

**Overview of Common Civil Penalties  
Asserted by the IRS**

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## INTRODUCTION

In 1989, Congress enacted legislation substantially revising the civil penalty provisions. The Improved Penalty Administrative Compliance Tax Act ("IMPACT"), Omnibus Budget Reconciliation Act of 1989, P.L.101-239, Title VII, Subtitle G (Dec. 19, 1989), applies to tax years for which the due date of a tax return, without consideration of extensions, is after December 31, 1989.

The IMPACT legislation did not significantly change the failure to file, failure to pay tax and estimated tax penalties, which are the penalties most frequently asserted when delinquent returns are filed. IMPACT, however, revised the negligence and substantial understatement penalties, along with certain other penalties, by providing for a new accuracy-related penalty. IMPACT also created a new penalty for fraudulent failure to file tax returns.

### 1. Failure to File Penalty

The Internal Revenue Code imposes a delinquency penalty for failure to timely file a tax return. IRC § 6651(a)(1). The penalty is equal to 5 percent of the net amount of tax due on the return for each month the return is delinquent, up to a maximum of 25 percent. A minimum penalty equal to the lesser of \$100 or 100 percent of the tax required to be shown on the return will be imposed if the return is not filed within 60 days of the due date. IRC § 6651. The IRS may assess the penalty based upon the tax shown on the return without first issuing a Notice of Deficiency. However, if the IRS asserts the penalty based on an additional deficiency in tax, it must issue a Notice of Deficiency before the penalty may be assessed. IRC § 6665(b)(1).

A taxpayer seeking to avoid the failure to file penalty must establish the existence of reasonable cause and that the failure to file was not due to willful neglect. The primary consideration in determining whether reasonable cause exists for a failure to file a tax return is whether the taxpayer was unable to file the tax return on time notwithstanding the exercise of ordinary business care and prudence. Treas. Reg. § 301.6651-1(c)(1). Willful neglect is defined as a conscious, intentional failure or reckless indifference to the filing requirement. *United States v. Boyle*, 469 U.S. 241, n.3 (1985).

In general, ignorance of the law is not an excuse for failing to timely file a tax return. *Logan Lumber Co. v. United States*, 365 F.2d 846 (5th Cir. 1966). Nor does a taxpayer's reliance upon a professional to file a return constitute reasonable cause. *United States v. Boyle, supra*. However, reliance upon the advice a tax professional on a matter

of law, such as whether a tax liability exists or a return is required to be filed, can constitute reasonable cause. See *La Meres v. Commissioner*, 98 T.C. 24 (1992).

A taxpayer seeking to avoid imposition of the failure to file penalty must submit a written statement under penalties of perjury setting forth specific facts demonstrating the existence of reasonable cause. Treas. Reg. § 301.6651-1(c)(1). The statement should be submitted either to the District Director or to the Service Center where the return was filed.

## 2. Fraudulent Failure to File Return Penalty

Where the IRS determines that a failure to file was due to fraud, the failure to file penalty is increased from 5 percent per month to 15 percent per month, up to a maximum of 75 percent of the tax due. IRC § 6651(f). The IRS has the burden of proving the fraud element of the increased portion of the penalty by clear and convincing evidence.

## 3. Failure to Pay Tax Penalty

The Internal Revenue Code imposes a delinquency penalty for failure to pay tax shown to be due on a return. The failure to pay tax penalty is equal to  $\frac{1}{2}$  of 1 percent of the tax per month, up to a maximum of 25 percent. IRC § 6651(a)(2). For any month in which the failure to file and failure to pay penalties both apply, the amount of the failure to pay penalty reduces the amount of the failure to file penalty. Because the failure to pay tax penalty is based upon the amount of tax shown to be due on the return but not paid, the penalty cannot be imposed if no return is filed or if the IRS prepares a substitute return. Rev. Rul. 76-562, 1976-2 C.B. 430.

The Internal Revenue Code also imposes a delinquency penalty for failure to pay tax on tax required to be shown on a return (deficiency/after audit) which is not paid within 21 days after notice and demand for payment (10 days if the amount is \$100,000 or more). IRC § 6651(A)(3). The penalty is reduced to  $\frac{1}{4}$  percent per month when an installment agreement is in effect.

