

MANUAL TRANSMITTAL

Department
of the
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Internal
Revenue
Service

4.10.6

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PURPOSE

This transmits a complete revision of Section 6, Penalty Considerations, of IRM 4.10, Examination of Returns, with changes.

BACKGROUND

This text complements the legal analysis of penalties provided in IRM 20.1, Penalty Manual, by providing guidelines and examination techniques to be considered and, when warranted, used to develop penalty issues. Although each penalty has its own legal basis and standards (see Penalty Manual), there are commonalities for determining the applicability of penalties at the examiner's level.

This section also provides techniques for recognizing, developing and finalizing penalty determinations; discusses common taxpayer defenses, and furnishes guidelines for documenting the workpapers.

NATURE OF CHANGES

This transmittal reissues existing procedures. The text has been renumbered and updated as necessary to reflect changes pursuant to the IRS reorganization such as the new organizational names and titles.

INTENDED AUDIENCE

SBSE Compliance Examination Field Operations Employees.

EFFECT ON OTHER DOCUMENTS

None

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4.10.6.1 (05-14-1999)

Overview

- (1) The Service maintains an ongoing effort to develop, monitor and revise programs designed to assist taxpayers in complying with legal requirements and avoid penalties. As indicated in Policy Statement P-1-18, "the Service uses penalties to encourage voluntary compliance by:"
 - a. Helping taxpayers understand that compliant conduct is appropriate and that noncompliant conduct is not;
 - b. Deterring noncompliance by imposing costs on it; and
 - c. Establishing the fairness of the tax system by justly penalizing the noncompliant taxpayer.
- (2) Policy Statement P-1-18 also states that the IRS administers a penalty system that is designed to:
 - a. Ensure consistency;
 - b. Ensure accuracy of results in light of the facts and the law;
 - c. Provide methods for taxpayers to have their interests heard and considered;
 - d. Require impartiality and commitment to achieve the correct decisions;
 - e. Allow for prompt reversal of initial determinations when sufficient information has been presented to indicate that the penalty is not appropriate;
 - f. Ensure that penalties are used for their proper purpose and not as bargaining points in the development or processing of cases.

4.10.6.1.1 (05-14-1999)

**Examiner
Responsibility**

- (1) The determination whether to assert penalties, identify the appropriate penalties, and calculate the penalty amount accurately is primarily the examiner's responsibility.

4.10.6.1.2 (05-14-1999)

**Common
Penalties**

- (1) See IRM 20.1, Penalties for a list of common civil tax penalties. This list includes the applicable IRC section, penalty amount and description, penalty reference numbers, and computation methods. These penalties include the following:
 - a. Aiding and abetting the understatement of tax liability;
 - b. Estimated tax understatement;
 - c. Failure to file;
 - d. Failure to pay (on returns secured by Examination);
 - e. Fraud;
 - f. Frivolous returns;
 - g. Negligence;
 - h. Penalties for paid tax return preparers;
 - i. Promoting abusive tax shelters;
 - j. Substantial understatement; and
 - k. Valuation overstatement.

4.10.6.1.3 (05-14-1999)

Purpose of Chapter

- (1) This section is designed to compliment the legal analysis of penalties provided in IRM 20.1, Penalties, by providing guidelines and audit techniques to fairly apply penalties. Although each penalty has its own legal basis and criteria, there are commonalities for deciding the applicability of penalties at the examiner's level. Accordingly, the emphasis of this chapter is on the examination techniques common to the civil tax penalties.
- (2) This chapter is divided into the following sections:
 - 6.2, Recognizing Noncompliance
 - 6.3, Developing Penalty Issues
 - 6.4, Finalizing Penalty Determinations
 - 6.5, Penalty Computations
 - 6.6, Report Writing
 - 6.7, Workpapers — General Requirements
 - 6.8, Other Considerations

4.10.6.2 (05-14-1999)

Recognizing Noncompliance

- (1) The assessment of penalties should be considered throughout the audit. Indicators of noncompliant behavior are specific for individual penalties and each case is unique, but there are common patterns of noncompliance. The following sections list common badges of negligence and fraud.

