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L. Paige Marvel

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## CIVIL PENALTIES UNDER THE INTERNAL REVENUE CODE

By

L. PAIGE MARVEL<sup>\*/</sup>

### I. Introduction

A. The last ten years have seen the landscape of tax compliance change considerably.

B. The changes have included:

1. The addition of a significant number of new civil penalties;

2. The expansion of many of the "old" civil penalties to reach more taxes and to increase the cost of penalized activity;

3. The shifting of the burden of proof on penalty conduct in some instances;

4. The establishment of a penalty structure that permits the imposition of several different penalties on the same operative conduct;

5. The use of interest as an additional penalty;

6. The increase in criminal sanctions applicable to tax crimes;

7. The development of a sentencing guideline system on the federal level which, once it becomes effective, is predicted to increase the amount of time actually served by those defendants found guilty of tax crimes.

C. The net effect of this increasingly complex compliance scheme cannot be fully analyzed or predicted at this time. However, certain effects are immediately apparent:

1. Certain civil penalties are now more costly, e.g. the negligence and fraud penalties;

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<sup>\*/</sup> Partner, Venable, Baetjer and Howard, Baltimore, Maryland and Washington, D.C.; Editor, "Criminal Investigations and Prosecutions" Department, The Tax Times; Chair, Court Procedure Committee, American Bar Association Section of Taxation 1985-1987; Concentration in civil and criminal tax litigation and administrative tax disputes at both the federal and state levels.

2. Tax misbehavior is much more expensive since penalties can be imposed for a single act of noncompliance;

3. The burden of proof rules that apply to penalties will make it more difficult to convince the Internal Revenue Service and the courts that a penalty should not be imposed. (E.g., the automatic negligence penalty applicable to a taxpayer's failure to report income from information returns where the taxpayers must prove "no negligence" by "clear and convincing evidence" to avoid the penalty; the burden of proof on the fraud penalty which shifts to the taxpayer to disprove fraud on the balance of an underpayment once the government proves that any part of an underpayment is due to fraud).

D. This outline examines some of the principal civil penalties in the Internal Revenue Code at the present time. The object of this outline is to give taxpayers and those who represent them an updated roadmap to at least some of the possible pitfalls and to provide some practice pointers for avoiding and/or minimizing exposure to civil penalties for tax misconduct.

## II. The Major Civil Penalties and Their Impact on Taxpayers and their Representatives

### A. An Overview of the Civil Penalty Structure

1. At the present time, it is estimated that there are over 200 civil penalties that are authorized under the provisions of the Internal Revenue Code of 1986.

2. The penalties can be classified generally into several categories:

a. Penalties which reach a failure to pay a tax as and when required by law [E.g. failure to pay penalties under Section 6651(a)(2) and (3),<sup>1/</sup> negligence penalty under Section 6653(a), fraud penalty under Section 6653(b)];

b. Penalties which reach a failure to file a return or to perform a required act on or before the due date [E.g. the failure to file penalty under Section 6651(a)(2), failure to file information returns penalty under Section 6652];

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<sup>1/</sup> All references are to the Internal Revenue Code of 1986 as amended unless otherwise indicated.

c. Penalties which impose a form of strict liability for understating or overstating important tax facts. [E.g. the penalty for valuation overstatements for income tax purposes under Section 6659; the penalty for valuation understatements in estate and gift tax matters under Section 6660; the penalty for substantial understatement of income tax liability under Section 6661].

3. The penalties can be aggregated in some cases, resulting in a significant increase in a taxpayer's liability for a tax mistake.

B. Failure to File Timely Return [§ 6651(a)(1)]

1. General Rule. This addition to tax applies to any failure to file a return required under subchapter A of Chapter 61 (including estate and gift tax returns) on or before the prescribed due date (taking into account any extension of time for filing) unless the taxpayer shows that the failure was due to reasonable cause and not to willful neglect. Section 6651(a)(1).

2. Computation of the Penalty. As a general rule, the penalty is equal to 5% of the amount of the tax required to be shown on the return per month<sup>2/</sup> for each

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<sup>2/</sup> In determining the applicable time period for the imposition of any of the delinquency penalties under § 6651, the following rules apply:

1. If the date prescribed for filing the return or paying the tax is the last day of a calendar month, each succeeding calendar month or fraction of a month will equal a month for purposes of calculating a penalty under § 6651.

2. If the applicable date is a date other than the last day of the calendar month, then a "month" for purposes of calculating an § 6651 penalty is the period terminating on the same day in succeeding months. (E.g. if the due date is April 15, a month for § 6651 purposes ends on the 15th of each month.)

3. If a return is not timely filed or the tax is not timely paid, it is irrelevant that the due date falls on a Saturday, Sunday, or holiday in determining when a "month" starts to run. Treas. Reg. §301.6651-1(b)(1)-(3).

month or fraction of a month that the return is late to a maximum of 25%.

a. In calculating the amount of the penalty, the amount of the tax required to be shown on the return must be reduced by the amount of the tax which is paid on or before the date prescribed for payment of the tax and by the amount of any credit against the tax that may be claimed on the return. Section 6651(b)(1); Treas. Reg. §301.6651-1(a)(1).

b. The amount of the penalty under Section 6651(a)(1) is further reduced by the amount of any penalty imposed under Section 6651(a)(2) [the failure to pay penalty] for any month or fraction thereof to which both penalties apply. Section 6651(c)(1). However, this reduction cannot go below the minimum penalty authorized by the last sentence of Section 6651(a).

c. Minimum penalty. If a taxpayer fails to file a return within 60 days of the date prescribed for filing (including extensions), there is a minimum penalty for the failure to file a timely return in an amount equal to the lesser of \$100 or 100% of the amount required to be shown as tax on the return. This minimum penalty is subject to a reasonable cause defense, however.

### 3. Relationship to Other Penalties

a. If the fraud penalty authorized by Section 6653(b) is assessed, no late filing penalty under Section 6651(1)(1) will be assessed with respect to the portion of the underpayment attributable to fraud. Section 6653(d); Treas. Reg. §301.6651-1(e).

b. The late filing payment under Section 6651(a)(1) does not apply to a failure to pay estimated tax under Section 6154 or 6654. Section 6651(e).

### 4. Procedure for Contesting and/or Assessing the Penalty

a. Except as otherwise provided in the Code, a civil penalty (i.e. addition to tax or assessable penalty) imposed by chapter 68 of the Internal Revenue Code is payable on notice and demand and is assessed, collected, and paid in the same manner as tax. Section 6662(a)(1).

b. Ordinarily, this means that a penalty imposed in connection with a tax which is subject to the deficiency procedures set forth in Section 6211-6215 (i.e. income, estate, gift, and certain excise taxes) will also be subject to the deficiency procedures.

c. However, the failure to file penalty under Section 6651(a)(1) may be imposed without following the deficiency procedures unless and to the extent that the penalty is attributable to a deficiency in tax within the meaning of Section 6211.

