

How to Get Federal Tax Penalties Abated

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Introduction

In fiscal year 2015, the IRS assessed \$24 billion in penalties, and abated nearly \$9 billion (about 37 percent) in penalties.¹ In her 2016 report to Congress,² National Taxpayer Advocate Nina Olson identified penalties as four of the 10 most frequently-litigated issues. So, federal tax penalties are a large problem.

Some of the more common penalties are failure to file, failure to pay, failure to deposit, underpayment of estimated tax, accuracy-related and various information return penalties. Oftentimes, these penalties are unwarranted and need to be abated. As a result, it's important for tax practitioners to understand how to get these penalties abated.

How much are these penalties? Which of them can be abated? How can you get the IRS to abate them? This article will explore these topics.

How Much Are the Penalties?

The following table lists some of the more common penalties you will encounter, and it shows how they are calculated:

IRC §	Description	Calculation/Amount
6651(a)(1)	Failure to File Return	5.0 percent of underpayment per month, maximum 25 percent
6651(a)(2)	Failure to Pay Tax	0.5 percent of underpayment per month, max. 25 percent (reduces FTF penalty to 4.5 percent for months where both penalties apply)
6651(a)(3)	Failure to Pay Notice	0.5 percent of notice amount per month, maximum 25 percent
6652(c)	Failure to File Exempt Organization Return	\$20 per day, maximum lesser of 5 percent of gross receipts or \$10,000 (penalty is higher for gross receipts over \$1 million)
6654, 6655	Underpayment of Estimated Tax	Complex calculation depending on several variables
6656	Failure to Deposit	10 percent (2 percent if corrected in five days, 5 percent if corrected in 15 days)
6698	Failure to File Partnership Return	\$195 per month x number of partners, maximum 12 months
6699	Failure to File S Corporation Return	\$195 per month x number of shareholders, maximum 12 months
6662	Accuracy-Related	20 percent of underpayment due to negligence, substantial understatement, others (can be 40 percent in some situations)
6721	Failure to File Correct Information Return	\$260 per return (lower if corrected within 30 days or by Aug. 1) (penalty is \$530 per return for intentional disregard)
6722	Failure to Furnish Info Return to Payee	\$260 per return (lower if corrected within 30 days or by Aug. 1) (penalty is \$530 per return for intentional disregard)

continued on p. 11

continued from p. 10

Which Penalties Can Be Abated by a Reasonable Cause Argument?

Except for the penalties for underpayment of estimated tax (§6654 for individuals, §6655 for corporations), all of the penalties listed above can be abated for reasonable cause. For the estimated tax penalties, there are specific situations where they won't be imposed, and in addition, in some circumstances, the IRS will waive them. This is discussed below.

Except for the estimated tax penalties, the penalties don't apply if the failure that resulted in the penalty (such as the failure to file a return on time) was due to reasonable cause and not due to willful neglect. "Reasonable cause" means that the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return or pay the tax.³ According to the IRS, a taxpayer has exercised ordinary business care and prudence when he or she has made provisions for business obligations to be met when reasonably foreseeable events occur.⁴ "Willful neglect" means a conscious, intentional failure or reckless indifference.⁵ In determining whether reasonable cause exists, the IRS will consider all relevant facts and circumstances.⁶

Strategies for Abatement

There are many strategies for getting the penalties abated. Except for the estimated tax penalties, these strategies apply to all of the penalties listed above. Later in this article I'll discuss some of the strategies that are specific to particular penalties.

1. Attach a "reasonable cause" statement to the return before filing it

With most penalties, the regulations provide that the IRS won't impose the penalty if the taxpayer makes an affirmative showing of all facts that are alleged as reasonable cause. For example, Treas. Reg. §301.6651-1(c)(1) states that a taxpayer who wishes to avoid the failure to file penalty must make an affirmative showing of the facts in a written statement containing a declaration that is made under penalties of perjury.

As a result, the first step to abatement is to prepare such a statement and attach it to the return because it might convince the IRS that it shouldn't assess the penalty in the first place.

