirement for partnerships

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[18] Proposed Reg. §1.401(a)(9)-3(c)(5)(ii)

[19] Jeff Levine CPA/CVA, CFP, Twitter Thread, February 23, 2022, https://twitter.com/CPAPlanner/status/1496654100792029184?s=20&t=aDl3ZzWBzRIVA5VlgVPt4Q (retrieved February 27, 2022)

[20] "Concerns Regarding Schedules K-2 and K-3 Reporting," Letter from the AICPA and State CPA Societies, February 24, 2022, https://us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/concerns-regarding-schedules-k-2-and-k-3-reporting.pdf (retrieved February 27, 2022)

and S corporations to complete and file Schedules K-2 and K-3 reporting items relevant to international tax reporting.

The IRS began requiring completion of Schedule K-2 and Schedules K-3 if the partnership or S corporation had any items of international tax relevance for tax years beginning after December 31, 2020. However, the IRS announced in December they would not be able to accept such forms in the regular MeF/XML filing system until after the due dates for affected returns.[21]

As well, on January 18, 2022 the IRS issued an online update to the instructions that clarified that, despite the wording of the first sentence in the "Who Must File" section of the instructions released back in August of 2021, even partnerships and S corporations with no international transactions or foreign equity holders may have items of international tax relevance requiring the entities to complete the forms.[22] The key item driving such a requirement for those entities would be equity holders who needed information on even U.S. source gross income and assets located in the U.S. to complete Form 1116, *Foreign Tax Credit*.

The AICPA letter begins by recognizing the reasons why the IRS developed these forms:

> A streamlined and expanded reporting tool of complex matters through fiscally transparent entities was undeniably necessary and we appreciate the importance of IRS's foreign passthrough reporting requirements. We also acknowledge the substantial efforts of Treasury and the IRS in developing redesigned international tax reporting passthrough forms of Schedules K-2 and K-3 (the "Schedules"), releasing final instructions, and providing certain transition relief for 2021 tax years. Filing complete and accurate returns are essential elements to a well-functioning and voluntary tax system.[23]

But the letter goes on to note the impact of the implementation issues that have plagued the attempt to get these forms filed with 2021 returns:

> However, recent revisions pertaining to the Schedules' filing instructions raise additional questions, perpetuating futility in filing a

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[21] "Schedules K-2 and K-3: Interim Electronic Filing for Tax Year 2021," IRS website, December 3, 2021, https://www.irs.gov/e-file-providers/schedules-k-2-and-k-3-interim-electronic-filing-for-tax-year-2021 (retrieved February 27, 2022)

[22] "Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065)," IRS website, January 18, 2022, https://www.irs.gov/forms-pubs/changes-to-the-2021-partnership-instructions-for-schedules-k-2-and-k-3-form-1065 (retrieved February 27, 2022), "Changes to the 2021 S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S)," IRS website, January 18, 2022, https://www.irs.gov/forms-pubs/changes-to-the-2021-s-corporation-instructions-for-schedules-k-2-and-k-3-form-1120-s (retrieved February 27, 2022)

[23] "Concerns Regarding Schedules K-2 and K-3 Reporting," Letter from the AICPA and State CPA Societies, February 24, 2022

> complete and accurate return and the goal of standardized international reporting. Further modifying the applicable scope of the new Schedules amidst tax filing season leaves the tax system confused and in disarray. The AICPA previously recommended that due to implementation difficulties, such as software development and the Coronavirus pandemic impacting the entirety of the 2020 filing season, a delay until 2023 was necessary.