#### 5. Establishing Reasonable Cause

a. If a taxpayer can establish either that a return was filed on or before the due date or that the failure to file timely was due to reasonable cause and not to willful neglect, the late filing penalty will not be applied or, alternatively, will be abated.

b. A taxpayer ordinarily has the burden of proving reasonable cause. Lee v. Commissioner, 227 F.2d 181 (5th Cir. 1955), cert. denied 351 U.S. 982 (1956); Bebb v. Commissioner, 36 T.C. 170, 173 (1961). But, where the Internal Revenue Service seeks to impose the penalty in an amended answer or otherwise after a notice of deficiency has issued, the burden of proof may be imposed on the Service. E.g., Harris v. Commissioner, T.C.M. 69-49; Pickett v. Commissioner, T.C.M. 75-33.

c. Under the applicable regulations, a taxpayer who wishes to avoid the Section 6651 penalties (including the late filing penalty) must make an affirmative showing of all facts alleged to constitute reasonable cause for the failure to act in the form of a written statement containing a declaration that it is made under penalties of perjury.

i. The statement should be filed with the district director or the director of the service center with whom the return was required to be filed. Treas. Reg. §301.6651-1(c)(1).

ii. A request for relief from the penalty may also be made, as a practical matter, in a protest submitted as part of the administrative appeal process or in a claim for refund or abatement.

iii. Care should be exercised in determining whether to contest a penalty on reasonable cause grounds since a request for relief will cause a representative of the IRS to review a return and may result in an audit of that return.

iv. Whether or not "reasonable cause" exists is a question of fact. In attempting to demonstrate reasonable cause, a taxpayer should attempt to establish as many of the following as possible:

a. That the taxpayer exercised ordinary business care and prudence and was, nevertheless, unable to file the return on time. Treas. Reg. §301.6651-1(c)(1);

b. That the taxpayer sought timely advice of counsel expert in federal tax matters;

c. That the taxpayer gave counsel all necessary information and withheld nothing meaningful;

d. That the taxpayer acted in good faith on the advice of counsel;

e. That there were other factors establishing the taxpayer's good faith effort to fulfill his tax filing responsibilities in a timely and reasonable manner.

v. As a general rule, ignorance of the law is no excuse and will not constitute reasonable cause for the failure to file a timely return. E.g., American Milk Products Corp. v. United States, 70 Ct.Cl. 169, 41 F.2d 966 (1930); Logan Lumber Co. v. United States, 365 F.2d 846 (5th Cir. 1966).

vi. Illness may constitute reasonable cause depending on the effect of the illness on the taxpayer's ability to file. E.g., Estate of Frederick C. Kirchner, 46 BTA 578 (1942).

vii. The inexperience and lack of knowledge of an executor will not qualify as reasonable cause. E.g., Henry P. Lamments Estate v.

Commissioner, 54 T.C. 420 (1970), aff'd. on this point, 456 F.2d 681 (2d Cir. 1972).

viii. An executor's reliance on an attorney to file a timely estate tax return is not reasonable cause. An executor of an estate has a duty to ascertain the statutory deadline for filing required tax returns and to meet that deadline. United States v. Boyle, 469 U.S. 241 (1985), rev'g. 710 F.2d 1251 (7th Cir. 1983).

#### 6. Practice Pointers to Avoid Liability for Late Filing Penalty

a. A taxpayer who fails to file timely tax returns may subject himself or herself not only to the failure to file penalty but also to a negligence claim.

b. A taxpayer should ascertain what filing requirements apply and the deadlines for any returns.

c. A taxpayer should take all steps necessary to establish that he or she acted with ordinary business care and prudence in attempting to satisfy the tax filing requirements.

d. When in doubt, a taxpayer should consult with an experienced and competent tax professional and should make an appropriate record that he or she supplied the professional with the information necessary to provide informed advice.

e. If a taxpayer cannot file a return on time, get an extension!

#### C. Failure to Pay Tax Shown on Return [§ 6651(a)(2)]

1. General Rule. If a taxpayer fails to pay the amount shown as tax on any return required by subchapter A of chapter 61 (including estate and gift tax returns) on or before the due date for payment (determined with regard to any extension of time for payment), an addition to tax under Section 6651(a)(2) will be imposed unless the taxpayer shows that the failure was due to reasonable cause and not to willful neglect. Section 6651(a)(2).

2. Computation of the Penalty. As a general rule, the penalty is equal to 0.5% of the amount of the tax shown on the return for each month or fraction of a



month<sup>3/</sup> that the payment is late to a maximum of 25%.  
 (Note: A delinquency in payment of 50 months will result in the maximum penalty being imposed.)

a. In calculating the amount of the penalty, the amount of tax shown on the return must be reduced by the amount of the tax paid on or before the beginning of such month and by the amount of any credit that may be claimed on the return.

b. If the amount required to be shown on the return is less than the amount actually shown as tax on the return (i.e. the taxpayer overreported his or her tax), the penalty will be calculated using the lower amount. Section 6651(c)(2).

c. Increase in rate under certain circumstances. As a result of the 1986 Act, the rate of the late payment penalty under Section 6651(a)(2) is increased from 0.5% to 1% on the date which is the earlier of

i. the day ten days after the date on which a notice of intention to levy is given under Section 6331(d)(1); or

ii. the day on which notice and demand for immediate payment is given under the last sentence of Section 6331(a).

### 3. Relationship to Other Penalties.

a. If the fraud penalty authorized by Section 6653(b) is assessed, no late payment penalty under Section 6651(a)(2) will be assessed with respect to the portion of the underpayment attributable to fraud. Section 6653(d); Reg. §301.6651-1(e).

b. The late payment penalty does not apply to a failure to pay estimated tax under Section 6154 or 6654. Section 6651(e).

4. Procedure for Contesting and/or Assessing the Penalty. The same procedures applicable to the late filing penalty under Section 6651(a)(1) apply to the late payment penalty under Section 6651(a)(2). See, part II.B.4. of this outline, supra.

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<sup>3/</sup> See footnote 2, supra.

## 5. Establishing Reasonable Cause

a. Like the late filing penalty, the late payment penalty may be avoided or abated if reasonable cause for the failure to pay is established. Section 6651(a)(2).

b. Reasonable cause must be established to the satisfaction of the district director or the director of the service center. Treas. Reg. §301.6651-1(a)(2).

c. Treas. Reg. §301.6651-1(c)(1) requires a taxpayer to make an affirmative showing of all facts alleged as a reasonable cause for failing to pay the tax on time in the form of a written statement made under penalties of perjury. The statement should be filed either with the district director or with the director of the service center with whom the return was required to be filed.

d. A failure to pay will be considered to be due to reasonable cause if the taxpayer demonstrates that he or she exercised "ordinary business care and prudence" in providing for payment of the tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship if the tax were paid on the due date. Id.

e. "Undue hardship" means more than an inconvenience to the taxpayer. It requires a showing that a substantial financial loss (e.g., a loss due to the sale of property at a sacrifice price) will result from making the payment on the due date. Id.; Treas. Reg. §1.6161-1(b). If a market for the property exists, the need to sell property at a current market price to generate the funds necessary to pay the tax is not considered ordinarily as an undue hardship. Treas. Reg. §1.6161-1(b).

f. Consideration will be given to all the facts and circumstances of a taxpayer's financial condition including the amount and nature of the taxpayer's expenditures compared with income or other amounts the taxpayer could reasonably expect to receive.

i. Lavish or extravagant living expenses compared with available income will preclude a finding that ordinary business care and prudence was exercised. Treas. Reg. §301.6651-1(c)(1).

ii. Investments in speculative or illiquid assets will also preclude a finding of ordinary business care and prudence unless the taxpayer's remaining assets and estimated income at the time of the investment were sufficient to pay the tax. Id.

iii. A taxpayer will be 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 the tax liability but, nevertheless, was unable to generate the necessary funds when the tax became due. Id.

iv. The type of tax involved can impact on the finding of reasonable cause. See, Treas. Reg. §301.6651-1(c)(2).

6. Practice Pointers to Avoid Liability for Late Payment Penalty under § 6651(a)(2)

a. A taxpayer, as a pure economic matter, should take all reasonable steps to avoid incurring charges and penalties for incomplete or imperfect compliance with the provisions of the Internal Revenue Code.

b. A taxpayer should ascertain his or her obligations to pay tax and should familiarize himself or herself with all relevant due dates which should be monitored actively. In addition to the normal income tax requirements, a taxpayer must be cognizant of any obligation to file and pay estimated taxes.

c. If a taxpayer perceives that there may be insufficient assets available to pay an upcoming tax liability, the taxpayer should consider taking the following steps:

i. Obtaining a loan to satisfy the tax obligation;

ii. Liquidating one or more assets;

iii. Obtaining an extension of time to pay the tax in question. See, Section 6161 and the applicable regulations for the procedure and requirements for securing an extension.

d. If an extension of time to pay tax is not obtained, the taxpayer should take steps to pay the

tax delinquency as soon as possible in order to minimize the amount of the late payment penalty, to avoid having to deal with the Collection Division of the IRS and to make a better record supporting a reasonable cause defense if one is available.