4.10.6.2.1 (05-14-1999)

Negligence

- (1) A component of the accuracy-related penalty involves taxpayer's negligence or disregard of rules or regulations — Per IRC section 6662 (c), "negligence" is defined as any failure to make a reasonable attempt to comply with the provisions of this title, and the term "disregard" includes any careless, reckless or intentional disregard. Some audit indicators for the negligence component of the accuracy-related penalty are listed below.
- (2) History of noncompliance — As part of the Required Filing Checks, examiners determine whether the return was timely filed. CFOL documents will also note penalties, such as most late payment and estimated tax penalties, that are usually assessed as part of return processing. Examiners should review available IRS information when making penalty determinations to establish payment patterns and history of noncompliance. Check the two preceding periods and all open modules. See section 5, Required Filing checks, for additional guidance.
- (3) Similar, prior audit results — Copies of any prior audit reports should be reviewed to establish history of noncompliance.
- (4) Failure to keep adequate books and records — Analysis of the taxpayer's books and records should include consideration of their adequacy and accuracy.

- (5) Inadequate internal controls for processing and reporting business transactions,
- (6) Unreported or understated income, combined with the taxpayer's failure to offer a reasonable explanation,
- (7) Overstated deductions or credits, including claiming clearly improper or exaggerated amounts, unsubstantiated by facts or documentation,
- (8) Using deduction descriptions in such a manner as to conceal the true nature of the deduction,
- (9) Failure to explain items questioned by the Service,
- (10) Actions taken by the taxpayer to ensure that the return preparer did not have all the necessary and appropriate information to prepare a correct and/or timely return,
- (11) Information determined from cooperative state programs and state tax reports which determined negligence for transactions having the same or similar Federal and State tax consequences — The decision to assert negligence, however, is the examiner's and is not to be automatically reflected based on the State's determination.

4.10.6.2.2 (05-14-1999)

Fraud

- (1) Fraud, as distinguished from negligence, is always intentional. One of the elements of fraud is an intent to evade tax. Some of the indications of fraud are as follows:
 - a. False explanations regarding understated or omitted income;
 - b. Large discrepancies between actual and reported deductions of income;
 - c. Concealment of income sources;
 - d. Numerous errors, all in the taxpayer's favor;
 - e. Fictitious records or other deceptions;
 - f. Large omissions of personal service income, specific items of income, gambling winnings, or illegal income;
 - g. False deductions, exemptions, or credits;
 - h. Failure to keep or furnish records;
 - i. Incomplete information given to the return preparer regarding a fraudulent scheme;
 - j. Large and frequent cash dealings that may or may not be common to the taxpayer's business; and
 - k. Verbal misrepresentations of the facts and circumstances.
 - l.

Note: Generally, the presence of only one indication of fraud is not sufficient to sustain fraud (e.g., unreported income alone does not necessarily support fraud).

Example: During the examination of a taxpayer's Form 1040, the examiner found numerous errors resulting in additional tax. One of the adjustments was a large amount of unreported income discovered in a concealed bank account. Other adjustments were supported with altered documents. The taxpayer gave false information and misrepresented the facts throughout the examination. All the acts of the taxpayer, when seen as a whole, indicate fraud.

4.10.6.3 (05-14-1999)

Developing Penalty Issues

- (1) Penalties should be considered whenever adjustments are made to a tax return. This section includes requirements and techniques for developing penalty issues.

4.10.6.3.1 (05-14-1999)

Initial Interview

- (1) Questions asked during the initial interview with the taxpayer and/or representative should provide the examiner with an understanding of the taxpayer's background and knowledge, familiarity with the business operations, and an overview of the taxpayer's books and records. It is also appropriate to ask the taxpayer if they are aware of any errors on the return and discuss any issues identified during the pre-audit analysis.

