

Best Practices in Defending Clients Against Tax Penalties

By Robert S. Horwitz

Robert Horwitz examines defending taxpayers against tax penalties.

The Internal Revenue Code (the “Code”) currently contains over 150 penalties that can be assessed against taxpayers, return preparers and persons required to file information returns. This is an increase of more than 10-fold over the penalties that were originally contained in the 1954 Code. There is a penalty for failing to comply with almost every filing, paying and reporting requirement in the Code. Assessable penalties and additions to tax include penalties for a) failure to file returns or pay tax when due¹; b) failure to make estimated tax payments²; c) failure to deposit taxes³; d) inaccurate returns⁴; e) return preparers, tax shelter promoters and material advisors⁵; f) information return⁶; g) international returns⁷; h) estate and gift tax and excise tax returns⁸; i) employee plans and exempt organization returns⁹; j) incorrect appraisal¹⁰; and k) miscellaneous matters.¹¹

In each of the past several years, the IRS has assessed over \$25 billion in penalties. At the same time, it has abated approximately 40 percent of the penalties assessed. For the fiscal year ending September 30, 2012, the IRS assessed \$26,864,993,000 in penalties and abated \$11,295,909,000 in penalties, or 42 percent.¹² For the fiscal year ending September 30, 2013, the IRS assessed \$25,893,295,000 in penalties and abated \$11,458,194,000 in penalties, or 44.25 percent.¹³ For the fiscal year ending September 30, 2014, the IRS assessed \$25,560,352,000 in penalties and abated \$9,891,799,000 in penalties, or 38.69 percent.¹⁴

The IRS’s guidelines and procedures for the administration of the penalty provisions of the Code are contained in the Penalty Handbook, which is Part 20.1 of the Internal Revenue Manual.

How the IRS Views Penalties

According to the Penalty Handbook, penalties “exist to encourage voluntary compliance by supporting the standards of behavior required by the Internal Revenue



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ROBERT S. HORWITZ is a Principal of Hochman, Salkin, Rettig, Toscher & Perez, P.C., in Beverly Hills, California, where he specializes in representing clients in civil and criminal tax controversies and litigation. He is chair of the Taxation Section of the California State Bar for 2015–2016.

Code.”¹⁵ Penalties also serve to assure compliant taxpayers that those persons who fail to comply with their reporting and payment obligations are penalized.¹⁶ To ensure the fairness and effectiveness of the tax system, penalties must a) be severe enough to deter noncompliance, b) encourage noncompliant taxpayers to comply, c) be proportional to the offense and d) provide an opportunity to educate taxpayers and encourage future compliance.¹⁷

To achieve the goal of using penalties to promote voluntary compliance, the IRS’s stated policy is that “examiners and their managers must consider the applicability of penalties in each case, and fully develop the penalty issue when the initial consideration indicates that penalties should apply.”¹⁸ The IRS personnel are to be consistent in their application of penalties in similar cases, conduct an unbiased analysis of the facts in each case and properly apply the law to the facts in each case. Taxpayers are to be afforded the opportunity to present evidence as to why the penalty should not apply, and the IRS is to give this evidence full and fair consideration and to only impose penalties when “full and fair consideration of the facts and the law support doing so.”¹⁹

There is a penalty for failing to comply with almost every filing, paying and reporting requirement in the Code.

Despite these policies, the IRS assesses many penalties automatically, including late filing, late payment and late deposit penalties and accuracy-related penalties under its Automated Underreporter Program. This program compares income information reported to the IRS by third parties with the income reported by taxpayers on their returns. Taxpayers who fail to explain why they did not report income and who fail to file a Tax Court petition in response to a notice of deficiency are automatically assessed a 20-percent accuracy penalty.²⁰

Section 3306(a) of the Internal Revenue Service Restructuring and Reform Act of 1998²¹ added two procedural requirements with which the IRS must comply when it imposes a penalty. First, the IRS must “include with each notice of penalty ... the name of the penalty, the Section of the [Code] under which the penalty is imposed, and a computation of the penalty.”²² Second, a penalty cannot be assessed unless the immediate supervisor of the IRS employee who initially determines to assess the penalty approves the initial determination of the assessment of

the penalty in writing.²³ Pre-assessment approval by a manager is not required for a) delinquency penalties (Code Sec. 6651), b) the penalty for failure to pay estimated individual income tax (Code Sec. 6654), c) the penalty for failure to pay estimated corporate income tax (Code Sec. 6655) or d) any other penalties that are automatically calculated through electronic means.²⁴

Penalties are not to be used by the IRS examiners as a bargaining chip.²⁵ In challenging penalties in a protest to the Appeals Office or post-assessment, it is important to obtain a copy of the IRS’s administrative files to determine whether a penalty can be challenged on procedural grounds.²⁶

A taxpayer may request that the IRS not assert a penalty, or that it abate an assessed penalty, at any time: when a return is filed, when a late payment is made, during an examination or appeal (prior to assessment) or after assessment of the penalty.²⁷

Timing-Related Penalties and the First-Time Abate Program

a. Delinquency Penalties Under Code Sec. 6651

The most frequently assessed penalties, both in total number of assessments and dollar amounts assessed, are the delinquency penalties.²⁸ Code Sec. 6651(a)(1)²⁹ imposes a penalty on any taxpayer who fails to file a tax return³⁰ on or before its due date, unless the failure is due to reasonable cause and not willful neglect. A return that is mailed to the appropriate IRS office on or before its due date (including extensions) is considered timely filed.³¹ The penalty also applies to a return that is filed electronically after the due date.³² A return that is due on a Saturday, Sunday or legal holiday is timely if it is filed by the next business day.³³