D. Failure to Pay Deficiency in Tax After Notice and Demand [§ 6651(a)(3)]

1. General Rule. This addition to tax applies to any failure to pay a deficiency (*i.e.*, an amount required to be shown on a tax return which is not so shown) within ten days of the date of notice and demand unless the failure is due to reasonable cause and not to willful neglect. Section 6651(a)(3).

2. Amount and Calculation of Penalty. As a general rule, the penalty is equal to 0.5% of the amount of the deficiency in tax for each month or fraction of a month<sup>4/</sup> that the payment is late to a maximum of 25%. (Note: A failure to pay the deficiency for five months or more will result in the maximum penalty.)

a. In calculating the amount of the penalty, the amount of tax stated in the notice and demand shall be reduced by the amount of the tax paid before the beginning of the month. Section 6651(b)(3).

b. Prior to the Tax Reform Act of 1986 ("1986 Act"), Section 6651(c)(1)(B) provided that the maximum amount of the penalty under Section 6651(a)(3) must be reduced by the late filing penalty under Section 6651(a)(1) attributable to tax for which notice and demand is made and which is not paid within ten days. However, this provision was repealed by the 1986 Act effective for failures to pay which begin after 12-31-86 and failures to pay which begin on or before 12-31-86 if, after 12-31-86, notice under Section 6631(d) is given or notice and demand for immediate payment is made under Section 6631(a).

c. Increase in rate under certain circumstances. As result of the 1986 Act, the rate of the late payment penalty under Section 6651(a)(3) is increased from 0.5% to 1% on the date which is the earlier of

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<sup>4/</sup> See footnote 2, *supra*.

i. The day ten days after the date on which notice of intention to levy is given under Section 6331(d)(1); or

ii. The day on which notice and demand for immediate payment is given under the last sentence of Section 6331(a).

3. Relationship to Other Penalties

a. If the fraud penalty authorized by Section 6653(b) is assessed, no late payment penalty under Section 6651(a)(2) will be assessed with respect to the portion of the underpayment attributable to fraud. Section 6653(d); Reg. §301.6651-1(3).

b. The late payment penalty does not apply to a failure to pay estimated tax under Section 6154 or 6654. Section 6651(e).

4. Procedure for Contesting and/or Assessing the Penalty. The same procedures applicable to the late filing penalty under Section 6651(a)(1) apply to the late payment penalty under Section 6651(a)(3). See, part II.B.4. of this outline, supra.

5. Establishing Reasonable Cause. Reasonable cause is available as a defense to the imposition of the late payment penalty under Section 6651(a)(3) just as it is for the late payment penalty authorized by Section 6651(a)(2). The discussion at part II.B.5. of this outline is incorporated herein by reference.

6. Practice Pointers to Avoid Liability for the Late Payment Penalty Under § 6651(a)(3)

a. Because the tax system has become increasingly impatient with tax scoflaws, a taxpayer must take the steps necessary to avoid and/or to minimize liability for failure to pay penalties which, at a maximum aggregate rate of 25%, can result in a substantial increase in tax liability.

b. If a taxpayer perceives that there may be insufficient assets available to pay an upcoming tax liability, the taxpayer should consider taking one or more of the following steps:

i. Obtaining a loan to satisfy the tax obligation;

ii. Liquidating assets;

iii. Obtaining an extension of time to pay the tax in question. See Section 6161 and the applicable regulations for the procedure and requirements for securing an extension.

E. Negligence Penalty [§ 6653(a)]

1. Returns Due After December 31, 1986

a. General Rule. If any part of an underpayment is due to negligence or disregard of rules and regulations, a negligence penalty equal to the sum of

i. 5% of the underpayment, and

ii. 50% of the interest payable under Section 6601 with respect to that portion of the underpayment which is attributable to negligence for the period beginning on the last date prescribed by law for payment of the underpayment (determined without regard to extensions) and ending on the earlier of the date of the assessment or the date of payment.

b. This two-tier negligence penalty, unlike the negligence penalty in effect prior to the 1986 Act, applies to all taxes including, but not limited to, income, estate and gift taxes.

c. For purposes of Section 6653(a), the term "negligence" is defined to include "any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code" and the term "disregard" includes "any careless, reckless, or intentional disregard."

d. Underpayment Defined

i. In the case of income, estate and gift taxes, an "underpayment" means a deficiency as defined by Section 6211.<sup>5/</sup> However, if the tax

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<sup>5/</sup> Section 6211(a) defines "deficiency" to mean the amount of tax imposed by the applicable Code section minus the excess of the sum of the amount shown as tax on a taxpayer's return plus amounts previously assessed and/or collected over the amount of any rebates made.

return was not filed timely, the "underpayment" for purposes of Section 6653(a) includes the amount of tax shown to be due on the return. Section 6653(c)(1).

ii. In the case of any other taxes, "underpayment" means the excess of (i) the sum of the amount of tax shown on a return (if the return was filed timely) plus any amount not shown on the return that was paid in respect of the tax over (ii) the amount of any rebates made. Section 6653(c)(2).

e. Special rules apply to the following situations:

i. The failure of a taxpayer to report unrecognized gain on straddle positions in personal property [Section 6653(f)];

ii. The failure of a taxpayer to report amounts shown on information returns as defined in Section 6724(d)(1) or on returns filed under Sections 6031 (partnership returns), 6037 (S corporation returns), 6012(a) by an estate or trust (income tax returns), 6050B (unemployment compensation return), or 6050E (state and local income tax refund reports).

In each of these cases, negligence will be assumed. And, although, a taxpayer who fails to report amounts from information returns can rebut the finding of negligence, he or she can only do so by clear and convincing evidence to the contrary.

f. Relationship to Other Penalties

i. In determining the amount of the negligence penalty, no portion of an underpayment which is attributable to fraud and on which the fraud penalty under Section 6653 (b) is imposed is taken into account. Section 6653(a)(2).

ii. The negligence penalty, however, can and often is combined with one or more of the other penalties in the Code that apply to a particular action or failure to act including the delinquency penalties of Section 6651, the substantial understatement penalty of Section 6661, and the valuation overstatement penalty of Section 6659.

iii. This potential "piling on" of penalties coupled with the compound interest and penalty interest provisions of the Code can make it extremely expensive to underreport or underpay tax liabilities.

g. Procedure for Contesting and Assessing the Negligence Penalty

i. The negligence penalty is payable upon notice and demand and is assessed, collected and paid in the same manner as taxes. Section 6662(a).

ii. For income, estate and gift tax disputes, a taxpayer will normally have the choice of either (i) paying the tax deficiency and penalties proposed by the Internal Revenue Service, filing a claim for refund and then filing suit in either a federal district court or the United States Claims Court, or (ii) filing suit in the United States Tax Court without paying the disputed tax and penalty first.

iii. No matter which approach the taxpayer chooses to contest a proposed tax deficiency and penalty, a taxpayer will ordinarily have the burden of proving that he or she was not negligent within the meaning of Section 6653(a). E.g., Riley v. Commissioner, 53 T.C. 8, 14 (1969).

iv. In addition to a defense on the merits, the negligence penalty can be defeated by establishing that -

a. in the case of a timely filed return, there is no deficiency (and therefore no underpayment). E.g., Carter v. Commissioner, T.C.M. 84-443; Guardianship of Fink v. Commissioner, T.C.M. 84-505;

b. the statute of limitations bars the assessment of any deficiency. E.g., Estate of J. B. Williams v. Commissioner, T.C.M. 1953-251, rev'd on another issue 216 F.2d 598 (4th Cir. 1954).

v. Since the negligence penalty is not item specific (i.e. the penalty is not limited to those items which were the result of negligence),



any portion of an underpayment attributable to negligence, no matter how small, will cause the penalty to be applied to the entire underpayment (except any part on which the fraud penalty is imposed). Section 6653(a); Commissioner v. Asphalt Products Co., Inc., 87-1 USTC 87,779, 59 AFTR2d 87-1085, \_\_\_\_\_ U.S. \_\_\_\_\_ (1987), rev'g. 796 F.2d 843 (6th Cir. 1986).

