

2016 IRS Nationwide Tax Forum

September 30, 2016

Responding to Penalty Notices

IRS Penalties - Background

- Purpose
 - Encourage voluntary compliance
 - Punish non-compliant taxpayers
- Type and number of penalties
 - 1955 – 14 penalty provisions in the IRC
 - 2016 – over 140 penalties ranging from civil fines to imprisonment
- Efforts for consistency in application of penalties
 - 1987 task force studies civil penalties
 - 1989 report issued to establish a philosophy and recommendations to resolve inconsistencies

IRS Additions to Tax/Assessable Penalties

- Late Filing – IRC 6651(a)(1) – 5% per month up to 25% of tax
- Late Payment of Tax – IRC 6651(a)(2) and 6651(a)(3) –
¼% or ½% plus 1% per month up to 25% of tax (not imposed while IRC 6651(a)(1) is accruing)
- Accuracy Related Penalties
 - Substantial Understatement – occurs if the understatement is \$5,000 or 10% of the correct tax, whichever is larger, for individuals; occurs if the understatement is \$10,000 or 10%, whichever is larger, for corporations, or if the understatement is \$10 million or more
 - IRC 6662 – 20% of net tax understatement on filed returns
 - IRC 6662 – 40% if attributable to gross valuation misstatements, nondisclosed noneconomic substance transactions and undisclosed foreign financial asset understatements
 - Submit IRS Form 8275 with return to establish a reasonable basis
 - Negligence and Disregard of the Rules or Regulations (careless, reckless or intentional disregard of IRS rules and regulations)
 - Must make a reasonable attempt to comply with IRS rules
 - Exercise ordinary and reasonable care in preparing a tax return
 - Keep adequate books and records to substantiate items properly
 - IRC 6662A – Increased to 30% for any portion of a reportable transaction understatement, not properly disclosed

IRS Additions to Tax/Assessable Penalties (cont.)

- Estimated Tax – Failure to pay IRC 6654 (Individuals and Trusts and Estates) and IRC 6655 (Corporations and Others)
 - Self-employment, interest, dividends, alimony rent, gains from the sale of assets, prizes and awards. Or, if insufficient tax is withheld from a salary, pension or other income.
- Civil Fraud – IRC 6651(f) for fraudulent failure to file – 15% per month up to 75%; IRC 6663 fraud concerning filed returns – 75%
- Frivolous Tax Return – frivolous arguments – \$5,000
- Bounced Check – IRC 6657 – 2% or \$25 if check is under \$1,250

Tax Return Preparer Penalties

IRC 6694 - Understatement of taxpayer's liability by a tax return preparer

- IRC 6694(a) – The greater of \$1,000 or 50% of the income derived (or to be derived) by the tax return preparer for each return, amended return or claim for refund prepared if there is an understatement or claim due to an unreasonable position taken that the preparer knew or reasonably should have known about. A position is unreasonable if:
 - There was not substantial authority for the position and the position was not disclosed
 - The position was disclosed but there was not reasonable basis for the position
 - The position is with respect to a tax shelter or reportable transaction under IRC 6662A and it is not reasonable to believe the position will be more likely than not sustained on the merits
- IRC 6694(b) – The greater of \$5,000 or 50% of the income derived (or to be derived) by the tax return preparer for returns, amended returns, and claims for refund when:
 - There is an understatement of liability, on a return or claim for refund due to a willful attempt to understate the tax liability by the preparer, or
 - The preparer has recklessly or intentionally disregarded rules or regulations

IRC 6695 – Other assessable penalties regarding the preparation of tax returns for others

- Assessed against preparers who, for example, fail to provide the taxpayer with a copy of the return, fail to sign the return, or provide an identifying number (\$50 per failure up to \$25,000 per year)
- Assessed against preparers who negotiate a refund check or misappropriate a refund via electronic means, \$500 per failure

IRC 6713 – Disclosure or use of information by preparers of returns (\$250 per disclosure, up to \$10,000 per calendar year)

Assessable v. Deficiency Penalties

- Penalties are assessable and not covered by deficiency procedures when they are not dependent upon the determination of a deficiency
- Assessable penalties are payable upon notice of demand and do not require a 30-day letter, agreement form or notice requirements prior to assessment
- Penalties based on the amount of income tax, income tax deficiency, adjustments to taxable income, tax credits, or income tax computations are return-related penalties and are covered by deficiency procedures
- Return-related penalties must be included in an examination report

Assessable v. Deficiency Penalties (cont.)