The amount of the penalty is five percent of the amount of tax that is required to be shown on the return if the return is late by no more than one month. There is an additional five-percent penalty for each additional month (or part thereof) by which the return is late, up to a maximum penalty of 25 percent of the tax required to be shown on the return.³⁴ If the failure to file is due to fraud, the penalty increases to 15 percent per month (or part thereof) up to a maximum of 75 percent of the tax required to be shown on the return.³⁵ The penalty is computed based on the “net amount due.” This is the tax required to be shown on the return less the sum any payments made on or before the due date of the return plus any credits against tax that can be claimed on the return.³⁶

Code Sec. 6651(a)(2) imposes a penalty for late payment of any tax shown on a return by the due date. The amount of the penalty is 0.5 percent per month or fraction thereof, up to a maximum of 25 percent. The penalty applies unless the taxpayer shows that the failure to pay was due to reasonable cause and not willful neglect.³⁷ The penalty is computed based on the net amount of tax due, *i.e.*, the tax shown on the return less any payments or credits.³⁸

If both the Code Sec. 6651(a)(1) failure-to-file penalty and the Code Sec. 6651(a)(2) failure-to-pay penalty apply, the failure-to-file penalty is reduced by the amount of the failure-to-pay penalty for each month (or part thereof) for which both apply.³⁹ This means that where both apply, the maximum failure-to-file penalty will be 22.5 percent ($(5\% - 0.5\%) \times 5$). The maximum failure-to-pay penalty will still be 25 percent.

A taxpayer who fails to pay a tax that was required to be, but was not, shown on a return within 21 days after the IRS's notice and demand for payment (10 days if the amount due is \$100,000 or more) is liable for a failure-to-pay penalty under Code Sec. 6651(a)(3). The amount of the penalty is 0.5 percent per month (or part thereof) of the unpaid balance of the tax assessed up to a maximum penalty of 25 percent.⁴⁰

A taxpayer is not liable for either failure-to-pay penalty if the failure is due to reasonable cause and not willful neglect.⁴¹ If a taxpayer fails to pay tax within 10 days after the IRS mails a notice of levy under Code Sec. 6331(d), the amount of the failure-to-pay penalties increases to one percent per month or part thereof.⁴²

If a taxpayer is filing a return or making a payment late, you should consider attaching a statement or a cover letter setting out the facts showing that the taxpayer's delinquency was due to reasonable cause.

b. Obtaining Penalty Relief Under the First-Time Abate Program

If the taxpayer has a prior history of complying with the filing and payment requirements of the Code, he or she can seek to have a failure-to-file and failure-to-pay penalty abated under the IRS's First Time Abate (FTA) program.⁴³ The FTA waiver is available for income tax and employment tax, but not for estate and gift tax returns or Form 1120/Form 1120-S returns if at least one Form 1120-S was filed late but not penalized.⁴⁴

To qualify for the FTA penalty waiver, a taxpayer must meet the following criteria:

- a) The taxpayer was not previously required to file a return or has filed all required returns (or a valid extension request) and does not have an outstanding request for a return from the IRS.

- b) The taxpayer must have paid, or arranged to pay, all tax due. If the taxpayer is in an installment agreement, all the payments must be current.
- c) The taxpayer has no prior penalties (except an estimated tax penalty) for the preceding three years. If a penalty was abated in the past for any reason other than FTA, the taxpayer is still eligible for FTA.⁴⁵

The FTA waiver only applies to one tax period. If a request for penalty relief is being considered for two or more tax periods and the earliest tax period meets FTA criteria, FTA relief will apply only to the earliest tax period. Penalty relief for all subsequent tax periods will be based on other relief provisions, such as reasonable cause criteria.⁴⁶

If a taxpayer is filing a return or making a payment late, you should consider attaching a statement or a cover letter setting out the facts showing that the taxpayer's delinquency was due to reasonable cause.

If a taxpayer who qualified for FTA relief files a return late or fails to pay all tax when due, a request for nonassertion of penalties should be attached to the return. Where the taxpayer has already paid the penalty, a Form 843, *Claim for Refund and Request for Abatement*, should be filed so that the taxpayer can obtain a refund of the penalties. A request for FTA can be made by calling the IRS's Practitioner Priority Line if the case is not assigned to a collection or examination function. The IRS employee who answers the phone should be able to pull up the taxpayer's account and determine whether the taxpayer meets the criteria for FTA relief. FTA relief can also be requested in writing to the IRS Service Center where the taxpayer would be required to file a current-year tax return for the tax to which the request relates. Form 843 should be used.

If the IRS determines that the taxpayer should be granted FTA relief, it will issue Letter 3502C (for BMF FTD penalty relief) or Letter 3503C (for IMF FTF and/or FTP penalty relief).⁴⁷ If the IRS determines that a taxpayer is not eligible for FTA relief, it can still grant relief if the taxpayer establishes reasonable cause. To make the reasonable-cause determination for individual failure-to-file and failure-to-pay penalties and for business failure to deposit penalties, the IRS uses the Reasonable Cause Assistant (RCA). RCA is an interactive software

program designed to reach a decision on whether there is reasonable cause for penalty relief.⁴⁸ It was developed to provide consistency in the analytical process through which decisions are made regarding whether to abate or reduce penalty assessments.

Reasonable-cause relief can be requested by telephone or in writing.⁴⁹ A taxpayer must provide “credible information” to support the claim for reasonable-cause relief. This information must show that “the taxpayer exercised ordinary business care and prudence, and cite specific dates for the non-compliance.” All the information must substantiate why the taxpayer was unable to comply.⁵⁰

If the IRS does not grant FTA relief or reasonable-cause relief, a taxpayer can request assistance from the National Taxpayer Advocate⁵¹ or can file a protest with the Office of Appeals.

