PENALTIES AND DEFENSES

11

Learning Objectives

After completing this session, participants will be able to perform the following job-related actions:

- ✔ Determine the applicability of a penalty
- ✔ Calculate the correct amount of the penalty
- ✔ Explain the defenses to abate penalties
- ✔ Appeal a denial of penalty relief
- ✔ Request relief from an FBAR penalty
- ✔ Recognize and avoid preparer penalties

Introduction

The IRS is increasingly asserting penalties against taxpayers to encourage greater compliance. Practitioners have to know whether the IRS has correctly assessed and calculated a penalty, and how and when to request abatement of a penalty. Understanding these key issues can result in substantial savings to a taxpayer.

Part 20, chapter 1, of the Internal Revenue Manual is the IRS *Penalty Handbook*, which specifies the legal authorities for assessing penalties and the criteria for penalty relief [`www.irs.gov/irm/part20/index.html`]. All IRS employees who administer penalties when examining returns, collecting taxes, or providing taxpayer services use the handbook. Divisions within the IRS, such as appeals or examination, may develop additional guidance, provided that it is consistent with the handbook.

This chapter reviews penalties commonly assessed against individuals and businesses, and it focuses on defenses to those penalties. It includes a chart that summarizes which defenses are available for which penalties, and it discusses how to appeal a denial of penalty relief.

This chapter also explains the foreign bank account reporting (FBAR) penalties and how to request relief from those penalties, and it includes a summary of other penalties that can be imposed on a taxpayer with international income or assets. Finally, this chapter reviews some of the penalties that the IRS can assert against tax return preparers, and it explains what defenses to those penalties are available.

INDIVIDUAL AND BUSINESS PENALTIES

This section explains penalties commonly assessed by the IRS against individual and business taxpayers.

In 1955, there were approximately 14 penalty provisions in the Internal Revenue Code. Now there are more than 10 times that number [I.R.M. § 20.1.1.1.1]. This section discusses the following common penalties:

- Failure-to-file and failure-to-pay penalties
- Estimated tax penalty
- Failure-to-deposit penalty
- Return-related penalties
- Information reporting penalties

This section discusses the basis for imposition of the penalty and the amount of the penalty. It also explains defenses and relief from penalties in the context of these particular individual and business penalties. A general discussion of penalty relief and defenses is in the "Individual and Business Penalties Defenses and Relief" section of this chapter.

Failure-to-File and Failure-to-Pay Penalties

Taxpayers must timely file all returns and pay all amounts owed. Failure to do so will result in a failure-to-file (FTF) and/or a failure-to-pay (FTP) penalty. The FTF and FTP penalties apply to income, estate, gift, employment, self-employment, and certain excise tax returns.

Timely mailing equals timely filing or paying in most circumstances. I.R.C. § 7502 provides that any return or payment received after its due date is treated as filed or paid on the postmark date, provided all of the following requirements are met:

1. The return or payment is deposited in the mail in the United States on or before the due date for filing or paying.
2. The envelope containing the return or payment is properly addressed.
3. The envelope contains sufficient postage for delivery.
4. The envelope was deposited with the US Postal Service or a designated private delivery service.

Practitioner Note Subsequent Payments

The I.R.C. § 7502 rules also apply to any payment due date stated in a notice and demand for payment of unpaid tax. Penalties and interest do not accrue beyond the notice date on amounts paid (mailed) by the date stated in the notice.

Under I.R.C. § 7503, if the due date for filing a return or paying tax is a Saturday, Sunday, or legal holiday, the return or payment is considered to have been filed or made on the due date if it is mailed on the next succeeding day that is not a Saturday, Sunday, or legal holiday.

Practitioner Note Extension Filed, but Tax Not Paid

Taxpayers save money by filing their returns on time, even if they cannot fully pay any balance due because timely filing eliminates the FTF penalty. Taxpayers who request an extension of time to file will avoid the FTP penalty if they pay at least 90% of the actual tax liability by the original due date and pay the remaining balance when they file the return by the extended due date of the return [Treas. Reg. § 301.6651-1(c)(3)].

The failure-to-file (FTF) and the failure-to-pay (FTP) penalties constitute 69% of all penalties assessed by the IRS. Generally, IRS computer programs automatically calculate and assess the penalties when they process a return.

Practitioner Note Verifying Penalty Computations

Certain miscellaneous penalties are recorded by the IRS in an account module that is separate from the income tax return module. Penalty transaction codes denote the type of penalty imposed and the date the penalty was assessed. To obtain a transcript of this module, an authorized representative must call the Practitioner Priority Service (PPS), with a Form 2848 (Power of Attorney and Declaration of Representative) or Form 8821 (Tax Information Authorization), specifically authorizing the IRS to provide information from the civil penalty module. To obtain information on how the IRS computed the penalty (and interest), the tax practitioner can request a PINEX (penalty and interest explanation) report.

FTF Penalty Rates

The FTF penalty is generally 5% of the unpaid tax for each month or part of a month that a return is filed after its due date, including extensions [I.R.C. § 6651(a)(1)]. The maximum FTF penalty is 25% of the liability that was not paid by the due date of the return, so the FTF penalty does not increase beyond 25% after a return is more than 5 months late. Beginning in 2016, if a return is filed more than 60 days after its due date or extended due date, the minimum FTF penalty is the lesser of $205 or 100% of the unpaid tax shown on the return. If the IRS proves the failure to file was fraudulent, the FTF penalty is 15% per month, up to a maximum of 75% of the liability that was unpaid as of the due date of the return.

Cross-Reference Increased Penalty Amounts

See the "New and Expiring Legislation" chapter in this book for more information about recently enacted legislation that increases penalty amounts.

FTP Penalty Rates

The FTP penalty begins at 0.5% of the unpaid tax for each month or part of a month after the due date of the return, without extensions. It is also limited to 25% of the tax that was unpaid on the due date [I.R.C. § 6651(a)(2)]. The FTP penalty increases to 1% per month on the unpaid balance after the IRS issues a notice CP504 demand for payment, and it continues to accrue as long as there is any unpaid balance, until it reaches the 25% limit. However, if the return was filed timely and the taxpayer enters into an installment agreement, the penalty is 0.25% for each month or part of a month that the installment agreement is in effect [I.R.C. § 6651(h)].

Law Change Passport Issuance

The Fixing America's Surface Transportation Act, Pub. L. No. 114-94, signed into law December 4, 2015, § 32101, authorizes the IRS to certify to the secretary of state that an individual owes a seriously delinquent tax debt, and the secretary of state can deny, revoke, or limit a passport after receiving certification from the IRS. According to the act, seriously delinquent tax debt is an individual's unpaid, legally enforceable federal tax liability that (1) the IRS has assessed at greater than $50,000, (2) for which the IRS has filed a Notice of Federal Tax Lien; and (3) the taxpayer's right to a hearing on the filing of the Notice of Federal Tax Lien has been exhausted or has lapsed, or the IRS has issued a levy. The IRS must also give notice to the taxpayer.

Both FTF and FTP Penalties Assessed

If both the FTF and the FTP penalties are assessed for the same month, the FTF penalty is reduced by the FTP penalty, so that the maximum assessment is 5% in any month. This effectively reduces the maximum FTF penalty to 22.5% [25% – (0.5% × 5 months)], and the maximum combined penalty to 47.5% [25% + 25% – (0.5% × 5 months)] of the unpaid tax. The FTP penalty does not reduce the FTF penalty if the minimum FTF penalty applies.

Waiver of the FTF and FTP Penalties

The FTF and FTP penalties may be waived for reasonable cause (discussed in greater detail later). To establish reasonable cause for FTF, the taxpayer must show that he or she exercised ordinary business care and prudence but was still unable to file by the due date. The taxpayer will not be held liable for the FTP penalty if he or she exercised ordinary business care and prudence but still could not pay by the due date, or if payment on that date would have caused undue hardship. The IRS will consider all the facts and circumstances of the taxpayer's financial situation to determine if the taxpayer exercised ordinary business care and prudence.

Treas. Reg. § 301.6651-1(c) provides examples of circumstances that may constitute reasonable cause (some of those examples are discussed later). IRS Policy Statement 3-2, *Reasonable Cause for Late Filing of Return or Failure to Deposit or Pay Tax When Due*, gives the following examples of reasonable cause:

1. The taxpayer died or suffered a serious illness, or someone in his or her immediate family died or suffered a serious illness.
2. The taxpayer was unavoidably absent.
3. The taxpayer's place of business or business records were destroyed by fire or other casualty.
4. The taxpayer was unable to determine the amount due for reasons beyond the taxpayer's control.
5. The taxpayer's ability to make deposits or payments has been materially impaired by civil disturbances.
6. The taxpayer lacks funds to pay despite the exercise of ordinary business care and prudence.

[I.R.M. § 1.2.12.1.2]

The taxpayer may also be eligible for a first-time abate (FTA) administrative waiver of the FTF and FTP penalties (discussed later).

Practitioner Note IRS System Error

If the IRS cannot find an approved or automatic extension of time to file request, the taxpayer must provide proof of filing (e.g., a certified mail receipt and a copy of the request for extension) or facts to show that it is more likely than not that the taxpayer filed a valid, timely request for an automatic extension of time to file (e.g., proof that a payment mailed with the request has been received). This is a request for a correction of a system error, not a penalty abatement.

Failure to File Partnership Returns

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, established a per-partner per-month FTF penalty for a partnership return. That penalty is now $195 per partner per month [I.R.C. § 6698]. The IRS can waive the penalty if there is reasonable cause for the failure to file.

The FTF penalty is charged for each month (or part of a month) that the failure continues, for up to 12 months. The FTF penalty for each month is calculated by multiplying the applicable base penalty rate ($195) by the number of persons who were partners in the partnership at any time during the tax year.

Reasonable Cause Relief for Small Partnership

I.R.C. § 6231 provides relief from the TEFRA audit rules for a small partnership unless the partnership elects to have those rules apply. A small partnership is defined as one having no more than 10 partners. Eligible partners for this purpose are individuals who are not nonresident aliens, C corporations, and the estates of deceased partners. A married couple filing a joint return and their estates are treated as one partner.

Cross-Reference New Audit Rules

See the "Business Entity Issues" chapter in this book for a discussion of the new partnership audit rules.

Under Rev. Proc. 84-35, 1984-1 C.B. 509, a small domestic partnership that is exempt from the TEFRA audit rules is considered to have met the reasonable cause exception if

1. all partners are individuals (excluding nonresident aliens) or the estate of a deceased partner;
2. all partners' capital and profits interests are identical, and all partnership items are allocated to the partners proportionately to those interests; and
3. all of the partners have fully reported their share of the partnership income, deductions, and credits on their timely filed (including extensions) income tax returns.