2. Take advantage of "First Time Abate"

For the failure to file (§6651(a)(1), §6698 and §6699), failure to pay (§6651(a)(2), §6651(a)(3)) and failure to deposit (§6656) penalties, the IRS will administratively waive these penalties for taxpayers who have been compliant in the past.⁷ This "first time offense" relief is granted if the taxpayer satisfies two requirements:

- (1) The taxpayer must not have had any penalties assessed (except for the estimated tax penalty) for the prior three years' returns; and
- (2) The taxpayer must be current on all tax return filings and tax payments.

A taxpayer is considered "current" on tax payments if the taxpayer is making payments under an installment agreement. The waiver applies to only one tax period.

The IRS will use the "First Time Abate" waiver before it considers any reasonable cause arguments. As a result, a delinquent taxpayer can't "game the system" by picking and choosing the year for which the waiver will apply, such as the year with the largest penalty. In the case of two or more years, the IRS will apply the waiver to the earliest year and will consider reasonable cause for the later years.⁸

There are many special rules for how and when the IRS will apply this waiver, so you might want to read the relevant Internal Revenue Manual (IRM) section (20.1.1.3.6.1) to see how it applies. For example, the IRS will not allow the waiver to be used for late returns filed by exempt organizations (§6652(c)), for an estate tax return, for information returns, or for a corporation's return if the corporation filed a late return in the previous three years but wasn't assessed a penalty.

3. Request abatement based on reasonable cause

If the IRS assesses the penalty, then the next strategy is to request abatement based on reasonable cause. In response to the IRS's letter that assesses the penalty, send a letter that outlines all of the facts and circumstances. I recommend that you send the letter by certified mail so that you have proof of mailing.

In writing the letter, IRM 20.1.1.3.2, *Reasonable Cause*, can be quite helpful. The IRS recommends that its employees consider the following:

- (1) What happened and when it happened;
- (2) What facts and circumstances prevented the taxpayer from filing a return, paying a tax, and/or otherwise complying with the law;
- (3) How the facts and circumstances resulted in the taxpayer not complying;
- (4) How the taxpayer handled the remainder of his or her affairs during this time; and
- (5) Once the facts and circumstances changed, what attempt the taxpayer made to comply.

So, you might want to address these questions. Be as specific about the events and dates as possible. According to IRM 20.1.1.3.2.2, the IRS will be looking for dates of the events that correspond to the period of noncompliance, the taxpayer's compliance history, the length of time of noncompliance and subsequent compliance, and whether the taxpayer could have anticipated the event that caused the noncompliance.

The IRS describes the following as events that could possibly constitute reasonable cause:

- (1) Death, serious illness or unavoidable absence;
- (2) Fire, casualty, natural disaster, or other disturbance;
- (3) Unable to obtain records;
- (4) Mistake was made;
- (5) Erroneous advice or reliance; or
- (6) Ignorance of the law.⁹

continued on p. 12

continued from p. 11

If your client's situation is described in one or more of these events, be sure to cite the appropriate IRM section in your letter.

The IRS states that reasonable cause **does not exist** if the taxpayer's noncompliant behavior continued for more than a reasonable time beyond the event that constitutes reasonable cause.¹⁰ For example, if the client was ill during the three-month period following the due date of the return, but didn't file the return until seven months after the due date, you need to explain why there was reasonable cause for the additional four-month delay.

4. Request appeal if the IRS denies abatement

If the IRS denies your request for abatement of the penalties, then you may appeal the denial to the Office of Appeals. All of the penalties listed above can be protested to Appeals.¹¹ If the amount is \$25,000 or less, you can use Form 12203, *Request for Appeals Review*, to request the appeal. If the amount is more, then prepare a written protest. Send the request to the same IRS office that sent the denial.