4.10.6.3.2 (05-14-1999)

Third Party Contacts

- (1) Examiners are authorized to request information from third parties when necessary to determine whether to assert, not assert, or abate a penalty. See section 1 of this chapter for more guidance, regarding third party contacts.

4.10.6.3.3 (05-14-1999)

Referrals

- (1) Specialists from specialty areas such as international or engineering can assist examiners factually develop penalty issues (including the fraud and negligence penalties) and are responsible for recommending penalties specific to their specialty. See Chapter 2 for more information, regarding referrals for specialists.
- (2) When a potential criminal fraud case is identified, preparation of a timely fraud referral to Criminal Investigation is necessary pursuant to the provisions of IRM 25.1, Fraud.

4.10.6.3.4 (05-14-1999)

Managerial Involvement

- (1) The group manager must be actively involved with the development of penalty issues if:
 - a. The examination of income reveals a understatement of income in a given year, the case should be discussed with the group manager. This discussion is mandatory for any examination with an understatement greater than \$10,000. The purpose of the discussion is to consider possible expansion of the examination scope/depth and the potential of fraudulent activity by the taxpayer.

- b. Coordination with Criminal Investigation, the Director of Practice in Headquarters Office, and/or area specialists such as the Return Preparer Coordinator or the Penalty Screening Committee, is required.

- (2) Managerial involvement should be documented on Form 9984, Examining Officer's Activity Record.

4.10.6.3.5 (05-14-1999)

Soliciting the Taxpayer's Explanations

- (1) To ensure the proper consideration and appropriate application of penalties, it is very important to solicit the taxpayer's explanation for adjustments. Some common explanations include:

4.10.6.3.5.1 (05-14-1999)

Off-Setting Adjustments

- (1) When large amounts of unreported income are identified, a taxpayer might claim that there are off-setting cash expenses, i.e., there are additional cash expenses which were not deducted.

Note: The burden is on the taxpayer to show that these expenses were incurred and paid.

4.10.6.3.5.2 (05-14-1999)

Lack of Knowledge

- (1) Defenses such as blaming others, lack of knowledge, or claiming incompetence are often offered by taxpayers. Explanations should be solicited and analyzed for reasonableness. Examiners should contact third parties when necessary for collaboration and properly document the results. See section 1 for more guidance, regarding third party contacts.

4.10.6.3.5.3 (05-14-1999)

Reliance On Representative and/or Return Preparer

- (1) Taxpayers often advise examiners that penalties are not applicable because they relied on a representative or return preparer. The representative or preparer is alleged to be the cause of the noncompliance.
- (2) These assertions should be documented and substantiated if possible.
- (3) Various regulations and court decisions have held that although a taxpayer may authorize a representative to prepare and file the tax return, this action does not relieve the client (taxpayer) of meeting their legal obligations as a taxpayer.
 - a. Regulation 1.6664-4(c)(1) states that "all facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor)."
 - b. Regulation 1.6664-4(c)(1)(ii) notes that, "the advice must not be based on unreasonable factual or legal assumptions."
 - c. Regulation 1.6664-4(b)(1) notes that the substantial understatement penalty does not apply to any portion of an underpayment if there was reasonable cause for the underpayment portion and the

taxpayer acted in good faith. Reliance on the advice of a professional tax adviser does not necessarily demonstrate reasonable cause and good faith. However, reliance on professional advice is reasonable cause and good faith if, under all the circumstances, the reliance was reasonable and the taxpayer acted in good faith.

- d. In considering the failure to file penalty, the United States Supreme Court has held that the fact that a taxpayer relies on an attorney to file a timely tax return does not relieve the taxpayer of the duty to meet the tax return deadlines (see R.W. Boyle, 85–1 USTC 13,602, 105 S. CT. 687).