In determining whether a partner has fully reported his or her share of partnership income, deductions, and credits, Rev. Proc. 84-35 says the penalty will not be asserted if there is an isolated clerical error that results in a de minimis understatement of the partner's tax liability, but that the penalty will be applied if the error or omission results in a material understatement of any income tax.

Schedule B, "Other Information," on Form 1065, U.S. Return of Partnership Income, indicates whether a partnership is exempt from the TEFRA rules, and the IRS generally does not assess the penalty if it is obvious that Rev. Proc. 84-35 applies. However, eligible partnerships that receive an IRS notice assessing the FTF penalty can request relief in a written response that addresses each of the criteria in Rev. Proc. 84-35. If the partnership does not meet those criteria, the partnership can still request relief by establishing reasonable cause for the FTF.

Practitioner Note Limited Liability Company Returns

A multimember limited liability company (LLC) that elects to be taxed as a partnership is treated as a partnership for all federal tax purposes. Thus, Rev. Proc. 84-35 also applies to qualifying LLCs.

Reasonable Cause Relief for other Partnerships

Partnerships that do not meet the definition of a small partnership and the following other types of partnerships are not eligible for automatic relief from the partnership FTF penalty:

- Partnerships having a trust or corporation as a partner
- Tiered partnerships
- Partnerships in which a partner's capital and profits interests are different or there are disproportionate or special allocations of income, deduction, or credit items

Such partnerships are still eligible for reasonable cause relief from the penalty if they can demonstrate reasonable cause for the FTF (the relief is not automatic). They may also be eligible for an FTA waiver.

Failure to File S Corporation Returns

I.R.C. § 6699 establishes a $195 per-shareholder per-month FTF penalty for S corporation returns. I.R.C. § 6231 and Rev. Proc. 84-35 do not apply to S corporations. Even a small S corporation (including an LLC taxed as an S corporation) must establish reasonable cause for abatement of the FTF penalty. The corporation may be eligible for a FTA waiver.

Practitioner Note Corporate Short Years

A corporation that has dissolved and files a final return generally has to file by the fifteenth day of the third month after the date it is dissolved. However, any penalty for filing late [I.R.C. § 6651(a)(1) or I.R.C. § 6699] is not assessed if the final return is filed and the tax is paid after the short-period return due date but on or before the regular return due date. This rule applies to both the FTF and the FTP penalty.

Practitioner Note Failure to Furnish Schedule K-1

A partnership or S corporation is required to provide a Schedule K-1 (Form 1065 or Form 1120S) to each partner or shareholder, respectively, by the due date of the return, including extensions. Unless the failure is due to reasonable cause, the penalty is $260 for each Schedule K-1 for which a failure occurs. The maximum penalty is $3,178,500 ($3,193,000 in 2016) for all such failures during a calendar year.

Estimated Tax Penalties

Taxpayers are generally required to pay income tax as income is earned. This is accomplished by withholding tax from income or by making estimated tax payments on income that is not subject to withholding. Estimated tax payments are used to pay income tax, self-employment tax, and other taxes and amounts reported on a tax return. If the taxpayer makes insufficient payments throughout the year, the IRS may assess a penalty for underpayment of estimated tax. Failure to make timely payments can also result in a penalty, even if a refund is due when the tax return is filed.

Individual Taxpayers

Individual taxpayers may have to make estimated tax payments on income from self-employment income, interest, dividends, alimony, rent, gains from the sale of assets, prizes, and awards. They may also have to pay estimated tax if not enough income tax is withheld from their salary, pension, or other income.

Generally, taxpayers must pay estimated tax if *both* of the following apply:

1. The taxpayer expects to owe at least $1,000 in tax for 2016, after subtracting any withholding and refundable credits.
2. The taxpayer expects his or her withholding and refundable credits to be less than the smaller of
   a. 90% of the tax on the 2016 tax return (66% if at least two-thirds of the gross income for 2015 or 2016 is from farming or fishing); or
   b. 100% of the tax on the 2015 tax return [for nonfarmers and fisherman, 110% if the taxpayer's 2015 AGI was more than $150,000, or $75,000 if filing married filing separately (MFS) on the current-year return]. The 2015 tax return must have covered all 12 months.

Taxpayers do not have to make estimated tax payments if all three of the following conditions are met:

1. The taxpayer had no tax liability for the prior tax year.
2. The taxpayer was a US citizen or resident alien for the whole year.
3. The prior tax year covered a 12-month period.

For estimated tax purposes, the year is divided into four payment periods. Each period has a specified payment due date. Failure to pay enough tax by the due date of each of the payment periods may result in assessment of a penalty. **Figure 11.1** shows the estimated tax payment due dates. If the due date falls on a Saturday, Sunday, or legal holiday, the payment is due on the following business day.

FIGURE 11.1 Estimated Tax Payment Due Dates

For the Period	Due Date
January 1–March 31	April 15
April 1–May 31	June 15
June 1–August 31	September 15
September 1–December 31	January 15 of the next year*

* If the taxpayer files Form 1040, U.S. Individual Income Tax Return, by January 31 of the next year and pays the remaining tax owed, then no estimated payment is required by January 15.

Amount of the Estimated Tax Penalty

The estimated tax penalty rate is the underpayment interest rate described in I.R.C. § 6621 (the federal short-term interest rate plus three percentage points). The underpayment interest rate is determined quarterly. Thus, the penalty on a $1,000 underpayment for one quarterly tax period may be different from the penalty on a $1,000 underpayment for a different quarterly tax period. For the first quarter of 2016, the underpayment rate is 3% for individual taxpayers, whereas for the second and third quarters of 2016, the underpayment rate is 4% [Rev. Rul. 2016-12, 2016-26 I.R.B. 1046].

Waiver of the Penalty

Once assessed, the penalty for underpayment of estimated tax cannot be removed or waived for reasonable cause alone. The penalty for underpayment of estimated tax generally is not automatically waived as a result of a disaster. However, in the case of a federally declared disaster area, the IRS may specify a period of up to 1 year that may be disregarded in determining whether or not estimated tax payments were paid on time. In these cases, the IRS will issue a memo with specific instructions regarding the payment of estimated tax in the affected area.

The IRS can waive the penalty for underpayment when a casualty or other unusual circumstance occurred and it would be inequitable to impose the penalty. Additionally, the IRS can waive the penalty if the taxpayer retired (after reaching age 62) or became disabled in either of the 2 preceding tax years, there was reasonable cause for the underpayment, and it was not the result of willful neglect.

Form 2210

Taxpayers use Form 2210, Underpayment of Estimated Tax by Individuals, Estates, and Trusts, to determine if the taxpayer owes a penalty for underpayment of estimated tax, to calculate the penalty, to request a reduction in the penalty, and to apply excess withholding to specific income.

If a taxpayer is not required to complete Form 2210, or if the taxpayer completes Form 2210 but does not check box B, C, or D in Part II, then he or she is not required to calculate the penalty. The IRS will calculate the penalty and send the taxpayer a notice showing how it was calculated. If the return is timely filed (not including extensions), and the penalty assessed on the notice is paid by the due date of the notice, then no interest is charged on the penalty.

If the penalty would be reduced by submitting Form 2210, the taxpayer can send Form 2210 separately from the return after the taxpayer receives the notice. If the reduction is due to the annualized income installment method, then the taxpayer must complete and submit Form 2210 and Schedule AI (Form 2210). A taxpayer requesting a waiver based on an unusual circumstance, retirement, or disability must check the appropriate waiver reason on Form 2210 and attach an explanation and supporting documentation.

If a taxpayer fails to make one of the required estimated tax installment payments, then any subsequent payment will be used to meet the prior requirement. The taxpayer must fully pay the earliest liability before payments can be applied to later installments. Any withholding or excess social security tax is divided evenly among the required installments. However, taxpayers may elect to apply withholding against the specific income it is connected to by completing Form 2210 and checking box D in Part II of the form.

The penalty is calculated separately for each payment and is based on the number of days between the due date and the payment date. See IRS Publication 505, *Tax Withholding and Estimated Tax*, for a calendar to determine the number of days that a payment is late.

Example 11.1 Allocating Withholding

John Jackson has federal income tax withholdings from his wages and from a distribution from a pension plan. John can file Form 2210 to elect to treat the withholding from the pension as paid when it was actually withheld, and the withholding from wages will be applied equally over all four installments of estimated tax.

Corporate Taxpayers

I.R.C. § 6655 imposes a penalty when a C corporation, S corporation, private foundation, private foundation organized as a trust, or tax exempt organization makes an underpayment of estimated tax. A corporation (or other entity subject to I.R.C. § 6655) must make estimated tax payments if its tax shown on the return (income tax minus credits) is $500 or more. If the tax is less than $500, no estimated payments are required, and the IRS will not assess a penalty.

The estimated tax payment must be the lesser of 100% of the current-year tax liability or 100% of the previous-year tax liability. If the previous-year tax liability was zero or it did not cover a 12-month period, then the estimated payment must be 100% of the current-year tax liability. The special rules that apply to large corporations are discussed later.

Example 11.2 Corporate Estimated Tax Payments

Corporation A is not a large corporation. Corporation A reported a loss and zero tax on its 2015 return. Rev. Rul. 92-54, 1992-2 C.B. 320, which allows a taxpayer to base required installment payments of estimated tax on the tax shown on the return for the preceding tax year, does not apply if the return for the preceding taxable year showed zero tax liability. Therefore, Corporation A may not use the 2015 tax to determine the required amount of 2016 estimated tax payments. Its required annual estimated tax payment is 100% of the 2016 tax.

Generally, the due dates for payment of estimated tax by a corporation are the fifteenth day of the fourth, sixth, ninth, and twelfth months of the tax year. For a calendar-year filer, the due dates are April 15, June 15, September 15, and December 15.

The estimated tax penalty rate for corporations is the same as the rate for individuals (discussed previously). Corporations may complete

Form 2220, Underpayment of Estimated Tax by Corporations, to compute, reduce, or eliminate an estimated tax penalty. A corporation is required to file Form 2220 with its return if the corporation uses the adjusted seasonal installment method or the annualized income installment method, or if the taxpayer is a large corporation and is figuring its first required installment based on the prior year's tax.

Large Corporations

Large corporations are required to pay 100% of the current-year tax. A large corporation is defined as a corporation having taxable income of $1,000,000 or more during any of the 3 preceding tax years. Pursuant to I.R.C. § 6655(d)(2)(B), a large corporation may use 100% of its prior-year tax liability to determine the estimated tax payment required for only the first installment of any tax year. The prior-year tax liability may not be used if the tax was zero. When the first estimated tax payment is based on 100% of the prior-year tax liability, and that payment is less than the applicable percentage for the current-year tax liability, the corporation must add the difference to the required payment for the second-quarter installment.