Appeals considers the following questions in deciding whether the taxpayer has established reasonable cause:

- (1) Do the taxpayer's explanations directly relate to the penalty that was assessed?
- (2) Do the dates and times coincide with the taxpayer's explanation?
- (3) Could the noncompliance have been anticipated and/or prevented?
- (4) Did the taxpayer make an honest mistake?
- (5) Has the taxpayer provided sufficient detail (dates, relationships, documents) to determine if ordinary business care and prudence was exercised?
- (6) Is the taxpayer an individual, third party such as a reporting agent, accountant or lawyer?
- (7) Is there a history of the taxpayer being assessed the same penalty?
- (8) Were there prior abatements of the same or similar penalties?¹²

Unlike other IRS employees, Appeals employees are allowed to consider the "hazards of litigation" (the uncertainties of the outcome of a court's decision in the event of trial) in deciding whether to abate the penalties.¹³ Appeals has the authority to partially abate a penalty if there exist hazards of litigation. As a result, if there are court cases with facts similar to your client's, where the court ruled that the penalty didn't apply, be sure to cite them in your request for appeal.

Strategies for Particular Penalties

Failure to Pay Penalty (§6651(a)(2), §6651(a)(3))

Treas. Reg. §301.6651-1(c)(1) states that a taxpayer who has provided for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship if he paid on the due date has demonstrated

reasonable cause. "Undue hardship" requires more than an inconvenience to the taxpayer; it requires the risk of a substantial financial loss resulting from making the tax payment on time.¹⁴

The regulation also states that the taxpayer's financial situation prior to the date prescribed for payment of the tax is a fact to be considered in deciding whether the taxpayer has exercised ordinary business care and prudence. As a result, a taxpayer who does not have reasonable cause for filing a return late may nevertheless have reasonable cause for failing to pay the tax on time.

IRC §6651(h) provides that the failure to pay penalty rate is cut in half (0.25 percent per month) for any month during which an installment agreement is in effect. Accordingly, a taxpayer who needs to pay the tax over time should obtain an installment agreement as soon as possible in order to reduce the rate of this penalty.

Penalty for Underpayment of Estimated Tax (§6654, §6655)

Although there is no general reasonable cause exception, this penalty will not be imposed if the amount due is less than \$1,000 (\$500 for a corporation), or if the taxpayer was a U.S. citizen or resident who had no tax liability for the preceding year.¹⁵

If your client is liable for this penalty, you might consider using the "annualized income installment" method to calculate the penalty if your client's income was higher (or deductions lower) towards the end of the year than the beginning of the year.¹⁶ It takes a little extra work, but this often overlooked method for calculating the penalty can result in a substantial savings.

The IRS will waive the penalty if failure to make the estimated tax payments was due to casualty, disaster or other unusual circumstances.¹⁷ The IRS will also waive the penalty if the taxpayer retired after age 62 or became disabled in the taxable year in which the estimated tax payments were required to be made, and there was reasonable cause for the taxpayer's failure to make the payments.¹⁸ You should request these waivers on Form 2210 (preferably filed with the return), and include documentation to prove the casualty, disaster or date of retirement/disability.¹⁹

Failure to Deposit Penalty (§6656)

The IRS will conclude that reasonable cause exists if the taxpayer has satisfied the general rule of Treas. Reg. §301.6651-1(c)(1) for exercising ordinary business care and prudence.²⁰ In determining whether this occurred, the courts have ruled that the primary factors to consider are:

- (1) If the taxpayer favored other creditors over the government;
- (2) If the taxpayer had a history of failing to make deposits;
- (3) The taxpayer's financial decisions; and
- (4) The taxpayer's willingness to decrease expenses and personnel.²¹

continued on p. 13

continued from p. 12

In addition to the general reasonable cause exception, the IRS has the authority to waive the penalty for an employer's failure to deposit employment taxes if the failure was inadvertent, the taxpayer's net worth didn't exceed \$2 million, the failure occurred in the first quarter that the employer was required to deposit employment taxes, and the taxpayer timely filed the return.²²

Accuracy-Related Penalty (§6662)

For an underpayment of income tax, IRC §6662(a) provides for a 20 percent penalty for the portion of the underpayment that is due to negligence, substantial understatement, substantial valuation misstatement, disallowance of tax benefits by reason of a transaction lacking economic substance, an undisclosed understatement of foreign financial assets, or an inconsistent estate basis.²³

