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**CLOSELY HELD BUSINESSES AND
CIVIL AND CRIMINAL TAX
PENALTIES COMMITTEES**

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APPROACHING PENALTY ABATEMENTS: STRATEGIES & PITFALLS

I. INTRODUCTION

During these difficult economic times, many taxpayers have struggled to pay their bills, including IRS tax liabilities. Businesses and individuals have been unable to pay their taxes or make deposits in a timely fashion. As a result, the IRS has assessed various penalties against these taxpayers. The concept of owing taxes to the IRS is stressful enough for taxpayers. The addition of penalties to a taxpayer's bill may turn an otherwise manageable debt into a seemingly insurmountable tax problem.

Practitioners can assist their clients greatly by exploring ways to reduce the taxpayer's liability to an amount the taxpayer can afford. If there are legitimate grounds to do so, practitioners may request penalty abatement on behalf of their clients. Taxpayers who are seeking to avoid or reduce penalties must demonstrate reasonable cause. The IRS will determine whether to grant the request for penalty abatement on a case by case basis.

A. Significant Types of Penalties

The IRS may assess several different types of penalties such as failure to file, failure to pay, failure to deposit, the estimated tax penalty, accuracy-related penalties (including those due to substantial understatement or negligence), fraud and the trust fund recovery penalty.

B. Discussion Focus

The failure to file and failure to pay penalties are two of the most frequently asserted penalties by the IRS, and thus this outline will primarily focus on seeking penalty abatement for these penalties.

1. Failure to file penalty

I.R.C. § 6651(a)(1) provides a delinquency penalty for a taxpayer's failure to file returns by the due date or extended due date.

2. Failure to pay penalty

I.R.C. § 6651(a)(2) provides a delinquency penalty for a taxpayer's failure to pay the amount of tax shown on the return by the due date. It is important to note that an extension of time to file is not an extension of time to pay.

Taxpayers are not subject to the delinquency penalties if they can prove that their failure to timely file the returns or failure to timely pay the tax was due to reasonable cause and not willful neglect. Treas. Reg. § 301.6651-1(a).

3. Failure to deposit penalty

I.R.C. § 6656 provides a penalty for a taxpayer's failure to make a required timely tax deposit. Taxpayers are not subject to the failure to deposit penalties if they can prove that their failure to timely deposit was due to reasonable cause and not willful neglect. I.R.C. § 6656(a).

C. Amount of the Penalty

The amount of the penalty varies according to the type of tax and tax form at issue.

1. Late filing of income taxes

Generally, the penalty for failure to file is 5% of the unpaid tax for each month or portion of the month that the return is delinquent. I.R.C. § 6651(a)(1). The maximum penalty cannot exceed 25% of the unpaid tax. An exception exists in the case of a fraudulent failure to file, in which instance the penalty is 15% of the unpaid tax, not to exceed 75% of the unpaid tax.

2. Late payment of income taxes

Generally, the penalty for failure to pay is 0.5% of the unpaid tax for each month or portion of the month the tax remains unpaid. I.R.C. § 6651(a)(2). The maximum penalty cannot exceed 25% of the unpaid tax. For individuals who filed their returns on or before the due date (including extensions), the failure to pay penalty is .25% during any month in which the taxpayer has an Installment Agreement with the IRS. I.R.C. § 6651(h).

3. Late deposit of payroll taxes

The penalty is calculated as a percentage of the underpayment, which is the excess of the amount of tax required to be deposited over the amount actually deposited on or before the due date. I.R.C. § 6651(b)(2). If the failure is not more than 5 days, the penalty is 2% of the underpayment. I.R.C. § 6651(b)(1)(A). If the failure is greater than 5 days but no more than 15 days, the penalty is 5% of the underpayment. I.R.C. § 6651(b)(1)(A). If the failure is more than 15 days, the penalty is 10% of the underpayment. I.R.C. § 6651(b)(1)(A).

In certain cases where the tax is not deposited on or before the earlier of: (1) the 10th day after the date of the first delinquency notice or (2) the day on which notice and demand for immediate payment is given under a jeopardy assessment, the penalty is 15% of the underpayment. I.R.C. § 6651(b)(1)(B).

D. **Overview of Other Penalties -- Is Relief Available?**

The IRS may also assess other types of penalties which are outside the scope of this outline. These penalties include the following:

- Trust fund recovery penalty, also known as the 100% penalty;
- Negligence penalty (accuracy-related);
- Substantial understatement penalty (accuracy-related);
- Fraud penalty; and
- Penalties for failure to file certain information returns.