Example 11.3 Estimated Tax for Large Corporations

Corporation B is a large corporation that owed $400,000 tax in 2015 and $600,000 tax in 2016. Corporation B must make $600,000 in estimated tax payments in 2016 (which is $150,000 per quarter). If the corporation pays the minimum required amount of $100,000 as its first installment ($400,000 prior-year tax liability ÷ 4 quarters), Corporation B must pay the difference between the amount paid and the amount that would otherwise be due. Corporation B's second estimated tax payment must be $200,000 [($150,000 – $100,000) + $150,000] to avoid the underpayment of estimated tax penalty.

Waiver of the Penalty

The penalty for underpayment of estimated tax by a corporation is adjusted after initial assessment in only the following five circumstances:

1. The penalty was computed incorrectly.
2. The amount or effective date of estimated tax payments or credits in the taxpayer's account changes.
3. The taxpayer files a superseding return.
4. An administrative or legislative waiver applies.
5. The IRS misapplied a payment or credit, resulting in a penalty, and assertion of the penalty would be against equity and good conscience.

There is no provision in I.R.C. § 6655 for waiver of the penalty for reasonable cause, or in unusual circumstances. Thus, the penalty applies even if assertion of the penalty under the circumstance seems inequitable and against good conscience. Penalty abatement requests generally must be in writing. However, requests to verify the accuracy of a penalty computation do not have to be in writing, even if they result in the abatement of all or part of the penalty.

Failure-to-Deposit Penalties

In general, employers must deposit federal income tax withheld, and deposit both the employer and employee portions of social security and Medicare taxes. If a deposit is not made timely, in the correct amount, and in the correct manner, the IRS can assess a failure-to-deposit (FTD) penalty.

Small employers can pay the tax with their Form 941, Employer's QUARTERLY Federal Tax Return, if the total tax in either the current quarter or the prior quarter is less than $2,500. However, if the total tax is $2,500 or more in the current quarter and in the prior quarter, or there is a $100,000 next-day deposit obligation in the current quarter, any amount paid with the current quarter return is subject to the 10% penalty. Employers with tax in excess of $2,500 must use the electronic funds transfer (EFT) deposit system to make monthly or semiweekly deposits. If these employers make payments directly to the IRS, the IRS can assess a 10% FTD penalty.

Example 11.4 Form 941 De Minimis Exception

Fun Toy Company's quarterly tax liability for the second quarter of 2016 was $2,450. In the third quarter of 2016, the tax liability was $2,550.

Under the Form 941 de minimis deposit exception, if Fun Toy pays the $2,550 with the return for the third quarter of 2016, the amount is considered timely deposited for that quarter.

Figure 11.2 shows the different deposit requirements.

FIGURE 11.2 Deposit Requirements

Tax Liability	Deposit Obligation
Less than $2,500 for the year	No deposit is required. The tax can be paid by check or money order with Form 944, Employer's ANNUAL Federal Tax Return, or by credit card.
$2,500 or more for the year, but less than $2,500 for the quarter	The employer can deposit the taxes by the last day of the month after the end of a quarter. However, if the fourth-quarter tax liability is less than $2,500, the fourth-quarter tax liability can be paid by check or money order with a timely filed Form 941, or by credit card.
$2,500 or more for the quarter	Deposits are due either monthly or semiweekly (discussed later), depending on the deposit schedule. Taxes of $100,000 or more in a deposit period must be deposited in time to settle on the next banking day for either the monthly or semiweekly depositor. See IRS Publication 15, *(Circular E), Employer's Tax Guide*.

Taxpayers follow a predetermined deposit schedule, under which the frequency of deposits generally remains consistent throughout the year. An employer is either a monthly depositor or a semiweekly depositor for a calendar year based on an annual determination of the aggregate amount of employment taxes reported on the original returns filed during the employer's lookback period. For quarterly return filers, the *lookback period* for each calendar year is the 12-month period ending the preceding June 30. For example, the lookback period for calendar year 2016 considers the Form 941 returns filed from July 1, 2014, to June 30, 2015 (which encompasses the third and fourth quarters of 2014 and the first and second quarters of 2015).

A new employer is treated as having employment tax liabilities of zero for any calendar quarter or year of the lookback period before the date the employer started or acquired its business. Therefore, most new businesses begin as monthly depositors.

The IRS issues a courtesy Deposit Status Information Notice in November of each year to taxpayers that change deposit frequencies from their current status. Employers are instructed to review their lookback period each year and adjust their deposits accordingly, as failure to receive the notice is not a basis for abatement of the FTD penalty.

If an employer reported employment taxes of $50,000 or less during the 1-year lookback period, the employer is a monthly depositor and generally must deposit employment taxes on a monthly basis during the calendar year. Under the monthly rule, the employer must deposit the taxes for the month on or before the fifteenth day of the following month. If the fifteenth of the following month falls on a Saturday, Sunday, or a legal holiday in the District of Columbia, the employer has until the next business day to make a timely deposit.

Practitioner Note Depositing More Frequently

Taxpayers choosing to deposit employment taxes more frequently than their assigned deposit schedule will not be penalized.

If an employer reported employment taxes of more than $50,000 during the lookback period, the employer must deposit taxes using the semiweekly rule. Under this rule, the day a deposit is due is determined by the day of the payroll. The semiweekly rule does not require an employer to make deposits twice a week (semiweekly). Rather, the deposits are due based on a schedule that divides the calendar week into two (semiweekly) sections. **Figure 11.3** shows the schedule for semiweekly deposits.

FIGURE 11.3 Semiweekly Deposit Rules

If the Payday Falls on a	Then Deposit Taxes
Wednesday, Thursday, or Friday	on or before the following Wednesday
Saturday, Sunday, Monday, or Tuesday	on or before the following Friday

Treas. Reg. § 31.6302-1(c)(2)(iii) provides that all semiweekly depositors have at least 3 business days following the close of the semiweekly period to deposit employment taxes accumulated during the semiweekly period. Therefore, if a recognized holiday falls within the period between the payroll and the due date, the deposit due date is extended by the same number of days. For example, if a deposit is due on a Friday, but that Friday is a legal holiday, the deposit is timely if received by the following Monday.

Safe Harbor Rules

Taxpayers are required to deposit 100% of their tax liability on or before the deposit due date. However, penalties won't be applied for depositing less than 100% if

- any deposit shortfall doesn't exceed the greater of $100 or 2% of the amount of taxes otherwise required to be deposited, and
- the deposit shortfall is paid or deposited by the shortfall makeup date.

The shortfall makeup safe harbor for a monthly depositor requires the depositor to deposit the shortfall or pay it with the return by the due date of the return for the return period in which the shortfall occurred. Taxpayers may pay the shortfall with the return even if the amount is $2,500 or more. The shortfall makeup date for a semiweekly depositor requires the depositor to deposit the shortfall by the earlier of

- the first Wednesday or Friday (whichever comes first) that falls on or after the fifteenth day of the month following the month in which the shortfall occurred, or
- the due date of the return (for the return period of the tax liability).

Failure-to-Deposit Penalty Rates

I.R.C. § 6656(b)(1) establishes a four-tier penalty system for late deposits. The penalty rate depends on the number of calendar days a deposit is late, beginning on the due date of the deposit. For liability amounts not properly or timely deposited, the penalty rates are as follows:

1. 2% for deposits 1 to 5 days late
2. 5% for deposits 6 to 15 days late
3. 10% for deposits made more than 15 days late (This also applies to amounts paid within 10 days of the date of the first notice requesting payment for the tax due.)
4. 10% for amounts subject to electronic deposit requirements but not deposited using EFTPS and 15% (a 5% addition to the 10% penalty for late payment listed in item 3) for all amounts still unpaid more than 10 days after the date of the first notice requesting payment of the tax due or the day on which the taxpayer received notice and demand for immediate payment, whichever is earlier

Waiver of the Failure-to-Deposit Penalty

The IRS can waive the FTD penalty for reasonable cause (discussed later). IRS Policy Statement 3-2 (discussed previously) gives examples of circumstances that establish reasonable cause. The taxpayer may also be eligible for a first-time abatement (FTA) administrative waiver of the FTD penalty, including an FTA following a deposit schedule frequency change (discussed later), and may be able to designate certain payments for certain periods (also discussed later).

Return-Related Penalties

Return-related penalties include the accuracy-related penalties, civil fraud penalty, and erroneous claim for refund or credit penalty.

Accuracy-Related Penalties

I.R.C. § 6662(d) imposes an accuracy-related penalty for any substantial understatement of income tax. There is a substantial understatement of income tax for any tax year if the amount of the understatement for the tax year exceeds the greater of 10% of the tax required to be shown on the return or $5,000.

Accuracy-Related Penalty Rate

The accuracy-related penalty is equal to 20% of the underpayment amount.

Relief from the Accuracy-Related Penalty

There is no accuracy-related penalty if the taxpayer demonstrates that he or she had substantial authority for the position taken; if the taxpayer disclosed the relevant facts on a return or on a statement attached to the return, and the taxpayer had reasonable basis for tax treatment of the item; or if the taxpayer acted in good faith and had reasonable cause for the underpayment.

Cross-Reference Substantial Authority

See the "Rulings and Cases" chapter in this book for a discussion of what constitutes substantial authority.

Taxpayers who believe the IRS interpretation of a tax law is incorrect can take a contrary position and avoid the accuracy-related penalty by filing Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, with their tax returns. The taxpayer's interpretation of the law must be a good-faith challenge to the IRS's position, and it must have a reasonable basis.

The taxpayer has a reasonable basis if he or she reasonably believed that his or her treatment of the item was more likely than not the proper tax treatment. A taxpayer is treated as having a reasonable basis only if the belief is based on the facts and the law that exist at the time the return is filed, and the belief relates solely to the taxpayer's chances of success on the merits of the tax treatment of the issue.

Treas. Reg. § 1.6664-4 establishes and gives examples of the reasonable cause and good-faith exception to I.R.C. § 6662 penalties. 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; and reliance on an information return, professional advice, or other facts, if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.

Accuracy-Related Penalty for Reportable Transactions

I.R.C. § 6662A imposes a 20% accuracy-related penalty on any reportable transaction understatement. The penalty applies only to listed transactions and reportable transactions if a significant purpose of the transaction is the avoidance or evasion of federal income tax.

Failure to disclose a reportable transaction on Form 8886, Reportable Transaction Disclosure Statement, is an indication that the taxpayer did not act in good faith with respect to the portion of an underpayment attributable to a reportable transaction. Therefore, a higher 30% penalty applies to a reportable transaction understatement if a taxpayer does not adequately disclose, in accordance with Treas. Reg. § 1.6011-4, the relevant facts affecting the tax treatment of the item giving rise to the reportable transaction understatement. The reasonable basis defense is not available for the 30% penalty.