vi. The negligence penalty may be imposed on the estate of a deceased taxpayer who was negligent or disregarded applicable rules and regulations. E.g., Roger Simpkins Estate v. Commissioner, T.C.M. 1978-338, aff'd. by unpublished order (4th Cir. 1980).

vii. The negligence penalty has also been imposed on the executor of an estate who appropriated estate funds and failed to report the amount of the funds on his or her tax return. Moncie Rasmus, Jr. v. Commissioner, T.C.M. 1984-8.

h. Practice Pointers to Avoid or Minimize Liability for the Negligence Penalty

i. A taxpayer with complex tax matters who is not trained in federal tax law would do well to consult with an experienced tax practitioner concerning his or her tax reporting and payment obligations and to arrange for the timely preparation of any required returns.

ii. A taxpayer, however, should not rely solely on his or her tax advisor or C.P.A. to file timely and accurate returns. A taxpayer should monitor all deadlines and make sure that they are met.

iii. A taxpayer should never guess at the proper tax treatment for an item. He or she should do what is necessary to investigate the proper tax treatment including research into applicable tax law. If substantial doubt still exists concerning the proper tax treatment of an item, consideration should be given to making disclosure of the relevant facts and circumstances and/or the legal issue involved on the tax return itself. Disclosure of the facts involving a disputed transaction on a tax return has been held sufficient to avoid the negligence

penalty. E.g. Pullman, Inc. v. Commissioner, 8 T.C. 292, 299 (1947), acq. 1947-1 CB 3; Sanders v. Commissioner, T.C. Memo 1986-26, appeal pending (9th Cir.).

iv. Although reliance on a lawyer or accountant will not, in and of itself, avoid the negligence penalty if a mistake is made that results in an underpayment, good faith reliance on a competent tax professional who is furnished with all the relevant facts will usually be sufficient to avoid the penalty. E.g. Kappel v. United States, 369 F.Supp. 267 (D.C. Pa. 1974); Gorton v. Commissioner, T.C. Memo 1985-45.

2. Returns Due Prior to December 31, 1986

a. Prior to the changes made in the negligence penalty by the 1986 Act, the negligence penalty under Section 6653(a) applied only to certain taxes (income, gift and windfall profit tax) and was not imposed with respect to any underpayment on which the fraud penalty was imposed.

b. Under the former provisions of Section 6653(a), the penalty could not be imposed on underpayments of federal estate tax.

c. For taxes due prior to 1982, the second tier time sensitive negligence penalty under Section 6653(a)(2) does not apply.

F. Fraud Penalty [I.R.C. §6653(b)]

1. Returns Due After December 31, 1986

a. General Rule. If any part of an underpayment of tax required to be shown on a return is due to fraud, a fraud penalty equal to the sum of -

i. 75% of the portion of the underpayment which is attributable to fraud, and

ii. an amount equal to 50% of the interest payable under Section 6601 with respect to such portion for the period beginning on the last date prescribed by law for payment of the underpayment (determined without regard to any extensions) and ending on the earlier of the date of the assessment or the date of payment.

b. This two-tier fraud penalty applies to any tax required to be shown on a return including income, estate and gift taxes.

c. Underpayment Defined

i. In the case of income, estate and gift taxes, an "underpayment" means a deficiency as defined by Section 6211.<sup>6/</sup> However, if the tax return was not filed timely, the "underpayment" for purposes of Section 6653(b) includes the amount of tax shown to be due on the return. Section 6653(c)(1).

ii. In the case of any other taxes, "underpayment" means the excess of (i) the sum of the amount of tax shown on a return (if the return was filed timely) plus any amount not shown on the return that was paid in respect of the tax over (ii) the amount of any rebates made. Section 6653(c)(2).

d. Relationship to Other Penalties

i. The negligence and fraud penalties cannot be imposed on the same portion of an underpayment. Section 6653(a)(2). However, both the negligence and fraud penalties can be imposed on different portions of the same underpayment.

ii. The fraud penalty can be and often is imposed in combination with one or more of the other penalties in the Code that apply to a particular action or failure to act including the substantial understatement penalty of Section 6661, and the valuation overstatement penalty of Section 6659. However, if a fraud penalty is assessed, none of the delinquency penalties under Section 6651 can be assessed with respect to that portion of the underpayment attributable to fraud. Section 6653(d).

e. Procedure for Contesting and Assessing the Fraud Penalty

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<sup>6/</sup> Section 6211(a) defines "deficiency" to mean the amount of tax imposed by the applicable Code section minus the excess of the sum of the amount shown as tax on a taxpayer's return plus amounts previously assessed and/or collected over the amount of any rebates made.

i. The fraud penalty is payable upon notice and demand and is assessed, collected and paid in the same manner as taxes. Section 6662(a).

ii. For income, estate and gift tax disputes, a taxpayer will normally have the choice of either (i) paying the tax deficiency and penalties proposed by the Internal Revenue Service, filing a claim for refund, and then filing suit in either a federal district court or the United States Claims Court, or (ii) filing suit in the United States Tax Court without paying the disputed tax and penalty first.

iii. Burden of proof. The Internal Revenue Service has the burden of proving, by clear and convincing evidence, that at least some portion of the underpayment is attributable to fraud.

a. If the Service meets its burden of proof and establishes that any portion of the underpayment is due to fraud, the entire underpayment is treated as attributable to fraud except with respect to any portion of the underpayment which the taxpayer establishes is not attributable to fraud. Section 6653(b)(2).

b. These new burden of proof rules which were promulgated as part of the 1986 Act will make a determination of fraud in a civil tax case quite complex particularly if fraud is proposed and a number of the adjustments are arguably not fraudulent and/or negligent.

f. Innocent Spouse Rule. In the case of a joint return, no fraud penalty can be imposed with respect to a spouse unless some part of the underpayment is due to the fraud of such spouse. See also, Section 6013(e).

g. Examples of the Fraud Penalty in Operation

i. Even where a taxpayer's conduct was fraudulent, the penalty does not apply if the Service fails to prove that there was an underpayment of tax. E.g. Derksen v. Commissioner, T.C. Memo 1985-470.

ii. The fraud penalty may be assessed and can be collected against the estate of a deceased taxpayer. Kirk v. Commissioner, 179 F.2d 619

(1st Cir. 1950) aff'g. 11 T.C. 1095; Estate of Lee v. Commissioner, T.C. Memo 1953-262, aff'd. 227 F.2d 181 (5th Cir. 1955); Rev. Rul. 73-293, 1973-2 C.B. 413, supsd'g. GCM 22326, 1940-2 C.B. 159; Estate of Reimer v. Commissioner, 12 T.C. 913, aff d. per curiam 180 F.2d 159 (6th Cir. 1950).

iii. The fraud penalty has been imposed on an estate even though the taxpayer died before the return was filed and the return was signed by the widow and executor without knowledge of the fraud where the taxpayer's Past conduct caused the understatement. Kahr Estate v. Commissioner, 414 F.2d 621 (2d Cir. 1969), rev'g. on this point 48 T.C. 929 (1967), non-acq. 1972-2 CB 3.

iv. In Estate of Samuel I. Newhouse v. Commissioner, Docket No. 23588-83 (U.S. Tax Court), the Internal Revenue Service issued a notice of deficiency which claimed that the estate underpaid its estate tax by 609.5 million dollars. In addition, the Service took an extremely aggressive position by asserting the 50% fraud penalty under prior §6653(b) on the deficiency in a case where the principal issues involved the valuation of assets and where the valuation was supported by an independent appraisal and the return was prepared by certified public accountant under the guidance of expert tax counsel.<sup>2/</sup>

h. Practice Pointers for the Taxpayer Facing a Fraud Penalty

i. A taxpayer should gather all relevant information and documents and arrange for witnesses who can assist him or her in defending against the penalty. Information concerning the taxpayer's background and tax compliance history, if helpful, should be developed.

ii. A taxpayer should consider trying to negotiate a resolution of a fraud issue with the Internal Revenue Service at the administrative

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<sup>2/</sup> The fraud penalty issue was dropped during the pendency of the case by agreement of the parties.

level if possible. In doing so, the taxpayer should keep in mind that the government has the burden of proving fraud by clear and convincing evidence and that this burden is taken seriously by the courts.

iii. Under the terms of the Internal Revenue Manual, a fraud penalty can be negotiated that is less than the maximum percentage specified in Section 6653(b).

