

IRS Penalties – A Brief Primer

By Jason B. Freeman, JD, CPA | Column Editor

There are currently more than 150 penalties contained in the Internal Revenue Code – a penalty for nearly every conceivable reporting, filing and payment requirement failure. While penalties have long been a component of the federal tax laws, the number of penalties has grown substantially over time. There are, to put it in perspective, nearly 10 times more penalties in the current code than were contained in the 1954 code.

During the most recent fiscal year, the IRS assessed over \$27 billion in civil penalties, an amount that is slightly higher than in recent years. At the same time, the IRS abated nearly \$9 billion in penalties. In other words, almost a third of penalties were abated.

The Purpose of Tax Penalties

The Internal Revenue Manual provides some insight into the purpose of tax-related penalties: they exist primarily “to encourage voluntary compliance.” According to the Internal Revenue Manual, “[v]oluntary compliance is achieved when a taxpayer makes a good faith effort to meet the tax obligations defined by the Internal Revenue Code.” Practitioners seeking penalty abatement may sometimes find support for their position by invoking the underlying purpose of those penalties.

Common Penalties

While there are many tax-related penalties, there is a handful of particularly common penalties that tax practitioners should be familiar with. These include the failure-to-file, failure-to-pay, failure-to-deposit, accuracy-related and fraud penalties. Of course, there are other penalties that practitioners should be familiar with, such as penalties for aiding and abetting the understatement of a tax liability, filing frivolous returns and promoting abusive tax shelters, but the following penalties are among the most frequently encountered in most tax practices.



The Failure-to-File Penalty Under Code Sec. 6651(a)(1)

The Internal Revenue Code imposes a delinquency penalty for failing to timely file a tax return. This failure-to-file penalty is equal to 5 percent of the outstanding tax due on the return for each month that the return is delinquent, up to a maximum of 25 percent.

The Failure-to-Pay Penalty Under Code Sec. 6651(a)(2)

The code also imposes a penalty for failing to timely pay the tax shown as due on a tax return. This failure-to-pay penalty is equal to one-half of 1 percent of the delinquent tax amount for each month that the amount remains unpaid, up to a maximum of 25 percent.

The Failure-to-Timely-Deposit Penalty Under Code Sec. 6656

The code imposes a penalty for failing to properly deposit taxes. The penalty is

imposed at a rate of 2 percent for a failure of not more than five days. The rate is increased to 5 percent for a failure of five to 15 days. And the rate is increased to 10 percent for a failure of more than 15 days.

The Accuracy-Related Penalty Under Code Sec. 6662

The code imposes an accuracy-related penalty generally equal to 20 percent of an understatement of tax attributable to one or more of the following:

- negligence or disregard of rules or regulations;
- a substantial understatement of income tax;
- a substantial valuation misstatement;
- a substantial overstatement of pension liabilities;
- a substantial estate or gift tax valuation understatement;
- a disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of

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- section 7701(o)) or failing to meet the requirements of any similar rule of law;
- an undisclosed foreign financial asset understatement;
 - an inconsistent estate basis.

The general 20 percent penalty is increased to 40 percent for certain types of understatements, including understatements attributable to gross valuation misstatements, gross estate or gift tax valuation understatements, undisclosed transactions lacking economic substance and undisclosed foreign financial assets.

The most common accuracy-related penalties include the negligence and substantial-understatement penalties. Negligence in this context is defined as a failure to make a reasonable attempt to comply with the Internal Revenue Code and the term “disregard” is defined to include any careless, reckless or intentional disregard. A substantial understatement of income tax is generally defined as the amount by which an understatement exceeds the greater of (i) 10 percent of the tax required to be shown on the return for the tax year or (ii) \$5,000. For corporations other than S corporations or personal holding companies, however, the phrase is defined differently. For such corporations, there is a substantial understatement if the amount of the understatement exceeds the lesser of (i) 10 percent of the tax required to be shown on the return (or if greater, \$10,000) or (ii) \$10,000,000.

The Fraud Penalty

Finally, the code provides for a fraud penalty equal to 75 percent of any underpayment attributable to fraud. The term fraud has been defined as an intentional wrongdoing on the part of a taxpayer with the specific purpose of evading a tax known or believed to be owed. The IRS bears a heightened burden of proof

when it comes to establishing fraud. It must establish, by clear and convincing evidence, that there is an underpayment and that the underpayment is attributable to fraud. To substantiate the existence of fraud, the IRS generally looks for the existence of so-called badges of fraud.

Penalty Defenses

Several defenses may be available to penalty assessments. Practitioners should consider whether statutory exceptions may be available, whether the penalty may be due to a service error or whether the taxpayer may have a reasonable cause defense or satisfy the criteria for first-time abatement relief.

Reasonable cause is perhaps the most common defense to accuracy-related and fraud penalties. It is a penalty defense, or at least a component of a defense, to most civil penalties. Reasonable cause is generally defined as the exercise of ordinary business care and prudence in determining one’s tax obligations. The “reasonable cause” standard draws on a broad range of guidance, and whether it exists is based upon all the surrounding facts and circumstances. Taxpayers seeking reasonable cause relief should ensure that they submit a detailed reasonable cause statement that complies with the governing regulation at issue. Depending on the context of the submission, taxpayers should also consider tailoring the submission to maximize the chances of acceptance under the IRS’ Reasonable Cause Assistant software – artificial intelligence software employed by the IRS for certain penalty abatement decisions.

Practitioners should also consider whether first-time abatement relief may be available to the taxpayer. First-time abatement relief is an administrative waiver that may be available for failure-to-file, failure-to-pay and failure-to-deposit

penalties. It is generally available where a taxpayer can demonstrate that they have no penalties (other than estimated tax penalties) for the prior three years, have filed a return or valid extension for all currently required returns and have paid or made arrangements to pay any tax due. Where available, first-time abatement relief can be a cost-effective mechanism to reduce penalties.

There are, of course, other potential avenues to avoid or minimize penalty exposure depending on the context. Practitioners should, for example, consider whether a qualified amended return may allow a taxpayer to reduce their exposure to accuracy-related penalties or whether proactive disclosure, such as through the procedures of Revenue Procedure 94-69, may provide a taxpayer with an opportunity to reduce accuracy-related penalty exposure even after contact by the IRS. And, of course, taxpayers may be able to mitigate penalty exposure through proper use of Form 8275, *Disclosure Statement*, or Form 8275-R, *Regulation Disclosure Statement*, attached to an original or qualified amended return.

Selecting the Approach

While the code contains a mind-numbing array of penalties, many can be avoided through proper procedures and diligence on the front end. But where that fails, practitioners should vet the applicable penalty defenses.

As indicated above, while the IRS assessed over \$27 billion in civil penalties during the most recent fiscal year, it also abated nearly one-third of those penalties. As these figures imply, where penalties have been assessed, practitioners would often be wise to heed the advice that “those who do not ask do not receive.” A well-crafted and reasoned penalty abatement request may be well worthwhile. ■