Civil Fraud Penalty

Under I.R.C. § 6663(a), if any underpayment of tax is due to fraud, a penalty is imposed equal to 75% of the portion of the underpayment due to fraud. Although I.R.C. § 6663 does not define *fraud*, most court definitions require an intent to evade tax. Intent is distinguished from inadvertence, reliance on incorrect professional advice, honest difference of opinion, negligence, or carelessness.

In order to assert the civil fraud penalty, the IRS must establish that a part of the deficiency is due to a knowingly false representation of facts by the taxpayer. The IRS bears the burden of proving civil fraud by clear and convincing evidence. The IRS must show that the taxpayer

- knew the content of the return was false, and
- filed the return with the intent to evade tax.

There is no reasonable cause or other relief from the civil fraud penalty.

If the taxpayers file a joint return, the IRS must establish intent separately for each spouse. The IRS cannot use fraud of one spouse to impute fraud by the other spouse.

Erroneous Claim for Refund or Credit Penalty

The I.R.C. § 6676 penalty was enacted in the Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28, to complement and close a gap left by the accuracy-related penalty, the accuracy-related penalty for reportable transactions, and the fraud penalty. This penalty does not apply to any amounts subject to any of the other understatement penalties.

The erroneous-claim penalty may be imposed on a taxpayer who files an erroneous claim for a refund or credit with respect to federal income tax (other than a claim relating to the earned income tax credit) that is excessive in amount and for which there is no reasonable basis for the claimed tax treatment. The penalty applies to all claims, formal and informal, relating to federal income taxes. The taxpayer making such a claim is liable for a penalty in the amount of 20% of the excessive amount claimed. The *excessive amount* is the amount of the claim for refund or credit that exceeds the amount allowed.

There is no reasonable cause relief, but the penalty does not apply if the taxpayer has reasonable basis for the claimed tax treatment.

Information Reporting Penalties

Penalties may be imposed under I.R.C. § 6721 for failure to file under I.R.C. § 6672 or for failure to furnish correct information returns, including Form W-2, Wage and Tax Statement [filed with the Social Security Administration (SSA)], and Form 1098 series, Form 1099 series, and other information documents. Failure-to-file penalties include failure to timely file, failure to file on proper media, failure to file in the proper format, and/or missing and incorrect name or taxpayer identification number (TIN). Failure-to-furnish penalties include failure to timely furnish, providing an incorrect payee, missing required information, or including incorrect information.

Filing Requirements

Figure 11.4 shows the due dates for most information returns. The return must be postmarked or electronically filed by the due date.

FIGURE 11.4 Information Returns Filing Requirements

Form	Due Date
1042-S	File with the IRS and furnish to the recipient by March 15 of the year following the calendar year the funds were distributed.
1095-B	File with the IRS by February 28 (March 31 if filed electronically) with a Form 1094-B transmittal.
1095-C	File with the IRS by February 28 (March 31 if filed electronically) with a Form 1094-C transmittal.
1097-BTC	File with the IRS no later than February 28 (March 31 if filed electronically) of the year the return is required to be filed with a Form 1096 transmittal. Furnish to the recipient on or before the fifteenth day of the second calendar month after the close of the calendar quarter.
1098	File with the IRS no later than February 28 (March 31 if filed electronically) of the year the return is required to be filed with a Form 1096 transmittal.
1098-C	Donees required to file Form 1098-C must provide copies B and C of the form to a donor within 30 days from the sale of the vehicle (if it is sold without material improvements or significant intervening use) or within 30 days of the contribution.
1098-E	File with the IRS no later than February 28 (March 31 if filed electronically) of the year the return is required to be filed with a Form 1096 transmittal.
1098-T	File with the IRS no later than February 28 (March 31 if filed electronically) of the year the return is required to be filed with a Form 1096 transmittal.
1099	File with the IRS no later than February 28 (March 31 if filed electronically) of the year the return is required to be filed with a Form 1096 transmittal. Effective for tax year 2016 (filed in 2017), returns or statements reporting nonemployee compensation (e.g., Form 1099-MISC) must be filed no later than January 31 (both paper and electronic).

FIGURE 11.4 Information Returns Filing Requirements (Continued)

Form	Due Date
3921	File with the IRS no later than February 28 (March 31 if filed electronically) of the year the return is required to be filed with a Form 1096 transmittal.
3922	File with the IRS no later than February 28 (March 31 if filed electronically) of the year the return is required to be filed with a Form 1096 transmittal.
8027	File with the IRS no later than February 28 (March 31 if filed electronically) of the year the return is required to be filed.
8282	When a donee disposes of certain charitable property within 3 years of its receipt, the donee must provide an information return to the IRS on or before the 125th day after the disposition date of the property.
8300	Furnish a statement to each person named on the information return by January 31. Provide a written statement to each person named on the form showing name, telephone number, and address of the information contact for the business, the aggregate amount of reportable cash, and that the information was provided to the IRS. Provide the statement on or before the last day of January of the year following the calendar year in which the cash was received. The recipient of more than $10,000 in cash received in a trade or business must file Form 8300 within 15 days after the date the cash is received.
8308	A partnership must file a separate Form 8308 with its Form 1065 when money or property is received by a partner in exchange for all or part of a partnership interest that is attributable to unrealized receivables or substantially appreciated inventory items (I.R.C. § 751 exchange). All partnerships required to file Form 8308 must furnish a copy of the form to each transferor and transferee by January 31 of the year following the calendar year in which the I.R.C. § 751 exchange occurred or, if later, 30 days after the partnership has notice of the exchange.
8594	The buyer and the seller must file Form 8594, Asset Acquisition Statement, with their federal income tax returns for the year that includes the date of the acquisition. The form must include ■ the date of the sale and total sale price (Part I), ■ the allocation of the sale price among seven asset classes and the aggregate fair market value of each class of assets (Part II), and ■ supplemental information statements to cover increases and decreases in consideration received by the buyer (Part III).
W-2	File Form W-2 and Form W-3 with the SSA no later than February 28 (March 31 if filed electronically) of the year the return is required to be filed. Effective for tax year 2016 (filed in 2017), these returns must be filed no later than January 31 (both paper and electronic).
W-2G	File with the IRS no later than February 28 (March 31 if filed electronically) of the year the return is required to be filed with a Form 1096 transmittal.

Electronic Filing Waiver

Pursuant to I.R.C. § 6011(e), information returns must be filed using electronic media when 250 or more of the same document types are submitted. The penalty applies to the returns that exceed this threshold. For example, if 300 Forms 1099-DIV, Dividends and Distributions, are filed on paper, only 50 will be subject to penalties.

A filer may request a waiver from the requirement to file on electronic media by filing Form 8508, Request for Waiver From Filing Information Returns Electronically. The filer must show that it would cause an undue economic hardship to file on electronic media. The request should be filed at least 45 days before the due date of the returns for which the filer is requesting a waiver.

Extension of Time to File Information Returns

A filer may request a 30-day extension of time to file information returns by filing Form 8809, Application for Extension of Time To File Information Returns. The extension request must be postmarked no later than the due date of the return, or the filer can submit a request online through the File Information Returns Electronically (FIRE) system. Online requests must be submitted by the due date of the return. Approvals are automatically displayed online if the request is made by the due date of the return.

If an automatic extension is granted, a filer can request one additional extension of not more than 30 days by submitting a second Form 8809 before the end of the first extension period. However, only one extension of time to file Form W-2, Wage and Tax Statement, is available.

Penalty Amounts and Limitations

I.R.C. § 6721 imposes a penalty when an information return or statement is not timely and/or correctly filed by the due date of the return. I.R.C. § 6722 imposes a penalty when a payee statement is not timely and/or correctly furnished. Both penalties are tiered depending on the length of time before the return or statement is filed or corrected.

Section 806 of the Trade Preferences Extension Act (TPEA) of 2015, Pub. L. No. 114-27, increased the tiered penalty amounts for I.R.C. §§ 6721 and 6722. The following penalty amounts are effective for information returns and statements required to be filed on or after January 1, 2016 (these amounts will be indexed for inflation in future years):

- $50 per failure, not to exceed an annual maximum of $529,500 ($185,000 for a small business) for returns filed correctly within 30 days of the due date
- $100 per failure, not to exceed an annual maximum of $1,589,000 ($529,500 for a small business) for returns filed correctly after 30 days, but on or before August 1
- $260 per failure, not to exceed an annual maximum of $3,178,500 ($1,059,500 for a small business) for returns filed after August 1

[Rev. Proc. 2016-11, 2016-2 I.R.B. 274, and see also Rev. Proc. 2015-53, 2015-44 I.R.B. 615 for returns and statements required to be filed on or after January 1, 2017]

I.R.C. § 6723 imposes a $50 penalty for each failure, with a maximum of $100,000 for any calendar year, to comply with other information reporting requirements.

Reasonable Cause for Information Returns

The IRS can remove or abate the penalty if the taxpayer has reasonable cause. There is no first time abatement (FTA) relief. To request abatement, the taxpayer must provide an affirmative showing of reasonable cause in the form of a written statement, under penalties of perjury, setting forth all the facts alleged as reasonable cause.

Practitioner Note Reporting History

During the evaluation of a penalty abatement, the IRS reviews a taxpayer's history of filing similar returns. The IRS system has the filings for the last 5 years, so the taxpayer should address any issues for other years in the reasonable cause explanation.

Reasonable cause penalty abatement for the information return penalties generally exists when the filer acted in a responsible manner, both before and after the failure occurred, and there are significant mitigating factors, or the failure was the result of circumstances beyond the filer's control [Treas. Reg. § 301.6724-1(d)].

Responsible Manner

To act in a responsible manner under Treas. Reg. § 301.6724-1(d), the taxpayer generally must exercise the same degree of care that a reasonably prudent person (or organization) would use in the course of its business in determining filing obligations and in handling account information, such as account numbers and balances. Acting in a responsible manner also includes taking steps to avoid the failure, such as

- requesting appropriate extensions of time to file when practical to avoid the failure;
- attempting to prevent a failure if it was foreseeable;
- acting to remove an impediment or the cause of the failure; and
- correcting the failure as promptly as possible, generally within 30 days.

Significant Mitigating Factors

Events generally considered to be significant mitigating factors include, but are not limited to, the following:

- Prior to the failure, the filer was never required to file this particular form or statement.

- The filer has a history of complying with the information return reporting requirements.

Practitioner Note Compliance History

A good compliance history may benefit a filer who can show that he or she acted in a responsible manner but cannot show that an event beyond the filer's control caused the failure.

Events beyond Taxpayer's Control

Events generally considered beyond the control of the filer include (but are not limited to) the following:

- The unavailability of the relevant business records
- An undue economic hardship relating to filing on magnetic media
- Reliance on erroneous written information provided by the IRS (The filer must also show that reliance on the written advice was reasonable and that it relied in good faith on the information.)
- Actions of an agent (imputed reasonable cause). (The filer must show that he or she exercised reasonable business judgment when contracting with the agent to timely file correct returns, that the taxpayer provided the agent with proper information well in advance of the due date of the return or statement, and the agent satisfied the significant mitigating factors; or an event beyond the agent's control occurred that could establish reasonable cause.)