In footnotes to this section the AICPA refers to changes in the scope of filing issued on February 18, 2022 and inconsistencies the Institute notes in the FAQ issued that day regarding the scope of the relief:

> For example, the "know or reason to know" standard regarding indirect partners included in FAQ 15 is inconsistent under current statutes and guidance (e.g., section 6031). Additionally, FAQ 15 lacks a bright-line standard by conflating direct and indirect partner reporting obligations.[24]

The AICPA formally recommended the following delays in the letter:

> We continue to urge the IRS to delay implementation of the Schedules K-2 and K-3 to 2023 (the 2022 tax year filing season). If the IRS is not prepared to electronically accept the new Schedules in time for the initial filing dates of these forms, the filing requirement should apply for tax years beginning after the date the IRS and software providers are able to properly provide and process the new schedules in an electronic format. Further, we recommend no assessment of penalties against Partnerships or S Corporations for failing to file or failing to timely provide Schedules K-2 and K-3 for the 2021 tax year.[25]

Anticipating the IRS's response of pointing to Notice 2021-39's discussion of reasonable cause relief, a defense the IRS attempted to use previously in this

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[24] "Concerns Regarding Schedules K-2 and K-3 Reporting," Letter from the AICPA and State CPA Societies, February 24, 2022, Footnote 4

[25] "Concerns Regarding Schedules K-2 and K-3 Reporting," Letter from the AICPA and State CPA Societies, February 24, 2022

controversy[26] before issuing the FAQ on February 18, 2022, the AICPA noted in a footnote to the above paragraph in the letter:

> Notice 2021-39 provided penalty relief for good faith compliance efforts. However, this relief is insufficient given the 2022 updates to the final instructions.[27]

The AICPA letter states that "[d]elay is essential until e-filings can be accepted and uncertainty regarding taxpayer filing obligations is resolved" and specifically notes the issues caused by the IRS's own inability to handle electronically filed versions of the form:

> Currently, the IRS is unable to accept electronically filed returns containing the Schedules K-2 or K-3 via the Modernized e-File (MeF) system for partnership returns until March 20, 2022, and for S corporations returns until mid-June. The lack of a timely available MeF filing option for these forms in electronic format will cause unnecessary hardship to all affected parties.
>
> These tentatively planned dates to accept e-filings are past the original due dates for all passthrough returns, which — given the continual changes regarding applicable filing obligations and MeF system unavailability — will presumptively necessitate filing extensions for significantly more partnership, S corporation, and owners' individual income tax returns than in prior years. A major consequence of not having an MeF option is that the IRS will be tasked with processing unnecessary extensions in addition to the paper-filed returns for those entities who choose not to extend. Software providers also cannot offer sufficient solutions until the MeF system is complete.[28]

The letter concludes:

> The 2022 filing season has commenced and the IRS as well as taxpayers are unclear as to who is required to file the Schedules (emphasis in the original document), nor can taxpayers properly file and the IRS process these Schedules. These threshold issues nearly preclude complete and accurate returns for the 2022 filing season on

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[26] See Kristen A. Parillo, "IRS Feels Your Pain on Schedules K-2 and K-3," *Tax Notes Today Federal*, February 14, 2022, https://www.taxnotes.com/tax-notes-today-federal/information-reporting/irs-feels-your-pain-schedules-k-2-and-k-3/2022/02/14/7d60f (subscription required, retrieved February 27, 2022)

[27] "Concerns Regarding Schedules K-2 and K-3 Reporting," Letter from the AICPA and State CPA Societies, February 24, 2022, Footnote 6

[28] "Concerns Regarding Schedules K-2 and K-3 Reporting," Letter from the AICPA and State CPA Societies, February 24, 2022

> which our tax system relies and on which the Schedules are predicated in the goal to standardize international tax reporting.[29]

From a practical perspective any relief would need to come quickly to be at all relevant for partnerships and S corporations who plan to file their tax returns by the rapidly approaching unextended due date of March 15 for calendar year entities. As well, it's likely entities that are planning to file on time have already expended significant time dealing with this issue, lost time that wouldn't be remedied by the relief even if such relief had been granted on the day the letter was sent.

A better possibility for practical relief is that the letter may make it clear to the IRS the need to have broad based penalty relief on this issue for 2021 return filings, rather than the limited relief offered up by Notice 2021-39.