For an individual, a substantial understatement of tax is an understatement that exceeds the greater of 10 percent of the tax required to be shown on the return, or \$5,000.²⁴ In most audits (including CP2000 notices), once the IRS determines that the taxpayer exceeds this threshold, it adds the 20 percent accuracy-related penalty (based on substantial understatement) automatically, apparently without any thought to whether the taxpayer had reasonable cause for the understatement. I believe that this stems from multiple reports from the Treasury Inspector General for Tax Administration that have criticized IRS examiners for not asserting the penalty.²⁵

There are several defenses to the accuracy-related penalty based on negligence or substantial understatement.

The penalty based on negligence does not apply if the taxpayer's position was adequately disclosed in the return and there was a reasonable basis for the tax treatment.²⁶ Similarly, for the penalty based on substantial understatement, the amount of the understatement must be reduced for any item that has been adequately disclosed in the return and for which there is a reasonable basis for the tax treatment.²⁷

"Reasonable basis" means that there is about a 20-30 percent chance of prevailing on the issue.²⁸ Form 8275, *Disclosure Statement*, can be attached to the return to disclose the item.²⁹ In addition, every year the IRS issues a revenue procedure listing the circumstances under which disclosure will be deemed to be adequate if the taxpayer has completed certain portions of the tax return.³⁰ For example, if a taxpayer completes Schedule A, *Itemized Deductions*, and provides all information required, this could be deemed to be adequate disclosure that will eliminate the penalty.³¹

For the penalty based on substantial understatement, the amount of the understatement must be reduced for any item for which there was substantial authority for the tax treatment, even if not adequately disclosed in the return.³² "Substantial authority" means that there is about a 40-50 percent chance of prevailing on the issue.³³

IRC §6664(c)(1) provides that the accuracy-related penalty shall not be imposed if it is shown that there was reasonable cause for the underpayment and that the taxpayer acted in

good faith.³⁴ Treas. Reg. §1.6664-4 is helpful to determine whether the facts and circumstances will demonstrate that the taxpayer had reasonable cause and acted in good faith.

One of the most frequently used reasonable cause arguments is reliance. Reliance on erroneous **written** advice provided by the IRS is statutory grounds for abating a penalty.³⁵ Reliance on erroneous **oral** advice provided by the IRS is also grounds for abatement, but this is IRS policy rather than law.³⁶

Taxpayers often claim that there was reasonable cause due to reliance on a tax adviser. The courts have ruled that for this to apply, the taxpayer must prove that:

- (1) The adviser was a competent professional who had sufficient expertise to justify reliance;
- (2) The taxpayer provided necessary and accurate information to the adviser; and
- (3) The taxpayer actually relied in good faith on the adviser's judgment.³⁷

Partnership Late Filing Penalty (§6698)

IRC §6031 requires a partnership to file an annual information return. IRC §6698(a) imposes a \$195 penalty for each month that the return is filed late (up to a maximum of 12 months) multiplied by the number of partners. The penalty will not be imposed if the partnership shows that the failure to file was due to reasonable cause.

However, there are two possible defenses to this penalty. First, the partnership might not be required to file a return. Treas. Reg. §1.6031(a)-1(a)(3) states that a partnership that has no income, deductions or credits for federal income tax purposes for a taxable year is not required to file a partnership return for that year. In addition, a partnership that rents a building to tenants, whose owners are tenants-in-common, isn't a partnership (and has no filing requirement) as long as rental operations are handled by a management company and no services are provided to tenants.³⁸

Second, for partnerships with 10 or fewer partners who are individuals or estates, pursuant to Rev. Proc. 84-35, the IRS will waive the IRC §6698 penalty for a delinquent partnership return if all of the partners have timely filed their returns and have reported their shares of partnership income or loss.³⁹

S Corporation Late Filing Penalty (§6699)

IRC §6037 requires an S corporation to file an annual information return. IRC §6699(a) imposes a \$195 penalty for each month that the return is filed late (up to a maximum of 12 months) multiplied by the number of shareholders. The penalty will not be imposed if the corporation shows that the failure to file was due to reasonable cause.