As with the failure to file penalty, the failure to pay tax penalty may be excused by establishing reasonable cause. The taxpayer must demonstrate that despite the exercise of ordinary business care and prudence he was nevertheless unable to pay the tax when due or would have suffered an undue hardship if the tax was paid on the due date. Treas. Reg. § 301.6651-1(c)(1). Undue hardship is something more than inconvenience to the taxpayer. Undue hardship exists, for example, if payment of the tax when due would have resulted in a substantial financial loss, such as the sale of property at a sacrifice

price. Treas. Reg. §§ 6651-1(c)(1), 1.6161-1(b). The procedure for obtaining relief from the failure to pay tax penalty is identical to that for obtaining relief from the failure to file penalty.

#### 4. Estimated Tax Penalty

If the taxpayer has not made sufficient prepayments of his tax liability, the IRS may assert a penalty for failure to make estimated tax payments. IRC § 6654. The penalty is computed in accordance with a formula that takes into account the amount and timing of estimated tax payments that were required to have been made. IRC § 6654(d). There is no reasonable cause exception to the imposition of the estimated tax penalty. However, the IRS may waive the penalty under certain circumstances if it is determined that by reason of casualty, disaster, or other unusual circumstances imposition of the penalty would be against equity and good conscience. IRC § 6654(e)(3)(A).

#### 5. Failure to Timely Deposit Penalty

IRC Section 6656 imposes a time sensitive failure to deposit penalty. The penalty ranges from 2 percent to 10 percent based on days elapsed after the due date. A 15 percent penalty rate may apply if payment is not made subsequent to notice and demand.

#### 6. Accuracy-Related Penalty

The IMPACT legislation created an accuracy-related penalty designed to replace a number of penalties, including the negligence and substantial understatement of tax penalties. IRC § 6662. The penalty is equal to 20 percent of the portion of the underpayment attributable to negligence or disregard of rules or regulations, or a substantial understatement of tax. IRC § 6662(a).

The accuracy-related penalty only applies where a return is filed with the IRS. Accordingly, the penalty does not apply when the IRS prepares substitute returns. In general, the accuracy-related penalty can be avoided upon a showing of reasonable cause. IRC § 6664(c)(1). The substantial understatement prong of the penalty can also be avoided if there is substantial authority for the taxpayer's position or adequate disclosure. The IRS may impose the accuracy-related penalty in addition to the failure to file penalty, but may not consider the fact that the return was filed late in determining whether to impose the accuracy-related penalty. Treas. Reg. § 1.6662-2(a).

The term “negligence” includes any failure to make a reasonable attempt to comply with the applicable rules and regulations. The term “disregard” includes any careless, reckless or intentional disregard. IRC § 6662(c).

A “substantial understatement” is an understatement of tax exceeding the greater of (i) 10 percent of the tax required to be shown on the return for the tax year, or (ii) \$5,000. (Special rules for corporations.) The term “understatement” refers to the excess of (i) the amount of the tax required to be shown on the return for the tax year, over (ii) the amount of tax which is set forth on the return. The amount of understatement for purposes of § 6662 is reduced by the portion attributable to: (1) the tax treatment of any item if there is or was “substantial authority” for such treatment, or (2) any item if: (a) the relevant facts affecting the item’s tax treatment are adequately disclosed in the return or in a statement attached to the return; and (b) there is a reasonable basis for the tax treatment of such item by the taxpayer. Disclosure must be made on a return or qualified amended return on Form 8275 (Disclosure Statement) or, in the case of a position contrary to a regulation, on a Form 8275-R (Regulation Disclosure Statement).

The accuracy-related penalty is also imposed for substantial errors in valuing property on income, estate and gift tax returns, and overstatements of pension liabilities. Valuation errors are subject to a two-tier penalty rate structure of 20 percent and 40 percent. Valuation misstatements must meet certain threshold levels before the penalties apply. Misstatements related to Code § 482 transactions may also be subject to overstatement penalties.

## 7. Fraud Penalty

In general, for all tax years since 1986 the civil fraud penalty is equal to 75 percent of the underpayment attributable to fraud. Former IRC § 6553(b)(1); IRC 6663(a). The term "fraud" means an "intentional wrongdoing on the part of the taxpayer motivated by a specific intent to evade a tax known or believed to be owing." *Stolzfus v. United States*, 398 F.2d 1002, 1004 (3rd Cir. 1968), cert. denied, 393 U.S. 1020 (1969). The IRS must establish fraud by clear and convincing evidence.