- **Assessable penalties**
 - These are found in IRC 6671-6720C
 - IRS can assess these without a notice of deficiency
 - The Tax Court does not have jurisdiction (except in certain CDP cases)
 - These can be protested to the Appeals Office either pre- or post-assessment
 - Examples:
 - IRC 6672 – Trust fund recovery penalty
 - IRC 6654 & 6695 – Return-preparer penalties
 - IRC 6702 – Frivolous tax return penalties
- **Penalties always subject to deficiency procedures**
 - These penalties arise in conjunction with income tax examinations
 - The IRS must follow deficiency procedures to assert these penalties
 - Examples:
 - IRC 6662 – Accuracy-related penalties
 - IRC 6663 – Fraud penalties
 - IRC 6651(f) – Fraudulent failure to file
- **Penalties that could either be assessed or be subject to deficiency procedures**
 - These penalties can be assessed without a notice of deficiency if the penalty is based upon the balance due on the tax return
 - If the IRS conducts an income tax examination, the penalties may be disputed in Tax Court
 - Examples:
 - IRC 6651(a)(1) – late-filed return
 - IRC 6651(a)(2) – late payment
 - IRC 6654(a) – failure to make estimated payments

Requesting Penalty Relief

- General penalty relief categories:
 - Reasonable Cause (not available for all penalties)
 - Statutory exceptions
 - Administrative waivers
 - Correction of IRS error
- Pre-assessment; post-assessment/pre-payment
- Burden of proving entitlement to relief is generally upon the taxpayer (burden on IRS for fraud)
 - Illustrate ordinary business care and prudence
 - Establish history of tax compliance
 - Identify legitimate reason for non-compliance
- IRS Form 843 – Claim for Refund and Request for Abatement

Form 843 – Claim for Refund and Request for Abatement

Form 843 (Rev. August 2011) Department of the Treasury Internal Revenue Service	Claim for Refund and Request for Abatement ▶ See separate instructions.	OMB No. 1545-0024	
Use Form 843 if your claim or request involves:			
(a) a refund of one of the taxes (other than income taxes or an employer's claim for FICA tax, RRTA tax, or income tax withholding) or a fee, shown on line 3,			
(b) an abatement of FUTA tax or certain excise taxes, or			
(c) a refund or abatement of interest, penalties, or additions to tax for one of the reasons shown on line 5a.			
Do not use Form 843 if your claim or request involves:			
(a) an overpayment of income taxes or an employer's claim for FICA tax, RRTA tax, or income tax withholding (use the appropriate amended tax return),			
(b) a refund of excise taxes based on the nontaxable use or sale of fuels, or			
(c) an overpayment of excise taxes reported on Form(s) 11-C, 720, 730, or 2290.			
Name(s)		Your social security number	
Address (number, street, and room or suite no.)		Spouse's social security number	
City or town, state, and ZIP code		Employer identification number (EIN)	
Name and address shown on return if different from above		Daytime telephone number	
1 Period. Prepare a separate Form 843 for each tax period or fee year. From _____ to _____		2 Amount to be refunded or abated: \$ _____	
3 Type of tax or fee. Indicate the type of tax or fee to be refunded or abated or to which the interest, penalty, or addition to tax is related. <input type="checkbox"/> Employment <input type="checkbox"/> Gift <input type="checkbox"/> Estate <input type="checkbox"/> Excise <input type="checkbox"/> Income <input type="checkbox"/> Fee			
4 Type of penalty. If the claim or request involves a penalty, enter the Internal Revenue Code section on which the penalty is based (see instructions). IRC section: _____			
5a Interest, penalties, and additions to tax. Check the box that indicates your reason for the request for refund or abatement. (If none apply, go to line 6.) <input type="checkbox"/> Interest was assessed as a result of IRS errors or delays. <input type="checkbox"/> A penalty or addition to tax was the result of erroneous written advice from the IRS. <input type="checkbox"/> Reasonable cause or other reason allowed under the law (other than erroneous written advice) can be shown for not assessing a penalty or addition to tax.			
b Date(s) of payment(s) ▶ _____			
6 Original return. Indicate the type of fee or return, if any, filed to which the tax, interest, penalty, or addition to tax relates. <input type="checkbox"/> 706 <input type="checkbox"/> 709 <input type="checkbox"/> 940 <input type="checkbox"/> 941 <input type="checkbox"/> 943 <input type="checkbox"/> 945 <input type="checkbox"/> 990-PF <input type="checkbox"/> 1040 <input type="checkbox"/> 1120 <input type="checkbox"/> 4720 <input type="checkbox"/> Other (specify) ▶ _____			
7 Explanation. Explain why you believe this claim or request should be allowed and show the computation of the amount shown on line 2. If you need more space, attach additional sheets.			
Signature. If you are filing Form 843 to request a refund or abatement relating to a joint return, both you and your spouse must sign the claim. Claims filed by corporations must be signed by a corporate officer authorized to sign, and the officer's title must be shown.			
Under penalties of perjury, I declare that I have examined this claim, including accompanying schedules and statements, and, to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.			
Signature (title, if applicable. Claims by corporations must be signed by an officer.)		Date	
Signature (spouse, if joint return)		Date	
Paid Preparer Use Only	Print/type preparer's name	Preparer's signature	Date
	Firm's name ▶	Firm's EIN ▶	Check <input type="checkbox"/> if self-employed PTIN
	Firm's address ▶	Phone no.	