1. Trust fund recovery penalty

Under I.R.C. § 6672, the IRS may assess the trust fund recovery penalty against taxpayers who are responsible for collecting, accounting for and paying over withheld income and employment taxes but who willfully fail to do so. The penalty is equal to the unpaid balance of the trust fund tax, which is calculated as the unpaid income tax withheld plus the employee's portions of the withheld FICA taxes.

There is a split in the circuits regarding whether reasonable cause may constitute a defense to the trust fund recovery penalty. *See Olsen v. U.S.*, 952 F.2d 236 (8th Cir. 1991) and *Harrington v. U.S.*, 504 F.2d 1306 (1st Cir. 1974) (reasonable cause is not a defense to the trust fund recovery penalty). *See also Smith v. U.S.*, 555 F.3d 1158 (10th Cir. 2009); *Thosteson v. U.S.*, 331 F.3d 1294 (11th Cir. 2003); *Winter v. U.S.*, 196 F.3d 339 (2^d Cir. 1999) and *Logal v. U.S.*, 195 F.3d 229 (5th Cir. 1999) (reasonable cause defense should be construed very narrowly).

2. Accuracy-related penalties

Under I.R.C. § 6662, the IRS may impose accuracy-related penalties for underpayments of tax which are attributable to negligence or disregard of the rules and regulations or substantial understatement of income tax. The amount of the penalty is 20% of the portion of the underpayment due to negligence or substantial understatement. I.R.C. § 6662(a).

Negligence is defined as the "failure to make a reasonable attempt to comply with tax laws" and disregard includes any "careless, reckless or

intentional disregard.” I.R.C. § 6662(c). The negligence penalty is not applicable if the taxpayer’s position has a reasonable basis. Treas. Reg. § 1.6662-3. The penalty for disregard of rules and regulations is inapplicable if the taxpayer adequately discloses the position on the appropriate disclosure statement. Treas. Reg. § 1.6662-3.

A substantial understatement of income tax exists during any taxable year if the amount of the understatement exceeds the greater of: (1) 10% of the tax required to be shown on the return or (2) \$5,000. I.R.C. § 6662(d)(1)(A). With respect to corporations other than S corporations or personal holding companies, a substantial understatement exists if the amount of the understatement for the taxable year exceeds the lesser of: (1) 10% of the tax required to be shown on the return (or, if greater, \$10,000) or (2) \$10,000,000. I.R.C. § 6662(d)(1)(B). This penalty does not apply to any item for which substantial authority exists or the taxpayer can show reasonable basis and the taxpayer adequately disclosed the relevant facts. Treas. Reg. § 1.6662-4.

3. Fraud Penalty

Under I.R.C. § 6663(a), the IRS may impose a penalty if any portion of an underpayment of tax is due to fraud. The amount of the penalty is 75% of the portion of an understatement attributable to fraud. I.R.C. § 6663(a). The burden of proof is on the IRS to prove fraud by clear and convincing evidence. I.R.C. § 7454(a); I.R.M. 25.1.6.1 (October 30, 2009). The fraud penalty is only applicable in cases where the taxpayer actually filed a tax return. I.R.M. 8.17.7.9 (November 2, 2007).

II. BASES FOR GRANTING PENALTY RELIEF

A. Reasonable Cause

B. Other Bases

1. Statute of Limitations
2. Misapplied/Miscalculation/IRS Error
3. Innocent Spouse
4. Substantial authority, adequate disclosure
5. Administrative Waivers

6. "First time offender" – IRS will generally waive the penalty for failure to deposit employment taxes for certain first-time depositors. Treas. Reg. § 301.6656-1(a).
7. Undue Hardship (does not apply to 6672 Trust Fund Penalties)

III. WHAT IS REASONABLE CAUSE?

A. Reasonable Cause Standard

1. The “reasonable cause” standard draws on a broad range of potentially applicable guidance, including the I.R.C., Treasury Regulations, the IRS’s Penalty Handbook contained in the I.R.M. (I.R.M. 20.1), and case law.

“Reasonable cause is based on all the facts and circumstances. . . .” I.R.M. 20.1.1.3.2 (Nov. 25, 2011). “Reasonable cause relief is generally granted when the taxpayer exercised ordinary business care and prudence in determining their tax obligations but nevertheless failed to comply with those obligations.” *Id.*

2. “Mistake,” “forgetfulness,” or ignorance of the law typically will not establish reasonable cause and are sometimes pointed to as indicating a lack thereof. *See, e.g.*, I.R.M. 20.1.1.3.2.2.4 ¶ 1 (Dec. 11, 2009) (“mistake” generally not sufficient); I.R.M. 20.1.1.3.2.2.7 ¶ 1 (Dec. 11, 2009) (“forgetfulness” or oversight typically not sufficient); I.R.M. 20.1.1.3.2.2.6 ¶ 1 (ignorance of the law generally not sufficient).