# SECTION: 6662
# NO REASONABLE CAUSE FOUND FOR UNDERSTATEMENT CAUSED BY DATA ENTRY ERROR OF MAGNITUDE THE TAXPAYERS SHOULD HAVE NOTICED WHEN REVIEWING THE RETURN

## Citation: Busch v. Commissioner, Tax Court Docket No. 14085-20S (Bench Opinion), 2/25/22

In the case of *Busch v. Commissioner*, Tax Court Docket No. 14085-20S (Bench Opinion)[30] the taxpayers argued that they should not be subjected to penalties for understating their tax due to the fact they failed to notice their tax software only worked with full dollar amounts. Because of this, they overstated their mortgage interest deduction by factor of 100.

This taxpayer was preparing the couple's return using consumer tax return preparation software:

> Candice Busch prepared the return using a popular version of return preparation software. According to petitioners, the program allows only for the entry of items of income and deduction in whole dollar

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[29] "Concerns Regarding Schedules K-2 and K-3 Reporting," Letter from the AICPA and State CPA Societies, February 24, 2022

[30] *Busch v. Commissioner*, Tax Court Docket No. 14085-20S (Bench Opinion), February 25, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/failure-to-review-return-undermines-couple%e2%80%99s-penalty-defense/7d76f (retrieved February 27, 2022)

> amounts, that is, it does not allow for the entry of cents, or numbers to the right of the decimal point.[31]

The mortgage interest entry error she made was entering the cents portion of the interest listed on the Form 1098 she received:

> Petitioners paid $21,201.25 of mortgage interest during 2017, and they are entitled to a mortgage interest deduction in that amount for that year. That being so, when Mrs. Busch entered $21,201.25, on the line for the deduction for mortgage interest, the deduction was shown as $2,120,125 instead. The overstated deduction is taken into account in the computation of petitioners' taxable income and Federal income tax, both shown as zero on the return, which in turn resulted in the refund of all of the Federal income tax withheld from both of their wage incomes over the course of 2017.[32]

Apparently neither taxpayer questioned why they were getting a refund of the entire amount of taxes paid in during 2017, and simply filed the return asking for all of their wage withholdings back.

The IRS, not surprisingly, noticed this error when matching up the Form 1098 with what was reported on the taxpayers' return and issued a notice of deficiency which included the 20% accuracy related penalty:

> The correct amount of their mortgage interest deduction is taken into account in the computation of the deficiency shown in the notice. Petitioners now concede that deficiency.[33]

The taxpayers, while fine with the tax shown as due, complained they should not have to pay the accuracy related penalty equal to 20% of the deficiency, while the IRS believed that the penalty was appropriate in the circumstances:

> We are called upon to decide whether they should be held liable for the accuracy-related penalty imposed in the notice. According to petitioners, the overstatement was due to an "honest" mistake, and they should not be penalized for that mistake. According to respondent, imposition of the penalty is appropriate under the circumstances.[34]

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[31] *Busch v. Commissioner*, Tax Court Docket No. 14085-20S (Bench Opinion), February 25, 2022

[32] *Busch v. Commissioner*, Tax Court Docket No. 14085-20S (Bench Opinion), February 25, 2022

[33] *Busch v. Commissioner*, Tax Court Docket No. 14085-20S (Bench Opinion), February 25, 2022

[34] *Busch v. Commissioner*, Tax Court Docket No. 14085-20S (Bench Opinion), February 25, 2022

The penalty in question here is the substantial understatement penalty:

> As relevant here, section 6662(a) imposes a penalty of 20% of the portion of an underpayment of tax attributable to the taxpayer's substantial understatement of income tax. Sec. 6662(a) and (b)(2). In this case the underpayment of tax, as defined in section 6664(a), is equal to and computed in the same manner as the deficiency, see sec. 6211, and that underpayment of tax is a substantial understatement of income tax because it exceeds the greater of $5,000 or 10% of the amount of tax required to have been shown on petitioners' 2017 return, see sec. 6662(d)(1)(A).[35]

As the tax due was in excess of the level necessary to trigger this penalty, the burden now shifted to the taxpayers to demonstrate there was reasonable cause for the understatement per IRC §6664(c)(1). The question was whether the taxpayers had reasonable cause given the error arose from the data entry issue the taxpayer had with the software program.