There is no relief similar to Rev. Proc. 84-35 for S corporation returns. In a 2012 case that can't be cited as precedent,⁴⁰ the Tax Court held that an S corporation had reasonable cause for filing its return late because its president timely mailed the Schedules K-1 to the shareholders, and one of the shareholders filed a timely individual income tax return that

continued on p. 14

continued from p. 13

reflected the information shown on the Schedule K-1. But don't expect this case to be followed in the future, especially in view of a 2015 case⁴¹ that refused to grant Rev. Proc. 84-35 relief to a partnership when not all of the partners timely-filed their returns.

Failure to File and/or Furnish Information Returns (§6721, §6722)

IRC §6721 provides for a \$250 penalty for failure to file a correct information return with the IRS. IRC §6722 provides for an additional \$250 penalty for failure to provide a correct information return to the payee. These penalties are indexed for inflation, so that each is now \$260.⁴² Each of these penalties increases to \$530 in the case of intentional disregard.⁴³ Each penalty is reduced to \$50 if the failure is corrected within 30 days after the due date, and to \$100 if the failure is corrected by August 1.⁴⁴

There is a "de minimis" exception to the penalties. If the failure is corrected by August 1, then no penalty will be imposed if the number of information return failures is not more than 10 (or 0.5 percent of the total number of information returns, if greater).⁴⁵

These penalties will not be imposed if the taxpayer shows that the failure to file and/or failure to furnish correct information returns was due to reasonable cause and not to willful neglect.⁴⁶ Reasonable cause for these penalties means that the taxpayer acted in a responsible manner both before and after the failure occurred, and either there were significant mitigating factors or the failure was the result of circumstances beyond the taxpayer's control.⁴⁷ There is a good discussion of this in the regulations.⁴⁸

Summary and Conclusion

The IRS assesses a multitude of penalties, many of which can be abated if you have good facts, are aware of the arguments that can be made, and if you follow the proper procedures. Knowing how to get these penalties abated will save your clients money and will enhance your tax practice.

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¹ Internal Revenue Service Data Book, 2015, Publication 55B (Table 17).

² www.TaxpayerAdvocate.irs.gov/2016AnnualReport.

³ Treas. Reg. §301.6651-1(c)(1).

⁴ See IRM 20.1.1.3.2.2(1).

⁵ *United States v. Boyle*, 469 U.S. 241, 245 (1985).

⁶ Treas. Reg. §301.6651-1(c)(1).

⁷ See IRM 20.1.1.3.6.1.

⁸ See IRM 20.1.1.3.6.1(3) and (4).

⁹ See IRM 20.1.1.3.2.2.1 through 20.1.1.3.2.2.6. The IRM also lists "forgetfulness," but states that it doesn't provide a basis for reasonable cause.

¹⁰ See IRM 20.1.1.3.2(6).

¹¹ See IRM 20.1.1.4 and 8.11.1.1.2.

¹² See IRM 8.11.1.7.1(2).

¹³ See IRM 8.11.1.1.7.5.

¹⁴ Treas. Reg. §301.6651-1(c), citing §1.6161-1(b). See also IRM 20.1.1.3.3.3 and *Merriam v. Commissioner, T.C. Memo. 1995-432*.

¹⁵ IRC §6654(e)(1), (2) and 6655(f).

¹⁶ IRC §6654(d)(2). Use Schedule AI of Form 2210 for this calculation.

¹⁷ IRC §6654(e)(3)(A). See also IRM 20.1.3.2.2.1.2.

¹⁸ IRC §6654(e)(3)(B). See also IRM 20.1.3.2.2.1.3.

¹⁹ See the instructions for Form 2210.

²⁰ See IRM 20.1.4.1.