Practice Pointer: Avoid using phrases such as these in requests for reasonable cause relief.

3. General Policy Themes Behind Penalty Enforcement
 - a. Encourage voluntary compliance
 - b. Consistency and fairness
 - c. Efficient tax administration
 - d. According to the I.R.M., “penalties are not a ‘bargaining point’ in resolving the taxpayer’s other tax adjustments.”
4. Important Factors:
 - a. Taxpayer’s Compliance History –

- (1) IRS Penalty Handbook directs IRS personnel assessing requests for reasonable cause relief to consider taxpayer's compliance history for the three preceding tax years. I.R.M. 20.1.1.3.5 ¶ 6.
 - (2) Certain Treasury Regulations governing the extension of reasonable cause relief consider a taxpayer's compliance history. Treas. Reg. § 301.6724-1(b)(2) (reasonable cause for certain information reporting penalties).
 - (3) Courts, *e.g.*, *Payless Drugstores Northwest Inc. v. United States*, 73 A.F.T.R. 2d 94-370 (D. Or. 1993), have cited a taxpayer's compliance history as support for finding reasonable cause for failures to comply with tax requirements.
- b. Length of Time. The length of time between the event cited as a reason for noncompliance and the subsequent compliance.
 - c. Circumstances Beyond the Taxpayer's Control. Could the taxpayer have anticipated the event that caused the noncompliance?

B. Limitations on Requests for Reasonable Cause Relief—Potential Pitfalls

1. Circular 230 Section 10.34(b)(1), (2)(ii)—tax practitioner cannot advise a client to submit a reasonable cause statement that is frivolous.
2. Model Rules of Prof'l Conduct R. 3.1—Lawyer may not litigate a frivolous claim for reasonable cause relief.
3. I.R.C. Section 6676(a)—If reasonable cause statement is submitted along with claim for refund, tax practitioner must ensure that a “reasonable basis” for the claim exists.
4. I.R.C. Section 6673(a)(1)(B)—in Tax Court proceedings, the court may penalize a taxpayer up to \$25,000 if the taxpayer's position is frivolous or groundless.
5. Asserting reliance on professional advice as the basis for reasonable cause puts that advice “at issue” and may waive the attorney-client privilege.

C. Common Reasons for Reasonable Cause

1. Death, serious illness, or unavoidable absence

2. Fire, casualty, natural disaster, or other disturbance
3. Inability to obtain records
4. Erroneous advice or reliance
5. Ignorance of the law in conjunction with other facts and circumstances
6. Misfeasance by employee or agent leaving taxpayer “incapacitated” or “disabled”
7. Financial hardship

Useful, favorable case law:

Haynes v. Comm’r, T.C. Memo. 1990-135 (no penalty where taxpayer was audited for many years with no change to his method of accounting and IRS agent had advised that no change was necessary);

Levine v. Comm’r, T.C. Memo. 1963-230 (exception to general rule that taxpayers have nondelegable duty to file timely returns where return was timely prepared, misplaced, and later filed late by taxpayer that had timely filed previous returns);

Dillin v. Comm’r, 56 T.C. 228 (1971) (exception to general rule that “mistake” is not grounds for reasonable cause relief where taxpayers mistakenly believed they were exempt from tax involving complex issues);

In re Sims, 92-1 U.S.T.C. 1991 WL 253017 (Bankr. E.D. La. 1991) (reasonable cause where information necessary to file return was unavailable);

Payless Drug Stores Northwest Inc. v. United States, 73 A.F.T.R. 2d 94-370 (D. Ore. 1993) (reasonable cause where taxpayer had a consistent tax compliance history).

D. **Variation in Application of Reasonable Cause Exception**

1. Reasonable Cause Assistant (“RCA”)—I.R.M. 20.1.1.3.6 ¶ 1 (Dec. 11, 2009)

“[D]ecision-support interactive software program developed to reach a reasonable cause determination,” I.R.M. 20.1.1.3.6 ¶ 2 (Dec. 11, 2009), designed to “ensure consistent and equitable administration of penalty

relief consideration.” *Id.* ¶ 3. Applies to Failure-to file, failure-to-pay, and failure to deposit penalties. *Id.* ¶ 1.

RCA provides option for “First-Time Abate” if no other penalties have been assessed against the taxpayer for the preceding three years. I.R.M. 20.1.1.3.6 ¶ 1 (Dec. 11, 2009). “First-Time Abate” is an administrative waiver of a penalty and is, therefore, not technically reasonable cause relief. I.R.M. 20.1.1.3.6.1 ¶ 1 (Dec. 11, 2009).