> According to petitioners, they should not be liable for the penalty because the overstatement of their home mortgage interest deduction was due to a return preparation software feature or limitation that resulted in an unnoticed error made by Mrs. Busch after the amount of mortgage interest was entered in the program. According to petitioners, the penalty should not apply to any portion of the underpayment of tax. As they see, they had reasonable cause and acted in good faith with respect to the entire amount of the underpayment of tax that resulted from the mistaken entry.[36]

The Court begins by recognizing that there are situations of reasonable cause for an understatement due to an entry error or software issue.

> They ask the Court to recognize, as they point out that honest mistakes are sometimes made. As a general proposition of life, we agree with petitioners on the point, and we further agree with petitioners' suggestion that not every mistake made on a Federal income tax return should result in the imposition of an accuracy-related penalty. A person preparing a return might understandably get distracted while doing so and enter the wrong amount for an item, or if not distracted, when transferring numbers from one document to another, transpositions often occur. If a computer-based software program is being used in the process, the limitations and requirements of a software program might not be fully appreciated by the user. Any number of situations could cause an "honest" mistake to be made

[35] *Busch v. Commissioner*, Tax Court Docket No. 14085-20S (Bench Opinion), February 25, 2022

[36] *Busch v. Commissioner*, Tax Court Docket No. 14085-20S (Bench Opinion), February 25, 2022

> when amounts are incorrectly reported on a Federal income tax return.[37]

But that mistake, by itself, would not constitute reasonable cause if the error is one that should have been noticed by the taxpayer when reviewing the return before signing:

> But petitioners' focus on the erroneous entry as the "mistake", and their explanation describing how the mistake occurred, misses the point. The mistaken entry is not the real problem. Their mistake was failing to review the return carefully enough to have recognized the erroneous entry before the return was filed. After all, it should go without saying, that a taxpayer's obligation to prepare and file a Federal income tax return includes the duty to review that return to ensure that the information reported or shown on the return is accurate before the return is filed.[38]

And here is where the Court found that the return produced by the software clearly showed an amount of interest deduction that the taxpayer should have immediately realized was wildly overstated had they looked at Schedule A.

> The deduction for mortgage interest shown on the return occupies at least two additional columns to the left of any other number shown on the page of the return where the deduction is claimed. Looking up and down the columns showing other items reported on the return, the mortgage interest deduction sticks out, as the saying goes, "like a sore thumb". A careful review of the return after it was prepared would most certainly have caught the error; actually, even as little as a quick glance at the return probably would have done so.[39]

As the taxpayers had tacitly admitted in the case, they had not reviewed the return before it was submitted—and that failure is not one that a party taking reasonable care to assure they had accurately computed the proper amount of tax due would have allowed to happen.

> At trial petitioners more or less acknowledge that they failed to carefully review the return before it was forwarded to the Internal Revenue Service. It was a mistake for petitioners not to review the return carefully, or as recollected by one of them, not to review it at all after it was prepared. Their failure to review the return carefully was a careless mistake that completely undermines their claim that they acted

[37] *Busch v. Commissioner*, Tax Court Docket No. 14085-20S (Bench Opinion), February 25, 2022

[38] *Busch v. Commissioner*, Tax Court Docket No. 14085-20S (Bench Opinion), February 25, 2022

[39] *Busch v. Commissioner*, Tax Court Docket No. 14085-20S (Bench Opinion), February 25, 2022

> with reasonable cause and in good faith with respect to the underpayment of tax that, as it turned out, resulted from that failure.[40]

Note that the same requirement applies to taxpayers who have their return prepared by a tax professional, something that the Tax Court had pointed out in the past. But at least in that case the taxpayers likely have some recourse against the professional who would have allowed the return to be released to the client with this sort of obvious error on the return.

So even though this is just a bench opinion (and thus not precedential), it does point out a key responsibility all taxpayers have.

[40] *Busch v. Commissioner*, Tax Court Docket No. 14085-20S (Bench Opinion), February 25, 2022