²¹ *Staff It, Inc. v. United States*, 482 F.3d 792 (5th Cir. 2007); *Diamond Plating Co. v. United States*, 390 F.3d 1035, 1038 (7th Cir. 2004); *Van Camp & Bennion v. United States*, 251 F.3d 862, 868 (9th Cir. 2001); *East Wind Industries, Inc. v. United States*, 196 F.3d 499, 508-509 (3d Cir. 1999); *Fran Corp. v. United States*, 164 F.3d 814, 819-820 (2d Cir. 1999).

²² IRC §6656(c), Treas. Reg. §301.6656-1(a).

²³ The penalty rate is increased to 40 percent for a "gross valuation misstatement" or for an undisclosed transaction that lacks economic substance. IRC §6662(h) and (i).

²⁴ IRC §6662(d)(1)(A).

²⁵ "Additional Managerial Involvement Is Needed to Promote Consistent Use of Accuracy-Related Penalties" (No. 2009-30-124, 9/11/2009); "Accuracy-Related Penalties Are Seldom Considered Properly During Correspondence Audits" (No. 2010-30-059, 6/4/2010); "Automated Underreporter Program Tax Assessments Have Increased Significantly; However, Accuracy-Related Penalties Were Not Always Assessed When Warranted" (No. 2015-30-037, 5/8/2015); "The Examination and Automated Underreporter Functions Did Not Always Ensure That Accuracy-Related Penalty Abatements Were Appropriate" (No. 2015-30-066, 8/3/2015).

²⁶ Treas. Reg. §1.6662-3(a).

²⁷ IRC §6662(d)(2)(B)(iii).

²⁸ Somewhere above "not frivolous" (about 10 percent) and based on one or more authorities. See Treas. Reg. §1.6662-3(b)(3).

²⁹ Form 8275-R, Regulation Disclosure Statement, can be used when the position taken is contrary to IRS regulations, but it seems questionable how a position that is contrary to regulations can have a reasonable basis.

³⁰ For 2013, 2014 and 2015 returns, see Rev. Proc. 2014-15, 2014-5 I.R.B. 456, Rev. Proc. 2015-16, 2015-7 I.R.B. 596 and Rev. Proc. 2016-13, 2016-4 I.R.B. 290, respectively.

³¹ Refer to the applicable Rev. Proc. as to the specific information for each deduction that must be disclosed.

³² IRC §6662(d)(2)(B)(i); Treas. Reg. §1.6662-4(d)(1).

³³ Less stringent than the "more likely than not" (51 percent) standard. The weight of the authorities supporting the treatment must be substantial in relation to the weight of authorities supporting contrary treatment. See Treas. Reg. §§1.6662-4(d)(2) and (3).

³⁴ There are special rules for certain valuation overstatements, and this exception doesn't apply to the penalty for disallowance of tax benefits by reason of a transaction lacking economic substance.

³⁵ IRC §6404(f); Treas. Reg. §301.6404-3.

³⁶ See IRM 20.1.1.3.3.4.2.

³⁷ *Neonatology Associates, P.A., et al. v. Commissioner*, 115 T.C. 43, 99 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002). See also IRM 20.1.1.3.3.4.3.

³⁸ See *Medlin v. Commissioner, T.C. Memo. 2003-224*; Rev. Rul. 75-374, 1975-2 C.B. 261; and Treas. Reg. §301.7701-1(a)(2).

³⁹ See Rev. Proc. 84-35, 1984-1 C.B. 509. All of the partners must have timely-filed their returns, otherwise relief will not be granted. See *Battle Flat, LLC v. United States*, No. 5:2013cv05070-JLV (W.D. SD 2015).

⁴⁰ *Ensync Technologies v. Commissioner, T.C. Sum. Op. 2012-55*.

⁴¹ *Battle Flat, LLC v. United States*, *supra*.

⁴² IRC §6721(f) and 6722(f). See also Rev. Proc. 2016-55, 2016-45 I.R.B. 707.

⁴³ IRC §6721(e) and 6722(e).

⁴⁴ IRC §6721(b) and 6722(b).

⁴⁵ IRC §6721(c) and 6722(c).

⁴⁶ IRC §6724(a).

⁴⁷ Treas. Reg. §301.6724-1(a)(2).

⁴⁸ *Id.*