

Minnesota Department of Revenue

Revenue Notice # 22-03: Civil Procedures - Substantial Understatement Penalty – Definitions

Introduction

This Revenue Notice states the Department’s position that the terms “substantial authority” and “reasonable basis” used in *Minnesota Statutes*, section 289A.60, subdivision 4(d) have the meaning given to those terms in *Treasury Regulations*, sections 1.6662-4(d)(2), -4(d)(3)(i) and (ii), and 1.6662-3(b)(3), as amended through the date of publication of this Notice (collectively herein, the “Federal Definitions”) as well as the meaning given to those terms in the “Cross-Referenced Language” as that term is defined below.

Background

Minnesota Statutes, section 289A.60, subdivision 4 requires the Commissioner of Revenue to “impose a penalty for substantial understatement of any tax payable to the commissioner, except the tax imposed under chapter 297A.” Section 289A.60, subdivision 4(d) provides, in pertinent part, that:

The amount of the understatement shall be reduced by that part of the understatement that is attributable to the tax treatment of any item by the taxpayer if (1) there is or was **substantial authority** for the treatment, or (2)(i) any item with respect to which the relevant facts affecting the items are adequately disclosed in the return or in a statement attached to the return and (ii) there is a **reasonable basis** for the tax treatment of the item. (Emphasis added.)

The terms “substantial authority” and “reasonable basis” are not defined in section 289A.60, subdivision 4(d). However, that section does provide cross-references to certain provisions of section 6662(d) of the *Internal Revenue Code* when discussing the terms “substantial authority,” “reasonable basis,” and “special rules in cases involving tax shelters” (collectively, the “Cross-Referenced Language”).

Section 6662 of the *Internal Revenue Code* imposes a penalty for, among other things, the substantial understatement of federal income tax. Section 6662(d)(2)(B) provides, similar to *Minnesota Statutes*, section 289A.60, subdivision 4(d), for reduction in the amount of the understatement penalty under the following conditions:

The amount of the [substantial] understatement under subparagraph (A) shall be reduced by that portion of the understatement which is attributable to—

(i) the tax treatment of any item by the taxpayer if there is or was **substantial authority** for such treatment, or

(ii) any item if—

(I) the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and

(II) there is a *reasonable basis* for the tax treatment of such item by the taxpayer.

(Emphasis added.)

Congress authorized the U.S. Department of the Treasury to prescribe regulations implementing the substantial understatement penalty and the related reductions provided therein. See section 7805(a) of the *Internal Revenue Code*. *Treasury Regulations*, sections 1.6662-3 and 1.6662-4 were first enacted in 1991 and last amended in 2003. The current version of those regulations contains the following provisions discussing the term "substantial authority":

(d) Substantial authority - . . .

(2) Substantial authority standard. The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard as defined in § 1.6662-3(b)(3). The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied.

(3) Determination of whether substantial authority is present -

(i) Evaluation of authorities. There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. The weight of authorities is determined in light of the pertinent facts and circumstances in the manner prescribed by paragraph (d)(3)(ii) of this section. There may be substantial authority for more than one position with respect to the same item. Because the substantial authority standard is an objective standard, the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment.

(ii) Nature of analysis. The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from

which information has been deleted, such as a private letter ruling, is diminished to the extent that the deleted information may have affected the authority's conclusions. The type of document also must be considered. For example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue. An older private letter ruling, technical advice memorandum, general counsel memorandum or action on decision generally must be accorded less weight than a more recent one. Any document described in the preceding sentence that is more than 10 years old generally is accorded very little weight. However, the persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account along with the age of the document. There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

Treasury Regulations, sections 1.6662-4(d)(2) and 1.6626-4(d)(3)(i) and (ii).

These treasury regulations also contain the following provision discussing the term “reasonable basis”:

(3) Reasonable basis. Reasonable basis is a relatively high standard of tax reporting, 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 § 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 § 1.6662-4(d)(2). (See § 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.)

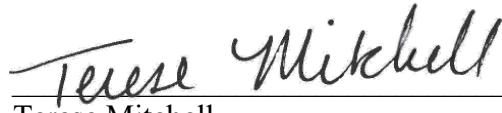
Treasury Regulations, section 1.6662-3(b)(3).

These provisions, which reflect the federal regulations in effect on the date of publication of this Revenue Notice, are collectively referred to in this Notice as the “Federal Definitions.” Any amendments made to these federal regulations after publication of this Notice are not automatically included within the term “Federal Definitions” as used in this Revenue Notice.

Department Position

This Revenue Notice provides taxpayers with guidance on how the Department interprets the terms “substantial authority” and “reasonable basis” in *Minnesota Statutes*, section 289A.60, subdivision 4(d). The Department has determined it is appropriate to give these terms the same meaning they are given in administering the comparable federal understatement penalty imposed under section 6662 of the *Internal Revenue Code*, as reflected in the Federal Definitions, as well as the Cross-Referenced Language in *Minnesota Statutes*, section 289A.60, subdivision 4(d).

Publication Date: December 12, 2022

A handwritten signature in black ink that reads "Terese Mitchell". The signature is written in a cursive style and is positioned above a horizontal line.

Terese Mitchell,
Director
Appeals, Legal Services, and Disclosure Division