## 2. Returns Due Prior to January 1, 1987

a. The fraud penalty in effect for returns due prior to January 1, 1987 is 50% of the entire underpayment even if only a part of the underpayment is due to fraud.

b. If the fraud penalty is imposed, the negligence penalty may not be imposed, [1954 Code, Section 6653(b)(3)].

c. Commencing with taxes payable after September 3, 1982, there is an additional "time sensitive" fraud penalty equal to 50% of the interest payable with respect to the amount of the underpayment attributable to fraud [1954 Code, Section 6653(b)(2)].

## G. Failure by an Individual to Pay Estimated Income Tax [I.R.C. §6654]

1. General Rule. If an individual underpays estimated income tax, a penalty will be imposed. Section 6654(a).

B. Computation of the Penalty. The amount of the penalty is determined by applying the underpayment rate under Section 6621 to the amount of the underpayment for the period of the underpayment. Id.

a. The amount of the underpayment is the excess of the required installment over the amount, if any, of the installment paid on or before the due date of the installment. Section 6654(b)(1).

b. The period of the underpayment runs from the due date of the installment to the earlier of the 15th day of the 4th month following the close of the taxable year or the date the underpayment is paid. Section 6654(b)(2).

c. Four estimated tax installments are required for each taxable year. The due dates of the installments are April 15, June 15, September 15, and January 15 of the following year. Section 6654(c)(1) and (2). But see, Section 6654(h) which sets forth a special rule affecting the fourth required installment where the taxpayer files his income tax return on or before January 31.

d. The amount of the required installment is 25% of the required annual payment. Section 6654 (d)(1)(A).

e. "Required annual payment" means the lesser of -

i. 90% of the tax shown on the return for the taxable year (80% for taxable years beginning prior to January 1, 1987), or

ii. 100% of the tax shown on the return of the individual for the preceding taxable year [Section 6654(d)(B)].

f. See Section 6654 for other rules affecting the computation of the penalty.

3. Exceptions. The penalty will not apply or may be waived under the following circumstances:

a. No penalty will be imposed where the tax shown on the return reduced by the credit allowable under Section 31 is less than \$500 [Section 6654(e)(1)].

b. No penalty will be imposed for any taxable year if the preceding taxable year was a full taxable year, the individual did not have any liability for tax for the preceding taxable year, and the individual was a citizen or resident of the United States throughout the preceding taxable year [Section 6654(e)(2)].

c. The penalty will be waived -

i. if and to the extent that the IRS determines that, because of casualty, disaster or other unusual circumstances, the imposition of the penalty "would be against equity and good conscience" [Section 6654(e)(3)(A)];

ii. if the IRS determines that the taxpayer retired or became disabled in the taxable year for which estimated payments were required or in the preceding taxable year and the underpayment was due to reasonable cause and not to willful neglect [Section 6654(e) (3)(B)].

4. Application of the Penalty to Fiduciaries. As a result of the 1986 Act, a trust and any estate (with respect to any taxable year ending two or more years after the date of the decedent's death) must make estimated income tax payments and, if estimated tax is underpaid, may incur liability for the Section 6654 penalty [Section 6654(1)]. This new rule applies for taxable years beginning after December 31, 1986. 1986 Act, §1404(d).

H. Penalty for Valuation Overstatements for Purposes of Income Tax [I.R.C. §6659]

1. General Rule. If an individual (or a closely held corporation or personal service corporation) has an underpayment of income tax for the taxable year which is attributable to a valuation overstatement, a valuation overstatement penalty will be applied. [Section 6659(a)].

2. Effective Dates. This penalty was introduced into the Code by the Economic Recovery Tax Act of 1981 ("ERTA"), Pub. L. 97-34 and applies to returns filed after December 31, 1981." The penalty was amended by the Tax Reform Act of 1984 ("1984 Act") effective for returns filed after December 31, 1984.

3. Computation of the Penalty. The amount of the penalty is determined with reference to the following table:

<u>If the valuation claimed is the following percent of the correct valuation</u>	<u>the applicable percentage is</u>
150% - 200%	10%
201% - 250%	20%
More than 250%	30%

The applicable percentage is multiplied by the amount of the underpayment attributable to the valuation overstatement to arrive at the amount of the penalty. [Section 6659(a), (b)].



4. Definition of Valuation Overstatement. For purposes of Section 6659, there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return is 150% or more of the amount determined to be the correct amount of the valuation or adjusted basis. [Section 6659(c)].

5. Special Rules Relating to the Application of the Penalty

a. Section 6659 does not apply if the underpayment attributable to the valuation overstatement is less than \$1,000 for the taxable year. [Section 6659(d)].

b. All or a part of the penalty may be waived on a showing that there was a reasonable basis for the valuation or adjusted basis claimed on the return and that the claim was made in good faith. [Section 6659(e)].

c. For returns filed before 1985, the penalty applies only if the property was held for five years or less. [Section 6659(c)(2)].

6. Special Rules for Overstatement of a Charitable Deduction

a. If charitable deduction property is involved, the applicable percentage is 30%. [Section 6659(f)(1)].

b. The authority to waive is limited to cases where the claimed value of the property was based on a qualified appraisal made by a qualified appraiser and the taxpayer made a good faith investigation of the value of the contributed property. [Section 6659(f)(2)]. See, Section 6659(f)(3) for definitions of "charitable deduction property", "qualified appraiser", and "qualified appraisal".

7. Examples of the Application of the Penalty

a. The Section 6659 penalty may apply where a beneficiary of an estate adopts the overstatement valuation of an asset shown on the estate tax return as the beneficiary's adjusted basis under Section 1014. Rev. Rul. 85-75, 1985-1 C.B.376.

b. The penalty has been applied most often in tax shelter cases. E.g. Chester v. Commissioner, T.C. Memo 1986-355; Dubin v. Commissioner, T.C. Memo 1986-433.

I. Penalty for Valuation Understatements in Estate and Gift Tax Matters [I.R.C. §6660]

1. General Rule. If there is an underpayment of estate or gift taxes attributable to a valuation understatement, a valuation understatement penalty will be applied [Section 6660(a)].

2. Effective Date. This penalty was introduced into the Code by the Revenue Act of 1984, Pub. L. 98-369 ("1984 Act") and applies to returns filed after December 3, 1984.

3. Computation of the Penalty. The amount of the penalty is determined with reference to the following table:

<u>If the valuation claimed is the following percent of the correct valuation</u>	<u>The applicable percentage is</u>
50% or more but not more than 66 2/3%	10%
40% or more but not more than 50%	20%
Less than 40%	30%

The applicable percentage is multiplied by the amount of the underpayment attributable to the valuation understatement to arrive at the amount of the penalty [Section 6660 (a),(b)].

4. Definition of Valuation Understatement. There is a valuation understatement if the value of any property claimed on an estate or gift tax return is less than 66 2/3% or less of the amount determined to be the correct valuation [Section 6660(c)].

5. Definition of Underpayment. The term "underpayment" has the same meaning as "underpayment" defined in Section 6653(c)(1) [Section 6660(f)].

6. Special Rules Relating to the Application of the Penalty

a. Section 6660 does not apply if the underpayment is less than \$1,000 for any taxable

period (if gift tax) or for an estate (of estate tax) [Section 6660(d)].

b. All or a part of the penalty may be waived on a showing that there was a reasonable basis for the valuation claimed on the return and that the claim was made in good faith [Section 6660(e)].

J. Penalty for Substantial Understatement of Income Tax Liability [I.R.C. §6661].

1. General Rule. If there is a substantial understatement of income tax liability, a penalty will be imposed [Section 6661(a)].

2. Effective Date. This penalty was added to the Code by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. 97-248, H.R. 4961, 97th Cong., 2d Sess., §323(a). It is effective for returns due after December 31, 1982.