Defending Against Accuracy-Related Penalties

a. The Accuracy-Related Penalties Assessable Under Code Sec. 6662

Code Sec. 6662 authorizes the imposition of a penalty equal to 20 percent of any understatement of tax due to one of the following:

- Negligence or disregard of rules or regulations⁵²
- Substantial understatement of income tax⁵³
- Substantial valuation misstatement⁵⁴
- Substantial overstatement of pension liabilities⁵⁵
- Substantial estate or gift tax valuation understatement⁵⁶
- Transactions lacking economic substance⁵⁷
- Undisclosed foreign financial assets⁵⁸

For purposes of the accuracy-related penalties, negligence or disregard includes “any failure to make a reasonable attempt to comply with” the internal revenue laws and any “reckless, careless, or intentional disregard.”⁵⁹ A substantial understatement exists if the amount of the understatement for the tax year exceeds the greater of 10 percent of the tax required to be shown on the return or \$5,000 in the case of an individual and the lesser of 10 percent of the tax required to be shown on the return (or \$10,000 if greater) or \$10 million in the case of a C corporation.⁶⁰

In addition, a 40-percent penalty applies to that portion of an understatement of tax resulting from:

- gross valuation misstatement,⁶¹
- gross overstatement of pension liabilities,⁶²
- gross estate or gift tax valuation understatement,⁶³

- undisclosed transactions lacking economic substance,⁶⁴
- undisclosed foreign financial assets.⁶⁵

Accuracy-related penalties assessed under Code Sec. 6662 must be approved in writing by the immediate supervisor of the IRS employee who initially determines to assert the penalty.⁶⁶ Managerial review is required if the IRS auditor determines not to assert an accuracy-related penalty and there is a substantial understatement of income tax under Code Sec. 6662(d).⁶⁷

b. Pre-Filing Strategies for Avoiding Accuracy-Related Penalties

The accuracy-related penalty does not apply if the taxpayer adequately discloses the position on a statement filed with the return that explains the factual basis of the position and there is a reasonable basis for the position taken.⁶⁸ The penalty does not apply to a position that is contrary to a regulation if the taxpayer discloses the position, and the position represents a good faith challenge to the regulation. A good faith challenge to the validity of a regulation generally requires a showing that the taxpayer conducted a careful analysis of reasonably available authorities. The disclosure is to be made on Form 8275, *Disclosure Statement*, or Form 8275-R, *Regulation Disclosure Statement*, whichever is applicable.⁶⁹ Disclosure will not avoid a penalty, however, in three circumstances: 1) if there is no reasonable basis for the position; 2) if the basis of the position is not adequately substantiated; or 3) if the taxpayer fails to keep adequate books and records with respect to the item or position.⁷⁰ Disclosure does not avoid a penalty for any item attributable to a tax shelter.⁷¹

If a taxpayer engaged in a reportable transaction entered into on or after January 1, 2003, and reported on a return filed after December 31, 2003, taxpayers must disclose the reportable transaction on Form 8886, as required under Code Sec. 6011.

If there is a substantial understatement, the penalty will not apply if the taxpayer’s position was supported by “substantial authority.” “Substantial authority” exists if the authority supporting the taxpayer’s position is “substantial” when weighed against the authority contrary to the taxpayer’s position.⁷² Substantial authority is defined as:

... applicable provisions of the Internal Revenue Code 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; 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); private letter rulings and technical advice memoranda issued after October 31, 1976; actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin); Internal Revenue Service information or press releases; and notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin. Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority.⁷³

“Substantial” means more than a reasonable basis but less than a preponderance. The substantial authority test is supposed to be an objective evaluation of the authorities for and against the position taken by the taxpayer on the return.⁷⁴

c. Post-Filing: Qualified Amended Returns

The accuracy penalty is computed based on the excess of the amount of tax that is required to be shown on the return over the “amount shown ... by the taxpayer on his return.” Reg. §1.6664-2(c)(2) defines “amount shown ... by the taxpayer on his return” to include “an amount shown as additional tax on a qualified amended return.” A taxpayer may thus avoid penalties by filing a qualified amended return. Accordingly, a taxpayer can avoid penalties, except as to items that are fraudulent, by filing a qualified amended.

A qualified amended return is an amended return that is filed after the due date of the return for the tax year and before the earliest of:

- a) the date the taxpayer is first contacted by the IRS concerning an examination with respect to the return;
- b) the date on which any person described in Code Sec. 6700(a) is first contacted by the IRS regarding a Code Sec. 6700(a) penalty with respect to a transaction from which the taxpayer claimed a direct or indirect benefit on the return;
- c) in the case of a passthrough item, the date on which the passthrough entity is first contacted by the IRS in connection with the return to which the passthrough item relates;
- d) the date on which the IRS first serves a John Doe summons “with respect to an activity for which the

- e) taxpayer claimed any tax benefit on the return directly or indirectly”; or
- e) if the taxpayer claimed a benefit from a listed transaction, the date on which the IRS announces a settlement initiative with respect to the transaction.⁷⁵

The Reasonable-Cause Exception to Delinquency and Accuracy-Related Penalties

Many penalties require that the taxpayer acted without reasonable cause. These include penalties under Code Sec. 6038B(c) (penalty for failure by U.S. person to file information return for transfers of property to a foreign corporation or partnership shall not apply if the person “shows such failure is due to reasonable cause and not to willful neglect”); Code Sec. 6651 (failure to file return when due or to pay tax when due is subject to a penalty “unless it is shown that such failure is due to reasonable cause and not due to willful neglect”); Code Secs. 6662 and 6663 (pursuant to Code Sec. 6664(c), a taxpayer is not liable for the accuracy-related penalty imposed by Code Sec. 6662 or the fraud penalty imposed by Code Sec. 6663 as to any portion of an underpayment of tax if “there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion”). Other penalties are imposed only if the taxpayer acted willfully, including penalties under Code Sec. 6663 (penalty for underpayment of tax due to fraud); Code Sec. 6672 (willful failure to collect and pay over withholding tax); and Code Sec. 6674 (willfully furnishing a false statement to employees or willfully failing to furnish the statement). Some penalties do not have a reasonable-cause exception, such as the penalty under Code Sec. 6707 (failure to file a return for a reportable transaction).