2. Certain I.R.C. penalties are so-called strict liability penalties. The “reasonable cause” standard is not applicable to these penalties—*e.g.*, transactions lacking economic substance. 6662(b)(6); 6664(c)(2), (d)(2).

IV. PROCEDURES FOR PENALTY RELIEF (GRW)

A. General

Deficiency assessment procedures are not applicable to late payment and late filing penalties. Procedures to contest these penalties differ from taxes and penalties that must follow deficiency procedures.

Several options are available to contest delinquency penalties all of which should provide opportunity, if needed, for IRS Appeals review of IRS' initial determination to deny penalty relief. Appeals review is often needed to achieve penalty relief.

Pre-payment judicial review of denial of penalty abatement request is generally not available. To obtain judicial review of penalty abatement denial, taxpayer must pay the penalty and file a refund suit. IRM 8.11.1.7.4. If refund of penalty is sought in refund suit, the claim is subject to standard refund claim IRS Appeals review procedures.

B. Procedures Available

1. Letter to IRS in response to IRS notice or bill asserting penalty

Most common method used to pursue penalty abatement

If request is denied, it will be by letter giving taxpayer right to protest denial to IRS Appeals. IRM 8.11.1.7.1.

2. Letter to IRS Penalty Abatement Coordinator (centralized penalty abatement request processing). Some protests to Appeals in penalty cases are made to this unit.
3. Letter to IRS accompanying filing asking IRS not to assert penalty

Proactive approach does appear to succeed sometimes in preventing IRS from assessing delinquency penalty.

4. Refund claim for paid penalties

Informal claim via letter requesting penalties paid to be refunded

Formal claim - Form 843. May obtain judicial review of denial.

5. Form 843 can also be used to request abatement of penalties (in addition to refund). IRS guidance states to use Form 843 to request abatement of penalties resulting from erroneous IRS advice.

6. Request for penalty relief from assigned Revenue Officer when working with him/her to, for example, set up installment agreement for tax

Revenue Officers may be more willing to grant penalty relief since they have more involvement with case, more direct contact/interaction with client/representative, may be able to reduce the taxpayer's balance and resolve remaining smaller balance. If Revenue Officer denies the request, taxpayer may protest the denial to IRS Appeals.

7. Collection due process hearing.

Submitting Offer in Compromise based on doubt as to liability for assessed penalty or otherwise contesting penalty as part of CDP process could seem like pre-payment method to obtain judicial review. Has taxpayer, however, had prior opportunity to contest liability for the penalty and, thus, cannot raise this in CDP hearing?

8. Offer in Compromise based on doubt as to liability for the assessed penalty

How does this differ from a letter to the IRS requesting penalty relief?

C. Best Practices in Presenting Position

Should you pursue multiple procedures simultaneously seeking penalty relief? Possibly. Only have to convince one IRS person to agree and abate penalties.

Refund statute of limitation applies if seeking refund of paid penalties.

With the initial penalty abatement request include factual statement outlining taxpayer's compliance history if compliance is good and all facts supporting reason for abatement. Also include supporting documentation. If reason is financial hardship, for example, include copies of documents showing taxpayer's financial hardship during the failure to pay period. If due to illness, include documents related thereto.

Request should be signed under penalty of perjury. Treas. Regs. §§ 301.6651-1(c), 301.6656-2(c).

When requesting late payment penalty relief for employment taxes based on financial hardship, IRS automatically denies stating that lack of funds is not reasonable cause for failure to pay employment taxes. This is the law in the 5th Circuit (Brewery, Inc. v. United States, 33 F.3d 589 (5th Cir. 1994)). However, the 2nd, 3rd and 9th Circuits hold differently. East Wind Indus, Inc. v. United States, 196 F.3d 499, 507 (3d Cir. 1999); Fran Corp. v. United States, 164 F.3d 814, 818 (2d Cir. 1999); Van Camp & Bennion v. United States, 251 F.3d 862 (9th Cir. 2001). Many businesses get behind on payroll taxes and are assessed late penalties thereon. Anytime a business retains you with payroll tax problems, consider seeking penalty relief for late penalties.

D. Appealing Denial of Penalty Relief Request

Unless the request is granted under the "first time violator" rule, penalty abatement requests are usually denied at the first level. Chances of success are much higher with IRS Appeals. Letters denying penalty relief and permitting protesting denial to IRS Appeals usually state time period in the letter to protest the denial but this timeframe in the letter is sometimes hard to find. Generally, deadline to protest denial is 90 days from the date of the denial letter.