Subsequent Requests for Penalty Relief

- Taxpayer may first request a conference with the agent's manager, or may request the case be forwarded to Appeals
 - Appeals will first determine whether the penalty should have been assessed, whether it was correctly calculated, and then consider relief options.
 - Appeals can settle penalties for less than the full amount based on the hazards of litigation
- Offer in Compromise – Doubt as to liability
- Collection Due Process hearing
- Taxpayer can pay the penalty and file a claim for refund with the IRS
- Taxpayer can file a petition in the U.S. Tax Court for deficiency penalties (without pre-payment), or pay the penalty and file suit in the US. District Court or Court of Federal Claims

Divisible v. Non-Divisible Penalties – The Flora Rule

- Generally, a taxpayer can sue in district court for a refund of federal income tax only after fully paying the assessed amount
- The *Flora* case requires full payment of a tax or penalty before it may be subject to a claim for refund – *Flora v. United States*, 362 U.S. 145 (1960)
- The exception to this general rule is “divisible” taxes/ penalties
- IRC 6721 – Failure to file an information return
- IRC 6722 – Failure to furnish a correct payee statement
- IRC 6672 – Responsible person penalties (TFRP)
- IRC 6695(d) – Tax preparer penalties
- Chief Counsel Advice (CCA) 2013-15017 – IRC 6721 and 6722 are divisible penalties and therefore the taxpayer must only pay the divisible amount of a single failure to file a refund claim and institute a refund suit under IRC 7422

Continuation Penalties

- IRC 6038 – Information reporting with respect to certain foreign corporations and partnerships
 - IRS Forms 5471 and 8865, respectively
 - Initial penalty \$10,000, continuation penalty after 90 days and every 30 days thereafter until \$50,000 penalty maximum per year
 - Penalty abatement may be considered if the taxpayer is in full compliance for all open years
 - **No reasonable cause exception for the continuation penalty**
- IRC 6038A – Information reporting with respect to certain foreign-owned corporations
- IRC 6038D – Information with respect to foreign financial assets
- IRC 6677 – Failure to file information with respect to certain foreign trusts
- IRC 6679 – Failure to file returns, etc., with respect to foreign corporations or foreign partnerships

First Time Abate (FTA)

IRM 20.1.1.3.6.1

May provide penalty relief for:

- Failure to File – IRC 6651(a)(1), IRC 6698(a)(1), and IRC 6699(a)(1)
- Failure to Pay – IRC 6651(a)(2) and IRC 6651(a)(3)
 - Penalty continues to accrue; consider waiting until all tax is paid to request FTA
- Failure to Deposit – IRC 6656
 - No prior penalties for three years (except the estimated tax penalty)
 - Current with filing compliance (or on a valid extension)
 - All tax paid or on a payment plan