Most delinquency penalties are assessed automatically when a taxpayer files a late return or fails to pay tax by the due date of the return.⁷⁶ Procedurally, a taxpayer can challenge delinquency penalties in this situation by either filing a Form 843, *Claim for Refund and Request for Abatement*,⁷⁷ or during a collection due process hearing.⁷⁸ Accuracy-related penalties are only asserted if there is an underpayment of tax on the taxpayer's return, *i.e.*, if the amount of tax reported on a return is less than the amount of tax required to be reported.⁷⁹

A taxpayer will not be liable for a delinquency penalty if he can establish that the failure to file a return on time or to pay tax on time was due to reasonable cause and not willful neglect.⁸⁰ A taxpayer will not be liable for an accuracy-related penalty if he can show that there was

reasonable cause for the underpayment and that he acted in good faith.⁸¹

The reasonable-cause exception for delinquency penalties is contained in Reg. §301.6651-1(c), which states:

- (1) Except as provided in subparagraphs (3) and (4) of this paragraph (b), a taxpayer who wishes to avoid the addition to the tax for failure to file a tax return or pay tax must make an affirmative showing of all facts alleged as a reasonable cause for his failure to file such return or pay such tax on time in the form of a written statement containing a declaration that it is made under penalties of perjury. Such statement should be filed with the district director or the director of the Service center with whom the return is required to be filed If the taxpayer exercised ordinary business care and prudence and was never-

If the IRS determines that a taxpayer is not eligible for FTA relief, it can still grant relief if the taxpayer establishes reasonable cause.

theless unable to file the return within the prescribed time, then the delay is due to a reasonable cause. A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship (as described in §1.6161-1(b) of this chapter) if he paid on the due date. In determining whether the taxpayer was unable to pay the tax in spite of the exercise of ordinary business care and prudence in providing for payment of his tax liability, consideration will be given to all the facts and circumstances of the taxpayer's financial situation, including the amount and nature of the taxpayer's expenditures in light of the income (or other amounts) he could, at the time of such expenditures, reasonably expect to receive prior to the date prescribed for the payment of the tax. Thus, for example, a taxpayer who incurs lavish or extravagant living expenses in an amount such that the remainder of his assets and anticipated income will be insufficient to pay his tax, has not exercised ordinary business care and prudence in providing for the payment of his tax liability. Further, a taxpayer who invests funds in speculative or illiquid assets has

not exercised ordinary business care and prudence in providing for the payment of his tax liability unless, at the time of the investment, the remainder of the taxpayer's assets and estimated income will be sufficient to pay his tax or it can be reasonably foreseen that the speculative or illiquid investment made by the taxpayer can be utilized (by sale or as security for a loan) to realize sufficient funds to satisfy the tax liability. A taxpayer will be considered to have exercised ordinary business care and prudence if he made reasonable efforts to conserve sufficient assets in marketable form to satisfy his tax liability and nevertheless was unable to pay all or a portion of the tax when it became due.

- (2) In determining if the taxpayer exercised ordinary business care and prudence in providing for the payment of his tax liability, consideration will be given to the nature of the tax which the taxpayer has failed to pay. Thus, for example, facts and circumstances which, because of the taxpayer's efforts to conserve assets in marketable form, may constitute reasonable cause for nonpayment of income taxes may not constitute reasonable cause for failure to pay over taxes described in section 7501 that are collected or withheld from any other person.

The reasonable-cause exception for accuracy-related penalties applies a fact-and-circumstances test to determine whether a taxpayer acted with reasonable cause and in good faith. Reg. §301.6664-4(c) provides, in pertinent part:

The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. (See paragraph (e) of this section for certain rules relating to a substantial understatement penalty attributable to tax shelter items of corporations.) 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. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily

indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice, or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.

Reasonable cause has been found to exist in some circumstances, but not in others. Among the more common circumstances alleged to constitute reasonable cause are:

- a. Reliance on others: Reliance on another person to either file the return or pay the tax is not reasonable cause since those duties cannot be delegated. In *R. W. Boyle*,⁸² the Supreme Court held that the taxpayer could not avoid a delinquency penalty by claiming that he relied on his attorney to file an estate tax return on time. A taxpayer cannot avoid a delinquency penalty due to the malfeasance of an employee.⁸³

In *P. Knapp*,⁸⁴ the IRS assessed a late-filing penalty against the executor of an estate who relied on the erroneous advice of a tax professional that it was possible to request a 12-month extension of the filing deadline and, therefore, did not file by the actual due date. The Ninth Circuit rejected the taxpayer's reasonable-cause claim, holding that "[t]he deadlines here brook no debate."⁸⁵ The question of whether "an extension was available was not a 'debatable' one," and "for that reason," the executor "cannot show reasonable cause to excuse his late filing," despite his reliance on the (ultimately mistaken) advice of a tax professional.⁸⁶

- b. Reliance on advice of a tax professional: A taxpayer can avoid liability for accuracy-related penalties where he has relied on the erroneous advice of a tax professional. To establish reasonable reliance on the advice of a tax professional, the taxpayer must show⁸⁷:
 - i. the taxpayer was a competent tax professional who had sufficient expertise to justify reliance;
 - ii. the taxpayer provided all necessary information to the professional;
 - iii. the taxpayer reasonably relied on the advice in good faith;
 - iv. the advisor was not "the taxpayer," *i.e.*, a corporation cannot avoid an accuracy penalty by relying on advice of in-house counsel⁸⁸; and
 - v. the professional must actually provide the advice to the taxpayer.