Failure to Electronically File Partnership Return

I.R.C. § 6011(e)(2) requires a partnership with more than 100 partners to file its return electronically [including Schedules K-1 (Form 1065)]. I.R.C. § 6721(a)(2)(A) imposes a penalty if the partnership fails to electronically file the partnership return. The penalty is $260 per partner and is assessed for each partner over the 100-partner threshold. The penalty does not apply if the partnership applied for and obtained a waiver from the electronic filing requirement.

Under I.R.C. § 6724(a), the penalty for failure to file a partnership return electronically does not apply if the failure is due to reasonable cause, and not due to willful neglect. The specific criteria for reasonable cause are set forth in Treas. Reg. § 301.6724-1. Generally, the partnership must show that it acted in a responsible manner with respect to the e-file requirement, both before and after filing. This means that the partnership made a reasonable effort to meet the e-file requirement prior to filing its return on paper, mitigating factors were present beyond its control, and the partnership has taken reasonable steps to prevent a recurrence of the failure to file electronically in future years.

The penalty should not be asserted, and reasonable cause is considered met, if the partnership is a new partnership (first-time filer) or the partnership has a history of complying with the e-file requirement.

Amounts Owed under the Affordable Care Act

Individual taxpayers, regardless of age, are required to maintain qualifying health insurance (*minimum essential coverage*) and pay an individual shared responsibility payment for the months that they and any family members do not have minimum essential coverage or a coverage exemption. Certain applicable large employers that do not offer affordable minimum value coverage to their employees may have to pay an employer shared responsibility payment if at least one full-time employee purchases insurance through a Marketplace and is determined to be eligible for and receives a premium tax credit (PTC). Employers that must file Form 1095-C, Employer-Provided Health Insurance Offer and Coverage, are subject to the I.R.C. §§ 6721 and 6722 information reporting penalties, and I.R.C. § 4980D imposes a $100-per-day per-employee excise tax when a group health plan fails to meet certain market reforms. No tax is owed if a failure due to reasonable cause is corrected during the 30-day period beginning on the first date anyone liable for the tax knew or, exercising reasonable diligence, would have known that the failure existed.

Cross-Reference Affordable Care Act

See the "Affordable Care Act" chapter in this book for more information about employer and employee obligations under the Affordable Care Act.

INDIVIDUAL AND BUSINESS PENALTY DEFENSES AND RELIEF

This section discusses four types of relief from penalties imposed on individuals and businesses, and it provides a chart showing the types of relief that apply to each penalty.

I.R.M. § 20.1.1.3 establishes four separate categories of relief from most penalties:

1. Reasonable cause
2. Statutory exceptions
3. Administrative waivers
4. Correction of IRS error

Practitioner Note Power of Attorney

The IRS will consider requests for penalty relief received from third parties, including requests from representatives without an authorized power of attorney (POA). Although IRS employees can accept information from third parties, they cannot discuss any taxpayer information with a third party unless the third party has a valid POA or other acceptable authorization from the taxpayer.

Reasonable Cause

Reasonable cause is based on all the facts and circumstances in each situation. Relief from a penalty is usually granted if the taxpayer acted in good faith and not with willful neglect. Reasonable cause means that the taxpayer exercised ordinary business care and prudence in providing for tax obligations but nevertheless was unable to comply with those obligations. This generally requires either the occurrence of an event outside the taxpayer's control or an undue hardship. Generally, the most important factor in determining whether the taxpayer has reasonable cause and acted in good faith is the extent of the taxpayer's effort to report the proper tax liability.

On the contrary, willful neglect involves a conscious, intentional failure or reckless indifference. Continued failure to file or pay (beyond the event of the "reasonable cause") may be evidence that the underlying reason for the failure to file or pay is willful neglect and not the reasonable cause claimed by the taxpayer.

In determining reasonable cause, the IRS will check at least 3 preceding tax years for payment patterns and the taxpayer's overall compliance history. The same penalty, previously assessed or abated, may indicate that the taxpayer is not exercising ordinary business care. If this is the taxpayer's first incident of noncompliant behavior, the IRS will weigh this factor with other reasons the taxpayer gives for reasonable cause, because a first-time failure to comply does not by itself establish reasonable cause (but see "Administrative Waivers" later in this chapter). The IRS will consider the following:

- The length of time between the event cited as a reason for the noncompliance and subsequent compliance. The IRS looks at (1) when the act was required by law, (2) the period of time during which the taxpayer was unable to comply with the law due to circumstances beyond the taxpayer's control, and (3) when the taxpayer complied with the law.
- Whether the taxpayer could have anticipated the event that caused the noncompliance. Reasonable cause is generally

established when the taxpayer exercises ordinary business care and prudence, but, due to circumstances beyond the taxpayer's control, the taxpayer was unable to timely meet the tax obligation. The taxpayer's obligation to meet the tax law requirements is ongoing. Ordinary business care and prudence requires that the taxpayer continue to attempt to meet the requirements, even though late.

Ordinary Business Care and Prudence

A taxpayer is considered to have exercised ordinary business care and prudence if he or she made reasonable efforts to conserve sufficient assets in marketable form to satisfy his or her tax liability and nevertheless was unable to pay all or a portion of the tax when it became due.

Treas. Reg. § 301.6651-1(c)(2) gives the following examples of *ordinary business care and prudence* (or a lack thereof) for a failure to pay:

- A taxpayer who incurs lavish or extravagant living expenses and does not reserve enough assets and anticipated income to pay the tax due has not exercised ordinary business care and prudence in providing for the payment of his or her tax liability. Alternatively, a taxpayer who was able to pay, but who needed the money to pay for necessary medical expenses, may be able to demonstrate that payment of the tax (in lieu of paying for the medical expense) would have resulted in a significant hardship.
- A taxpayer who invests funds in speculative or illiquid assets has not exercised ordinary business care and prudence unless at the time of the investment the remainder of the taxpayer's assets and estimated income will be sufficient to pay his or her tax or it can be reasonably foreseen that the investment can be utilized (by sale or as security for a loan) to realize sufficient funds to satisfy the tax liability.

Events outside of the Taxpayer's Control

Examples of events outside the taxpayer's control that could lead to a determination of reasonable cause include the taxpayer's serious illness, a death in the family, a fire or other casualty, or a loss of records. Mistake, erroneous reliance on advice, and ignorance of the law may also establish reasonable cause. However, forgetfulness typically does not establish reasonable cause.

Death, Illness, or Absence

Death, serious illness, or unavoidable absence of the taxpayer, or a death or serious illness in the taxpayer's immediate family, may establish reasonable cause for filing, paying, or depositing late. Immediate family includes a spouse, sibling, parents, grandparents, and children. For a corporation, estate, or trust, the IRS will focus on the events and relationship to the taxpayer who had sole authority to execute the return, make the deposit, or pay the tax.

Information to consider when evaluating a request for penalty relief based on reasonable cause due to death, serious illness, or unavoidable absence includes, but is not limited to, the following:

1. The relationship of the taxpayer to the other parties involved
2. The date of death
3. The dates, duration, and severity of illness
4. The dates and reasons for absence
5. How the event prevented compliance
6. If other business obligations were impaired
7. If tax duties were attended to promptly when the illness passed, or within a reasonable period of time after a death or return from an unavoidable absence

Fire, Casualty, or Disaster

The taxpayer can request reasonable cause relief from a penalty if there was a failure to timely comply with a requirement to file a return or pay a tax as the result of a fire, casualty, natural disaster, or other disturbance. However, one of these circumstances by itself does not necessarily provide penalty relief. Penalty relief may be appropriate if the taxpayer exercised ordinary business care and prudence, but due to circumstances beyond the taxpayer's control, he or she was unable to comply with the law. Factors to consider include the following:

- Timing
- Effect on the taxpayer's business
- Steps taken to attempt to comply
- If the taxpayer complied when it became possible

No Records

If the taxpayer was unable to obtain records necessary to comply with a tax obligation, the taxpayer may be able to establish reasonable cause. Reasonable cause may be established if the taxpayer exercised ordinary business care and prudence, but due to circumstances beyond the taxpayer's control, he or she was unable to comply. Information to consider when evaluating such a request includes, but is not limited to, an explanation as to the following:

- Why the records were needed for compliance
- Why the records were unavailable and what steps were taken to secure the records
- When and how the taxpayer became aware that he or she did not have the necessary records
- If other means were explored to secure needed information
- Why the taxpayer did not estimate the information
- If the taxpayer contacted the IRS for instructions on what to do about missing information
- If the taxpayer promptly complied once the missing information was received
- What supporting documentation such as copies of letters written and responses the taxpayer received in an effort to get the needed information

Mistake, Reliance, Ignorance, and Forgetfulness

Generally, a mistake is not in keeping with the ordinary business care and prudence standard and does not provide a basis for reasonable cause. However, the reason for the mistake may be a supporting factor if additional facts and circumstances support the determination that the taxpayer exercised ordinary business care and prudence but nevertheless was unable to comply within the prescribed time. The IRS will consider

- when and how the taxpayer became aware of the mistake,
- the extent to which the taxpayer corrected the mistake,
- the relationship between the taxpayer and the subordinate (if the taxpayer delegated the duty),
- if the taxpayer took timely steps to correct the failure after it was discovered, and
- the supporting documentation.

The taxpayer may try to establish reasonable cause by claiming he or she relied on another party to comply on his or her behalf or that another party provided erroneous advice. Generally, this is not a basis for reasonable cause, particularly for filing or paying obligations, because the taxpayer is responsible for meeting his or her tax obligations and that responsibility cannot be delegated. However, if the failure was attributable to lack of access to records or ignorance of the law, reasonable cause may apply.

In some instances, taxpayers may not be aware of specific obligations to file and/or pay taxes. The ordinary business care and prudence standard requires that taxpayers make reasonable efforts to determine their tax obligations. The taxpayer can establish reasonable cause if the taxpayer shows a good-faith effort to comply and ignorance of the law in conjunction with other facts and circumstances. The IRS will consider the following:

- The taxpayer's education
- If the taxpayer has previously been subject to the tax
- If the taxpayer has been penalized before
- If there were recent changes in the tax forms or law that a taxpayer could not reasonably be expected to know
- The level of complexity of a tax or compliance issue

Undue Hardship

Under Treas. Reg. § 1.6161-1(b), *undue hardship* means more than an inconvenience to the taxpayer. If an asset can be sold to pay the tax liability, its sale at the current market price is not ordinarily considered as resulting in an undue hardship, whereas a sale at a price that would result in a substantial financial loss could qualify.