Relief from Penalties – Reasonable Cause

IRC 6664(c) and (d); IRM 20.1.1.3.2

- Based on all circumstances, the taxpayer exercised ordinary business care and prudence in determining his or her tax obligations but nevertheless failed to comply with those obligations; not due to willful neglect
- Not available for all penalties (e.g. IRC 6672, some preparer penalties)
- Failure to file a tax return and/or pay tax – Treas. Reg. 301.6651-1(c)
- Accuracy related penalties – Treas. Reg. 1.6664-4
- Information return penalties – Treas. Reg. 301.6723-1A(d) and 301.6724-1
- Preparer/promotor penalties – Treas. Reg. 1.6694-2(e)(1)-(6) and 301.6707-1T Q&A 4

Relief from Penalties – Reasonable Cause

Advice from a Tax Advisor

- *U.S. v. Boyle*, 469 U.S. 241 (1985)
 - Reliance on advice from a tax attorney is reasonable if the taxpayer has no reason to believe the attorney's advice is mistaken
 - Failure to request an extension of time to file a return would not qualify because the due date is stated clearly in the IRC
 - Erroneous advice that a second extension to file an estate tax return qualifies as reasonable reliance because the taxpayer had no reason to believe the advice was erroneous
- *Estate of Kwang Lee v. Commissioner*, TC Memo 2009-84
 - Held, the executor reasonably relied on an estate tax attorney's erroneous advice that a second six-month extension was permissible

Relief from Penalties – Reasonable Cause

Advice from a Tax Advisor (cont.)

- *Neonatology Associates, P.A. v. Commissioner*, 115 T.C. 43, 99 (2000),
affd. 299 F.3d 221 (3rd Cir. 2002)
 - The taxpayer must prove by a preponderance of the evidence that the taxpayer meets all of these requirements:
 - The advisor was a competent professional who had sufficient experience to justify reliance;
 - The taxpayer provided necessary and accurate information to the advisor; and
 - The taxpayer actually relied in good faith of the advisor's judgment.
- *Rohrbaugh v. United States*, 611 F.2d 211 (7th Cir. 1979)
 - Held, relief may be granted if a taxpayer relies on improper advice of an accountant regarding tax law, such as whether a taxpayer has a duty to file a return, if the advisor is a professional with competency in the subject tax law and the advice is based on the taxpayer's full disclosure of the relevant facts and documents

Relief from Penalties (cont.)

- Written Advice From the IRS – IRC 6404(f), Treas. Reg. 301-6404-3 and IRM 20.1.1.3.3.4.1
- Oral Advice From IRS – extends IRC 6404(f) and Treas. Reg. 301.6404-3 to include erroneous oral advice
- Death, Serious Illness, or Unavoidable Absence 20.1.1.3.2.2.1
 - Taxpayer, immediate family, or death of person responsible for entities
 - For filing, paying or depositing late

Relief from Penalties (cont.)

- Unable to Obtain Records 20.1.1.3.2.2.3
- Mistake was Made 20.1.1.3.2.2.4
 - Generally inconsistent with ordinary business care and prudence
 - Consider when the taxpayer became aware of the mistake whether duties were delegated, corrective steps and documentation
- Fire, Casualty, Natural Disaster, or Other Disturbance – Major Disasters 20.1.1.3.3.5
- Official Disaster Area 20.1.1.3.3.6 – one-time special instructions issued when a significant disaster occurs affecting a wide area of taxpayers
- Correction of Service Error 20.1.1.3.4 – computing or assessing tax, crediting accounts, math error, etc.

Relief from Penalties (cont.)

- Ignorance of the law – IRM 20.1.1.3.2.2.6 – consider:
 - The taxpayer's education
 - Whether the taxpayer was previously subject to the tax
 - Whether the taxpayer was penalized previously
 - Recent changes in tax forms or tax law
 - Whether the taxpayer reasonably could be expected to know the requirement
- Forgetfulness – IRM 20.1.1.3.2.2.7
 - Generally inconsistent with ordinary business care and prudence
 - Cannot delegate the duty to file a timely return and make timely payments or deposits