A taxpayer's education, sophistication and business experience are all taken into account in determining whether the taxpayer's reliance on advice was reasonable.⁸⁹ A taxpayer is not required to challenge the advice of an independent and

competent advisor, to seek a second opinion or to conduct independent research to confirm the advice.⁹⁰ In most circumstances, a taxpayer may not rely on the advice of a tax professional if the professional has an inherent conflict of interest, such as the promoter of a tax shelter.⁹¹ Where the tax professional is not promoting a tax shelter, is paid an hourly fee by the taxpayer both to structure a transaction and advise on the tax effect of the transaction and was not paid based on a percentage of tax savings, a taxpayer may be able to rely on the advice to avoid penalties.⁹² A taxpayer may not rely on professional advice that a regulation is invalid unless it is disclosed in the return.⁹³ A taxpayer who claims reliance on the advice of a tax professional waives any attorney-client or federal tax preparer-client⁹⁴ privilege.⁹⁵

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- c. Death, Serious Illness or Unavoidable Absence: The death, serious illness or unavoidable absence of the taxpayer or a member of the taxpayer's family can constitute reasonable cause for late filing or late payment of a tax.⁹⁶ A taxpayer must show a) that he or a close family member was incapacitated, b) the date and duration of incapacity, c) why it prevented him with complying, d) that the incapacitating condition impaired his ability to carry out his daily business and e) the steps he took to comply once the incapacitating condition ended.⁹⁷
- d. Lack of Records: Normally, a lack of records will not constitute reasonable cause. Where the lack of records is due to a fire, theft, casualty loss or natural disaster, however, it may be reasonable cause if the taxpayer can show that he took reasonable steps to obtain the information needed to prepare his returns.
- e. Financial Difficulties: Financial difficulties may constitute reasonable cause negating the delinquency penalty.⁹⁸
- f. The taxpayer's reporting position is supported by substantial authority.⁹⁹
- g. Disclosure of a reasonable reporting position on the original or a qualified amended return.¹⁰⁰

- h. Filing of a qualified amended return prior to first being contacted by the IRS.

The reasons listed above are some of the more frequent ones that are relied upon by taxpayers who seek to obtain penalty relief. A taxpayer can also obtain penalty relief where he falls within a statutory exception to a penalty or there is an administrative waiver.¹⁰¹

Requesting Abatement or Nonassertion of Penalties

Regardless of what grounds are raised in seeking relief or the stage of the proceedings, a taxpayer's representative should ensure that she has provided sufficient detailed facts supported by witness statements and documentary evidence to substantiate the taxpayer's claim of reasonable cause.

If the penalty has already been proposed or assessed, regulations require that, in general, requests to waive or abate a penalty be in writing and signed under penalty of perjury.¹⁰² For the request for waiver or abatement of a penalty, the representative should write a clear, concise and logical statement that explains why the penalty should not apply. The statement should contain specific detailed facts supporting the taxpayer's position. The taxpayer should sign the statement under penalty of perjury. The taxpayer's statement should include the following language above the signature line: *"Under penalties of perjury, I declare that I examined the facts stated in this statement, including any accompanying documents, and, to the best of my knowledge and belief, they are true, correct, and complete."* The taxpayer should sign the statement in "blue ink" so it is clear that the document is an original.

Where possible, the request should be supported by documentary evidence and declarations from third-party witnesses.¹⁰³ The declarations should be signed under penalty of perjury. The documents and any declarations should be attached as numbered exhibits to the taxpayer's statement. Each fact in the statement that is supported by an exhibit should refer to that exhibit by number and name

so that the IRS can easily follow your presentation. The request should be sent to the appropriate IRS office with a cover letter. The representative should include a Power of Attorney (Form 2848) signed by both the representative and the taxpayer.

In preparing your submission, you should remember that you must show that the taxpayer exercised ordinary business care and prudence (or was unable to do so for reasons beyond his control). To do this, you should obtain transcripts from the IRS showing the taxpayer's compliance history since a pattern of late filing or prior audits with accuracy-related penalties being assessed may undercut a taxpayer's claim of reasonable cause. You should be careful to ensure that the statement is logically consistent and that the taxpayer's reasons make sense. If you are challenging a delinquency penalty, you should also consider the length of time between the event that caused noncompliance and the date when the taxpayer finally complied.¹⁰⁴

The IRS will review the material you submit, together with any other documentation in the IRS's files, to determine whether your client is liable for penalties. You should respond as soon as practicable to any requests by the IRS for additional materials to support your position. The IRS will send you and your client a letter if it denies your request for abatement or waiver of a penalty. You will have the right to appeal the denial to the IRS Appeals Office. Similarly, if the IRS proposes a penalty during an audit of your client's tax return, you will normally have the right to appeal the penalty and any other adjustments proposed by the IRS to the IRS Appeals Office.¹⁰⁵

Conclusion

The IRS has been increasingly aggressive in asserting penalties against taxpayers, return preparers and persons required to issue information returns. Many of these penalties are ultimately abated by the IRS. Effective representation with detailed information supporting the taxpayer's reason for why penalties should not apply will increase your chances of eliminating penalties that would otherwise be asserted.