3. Computation of the Penalty. The penalty is determined by taking the applicable statutory percentage and multiplying it by the amount of any underpayment attributable to the understatement. The applicable statutory percentages are as follows:

<u>For returns due</u>	<u>Applicable Percentage</u>
After 12/31/82 and before 1/1/87	10%
After 12/31/86	25% <sup>a/</sup>

4. Definitions. For purposes of Section 6661, the following definitions apply:

a. "Understatement" means the excess of -

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<sup>a/</sup> The statutory percentage was increased by the 1986 Act to 20% [1986 Act, §§1504(a) and (b)] and by the Omnibus Deficit Reduction Act of 1986, Pub.L. 99-509, 99th Cong., 2d Sess., §8002, to 25%. Although there may be a legal issue as to which percentage actually applies because of the order in which these acts were signed into law, the Internal Revenue Service has taken the position that 25% is the applicable rate for returns due after December 31, 1986. [IRB 86-149 (Nov. 6, 1986)].

i. the amount of the tax required to be shown on the return for the taxable year, over

ii. the amount of the tax imposed which is shown on the return, reduced by any rebate under Section 6211(b)(2). [Section 6661(b)(2)(A)].

The amount of the understatement for purposes of Section 6661 is reduced by that portion of the understatement which is attributable to the tax treatment of (i) any item for which there is or was "substantial authority" for the treatment or (ii) any item with respect to which there has been adequate disclosure on the return or in a statement attached to the return. [Section 6661(b)(2)(B)]. Special rules, however, apply to tax shelters. [Section 6661(b)(2)(C)].

b. "Substantial understatement" means an understatement of income tax liability for a tax year which exceeds the greater of -

i. 10% of the tax required to be shown on the return, or

ii. \$5,000 (\$10,000 in the case of a corporation other than an S corporation or personal holding company). [Section 6661(1)(A) and (B)].

##### 5. Waiver of the Penalty

a. This penalty is a strict liability penalty. It does not matter that the taxpayer was not negligent or fraudulent in understating his or her income tax liability.

b. Although fault is not required, the IRS may waive all or any part of the penalty on a showing by the taxpayer that there was reasonable cause for all or part of the understatement and the taxpayer acted in good faith. [Section 6661(c); Treas. Reg. §1.6661-6(a)].

c. In seeking a reasonable cause waiver, the most important factor in all cases other than those where disclosure has been made will be the extent of the taxpayer's effort to assess the taxpayer's proper tax liability under the law. Treas. Reg. §1.6661-6(b).

i. Reliance on a position contained in a proposed regulation will ordinarily constitute reasonable cause and good faith. Id.

ii. An honest misunderstanding of fact or law that is reasonable in light of the experience, education and knowledge of the taxpayer may also qualify.

iii. Other situations that may qualify for waiver of the penalty include:

a. a computational or transcriptional error (Id.);

b. reliance on an information return, professional advice, or other facts not known by the taxpayer to be erroneous if, under all the circumstances, the reliance was reasonable and the taxpayer acted in good faith (Id.).

iv. In the case of an understatement that is related to an item on the return of a pass-through entity (i.e., a Partnership, S corporation, estate, trust, regulated investment company, or a real estate investment trust), the good faith or lack of good faith of the entity generally will be imputed to the taxpayer in considering a reasonable cause waiver. [Treas. Reg. §1.6661-6(b)]. The imputation of good faith can be refuted, however. Id.

d. If a taxpayer shows an additional amount of tax or makes adequate disclosure of an item in the manner prescribed by Treas. Reg. §1.6661-4 on a qualified amended return, the IRS will waive any penalty that would not have been imposed if the tax was shown, or the disclosure made, on the original return. Treas. Reg. §1.6661-6(c).

i. A "qualified amended return" is an amended tax return or a timely request for administrative adjustment under Section 6227 which is filed after the due date of the return and before the earlier of -

a. the time the taxpayer is first contacted by the Internal Revenue Service concerning the examination of the return, or

b. the time any person described in Section 6700(a) (relating to the penalty for promoting abusive tax shelters) is first contacted by the Internal Revenue Service concerning an examination of an activity described in Section 6700(a) with respect to which the taxpayer claimed any tax benefit on the return. Treas. Reg. §1.6661-6(c)(2).

ii. If an item attributable to a pass-through entity is involved, any additional tax shown or disclosure made with respect to the item will not be considered as a timely disclosure sufficient to avoid the penalty unless the qualified amended return is filed by the taxpayer before the pass-through entity is contacted by the Internal Revenue Service. Treas. Reg. §1.6661-6(c)(3).

iii. The Commissioner, by revenue procedure, may prescribe the manner in which the automatic waiver provision may apply to particular classes of taxpayers. Treas. Reg. §1.6661-6(c)(4). See, Rev. Proc. 86-22, IRB 1986-19, p.9 (1986 returns); Rev. Proc. 85-19, 1985-1 CB 520 (1985 returns); Rev. Proc. 84-19, 1984-1 CB 433 (1984 returns); Rev. Proc. 83-21, 1983-1 CB 680 (1983 returns); Rev. Proc. 85-26, 1985-1 CB 580 [special procedure provided for taxpayers subject to Coordinated Examination Program (CEP)].

e. Neither Section 6661 nor the applicable regulations specify how or when a request to waive the Section 6661 penalty is to be made. However, the same type of procedure as that applicable to the delinquency penalties under Section 6651 will probably suffice. In addition, a claim of waiver can be made as part of a protest filed to contest the proposed imposition of the penalty and other adjustments.

6. Meaning of "Substantial Authority". If there is substantial authority for the treatment of an item, the item will be treated as if it were shown correctly on the return and any tax understatement attributable to the item will not be treated as part of the understatement considered in determining the applicability and amount of of the penalty. Treas. Reg. §1.6661-3(a)(1).

a. Substantial authority for a position exists if an analysis supporting the position takes into account the relevant facts and circumstances and

relevant authority and concludes that the weight of authority supporting the position is substantial compared to contrary authority. Treas. Reg. §1.6661-3(b)(1).

b. All authorities, favorable and unfavorable, must be considered in making a substantial authority analysis. Id.

c. The regulations acknowledge that there may be substantial authority for more than one position with respect to the same item. Id.

d. The "substantial authority" standard is less stringent than a "more likely than not" standard (i.e., a greater than 50% chance of prevailing in litigation) but is more stringent than a "reasonable basis" standard (i.e., the standard applicable to Section 6653). Treas. Reg. 1.6661-3 (a)(2). As a result, an arguable position that passes the "straight face test" will not necessarily pass muster under the "substantial authority" standard although it probably would if a "reasonable basis" standard applied.

e. In determining if there is substantial authority for a position, the regulations provide that only the following will be considered "authority":

- i. the Internal Revenue Code and other statutory provisions;
- ii. temporary and final regulations;
- iii. court cases;
- iv. administrative pronouncements including revenue rulings and revenue procedures;
- v. tax treaties and related regulations;
- vi. official explanations of tax treaties;
- vii. Congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, floor statements made prior to enactment by one of a bill's managers. Treas. Reg. §1.6661-3(b)(2).

f. The following will not be considered authority for purpose of Section 6661:

- i. treatises;
- ii. legal periodicals;
- iii. legal opinions;
- iv. opinions of other tax professionals;
- v. description of statutes prepared after enactment;
- vi. general counsel memoranda (except those published in pre-1955 C.8. volumes);
- vii. actions on decisions;
- viii. technical memoranda;
- ix. written determinations.

Treas. Reg. §1.6661-3(b)(2).

However, authorities underlying the above may give rise to "substantial authority".

7. Special Rules with respect to Tax Shelters. For items not attributable to tax shelters, the penalty under Section 6661 may be avoided or reduced by that portion of an understatement attributable to the tax treatment of an item if there is or was substantial authority for the treatment or the facts affecting the item's tax treatment are adequately disclosed on the return. However, with respect to an item attributable to tax shelters, the following rules apply:

a. In order to avoid the penalty with respect to a tax shelter item, a taxpayer must -

- i. have substantial authority for the tax treatment of the item;
- ii. have reasonably believed that the tax treatment of the tax shelter item was more likely than not the proper treatment. Section 6661(b)(2)(C).

b. Disclosure of the relevant facts on a tax return with respect to a tax shelter item will not



avoid the penalty if there is no substantial authority and the requirements of Section 6661(b)(2)(C) are not otherwise met.

c. For purposes of Section 6661, "tax shelter" means -

- i. a partnership or other entity;
- ii. any investment plan or arrangement;
- iii. any other plan or arrangement;

if the principal purpose of the partnership entity, plan or arrangement is the avoidance or evasion of federal income tax. Id.