The IRS will consider the following questions:

- When did the taxpayer know he or she could not pay?
- Why was the taxpayer unable to pay?
- Did the taxpayer explore other means to secure the necessary funds?
- Did the taxpayer supply supporting documentation, such as copies of bank statements?
- Did the taxpayer pay when the funds became available?
- Once the facts and circumstances changed, what attempt did the taxpayer make to comply?

Practitioner Note Cite Sources

Conducting research and citing applicable sections of the Code, regulations, the IRS's *Penalty Handbook*, and relevant court cases can strengthen the request for penalty relief. The request should include a detailed explanation of the events and third-party documentation that corroborate the taxpayer's explanation.

Practitioner Note Regulations Illustrate Reasonable Cause

Treasury regulations that have examples of circumstances the IRS considers in determining if a taxpayer has established reasonable cause for relief from other penalties include Treas. Reg. § 1.6664-4, for accuracy-related penalties; Treas. Reg. §§ 301.6723-1A(d) and 301.6724-1, for information return penalties; and Treas. Reg. §§ 1.6694-2(e)(1) through (6) and 301.6707-1T, Q&A (4), for preparer/promoter penalties.

Penalty Abatement Request

The taxpayer bears the burden of proof in persuading the IRS not to assert penalties or to abate them, but the IRS will evaluate each case on its own strengths and weaknesses. Practitioners need not be apprehensive about requesting penalty relief unless the request is frivolous. The IRS may occasionally allow partial relief even if the taxpayer's argument is flawed. The taxpayer should make the request for penalty abatement as early as possible in the collection cycle. A request that is denied initially may be appealed.

A request for a penalty waiver or abatement should explain what happened and when it happened, and include answers to the following questions:

- What facts and circumstances prevented the taxpayer from filing a return, paying a tax, or otherwise complying with the law?
- How did the facts and circumstances result in the taxpayer not complying?
- How did the taxpayer handle the remainder of his or her affairs during this time?

Reasonable Cause Assistant

IRS personnel are required to use a computer program called the Reasonable Cause Assistant (RCA) when a request for penalty relief is based on reasonable cause [I.R.M. § 20.1.1.3.6]. The IRS's expectation is that using the RCA will ensure consistent and equitable administration of penalty relief consideration.

The IRS employee enters the necessary data from the penalty relief request, the RCA makes an instant determination, and the RCA generates an approval or denial letter (Letter 3502C for an approval and 3503C for a denial of the request). If relief is denied, the letter explains the appeal procedure.

The RCA is unable to consider unique facts and circumstances. Tax professionals can verify whether the RCA system was used by reviewing the penalty reason code (PRC) that appears to the right of a transaction code (TC) on a transcript of the specific account.

- TC 291 means the penalty was abated, and PRC 020 shows that the RCA was used.
- TC 290 means the penalty abatement request was denied, and PRC 020 shows that the RCA system made the decision.

Statutory Exceptions

The Internal Revenue Code provides criteria for penalty relief in some situations. **Figure 11.5** lists the applicable law and where guidance can be found in the Internal Revenue Manual.

FIGURE 11.5 Statutory Penalty Relief

Topic	Legal Reference	I.R.M. Reference
Failure to file small partnership return*	I.R.C. § 6231	§ 20.1.2.3.3.1
Estimated tax penalties	I.R.C. § 6654(e)(1)–(3)	§ 20.1.3
Timely mailing treated as timely filing and paying	I.R.C. § 7502(a) and (e)	§ 20.1.2, 20.1.4
Information return penalties	I.R.C. § 6724(a) or (c)	§ 20.1.7
Erroneous written advice by the IRS	I.R.C. § 6404(f)	§ 20.1.1.3.3.4.1
Service in combat zone	I.R.C. § 7508	§ 20.1.2.1.2.1
Presidentially declared disaster or terroristic or military action	I.R.C. § 7508A	§ 25.16

* Rev. Proc. 84-35, 1984-1 C.B. 509

Erroneous Advice

The statutory exception for erroneous advice from the IRS does not apply to information provided by telephone assistors, although the IRS may consider reliance on oral advice in limited circumstances. Treas. Reg. § 301.6404-3 states that the erroneous IRS advice must be furnished to the taxpayer in writing in response to the taxpayer's specific written request for advice. The taxpayer must have provided adequate and accurate information and have reasonably relied on the erroneous written advice. This provision for penalty relief does not change the taxpayer's liability for the underlying tax.

Application of Late Deposits

Certain employment and excise taxes are subject to federal tax deposit (FTD) rules. Late penalties can arise if payments are not applied to the correct period. Under I.R.C. § 6656(e), a deposit is applied to the most recent period or periods within the specified tax period to which the deposit relates, unless the person making the deposit designates a different period or periods to which such deposit is to be applied. The designation must be made within 90 days after the date on the IRS notice assessing the FTD penalty.

Administrative Waivers

An administrative waiver grants automatic penalty relief in designated circumstances. Examples of criteria for administrative waivers are an IRS delay in printing or mailing tax forms or publishing necessary guidance. The IRS may announce an administrative waiver in a policy statement, a news release, or another formal communication stating that the policy of the IRS is to provide relief from a penalty under specific conditions.

Although relief is available to every qualifying taxpayer when an administrative waiver is announced, the return preparer generally must note on the return that the taxpayer is eligible for the waiver. If the preparer does not note the relief on the return and the IRS imposes the penalty, the IRS can abate the penalty upon request.

First-Time Abatement

A first-time abatement (FTA) is an administrative waiver of the penalties for failure to file (FTF) [I.R.C. §§ 6651(a)(1), I.R.C. § 6698(a)(1), and I.R.C. § 6699(a)(1)]; failure to pay (FTP) [I.R.C. § 6651(a)(2) and I.R.C. § 6651(a)(3)]; and/or failure to deposit (FTD) (I.R.C. § 6656). The FTA waiver for a given tax is available only for a single tax period. To qualify for the FTA, the taxpayer must not have previously been required to file a return and must have no prior penalties (except the estimated tax penalty) for the preceding 3 years on the same type of tax form and must have filed all required tax returns and paid (or arranged to pay) all taxes currently due. (Taxpayers are considered current if they have an open installment agreement and are current with their installment payments.)

If a taxpayer requests penalty relief for two or more periods, and the earliest period meets the FTA criteria, the FTA waiver can apply only to the earliest period. However, the taxpayer may show reasonable cause for abatement of the penalties for subsequent periods.

FTA penalty relief is not available for returns with an event-based filing requirement, such as Form 706, United States Estate (and

Generation-Skipping Transfer) Tax Return, and Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return. It also does not apply to Form 1120S, U.S. Income Tax Return for an S Corporation, if in the prior 3 years at least one Form 1120S was filed late but not penalized. This list is not all-inclusive.

Practitioner Note FTA Waiver Is Not Automatic

Taxpayers are not considered for FTF or FTP penalty relief under the FTA criteria unless they request FTA of the penalty.

Deposit Frequency Changes

I.R.C. § 6656(c) allows the IRS to waive an employment tax FTD penalty if the employer inadvertently fails to deposit the tax timely during the first quarter that FTDs are required or for the first deposit that is due after the employer is required to change the frequency of FTDs (such as from monthly to semiweekly deposits). To qualify for this waiver, the employer's net worth cannot exceed $7,000,000, and the employer cannot have more than 500 employees.

Because conditions apply, this is not an automatically applied statutory waiver.

Correction of IRS Error

If the IRS makes an error in processing a return or payment that results in a penalty assessment, the penalty is automatically abated when the processing error is corrected. For example, if the IRS misapplies a taxpayer's payment, the tax account for which the payment was intended will have a balance due on which the FTP penalty will be assessed. When the mistake is corrected, the IRS will remove the penalties without a formal request from the taxpayer for penalty relief.

Table of Penalties and Available Relief

Figure 11.6 lists the types of individual and business penalties, and it indicates whether each of those penalties is entitled to reasonable cause or other penalty relief.

FIGURE 11.6 Table of Penalties

Statute	Type of Penalty	Reasonable Cause Relief	Other Relief
I.R.C. § 6039E	Failure to provide information concerning resident status	Yes	Yes
I.R.C. § 6651(a)(1)	Failure to file tax return	Yes	Yes
I.R.C. § 6651(a)(2)	Failure to pay tax when due	Yes	Yes
I.R.C. § 6651(a)(3)	Failure to pay within 10 days of notice of additional tax due (notices issued prior to 01/01/1997)	Yes	Yes
I.R.C. § 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
I.R.C. § 6651(f)	Fraudulent failure to file	No	No
I.R.C. § 6652(a)(1)	Failure to file certain information returns	Yes	Yes
I.R.C. § 6652(c)(1)	Failure to file annual return by exempt organization	Yes	Yes
I.R.C. § 6652(c)(2)	Failure to file returns under I.R.C. § 6034 or I.R.C. § 6043(b)	Yes	Yes
I.R.C. § 6652(d)(2)	Notification of change in status of a plan	Yes	Yes
I.R.C. § 6652(e)	Information required in connection with certain plans of deferred compensation—Form 5500, Annual Return/Report of Employee Benefit Plan	Yes	Yes

FIGURE 11.6 Table of Penalties (Continued)

Statute	Type of Penalty	Reasonable Cause Relief	Other Relief
I.R.C. § 6652(h)	Failure to give notice to recipients of certain pension, etc., distributions	Yes	Yes
I.R.C. § 6652(i)	Failure to give written explanation to recipients of certain qualifying rollover distributions	Yes	Yes
I.R.C. § 6652(j)	Failure to file certification with respect to certain residential rental projects	Yes	Yes
I.R.C. § 6654	Estimated tax penalty on individuals	No	Yes
I.R.C. § 6655	Estimated tax penalty on corporations	No	No
I.R.C. § 6656(a)	Failure to deposit	Yes	Yes
I.R.C. § 6657	Bad checks	Yes	Yes
I.R.C. § 6662	Accuracy-related penalty on underpayments	Yes*	Yes
I.R.C. § 6662A	Accuracy-related penalty on understatements with respect to reportable transactions	Yes*	Yes
I.R.C. § 6663	Fraud	No	No
I.R.C. § 6676	Erroneous claim for refund or credit	No	Yes
I.R.C. § 6692	Failure to file actuarial report	Yes	Yes
I.R.C. § 6698	Failure to file partnership return	Yes	Yes
I.R.C. § 6699	Failure to file S corporation return	Yes	Yes
I.R.C. § 6721	Failure to file correct information reporting returns	Yes	Yes
I.R.C. § 6722	Failure to furnish correct payee statements	Yes	Yes
I.R.C. § 6723	Failure to comply with other information reporting requirements	Yes	Yes

* Reasonable cause does not apply to any portion of the underpayment [I.R.C. § 6662] or understatement [I.R.C. § 6662A] attributable to an I.R.C. § 6662(b)(6) transaction [transactions lacking economic substance within the meaning of I.R.C. § 7701(o), or failing to meet the requirements of any similar rule of law].