ENDNOTES

¹ Code Secs. 6651, 6698 and 6699.

² Code Secs. 6654 and 6655.

³ Code Sec. 6656.

⁴ Code Secs. 6662, 6662A, 6663 and 6676.

⁵ Code Secs. 6694, 6695, 6700, 6701, 6707, 6707A, 6708, 6713, 7407 and 7408.

⁶ Code Secs. 6011, 6721, 6722, 6723 and 6724.

⁷ Code Secs. 6038, 6038A, 6038D, 6039E, 6039G, 6039F, 6652(f), 6677, 6679, 6683,

6686, 6688, 6689 and 6712.

⁸ Code Secs. 4103, 6166, 6653, 6675, 6715, 6715A, 6717, 6718, 6719, 6720A, 6725, 7270, 7271, 7272, 7273, 7275, 7304 and 7342.

⁹ Code Secs. 6652, 6684, 6685, 6690, 6692, 6693, 6704, 6710, 6711 and 6714.

¹⁰ Code Sec. 6695A.

¹¹ Code Secs. 856(g)(5), 6652(a)/(b)/(j)-(l), 6657, 6672, 6673, 6674, 6682, 6697, 6702, 6705,

6706, 6709, 6720B, 6720C, 7268, 7519 and 9707.

¹² INTERNAL REVENUE SERVICE 2012 DATA BOOK, available online at www.irs.gov/pub/irs-soi/12databk.pdf.

¹³ INTERNAL REVENUE SERVICE 2013 DATA BOOK, available online at www.irs.gov/pub/irs-soi/13databk.pdf.

¹⁴ INTERNAL REVENUE SERVICE 2014 DATA BOOK, available online at www.irs.gov/pub/irs-soi/14databk.pdf.

¹⁵ IRM ¶120.11.2.1 (Nov. 25, 2011).