- (4) The taxpayer's reliance on a representative and/or return preparer should be documented in the case file. The examiner should make any necessary contacts with the representative and/or return preparer to determine appropriate penalty liability before closing the income tax case, since this determination will impact the results of the income tax case. Conclusions regarding the preparer's or representative's responsibility for errors should be documented.
- (5) Discussions with the taxpayer will be limited to the development of facts. The development of return preparer penalties (IRC sections 6694 and 6695 conduct penalties) will not be discussed/proposed in the taxpayer's presence. The preparer is to be given the right to explain why possible preparer penalties are not applicable.

4.10.6.4 (05-14-1999)

Finalizing Penalty Determinations

- (1) Every effort should be made to apply penalties in a fair and consistent manner. Penalties are not to be applied as a "bargaining chip" or because the taxpayer was uncooperative during the examination process. The decision to assert penalties must have a legal basis in the Internal Revenue Code or other authority.
- (2) The assertion of penalties, including alternative positions, should be discussed with the taxpayer and/or representative prior to issuing an examination report. Examiners should be prepared to discuss the penalty computation and the underlying law. The taxpayer's decision to agree or disagree with the findings may depend on understanding the penalty computation.
- (3) Taxpayers will have the opportunity to respond to the examiner's conclusion. The taxpayer's explanation(s) must be solicited and documented in the case file, including claims and audit reconsiderations in which the issues involved are penalties or can relate to penalties.
- (4) Taxpayers and/or representatives may respond with a reasonable basis for the examination results. A complete discussion of reasonable basis and relief from penalties is included in IRM 20.1, Penalties. Examiners should also consider whether the taxpayer could have anticipated the event that caused noncompliance, and the length of time between the event cited as a reason for noncompliance and the taxpayer's subsequent compliance.

4.10.6.5 (05-14-1999)

Penalty Computations

- (1) Most penalty computations can be performed using the Service's software programs. Using the software will ensure an accurate (and quickly calculated) penalty computation.
- (2) There are rules for computing the amount of the underpayment for the accuracy-related and fraud penalties. Under the computational method explained below, the portion of an underpayment subject to the highest penalty rate will be computed at the highest tax rate.
 - a. Step A — Compute the portion of a deficiency attributable to adjustments not subject to any penalties.
 - b. Step B — Compute the portion of a deficiency attributable to adjustments subject to a 20% penalty. Start with the "adjusted" taxable income and tax liability computed in Step A.
 - c. Step C — Compute the portion of a deficiency attributable to adjustments subject to a 40% penalty. Start with the "adjusted" taxable income and tax liability computed in Step B.
 - d. Step D — Compute the portion of a deficiency attributable to adjustments subject to a 75% fraud penalty by subtracting the sum of the portions of the deficiency determined in Steps A through C, from the total determined deficiency.
 - e. Step B — Apply prepayment credits, not previously claimed on the return that are directly allocable to any of the adjustments included in Steps A through D, to the portion of the deficiency determined in that step for purposes of computing the amount of underpayment; then multiply the result by the appropriate penalty rate to determine the amount of the penalty.
- (3) Refer to IRM 20.1, Penalties for examples of allocating the underpayment between penalties and for instructions for computation of penalties.

4.10.6.6 (05-14-1999)

Report Writing

- (1) A complete guide for report writing, including the presentation of penalties, is presented in section 8 of this chapter.

4.10.6.7 (05-14-1999)

Workpapers — General Requirements

- (1) The case file should fully document the consideration, assertion or non-assertion, and computation of all applicable penalties. "Applicable penalty" is defined as those penalties for which the legal premise for application is present in the case.
- (2) Penalties should not be asserted without an explanation. The extent of the explanation will depend on the nature of the adjustments and the amounts involved. However, canned statements, such as "negligence penalty applicable" or "negligence penalty deemed to be not applicable", are not sufficient.
- (3) Pro-forma check sheets (such as Form 4700) are acceptable documentation when properly completed. Simply checking the boxes is not adequate; a narrative should be included.