The list of penalties in Figure 11.6 is not all-inclusive. Refer to the appropriate I.R.M. § 20.1 section (see I.R.M. § 20.1.1.1.2) for relief provisions for penalties not listed in this table.

PENALTY APPEALS Taxpayers can appeal the denial of a request for penalty relief.

The IRS Appeals Office is independent of any other IRS office and serves as an informal administrative forum for any taxpayer who disagrees with an IRS determination. The mission of the Appeals Office is to settle tax disagreements without having a formal trial in a federal court. The Appeals Office can review a denial of penalty relief.

The IRS Appeals Office may recommend the abatement or nonassertion of a penalty based on reasonable cause, statutory exceptions, administrative waiver, or IRS error. In addition, the Appeals Office can consider the hazards of litigation, which other IRS employees cannot consider.

The taxpayer can usually appeal a penalty after assessment, regardless of whether the penalty has been paid. However, if the penalty was proposed during the examination of a return, and it is part of an audit deficiency, then the appeal is subject to the same rules as the deficiency that gave rise to the penalty.

When a penalty abatement request is denied, the taxpayer will receive a written notice stating the denial. This notice explains the process to request an appeal of the rejection. Different types of denials have different time frames to affirmatively request an appeal.

The request for appeal must be in writing and should include a detailed explanation of why the taxpayer should not be assessed the penalty, along with any supporting documentation that the taxpayer wants the Appeals Office to consider.

INTERNATIONAL PENALTIES

This section reviews international penalties and relief from those penalties.

The IRS National Taxpayer Advocate Service estimates that there are 6,000,000 US citizens living and working abroad, and even more immigrated citizens or resident aliens who have accounts abroad. Because foreign transactions are becoming increasingly popular, the IRS is taking a specific interest in the enforcement of the reporting laws for US citizens who have foreign accounts.

US citizens, residents, and certain other persons must annually report their direct or indirect financial interest in, or signature authority (or other authority that is comparable to signature authority) over, a financial account that is maintained with a financial institution located in a foreign country if, for any calendar year, the aggregate value of all foreign financial accounts exceeded $10,000 at any time during the year. A taxpayer who fails to file the Foreign Bank Account Report (FBAR), FinCEN Form 114, when required is subject to the FBAR penalty, although in some cases the penalties may be waived or reduced by participation in an IRS voluntary compliance program or for reasonable cause.

Cross-Reference FBAR Filing

See the "Foreign Tax Issues" chapter in this book for a discussion of the FBAR filing requirements.

Amount of FBAR Penalties

There are two categories of FBAR penalties: civil and criminal. Civil penalties may be willful or nonwillful. Nonwillful violations that the IRS determines were not due to reasonable cause are subject to a $10,000 penalty per violation. For willful violations the penalty is the greater of $100,000 or 50% of the amount in the account at the time of the violation [31 U.S.C. § 5321(a)(5)]. Penalties are determined per foreign account and not for each unfiled form, and the FBAR penalty can be applied to multiple people for the same account.

Criminal penalties such as intentionally filing a false FBAR report or willful failure can range up to $500,000 and/or 10 years' imprisonment. This can be in addition to criminal tax evasion charges under 26 U.S.C. § 7201or 31 U.S.C. §§ 5321(d) and 5322.

The IRS has the burden to prove that a failure to file the FBAR report was willful. However, if the taxpayer had any knowledge of the requirement to file, then the IRS meets its burden. The penalties may be mitigated, as discussed in the next section.

FBAR Penalty Relief

The IRS is still issuing and updating guidance on how to assert a penalty and when to allow penalty relief, and the IRS has advised its agents to use caution in issuing FBAR penalties. But if the IRS proposes to assess the penalty, the tax practitioner must quickly determine if the failure to file is really intentional and/or egregious, or merely a genuine oversight and lack of understanding.

Penalty relief is still available for FBARs, but the IRS will grant relief only if it clearly determines that the taxpayer had no intent to evade filing the FBAR. In addition, the IRS applies the reasonable cause relief (defined later) under I.R.C. § 6662 to FBAR penalties.

IRS Voluntary Compliance Program Relief

If the taxpayer participates in the Streamlined Filing Compliance Procedures or the Offshore Voluntary Disclosure Program, the penalties may be reduced or eliminated. **Figure 11.7** shows the reduced penalties.

FIGURE 11.7 FBAR Penalty Mitigation Guidelines—Per Person Per Year

Nonwillful (NW) Penalties	
To qualify for level I-NW, determine aggregate balance.	If the maximum aggregate balance for all accounts to which the violations relate did not exceed $50,000 at any time during the calendar year, level I–NW applies to all violations. See I.R.M. § 4.26.16.3.6, Aggregate Value Over $10,000, for instruction on determining the maximum aggregate balance.
The level I-NW penalty is:	$500 per violation, not to exceed a total of $5,000 per year.
To qualify for level II-NW, determine aggregate balance.	If the maximum aggregate balance of all accounts to which the violations relate exceeds $50,000, but does not exceed $250,000, level II-NW applies to all violations.
The level II-NW penalty is:	$5,000 per violation.
To qualify for level III-NW, determine aggregate balance.	If the maximum aggregate balance of all accounts to which the violations apply exceeds $250,000, level III-NW applies to all violations.
The level III-NW penalty is:	$10,000 per violation, the statutory maximum penalty for nonwillful violations.
Penalties for Willful Violation	
To qualify for level I-willful - determine aggregate balance	If the maximum aggregate balance for all accounts to which the violations relate did not exceed $50,000 during the calendar year, level I-willful mitigation applies to all violations. See I.R.M. § 4.26.16.3.6, Aggregate Value Over $10,000, for instruction on determining the maximum aggregate balance.
The level I willful penalty is:	The greater of $1,000 per year or 5% of the maximum aggregate balance of the accounts during the year to which the violations relate.
To qualify for level II-willful, determine aggregate balance.	If the maximum aggregate balance for all accounts to which the violations relate exceeds $50,000 but does not exceed $250,000, level II-willful mitigation applies to all violations. Level II-willful penalties are computed on a per-account basis.
The level II-willful penalty is:	For each account for which there was a violation, the greater of $5,000 or 10% of the maximum account balance during the calendar year at issue.
To qualify for level III-willful, determine aggregate balance.	If the maximum aggregate balance for all accounts to which the violations relate exceeds $250,000 but does not exceed $1,000,000, level III-willful mitigation applies to all violations. Level III-willful penalties are computed on a per-account basis.
The level III-willful penalty is:	For each account for which there was a violation, the greater of 10% of the maximum account balance during the calendar year at issue or 50% of the account balance on the day of the violation.
To qualify for level IV-willful, determine aggregate balance.	If the maximum aggregate balance for all accounts to which the violations relate exceeds $1,000,000, level IV-willful mitigation applies to all violations. Level IV-willful penalties are computed on a per-account basis.
The level IV-willful penalty is:	For each account for which there was a violation, the greater of 50% of the balance in the account at the time of the violation or $100,000 (i.e., the statutory maximum penalty).

Cross-Reference SFCP and OVDP

See the "Foreign Tax Issues" chapter in this book for a discussion of the Streamlined Filing Compliance Procedures (SFCP) and the Offshore Voluntary Disclosure Program (OVDP).

FBAR Reasonable Cause

Reasonable cause is based on a consideration of all the facts and circumstances. Reasonable cause relief is usually granted by the IRS when a taxpayer can demonstrate that he or she exercised ordinary business care and prudence in meeting their tax obligations but nevertheless failed to meet them. The IRS will look at the following to determine reasonable cause for abatement of FBAR penalties:

1. The reason for not meeting the filing obligation
2. The taxpayer's compliance history relating to all tax obligations
3. The length of time between the failure to meet the obligation and subsequent compliance and correction of the error when discovered
4. Whether circumstances beyond the taxpayer's control existed
5. Ignorance of the law, if the taxpayer made a reasonable and good-faith effort to comply with FBAR laws and general tax law
6. Whether the taxpayer was aware of the specific obligation, considering:
    a. The taxpayer's education level and any related level of sophistication or professional background
    b. Whether the taxpayer has been penalized before for this penalty
    c. The level of complexity of the tax or compliance issue
    d. Whether there were recent changes in the laws that were not reasonable to know
    e. Whether there was any intentional effort to conceal the reporting of income or assets

Other International Penalties

I.R.M. Exhibit 20.1.9-1 contains a Quick Reference Guide to International Penalties. The guide lists the filing requirements for various taxpayers. It also lists the Internal Revenue Code section for each penalty. This section provides a discussion of some of these penalties.

Failure to File Form 8938

Beginning with the 2011 tax year, a penalty is assessed for failing to file Form 8938, Statement of Specified Foreign Financial Assets, reporting the taxpayer's interest in certain foreign financial assets, including financial accounts, certain foreign securities, and interests in foreign entities, as required by I.R.C. § 6038D. The penalty for failing to file each information return is $10,000, with an additional $10,000 added for each month the failure continues, beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return.

Failure to File Form 3520

A penalty is assessed for failing to file Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. Taxpayers must also report various transactions involving foreign trusts, including creation of a foreign trust by a US person, transfers of property from a US person to a foreign trust, and receipt of distributions from foreign trusts under I.R.C. § 6048. This return also reports the receipt of gifts from foreign entities under I.R.C. § 6039F. The penalty for failing to file the information return, or for filing an incomplete return, is the greater of $10,000 or 35% of the gross reportable amount, except for returns reporting gifts, where the penalty is 5% of the gift per month, up to a maximum penalty of 25% of the gift.

Failure to File Form 3520-A

A penalty is assessed for failing to file Form 3520-A, Information Return of Foreign Trust With a U.S. Owner. Taxpayers must also report ownership interests in foreign trusts by US persons with various interests in and powers over those trusts under I.R.C. § 6048(b). The penalty for failing to file the information return or for filing an incomplete return is the greater of $10,000 or 5% of the gross value of trust assets determined to be owned by the US person.

Failure to File Form 5471

A penalty is assessed for failing to file Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. Certain US persons who are officers, directors, or shareholders in certain foreign corporations (including international business corporations) are required to report information under I.R.C. §§ 6035, 6038, and 6046. The penalty for failing to file each information return is $10,000, with an additional $10,000 added for each month the failure continues, beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return.

Failure to File Form 5472

A penalty is assessed for failing to file Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Taxpayers may be required to report transactions between a 25% foreign owned domestic corporation or a foreign corporation engaged in a trade or business in the United States and a related party as required by I.R.C. §§ 6038A and 6038C. The penalty for failing to file each one of these information returns, or to keep certain records regarding reportable transactions, is $10,000, with an additional $10,000 added for each month the failure continues, beginning 90 days after the taxpayer is notified of the delinquency.