- ¹⁶ IRM ¶20.1.1.2.1.7 (Nov. 25, 2011).
- ¹⁷ IRM ¶20.1.1.2.1 (Nov. 25, 2011).
- ¹⁸ Internal Revenue Service Policy Statement 20-1. *Id.*
- ¹⁹ *Id.*
- ²⁰ IRM ¶20.1.1.2.3.2 (Aug. 5, 2014).
- ²¹ Act Sec. 3306(a) of the Internal Revenue Service Restructuring and Reform Act of 1998 (P.L. 105-206), 112 Stat. 685.
- ²² Code Sec. 6751(a).
- ²³ Code Sec. 6751(b). In *J. Schlabach*, FedCl, 2012-1 ustr ¶50,114, 101 FedCl 678 (2011), the Court held that a taxpayer was not liable for a frivolous return penalty in part because the penalty was not approved in writing by a supervisor.
- ²⁴ Code Sec. 6751(b).
- ²⁵ IRM ¶20.1.1.2.3.1 (Nov. 25, 2011).
- ²⁶ Freedom of Information Act requests are sent to a central IRS Disclosure Office by facsimile at 877-891-6035 or by mail to the following address:
 IRS FOIA Request
 Stop 93A
 Post Office Box 621506
 Atlanta GA 30362-3006
 Further information on FOIA requests is available online at www.irs.gov/pub/irs-utl/irs_foia_guide.pdf.
- ²⁷ IRM ¶20.1.1.3.5 (Nov. 25, 2011).
- ²⁸ In fiscal 2014, failure-to-file and failure-to-pay penalties accounted for 75 percent of the total dollars in penalties assessed for individual income tax returns, 71 percent for business income tax returns, 80 percent for employment tax returns and 92 percent for estate and gift tax returns. 2014 IRS Data Book, at 44, available online at www.irs.gov/pub/irs-soi/14databk.pdf.
- ²⁹ All section references are to the Internal Revenue Code of 1986 unless stated otherwise.
- ³⁰ Code Sec. 6651 applies to returns required for taxes owed under subchapter A of chapter 61 (income tax for an individual, corporation, estate or trust; employment taxes; and estate and gift taxes), subchapter A of chapter 51 (distilled spirits, wines and beer), subchapter A of chapter 52 (tobacco, cigars, cigarettes and cigarette papers and tubes) and subchapter A of chapter 53 (machine guns and certain other firearms). It also applies to excise tax returns required to be filed under Code Sec. 4975. *A.S. Janpol*, 102 TC 499, Dec. 49,737 (1994).
- ³¹ Code Sec. 7502(a); Reg. §301.7502-1(a).
- ³² Reg. §301.6011-5T(c); §301.6033-4T(c); §301.6037-2T(c).
- ³³ Code Sec. 7503.
- ³⁴ Code Sec. 6651(a)(1).
- ³⁵ Code Sec. 6651(f).
- ³⁶ Code Sec. 6651(b)(1).
- ³⁷ Code Sec. 6651(a)(2).
- ³⁸ Code Sec. 6651(b)(2).
- ³⁹ Code Sec. 6651(c)(1).
- ⁴⁰ Code Sec. 6651(a)(3).
- ⁴¹ Code Sec. 6651(a)(2), (a)(3).
- ⁴² Code Sec. 6651(d).
- ⁴³ IRM ¶20.1.1.3.6.1 (Aug. 5, 2014). In 2012, TIGTA issued a report on the IRS's failure to apply the FTA program consistently. See www.treasury.gov/tigta/auditreports/2012reports/201240113fr.pdf.
- ⁴⁴ IRM ¶20.1.1.3.6.1.9 (Aug. 5, 2014).
- ⁴⁵ IRM ¶20.1.1.3.6.1.1 (Aug. 5, 2014).
- ⁴⁶ IRM ¶20.1.1.3.6.1.3 (Aug. 5, 2014).
- ⁴⁷ IRM ¶20.1.1.3.6.1.7 (Aug. 5, 2014).
- ⁴⁸ IRM ¶20.1.1.3.6 (Nov. 25, 2011).
- ⁴⁹ IRM ¶20.1.1.3.6.3 (Nov. 25, 2011).
- ⁵⁰ IRM ¶20.1.1.3.6.5 (Nov. 25, 2011).
- ⁵¹ Taxpayer Advocate Service Memorandum of February 7, 2012, available online at www.irs.gov/pub/foia/igt/tas/tas-13-0212-007.pdf.
- ⁵² Code Sec. 6662(b)(1).
- ⁵³ Code Sec. 6662(b)(2).
- ⁵⁴ Code Sec. 6662(b)(3).
- ⁵⁵ Code Sec. 6662(b)(4).
- ⁵⁶ Code Sec. 6662(b)(5).
- ⁵⁷ Code Sec. 6662(b)(6).
- ⁵⁸ Code Sec. 6662(b)(7).
- ⁵⁹ Code Sec. 6662(c).
- ⁶⁰ Code Sec. 6662(b).
- ⁶¹ Code Sec. 6662(h)(2)(A).
- ⁶² Code Sec. 6662(h)(2)(B).
- ⁶³ Code Sec. 6662(h)(2)(C).
- ⁶⁴ Code Sec. 6662(i).
- ⁶⁵ Code Sec. 6662(j). An undisclosed foreign financial asset is an asset about which information was required to be (but was not) provided under Code Sec. 6038 (interest in certain foreign corporations and partnerships), Code Sec. 6038B (transfers to certain foreign corporations or partnerships); Code Sec. 6038D (interests in certain foreign financial assets); Code Sec. 6046A (acquisition or disposition of an interest in a foreign partnership); and Code Sec. 6048 (creation or transfer to a foreign trust).
- ⁶⁶ Code Secs. 6751(b). This section applies to all penalties other than the delinquency penalties under Code Secs. 6651, 6654 and 6655 and any penalty "automatically calculated through electronic means."
- ⁶⁷ IRM ¶20.1.5.1.6 (Jan. 24, 2012). A substantial understatement for an individual exists if the understatement exceeds the greater of 10 percent of the tax required to be shown on the return or \$5,000. Code Sec. 6662(d)(1)(A). A substantial understatement for a corporation exists if the understatement exceeds the lesser of 10 percent of the tax required to be shown on the return (or \$10,000 if greater) or \$10 million. Code Sec. 6662(d)(1)(B).
- ⁶⁸ Code Sec. 6662(d)(2).
- ⁶⁹ Reg. §1.6662-4(f).
- ⁷⁰ Code Sec. 6662(d)(2)(B)(ii)(I).
- ⁷¹ Code Sec. 6662(d)(2)(C)(1).
- ⁷² Reg. §1.6662-4(d)(3)(i), (ii).
- ⁷³ Reg. §1.6662-4(d)(3)(iii).
- ⁷⁴ Reg. §1.6662-4(d)(2); *R.G. Klueger Est.*, CA-6, 98-2 ustr ¶50,712, 154 F3d 630.
- ⁷⁵ Reg. §1.6664-2(c)(2)(A)-(E).
- ⁷⁶ A taxpayer may request the nonassertion of a penalty before it is assessed. This usually would occur in the context of an audit, although a taxpayer who files a late return can attach a statement signed under penalty of perjury explaining why the return was filed late.
- ⁷⁷ Form 843 and instructions are available online at www.irs.gov/uac/Form-843,-Claim-for-Refund-and-Request-for-Abatement.
- ⁷⁸ Code Secs. 6320 and 6330 require the IRS to give a taxpayer notice and an opportunity for a hearing when it files a notice of federal tax lien and before it can levy on property of a taxpayer. A taxpayer has 30 days after notice within which to file a *Request for a Collection Due Process or Equivalent Hearing*, Form 12153, which is available online at www.irs.gov/pub/irs-pdf/f12153.pdf. During a collection due process hearing, a taxpayer can challenge liability for penalties if he did not receive a notice of deficiency or otherwise did not have an opportunity to dispute the liability. Code Sec. 6330(c)(2)(B).
- ⁷⁹ Code Sec. 6664(a).
- ⁸⁰ Code Sec. 6651(a).
- ⁸¹ Code Sec. 6664(c)(1). The reasonable-cause defense does not apply to that portion of any underpayment due to a transactions that "lacked economic substance" under Code Sec. 7701(o). Additional rules apply if the underpayment is due to a substantial or gross valuation misstatement for property contributed to charity. Code Sec. 6664(c)(2), (3).
- ⁸² *R.W. Boyle*, SCT, 85-1 ustr ¶13,602, 469 US 241, 105 S Ct 687.
- ⁸³ *Conklin Bros. of Santa Rosa*, CA-9, 93-1 ustr ¶50,116, 986 F2d 315 (a corporation did not have reasonable cause for failure to file or pay where it relied on a corporate controller who took active steps to hide her wrongdoings from her superiors); but see, *In re American Biomaterials Corp.*, CA-3, 92-1 ustr ¶50,194, 954 F2d 919 (delinquency penalties did not apply where the failure to file returns and pay tax was caused by the fraud of corporate officers who controlled the corporation and rendered it unable comply).
- ⁸⁴ *P. Knappe, Exr.*, CA-9, 2013-1 ustr ¶50,266, 713 F3d 1164.
- ⁸⁵ *Id.*, at 1173.
- ⁸⁶ *Id.*
- ⁸⁷ *Neonatology Assoc., P.A.*, 115TC 43, Dec. 53,970 (2000), *aff'd*, CA-3, 2002-2 ustr ¶50,550, 299 F3d 221 (2002). See Reg. §1.6664-4(c), which provides that the determination of whether a taxpayer reasonably relied on professional advice must be based on all the facts and circumstances of the case.
- ⁸⁸ *Seven W. Enterprises, Inc.*, 136 TC 539, Dec. 58,650 (2011).
- ⁸⁹ *Compare W.T. Romanowski*, 105 TCM 1379, Dec. 59,457(M), TC Memo. 2013-55 (professional football player reasonably relied on his tax advisor when investing in a horse-breeding tax shelter) with *W.G. Pederson*, 105TCM 1365, Dec. 59,456(M), TC Memo. 2013-54 (business owner with an MBA who invested in the same horse-breeding tax shelter did not reasonably rely in good faith on advice of his tax advisor).
- ⁹⁰ *Boyle*, SCT, 469 US 241 (1985).
- ⁹¹ *S.A. Blum*, CA-10, 2014-1 ustr ¶50,107, 737 F3d 1303 (a taxpayer cannot reasonably rely on the advice of an accounting firm that promoted a transaction); *R.G. LaVerne*, 94 TC 637, Dec.