#### 8. Relationship to Other Penalties.

a. The substantial understatement penalty is often proposed in tandem with other penalties such as the negligence penalty.

b. However, any part of an understatement attributable to a valuation overstatement on which the penalty under Section 6659 is imposed is not included in calculating the penalty under Section 6661.

#### 9. Procedures for Imposing and Contesting the Penalty

a. The substantial understatement penalty is assessed, collected and paid in the same manner as income tax. [Section 6662(a)].

b. As a result, the penalty may not be assessed until the deficiency procedures are followed unless the taxpayer consents to assessment.

#### 10. Practice Pointers to Avoid or Minimize Liability for the Penalty.

a. The substantial understatement penalty can result in a significant increase in a taxpayer's liability if it applies. Consequently, a taxpayer (and/or his representative) should review the tax treatment of items of an income tax return to determine if the tax treatment of any of the items is likely to be disputed in the event of an audit.

b. If a dispute would be likely in the event of an audit, consideration should be given to documenting that substantial authority exists and/or disclosing the relevant facts bearing upon the tax treatment of the item on the tax return in accordance with the applicable regulations.

c. If a penalty under Section 6661 is proposed, a review should be made of the facts to determine if a waiver of the penalty should be sought.

d. Settlement negotiations should also include a discussion of the penalty. Sometimes, the penalty can be negotiated out as part of the settlement.

K. Penalty for Aiding and Abetting the Understatement of Tax Liability [I.R.C §6701]

1. General Rule. Any person who -

a. aids or assists in, procures or advises with respect to the preparation or presentation of any portion of a return, affidavit, claim or other document in connection with any matter arising under the Internal Revenue laws,

b. knows that such portion will be used in connection with any material matter arising under the tax laws, and

c. knows that such portion (if so used) will result in an understatement of the liability for tax of another person,

shall be liable for a penalty with respect to each such document.

2. Effective Date. This penalty was added to the Code by TEFRA, Pub. L. 97-248, H.R. 4961, 97th Cong., 2d Sess., §324(a). The penalty took effect on September 4, 1982, the day after the date of enactment.

3. Amount of the Penalty. The amount of the penalty is \$1,000 except that, if the document in question relates to the tax liability of a corporation, the penalty is \$10,000. Section 6701(b)(1) and (2).

Note: Only one penalty will be applied with respect to a particular taxpayer for any taxable period. Section 6701 (b)(3).

4. Special Rules Bearing Upon the Application of the Penalty.

- a. The term "procures" includes -
  - i. ordering or causing a subordinate to act;
  - ii. knowing of, and not attempting to prevent, a subordinate from acting in a manner invoking the penalty. Section 6701(c)(1).

For purposes of Section 6701, "subordinate" means any other person over whose activities the person has direction, supervision or control. Section 6701(c)(2).

- b. It is not necessary that the taxpayer have knowledge of the understatement or consent to the preparation or presentation of the document in question for the penalty to apply. Section 6701(d).

5. Procedures for Contesting and Assessing the Penalty

- a. This penalty is an assessable penalty which may be imposed on a person other than the taxpayer.
- b. It is payable upon notice and demand and is assessed and collected in the same manner as tax. Section 6671(a)(1).
- c. The deficiency procedures do not apply to this penalty. [Section 6703(b)]. However, once an assessment of the penalty is made and notice and demand for payment of the penalty is mailed, a person may pay not less than 15% of the penalty, file a claim for refund, and insure that he or she can litigate the penalty issues before the entire penalty amount has to be paid. Section 6703(c)(1).
  - i. Within 30 days after the day on which the claim for refund is denied (or if earlier within 30 days after the expiration of 6 months after the date the claim was filed), the person must file a refund suit to contest the penalty or the balance of the penalty can be collected. Section 6703(c)(2).
  - ii. The running of the applicable statute of limitations on collection as provided in Section 6502 is suspended during the period that the IRS

is prohibited by Section 6703 from collecting the penalty.

d. In any proceeding involving the issue of whether a person is liable for the penalty under Section 6701, the IRS has the burden of proof. Section 6703(a).

#### 6. Relationship to Other Penalties

a. As a general rule, the penalty under Section 6701 may be imposed in addition to any other penalty provided by law. Section 6701(f)(1).

b. If, however, a penalty is assessed under Section 6701 with respect to a document, no preparer penalty may be assessed under Section 6694(a) or (b) with respect to the same document. Section 6701(f)(2).

#### 7. Practice Pointers

a. Unlike many of the penalties discussed previously, this penalty is imposed on a person other than the taxpayer who acts with respect to a taxpayer's liability in a way that results in an understatement of liability.

b. The penalty can apply with respect to all taxes including, but not limited to, income, estate and gift taxes.

c. This penalty provision will not be used often since the Service has the burden of proof and since the Service must show that the person subject to the penalty knew that the document in question would result in an understatement of tax liability of another person. However, the provision will be used as the parallel civil sanction where a criminal prosecution under Section 7206(2) is brought or in any situation where there is proof of willful and knowing action by a person which impacts negatively on a taxpayer's tax liability.

d. Under no circumstances should any C.P.A., attorney, or other professional person submit any document to the Service that is false or misleading.

#### L. Penalties for Failure to File Information Returns [I.R.C §§6721-6724]

1. Introduction

a. A person may be obligated to file or to furnish information returns or payee statements in certain circumstances. See, Sections 6031-6039E, 6041-6050N.

b. Failure to comply with the statutory requirement of filing or furnishing an information return or payee statement will result in the imposition of special penalties under Sections 6721-6724 of the Code.

2. General Rule - Failure to File Information Returns. Any person who fails to file an information return on the due date (including extension) will be liable for a \$50 penalty for each failure to a maximum of \$100,000 for any calendar year. Section 6721(a).

a. The penalty increases to the amounts specified in Section 6721(b) if the failure is due to intentional disregard of the filing requirements.

b. "Information Return" is defined in Section 6724(d)(1).

c. This section was added by Section 1501(a) of the 1986 Act and is effective with respect to returns due after December 31, 1986.

3. General Rule - Failure to Furnish Payee Statements. Any person who fails to furnish a payee statement on the due date will be liable for a \$50 penalty for each failure to a maximum of \$100,000 for any calendar year. Section 6722(a).

a. Failure to furnish the notice to a partnership of the exchange of a partnership interest as required by Section 6050K(c)(1) is covered by Section 6722(b).

b. Failure to provide the beneficiary statements required by Section 6034A is subject to this penalty. Section 6024(d)(2)(B); Section 6722(a).

c. "Payee Statement" is defined in Section 6724(d)(2).

d. This section was added by Section 1501(a) of the 1986 Act and is effective with respect to returns due after December 31, 1986.

4. General Rule - Failure to Include Correct Information. If a person files an information return or furnishes a payee statement and does not include all information required to be shown or includes incorrect information, the person is liable for a penalty of \$5 per return or statement to a maximum of \$20,000 for any calendar year. Section 6723(a).

a. If the failure is due to intentional disregard of the reporting requirement, the penalty increases in amount as specified in Section 6723(b).

b. No penalty may be imposed under Section 6723 if a penalty for failure to supply an identifying number under Section 6676 is imposed with respect to the return or statement.

5. Special Rules Applicable to the Penalties Authorized by Sections 6721-6723

a. The penalties may be excused if the failure to comply with the reporting requirements is due to reasonable cause and not to willful neglect. Section 6724(a).

Note: A higher standard for a waiver of the penalties applies if interest or dividend returns or statements are involved. Section 6724(c)(1). In addition, the limitations on the amount of the penalties are removed and tougher procedural rules apply. Section 6724(c)(2)-(4).

b. Penalties under Section 6721-6723 are payable on notice and demand and in the same manner as tax. Section 6724(b).