Failure to File Form 926

A penalty is assessed for failing to file Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation. Taxpayers are required to report transfers of property to foreign corporations and other information under I.R.C. § 6038B. The penalty for failing to file each one of these information returns is 10% of the value of the property transferred, up to a maximum of $100,000 per return, with no limit if the failure to report the transfer was intentional.

Failure to File Form 8865

A penalty is assessed for failing to file Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships. US persons with certain interests in foreign partnerships use this form to report interests in and transactions of the foreign partnerships; transfers of property to the foreign partnerships; and acquisitions, dispositions, and changes in foreign partnership interests under I.R.C. §§ 6038, 6038B, and 6046A. Penalties include $10,000 for failure to file each return, with an additional $10,000 added for each month the failure continues, beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return and 10% of the value of any transferred property that is not reported, subject to a $100,000 limit.

Fraud Penalties

Fraud penalties are imposed under I.R.C. § 6651(f) or 6663. Where an underpayment of tax, or a failure to file a tax return, is due to fraud, the taxpayer is liable for penalties that, although calculated differently, essentially amount to 75% of the unpaid tax.

Failure to File

A penalty for failing to file a tax return is imposed under I.R.C. § 6651(a)(1). Generally, taxpayers are required to file income tax returns. If a taxpayer fails to do so, a penalty of 5% of the balance due, plus an additional 5% for each month or fraction thereof during which the failure continues, may be imposed. The penalty shall not exceed 25%.

Failure to Pay

A penalty is assessed for failing to pay the amount of tax shown on the return under I.R.C. § 6651(a)(2). If a taxpayer fails to pay the amount of tax shown on the return, he or she may be liable for a penalty of 0.5% of the amount of tax shown on the return, plus an additional 0.5% for each additional month or fraction thereof that the amount remains unpaid, not exceeding 25%.

Underpayments

An accuracy-related penalty on underpayments is imposed under I.R.C. § 6662. Depending upon which component of the accuracy-related penalty is applicable, a taxpayer may be liable for a 20% or 40% penalty.

PREPARER PENALTIES

This section discusses penalties that the IRS can assess against a tax return preparer and defenses to those penalties.

Preparer penalties are intended to stop fraudulent, unscrupulous, or incompetent tax return preparers. The IRS can refer a preparer penalty to the Office of Professional Responsibility (OPR) for further review. Thus, the preparer should defend any proposed or assessed penalty whenever it is appropriate. This section discusses the penalty for disclosure or use of tax return information, the penalty for taking an unreasonable position on a tax return, and the I.R.C. § 6695 penalties.

Disclosure or Use of Tax Return Information

I.R.C. § 7216 prohibits certain disclosures or use of information by tax return preparers and imposes a criminal penalty for unauthorized disclosures or use. I.R.C. § 6713 imposes a civil penalty for unauthorized disclosure or use. There are two penalty levels:

- Tax return preparers face misdemeanor criminal charges under I.R.C. § 7216 if they *knowingly* or *recklessly* disclose or use tax return information without the taxpayer's consent. Tax return preparers convicted under this law can be fined up to $1,000 and imprisoned for up to a year for each violation.
- Tax return preparers face civil penalties under I.R.C. § 6713 if they disclose or use tax return information without the taxpayer's consent, even if the disclosure or use is inadvertent. The penalty is $250 for each violation, up to a $10,000 maximum per calendar year.

Practitioner Note Definition of Tax Return Preparer

Any person (including a partnership or corporation) who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of a tax return or claim for refund is a *tax return preparer* for disclosure penalty purposes. A nonsigning preparer who prepares a schedule or entry or portion that constitutes a substantial portion of the return may be considered a tax return preparer. In making the decision as to what constitutes a "substantial portion," compare the length, complexity, and tax liability or refund of the entity, schedule, or portion of the return or claim of refund prepared by the nonsigning preparer to the remainder of the return.

Tax return information includes all information that a tax return preparer collects to prepare tax returns, whether it is obtained from taxpayers or from any other sources, in any form or manner. This includes information obtained in connection with the preparation of tax returns even if the information is ultimately not used.

An *unauthorized disclosure* occurs whenever tax return information is made known to any person in any manner that is not authorized. An *unauthorized use* of tax return information occurs whenever a tax return preparer refers to or relies on tax return information to take or permit actions that are not authorized.

Unreasonable Position

I.R.C. § 6694(a) imposes a penalty on a tax return preparer who prepares a return or claim for refund reflecting an understatement of liability due to an "unreasonable position" if the tax return preparer knew (or reasonably should have known) of the position. A position is treated as unreasonable unless either there is or was substantial authority for the position or the position was properly disclosed and had a reasonable basis. Treas. Reg. § 1.6662-3(b)(3) states, "Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim."

Amount of the Penalty

The penalty for understatements due to unreasonable positions under I.R.C. § 6694(a) is the greater of $1,000 or 50% of the income derived (or to be derived) by the tax return preparer from the preparation of a return or claim with respect to which the penalty was imposed.

Penalty Relief

No penalty is imposed if, considering all the facts and circumstances, the understatement was due to reasonable cause and the tax return preparer acted in good faith [Treas. Reg. § 1.6694-2(e)].

A tax return preparer will be found to have acted in good faith when the tax return preparer relied on the advice of a third party who is not in the same firm as the tax return preparer and who the tax return preparer had reason to believe was competent to render the advice. The advice may be written or oral, but in either case, the burden of establishing that the advice was received is on the tax return preparer.

A tax return preparer is not considered to have relied in good faith if

- the advice is unreasonable on its face;
- the tax return preparer knew or should have known that the third-party adviser was not aware of all relevant facts; or
- the tax return preparer knew or should have known (given the nature of the tax return preparer's practice), at the time the tax return or claim for refund was prepared, that the advice was no longer reliable due to developments in the law since the time the advice was given.

The IRS will consider the following other factors:

1. Whether the error resulted from a provision that was so complex, uncommon, or highly technical that a competent preparer of returns or claims of the type at issue reasonably could have made the error
2. Whether the understatement was the result of an isolated error (such as an inadvertent mathematical or clerical error) rather than a number of errors
3. Whether the understatement was material in relation to the correct tax liability
4. Whether the preparer's normal office practice, when considered together with other facts and circumstances, such as the knowledge of the preparer, indicates that the error in question would rarely occur and the normal office practice was followed in preparing the return or claim in question

Willful or Reckless Understatement

I.R.C. § 6694(b) imposes a penalty on a tax return preparer who prepares a return or claim for refund reflecting an understatement of liability due to a willful attempt by a tax return preparer or reckless or intentional disregard of rules or regulations by a tax return preparer. The IRS bears the burden to prove that the preparer willfully attempted to understate the tax liability.

Reckless conduct is a highly unreasonable omission or misrepresentation involving an extreme departure from the standards of ordinary care that a practitioner should observe under the circumstances.

Example 11.5 Unallowed Expenses Claimed

Jill Stuart gave her tax return preparer, Vicki Taylor, detailed check registers showing personal and business expenses. One of the expenses was for domestic help, and this expense was identified as personal on the check register. Vicki knowingly deducted the expenses of Jill's domestic help as wages paid in Jill's business. Vicki is subject to the penalty under I.R.C. § 6694(b) [Treas. Reg. § 1.6694-3(d)].

Example 11.6 Expenses Overstated

Jill from Example 11.5 gave Vicki detailed check registers to compute her expenses. However, Vicki knowingly overstated the expenses on Jill's return. After adjustments by the examiner, the tax liability increased significantly. Because Vicki disregarded information provided in the check registers, she is subject to the penalty under I.R.C. § 6694(b) [Treas. Reg. § 1.6694-3(d)].

The penalty for understatements due to willful, reckless, or intentional disregard under I.R.C. § 6694(b) is the greater of $5,000 or 50% of the income derived (or to be derived) by the tax return preparer with respect to returns, amended returns, and claims for refund.

I.R.C. § 6695 Penalties and Reasonable Cause Relief

I.R.C. § 6695 imposes the following penalties on return preparers, and allows the following reasonable cause relief:

- *I.R.C. § 6695(a), Failure to furnish copy to taxpayer:* A $50 penalty will be asserted for each failure to furnish a completed copy of the return or claim for refund to the taxpayer before (or at the same time) the return or claim for refund is presented to the taxpayer for signature, with a maximum of $25,500 per preparer per calendar year. The penalty does not apply if the failure is due to reasonable cause and not due to willful neglect.
- *I.R.C. § 6695(b), Failure to sign return:* A $50 penalty will be asserted for each failure to sign the return or claim for refund with a maximum of $25,500 per preparer per calendar year. Preparers must sign the return or claim for refund that is not signed electronically using the appropriate method prescribed by the Treasury secretary after it is completed and before it is presented to the taxpayer for signature. The IRS no longer requires a manual signature. Alternative methods of signing, such as a rubber stamp, mechanical device, or computer software program, must include either a facsimile of the individual preparer's signature or the individual preparer's printed name. The penalty does not apply if the failure was due to reasonable cause and not due to willful neglect.
- *I.R.C. § 6695(c), Failure to furnish identifying number:* No more than one penalty may be imposed with respect to a single return or claim for refund. A $50 penalty will be asserted for each failure to provide the identifying number of the preparer required to sign the return, and the identifying number of the partnership or employer, with a maximum of $25,500 per preparer per calendar year. The penalty does not apply if the failure was due to reasonable cause and not due to willful neglect.
- *I.R.C. § 6695(d), Failure to retain copy or list:* A $50 penalty will be asserted for each failure to retain a completed copy of the return or list, with a maximum of $25,500 for any return period. The penalty does not apply if the failure was due to reasonable cause and not due to willful neglect.
- *I.R.C. § 6695(e), Failure to file correct information returns:* The penalty is $50 for each failure to file a return as required by I.R.C. § 6060 (Information returns of tax return preparers) and $50 for each failure to include a required item in the return. The maximum amount for any return period is $25,500. Each person who employs (or engages) one or more signing tax return preparers must retain a record of the name, taxpayer identification number, and place of work of each tax return preparer employed (or engaged) by him or her. The penalty does not apply if the failure was due to reasonable cause and not due to willful neglect.
- *I.R.C. § 6695(f), Negotiation of check:* The penalty is $510 for each negotiated check. There is no maximum amount. There is no reasonable cause exception to this penalty.

Practitioner Note Due Diligence

The IRS works with the Department of Justice to obtain due diligence injunctions against practitioners who prepare federal income tax returns that contain false information to increase their clients' earned income tax credit (EITC). The court orders permanently bar the enjoined individuals from ever again preparing federal income tax returns. The preparers could also face criminal prosecution and additional penalties. See the "Ethics" chapter in this book for a discussion of the EITC due diligence requirements and the new due diligence requirements for the child tax credit and the American opportunity tax credit.