46,544 (1990), *aff'd* without opn., CA-9, 956 F2d 274 (1992).

⁹² *American Boat Co., LLC*, CA-7, 2009-2 ustrc ¶150,665, 583 F3d 471.

⁹³ Reg. §1.6664-4(c)(1)(i).

⁹⁴ Code Sec. 7525 creates a limited privilege for tax advice from a federally authorized return preparer.

⁹⁵ In *AD Inv. 2000 Fund, LLC*, 142 TC 248, Dec. 59,880 (2014), the IRS sought an order compelling the production of two opinion letters that a limited liability company had obtained from a law firm. The limited liability company relied upon the opinion letters to argue that no accuracy-related penalties should be imposed. The Court held that in placing its knowledge and understanding into contention in order to establish good-faith and state-of-mind defenses, the limited liability company forfeited the privilege protecting attorney-client communications relevant to its knowledge, understanding and beliefs. Thus, the taxpayer was ordered to produce the opinion letters.

⁹⁶ *J. Tamberella*, CA-2, 2005-2 ustrc ¶150,487, 139 FedAppx 319, *aff'g*, 87 TCM 1020, Dec. 55,556(M), TC Memo. 2004-47; *J.J. McLaine*, 138 TC 228, Dec. 58,977 (2012) (alcoholism not reasonable cause for late filing where the taxpayer was aware he had to file a tax return but failed to take steps to pay the tax); *A.D. Hardin*, 103 TCM 1861, Dec. 59,084(M), TC

Memo. 2012-162 (taxpayer who suffered from various mental diseases that affected his ability to concentrate did not have reasonable cause where he was able to conduct his daily business affairs, including managing two rental properties); *Poppe*, 110 TCM 401, Dec. 60,431(M), TC Memo. 2015-205 (taxpayer who allegedly suffered from Asperger's Syndrome was liable for delinquency penalties where during the relevant time period he was employed as a high school teacher and conducted numerous on-line stock transactions); *R.G. Ruckman*, 75 TCM 1880, Dec. 52,594(M), TC Memo. 1998-83 (taxpayers had reasonable cause for negligently failing to report self-employment income where the husband had minimal financial knowledge or training and the wife, who handled family finances, underwent surgery and cancer treatment when their return was being prepared).

⁹⁷ IRM ¶20.1.1.3.2.2.1(3) (Nov. 25, 2011).

⁹⁸ *East Wind Industries*, CA-3, 99-2 ustrc ¶150,968, 196 F3d 499 (a Defense Department contractor had reasonable cause for not paying employment tax when due where it lacked funds due to the wrongful acts of DoD employees that kept it from being awarded contracts); *Fran Corp.*, CA-2, 99-1 ustrc ¶150,208, 164 F3d 814 (recognizing that financial difficulties can constitute reasonable cause if the taxpayer exercised ordinary business care and prudence but was nonetheless unable to pay tax when due); *Van*

Camp & Bennion, CA-9, 2001-1 ustrc ¶150,446, 251 F3d 862, 867 (recognizing that financial difficulties can constitute reasonable cause); *but see Brewery, Inc.*, CA-6, 94-2 ustrc ¶150,435, 33 F3d 589, 592 (financial difficulties do not constitute reasonable cause).

⁹⁹ Reg. §1.6662-4(d)(3)(i).

¹⁰⁰ Code Sec. 6662(d)(2); Reg. §1.6662-4(f).

¹⁰¹ Besides the First Time Abatement program, the IRS regularly issues notices waiving delinquency penalties for taxpayers who reside in an area affected by a natural disaster, such as a flood, hurricane or earthquake.

¹⁰² See, e.g., Reg. §§301.6651-1(c)(1), 301.6652-1(f), 301.6652-2(f), 301.6679-1(a), 301.6688-1(c).

¹⁰³ IRM ¶20.1.1.3.5 (Nov. 25, 2011).

¹⁰⁴ IRM ¶20.1.1.3.2.

¹⁰⁵ In some cases, the IRS may issue a statutory notice of deficiency at the end of an audit. This allows the taxpayer to file a petition with the U.S. Tax Court. In almost all cases, if your client did not have the right to an appeals hearing prior to issuance of the notice of deficiency, he will have a right to an appeals conference while the case is pending in Tax Court. See Rev. Proc. 87-24, 1987-1 CB 720. The IRS has proposed updating the revenue procedure in Notice 2015-72, IRB 2015-44, 613.

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