M. The Interest Rules Applicable to Penalties

1. Introduction

a. Over the last several years, the rules with respect to interest due on tax deficiencies have changed considerably.

b. Prior to 1983, interest on tax deficiencies and overpayments was simple interest.

i. The rate, which was constant until July 1, 1975, fluctuated in accordance with a formula provided by statute from July 1, 1975.

ii. The rates of interest for periods prior to January 1, 1983 were as follows:

<u>Period</u>	<u>Simple Interest Rate</u>
Prior to July 1, 1975	6%
July 1, 1975 to January 31, 1976	9%
February 1, 1976 to January 31, 1978	7%
February 1, 1978 to January 31, 1980	6%
February 1, 1980 to January 31, 1982	12%
February 1, 1982 to December 31, 1982	20%

c. Commencing January 1, 1983, interest on tax deficiencies and overpayments is compounded daily. Section 6622(a).

i. As a result, interest is charged on interest accrued on or after December 31, 1982.

ii. This raises the effective rate of interest over the adjusted prime rate.

d. Commencing January 1, 1983 and continuing to December 31, 1986, the applicable interest rate was adjusted twice a year - on January 1 and July 1 of each year. 1954 Code, Section 6621(b)(1).

i. The rates of interest for periods beginning after December 31, 1982 through December 31, 1986 were as follows:

<u>Period</u>	<u>Interest Rate Compounded Daily</u>
January 1 to June 30, 1983	16%
July 1 to December 31, 1983	11%
January 1 to December 31, 1984	11%
January 1 to June 30, 1985	13%
July 1 to December 31, 1985	11%
January 1 to June 30, 1986	10%
July 1 to December 31, 1986	9%

e. As a result of the 1986 Act, the interest provisions have changed yet again. Effective January 1, 1987,

i. the interest rates change each calendar quarter, Section 6621(b)(1);

ii. the interest rates are pegged to the short-term federal rate, Section 6621(a)(1) and (2).

f. The net result of the changes summarized above is that the interest "cost" of a tax deficiency can be substantial. Interest is charged at market rates and, because of daily compounding, interest is charged on interest.

## 2. The Interest Rules Applicable to Penalties

Effective for interest accrued after July 18, 1984 except with respect to penalties for which notice and demand is made after that date, the following rules apply:

a. With respect to all penalties except those imposed under Sections 6651(a)(1), 6659, 6660, and 6661, interest will run on the penalty only if the penalty is not paid within 10 days of the notice and demand for payment. In such case, interest is imposed from the date of the notice and demand to the date of payment. [Section 6601(e)(2)(A)].

b. Interest on penalties imposed under Section 6651(a)(1), 6659, 6660, and 6661 is imposed from the date on which the return (with respect to which the penalty is imposed) is required to be filed (including extensions) to the date of payment of the penalty. [Section 6601(e)(2)(B)].

c. If a penalty is paid within 10 days after the date of the notice and demand for payment, interest will not be charged for the period after the date of the notice and demand. [Section 6601 (e)(3)].

### III. The Preparer Penalties

#### A. Introduction

1. The preparer penalties, which are codified as Sections 6694-6696 of the Internal Revenue Code, were originally added to the Code by the Tax Reform Act of 1976 and applied to documents prepared after December 31, 1976.

2. Since the effective date of the preparer penalties, the penalties have been increasingly asserted by the Service against preparers. Although the amount of



the penalties are relatively small (\$100 negligence; \$500 - willfulness), the assessment of a penalty against a preparer will result in a referral of the preparer to the Director of Practice and the possible imposition of disciplinary sanctions under Circular 230.

B. Negligent or Intentional Disregard of Rules and Regulations [I.R.C. §6694(a)]

1. General Rule. If any part of any understatement of tax liability on a return or claim for refund is due to the negligent or intentional disregard of rules and regulations by an income tax return preparer, the preparer must pay a penalty of \$100 [section 6694(a)].

2. An "income tax return preparer" is any person who prepares for compensation or who employs one or more persons to prepare for compensation any income tax return or claim for refund of income tax [Section 7701(a)(36)(A)].

a. The preparation of a substantial portion of a return or claim for refund is treated as if it were the preparation of a return or claim. Id.

b. A person is not deemed to be an income tax preparer merely because the person --

i. furnishes typing, reproducing or mechanical assistance,

ii. prepares a return or claim for refund of an employer (or officer or employee of the employer) who regularly and continuously employs him;

iii. prepares a return or claim for refund for any person as a fiduciary;

iv. prepares a claim for refund for a taxpayer in response to any notice of deficiency, or any waiver of restriction after commencement of an audit [Section 7701(a)(36)(B)].

3. For purposes of Section 6694(a), "understatement of liability" means any understatement of the net income tax payable or any understatement of the net amount creditable or refundable. [Section 6694(e)].

a. Except as provided in Section 6694(d) the determination of whether there is an understatement

is made without regard to any administrative or judicial action involving the taxpayer.

b. If, however, there is a final administrative determination or a final judicial decision that there was no understatement of liability on a return or claim with respect to which a penalty was assessed, Section 6694(d) requires that the penalty in question shall be abated and/or refunded if already paid.

#### 4. Contesting the Penalty

a. If a preparer pays an amount not less than 15% of the amount of the penalty within 30 days after the date on which notice and demand for the penalty is made and files a claim for refund of the amount made, collection of the remainder of the penalty is stayed and/or may be enjoined. [Section 6694(c)(1)].

b. The running of the period of limitations on collection under Section 6502 is suspended for the period during which collection is prohibited under Section 6694(c)(1). [Section 6694(c)(3)].

c. The preparer must bring suit in the appropriate United States district court to contest his liability for the penalty within 30 days after the day on which his claim is denied or, if earlier, within 30 days after the expiration of six months after the date of filing the claim. If he does not, the stay on collection is lifted. [Section 6694(c)(2)].

#### C. Willful Understatement of Liability [I.R.C. §6694(b)]

1. General Rule. If any part of any understatement of tax liability on a return or claim for refund is due to a willful attempt in any manner to understate a taxpayer's income tax liability by an income tax return preparer, the preparer must pay a penalty of \$500 [Section 6694(b)].

2. The same provisions for determining if there has been an understatement and for contesting the penalty applicable to the negligence penalty apply to the willfulness penalty.

#### D. Other Assessable Preparer Penalties

1. A preparer may also be assessed the following penalties:

a. A penalty of \$25 for failure to furnish a copy of a tax return or refund claim to a taxpayer as required by Section 6107(a).

b. A penalty of \$25 for failing to advise a taxpayer of the substantiation requirements of Section 274(d), obtain written confirmation from the taxpayer that the requirements were met and sign the return or claim<sup>2/</sup> [Section 6695(b)];

c. A penalty of \$25 for failing to furnish his or her identity number as required by Section 6109(a)(4)<sup>10/</sup> [Section 6695(c)];

d. A penalty of \$50 for failing to retain a copy of a return or claim or a list of such returns or claims as required by Section 6107(b)<sup>11/</sup> [Section 6695(d)];

e. A penalty of \$100 per return and \$5 for omitted item in the return for failing to file correct information returns as required by Section 6060<sup>12/</sup> [Section 6659(e)];

f. A penalty of \$500 for endorsing or negotiating a refund check [Section 6659(f)].

#### IV. Penalty Reform - Some Concluding Thoughts

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<sup>2/</sup> This penalty which became effective for tax years beginning after 1984 applies only to those income tax return preparers who are required by regulations to sign the return or claim. [Section 6695(b)]. This penalty may be avoided if reasonable cause is shown.

<sup>10/</sup> This penalty is subject to a reasonable cause defense. [Section 6695(c)].

<sup>11/</sup> This penalty is subject to a reasonable cause defense. It is also subject to a cap of \$25,000 for any return period. [Section 6695(d)].

<sup>12/</sup> This penalty is subject to a reasonable cause defense and a cap of \$20,000 for any return period [Section 6695(e)].