- (4) Citing appropriate regulations, rulings and court decisions in the workpapers is encouraged. Research findings, however, should be specific to the case's facts and circumstances, and not just provide exploratory background information on the penalties being asserted.
- (5) Alternative penalty positions should be documented in the workpapers when applicable (e.g. fraud versus negligence penalties, and various components of the accuracy-related penalty).

4.10.6.7.1 (05-14-1999)

**Workpapers —
Dollar Criteria**

- (1) Whenever the understatement of tax exceeds the dollar criteria for applying a penalty, the examiner must include a comment in the workpapers. For example, the substantial understatement component of the accuracy-related penalty provides for a dollar criteria; the understatement exceeds the greater of 10% of the tax required to be shown on the return, or \$5,000 (\$10,000 for corporations other than S corporations or personal holding companies).

4.10.6.7.2 (05-14-1999)

**Workpapers —
Late Filed
Returns**

- (1) For late filed returns that originally reflected a refund, examiners are required to document in the workpapers the applicability of the failure to file penalty to a subsequent audit deficiency.

4.10.6.7.3 (05-14-1999)

**Workpapers —
Negligence and
Fraud**

- (1) Assertion of negligence or fraud must include documentation of the "badges" that were discovered during the audit (even if the case is agreed) . See the discussion on the "badges of penalties" in subsection 6.2 above, Recognizing Noncompliance.

4.10.6.7.4 (05-14-1999)

**Workpapers —
Preparer
Penalties**

- (1) Consideration of preparer penalties should be documented in the examiner's case file. The workpapers should document only the taxpayer's statements and that inquiries on preparer penalties were made.
- (2) All information on the preparer's activities and the assertion of preparer penalties should be separated from the taxpayer's case file.

4.10.6.8 (05-14-1999)

**Other
Considerations**

- (1) This section includes miscellaneous information.

4.10.6.8.1 (05-14-1999)

**Civil and
Criminal Fraud**

- (1) The taxpayer's explanations, or lack of explanations, may help distinguish between civil and criminal fraud. In both criminal and civil fraud, the burden of proof rests with the Government. However, criminal fraud cases require proof beyond a reasonable doubt, while civil fraud cases require clear and convincing evidence. Note the following:

- a. A criminal conviction for tax evasion (under Section 7201) usually conclusively establishes liability for the civil fraud penalty.
- b. The civil fraud penalty can be imposed even when the taxpayer is acquitted in a criminal fraud prosecution. The rule of res judicata, that a matter once judicially decided is finally decided, does not operate as a bar to a subsequent civil action (including the civil fraud penalty) because of the difference in the degree of proof required in civil and criminal actions [see the U.S. Supreme Court's decision in Helvering v Mitchell, 303 U.S. 391, 58 S. CT. 630 (1938)].

4.10.6.8.2 (05-14-1999)
Return Preparer Penalties

- (1) Return preparer penalties relate to IRC sections 6694, 6695, 6700, 6701, 6713, 7407 and 7408. In the interest of overall sound tax administration, the Service focuses on preparer conduct and applies sanctions when warranted. Penalty assertion is the key enforcement vehicle for noncompliant preparers. Refer to IRM 20.1, Penalties, for specific instructions regarding a preparer penalty case.
- (2) A determination on a preparer penalty case is conducted independently of, and without regard to, the determination on the income tax case. The tax case has bearing on the preparer penalty case only insofar as assertion of the penalty requires an understatement of tax.
- (3) Generally, a return preparer penalty will not be proposed until the income tax examination is completed at the group level. However, if the preparer case is inseparable from the income tax examination, both cases may be completed simultaneously. The examiner may pursue the preparer penalty after an unagreed income tax case is submitted at the group level.

4.10.6.8.3 (05-14-1999)
Nonfilers

- (1) Examiners should ask taxpayers to explain why they did not timely comply with filing requirements. The reasonable cause guidelines as outlined in IRM 20.1. Penalties should be followed and fully documented in the workpapers.