If penalty abatement request is made to Revenue Officer assigned to case and denied, taxpayers may have only 15 days to file an administrative appeal. Treas. Regs. §§ 601.106(a)(1)(ii)(c), (a)(1)(iii).

Often the amount of the penalty does not justify pursuing the matter beyond IRS Appeals. Procedurally, the taxpayer generally must pay the tax and file a refund claim to obtain judicial review of a penalty relief request.

V. PENALTY FOCUS - LATE FILING OF FBARS AND FORMS 5471

A. Recent IRS Focus on Pursuing and Asserting Penalties for Late-Filed FBARS and Forms 5471

The IRS has increased its focus on international issues in recent years. Taxpayers who own financial accounts overseas or have ownership interests in foreign corporations should be aware of potential filing and reporting requirements.

B. FBAR – Applicable Penalties/Amount of Penalty - Willful, Non-Willful, Reasonable Cause Exception

Taxpayers who own or have authority over a foreign financial account may be required to file a Form TD F 90-22.1 Report of Foreign Bank and Financial Accounts (FBAR). A U.S. person is required to file an FBAR if (1) the person has a financial interest in, or signature authority over one or more accounts in a foreign country and (2) the aggregate value of all foreign financial accounts exceeds \$10,000 at any time during the calendar year.

The deadline for filing the FBAR is June 30. The FBAR is not filed with the taxpayer's income tax return, and taxpayers may not request an extension of time to file the FBAR. The FBAR is deemed filed on the date it is received by the IRS.

If the failure to file the FBAR is non-willful, the maximum penalty is \$10,000 per violation. The IRS may waive the penalty if the taxpayer can demonstrate that the non-willful failure to file the FBAR was due to reasonable cause. Taxpayers should attach a statement to the delinquent FBAR explaining why the form was not timely filed. If the failure to file the FBAR is willful, the penalty is the greater of (1) \$100,000 or (2) 50% of the account balance at the time of the violation. 31 U.S.C. § 5321(a)(5).

In some cases, taxpayers may also be subject to criminal penalties for the willful failure to file the FBAR. 31 U.S.C. § 5322.

C. Form 5471 – Applicable Penalties/Amount of Penalty/Reasonable Cause Exception

The law requires certain U.S. persons who have ownership interests in foreign corporations to file a Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. The Form 5471 is filed with the taxpayer's income tax return.

Under I.R.C. § 6038(a), taxpayers are required to report certain information with respect to certain foreign corporations. Under I.R.C. § 6038(b)(1), taxpayers are subject to a penalty of \$10,000 for each Form 5471 that is filed after the due date of the income tax return (including extensions) or that does not include the information outlined in § 6038(a).

The penalties under I.R.C. § 6038(b) are not imposed when any failure to file is due to reasonable cause.

VI. UPDATES AND TRENDS IN PENALTY RELIEF

A. New Legal Developments on Penalty Relief?

In March 2012, IRS announced it would give certain taxpayers a six month grace period and not apply the failure to pay penalty during that period. See IR 2012-31. The grace period is from April 17, 2012 to October 15, 2012 and the full amount of the tax and interest must be paid by the end of the period. Only taxpayers who have been unemployed for at least 30 consecutive dates during the period January 1, 2011 through April 17, 2012 and self-employed taxpayers who experienced at least a 25% drop in business income in 2011 can utilize this break on penalties. Income phase out limits apply. Eligible taxpayers must file Form 1127-A with their extension request.

B. Noticed Trends by Tax Practitioners in the Penalty Relief Area

Noted trends differ by practitioners. This practitioner noticed that the IRS about two years ago appeared to be slightly more willing to grant penalty relief but recently this shift appears to have stopped. IRS also seems to be asking for more specific documentation supporting reasonable cause position. IRS, however, recently has granted penalty relief requests more often under "first time violator" principle.

C. Abatements vs. Refunds – Does It Matter?

Some practitioners have noticed it is easier to get the IRS to agree a taxpayer owes less tax than to obtain a refund of tax based on a dispute over liability. Does this same observation apply to an abatement versus a refund of penalties? Possibly, although this practitioner has not noticed that to be the case. Often penalties to be refunded by a Revenue Officer will be applied to tax debt so the IRS seems less adverse to granting relief since the refund will be used to pay taxes owed.

VII. ALTERNATIVES TO SEEKING PENALTY RELIEF

A. Offer in Compromise

B. Installment Agreement

C. Taxpayer Assistance Order

D. Innocent Spouse Relief

E. Bankruptcy

F. Injunctive Relief