Relief from Penalties

Statutory and Regulatory Exceptions

IRM 20.1.1.3.3.1

Legal Reference	Title	IRM Reference
IRC 6654(e)(1), (2), or (3)	Estimated Tax Penalties (ES)	IRM 20.1.3
IRC 7502(a) and IRC 7502(e) (IRC 7502(e) does not apply to deposits due after Dec. 31, 2010)	Timely Mailing Treated as Timely Filing and Paying	IRM 20.1.2 and IRM 20.1.4
IRC 6724(a) or IRC 6724(c)	Waiver; Definitions and Special Rules, Information Return Penalties	IRM 20.1.7
IRC 6404(f)	Abatement of Any Penalty or Addition to Tax Attributable to Erroneous Written Advice by the Internal Revenue Service	<i>IRM 20.1.1.3.3.4.1</i>
IRC 7508	Time for Performing Certain Acts Postponed by Reason of Service in Combat Zone. This provision applies only in a presidentially declared Combat Zone	IRM 20.1.2.1.2.1, <i>Combat Zone-IRC 7508</i>
IRC 7508A and Treas. Reg. 301-7508A-1	Authority to Postpone Certain Deadlines by Reason of Federally Declared Disaster or Terroristic or Military Actions	IRM 25.16, <i>Disaster Assistance and Emergency Relief</i> and IRM 20.1.2.1.2.2, <i>Federal Disaster Area-IRC 7508A</i>

Relief from Penalties

Administrative Waivers

IRM 20.1.1.3.3.2

- The IRS may formally interpret or clarify a provision to provide administrative relief from a penalty by a policy statement, news release, or other formal communication.
- For example, when there is a delay by the IRS in:
 - Printing or mailing forms
 - Publishing guidance (Regulations)

Penalty Relief – Application Chart

Statute	Type of Penalty	Reasonable Cause Relief	Other Relief
IRC 6039E	Failure to Provide Information Concerning Resident Status	Yes	Yes
IRC 6651(a)(1)	Failure to File Tax Return	Yes	Yes
IRC 6651(a)(2)	Failure to Pay Tax When Due	Yes	Yes
IRC 6651(a)(3)	Failure to Pay Within 10 Days of Notice of Additional Tax Due (notices issued prior to 1/1/1997)	Yes	Yes
IRC 6651(a)(3)	Failure to Pay Within 21 Days of Notice of Additional Tax Due (10 business days if amount is \$100,000 or more) (notices issued after 12/31/1996)	Yes	Yes
IRC 6651(f)	Fraudulent Failure to File	No	No
IRC 6652(a)(1)	Failure to File Certain Information Returns	Yes	Yes
IRC 6652(c)(1)	Failure to File Annual Return by Exempt Organization	Yes	Yes
IRC 6652(c)(2)	Failure to File Returns Under IRC 6034 or IRC 6043(b)	Yes	Yes
IRC 6652(d)(2)	Notification of Change in Status of a Plan	Yes	Yes
IRC 6652(e)	Information Required in Connection With Certain Plans of Deferred Compensation—Form 5500, Annual Return/Report of Employee Benefit Plan	Yes	Yes
IRC 6652(h)	Failure to Give Notice to Recipients of Certain Pension, Etc., Distributions	Yes	Yes
IRC 6652(i)	Failure to Give Written Explanation to Recipients of Certain Qualifying Rollover Distributions	Yes	Yes

Penalty Relief – Application Chart (cont.)

Statute	Type of Penalty	Reasonable Cause Relief	Other Relief
IRC 6652(j)	Failure to File Certification With Respect to Certain Residential Rental Projects	Yes	Yes
IRC 6654	Estimated Tax Penalty on Individuals	No	Yes
IRC 6655	Estimated Tax Penalty on Corporations	No	No
IRC 6656(a)	Failure to Deposit	Yes	Yes
IRC 6657	Bad Checks	Yes	Yes
IRC 6662	Accuracy-Related Penalty on Underpayments	Yes*	Yes
IRC 6662A	Accuracy-Related Penalty on Understatements With Respect to Reportable Transactions	Yes*	Yes
IRC 6663	Fraud	No	No
IRC 6676	Erroneous Claim for Refund or Credit	No	Yes
IRC 6692	Failure to File Actuarial Report	Yes	Yes
IRC 6698	Failure to File Partnership Return	Yes	Yes
IRC 6699	Failure to File S Corporation Return	Yes	Yes
IRC 6721	Failure to File Correct Information Reporting Returns	Yes	Yes
IRC 6722	Failure to Furnish Correct Payee Statements	Yes	Yes
IRC 6723	Failure to Comply With other Information Reporting Requirements	Yes	Yes