For post-IMPACT tax years, it is presumed that the entire underpayment is attributable to fraud unless the taxpayer can establish otherwise by a preponderance of the evidence. IRC § 6663(b). Also for post-IMPACT tax years, the IRS cannot impose the civil fraud penalty unless a return has been filed. IRC § 6664(b). However, the fraudulent failure to file penalty may be imposed if no return is filed. IRC § 6651(f).

## 8. Interest

The taxpayer's liability will be increased not only as a result of penalties, but also from the accrual of interest. Interest is required to be paid on any tax underpayment at a rate established on a quarterly basis under the Internal Revenue Code. IRC § 6601. Interest is compounded daily. IRC § 6621.

Taxpayers are rarely successful in obtaining an abatement of interest. However, where the accrual of interest results from an error or delay on the part of an IRS employee to perform a ministerial or managerial act, interest may be abated. IRC § 6404(e)(1).

Interest is computed not only on the amount of the underpayment of tax but also on penalties. As a general rule, interest on penalties begins to accrue if the taxpayer fails to pay within ten days after notice and demand for payment is made. IRC § 6601(e)(2)(A). However, interest accrues on certain penalties such as the failure to file, fraud and accuracy-related penalties from the due date of the return. IRC § 6601(e)(2)(B).

## 9. Form TD F 90-22.1 - "Report of Foreign Bank and Financial Accounts" (FBAR)

While it is well known that U.S. persons are obligated to file income tax returns on an annual basis, it is not as well known that such persons may have additional reporting requirements if they have an interest in a foreign financial account. Form TD F 90-22.1, the "Report of Foreign Bank and Financial Accounts" and more commonly known as the FBAR, must be filed by U.S. persons on an annual basis if at any point during the calendar year they have an ownership interest in or signature authority or other authority over a financial account (or several such accounts) in a foreign country, with an aggregate value in excess of \$10,000.

The FBAR requirements apply to any "U.S. person," which includes all U.S. citizens and resident aliens. Nonresident aliens are not required to file a FBAR. However, a new form effective October 2008 provides that anyone "in and doing business in the United States" is required to file and provide their identifying information.

For purposes of the FBAR requirements, a U.S. person also includes all U.S. estates, trusts, partnerships, and corporations. Thus, if any of these domestic entities has an interest in or authority over a financial account worth more than \$10,000, the entity must file a FBAR.

Generally, any type of account that holds liquid assets or marketable securities will be a "financial account" for purposes of the FBAR requirements. A "financial account"

includes any bank, securities, securities derivatives or other financial instruments accounts. The term includes any savings, demand, checking, deposit or any other account maintained with a financial institution.

If an individual can order the distribution or disbursement of funds or other property from the institution where the funds or property are maintained, by signing a document providing such direction, that individual has signature authority over the financial account. Other authority exists in a person who can exercise comparable power over an account by direct communication to the financial institution or other persons with whom the account is maintained, either orally or by some other means.

Essentially, an individual has a financial interest in every account for which the individual is the owner of record or has legal title, whether the account is for the owner's benefit or for the benefit of another. There can be many situations in which several persons have an obligation to file a report with respect to the same account.

If a U.S. person has a foreign account that satisfies the FBAR requirements, the FBAR is due on June 30 of the following year (with no extensions). The form is filed with the Detroit Service Center, U.S. Department of Treasury, P.O. Box 32621, Detroit, MI 48232-0621. The duty to file the FBAR is independent of the obligation to file an income tax return even though the FBAR is cross-referenced on Form 1040, Schedule B, Part III.

The maximum value of account is the largest amount of currency and non-monetary assets that appear on any quarterly or more frequent account statements issued for the applicable year. If periodic account statements are not issued, the maximum account value is the largest amount of currency or non-monetary assets in the account at any time during the year. Convert foreign currency by using the official exchange rate at the end of the year. The value of stock, other securities or other non-monetary assets in an account reported on TD F 90-22.1 is the fair market value at the end of the calendar year. If the asset is withdrawn from the account, the value is the fair market value at the time of the withdrawal.

Prior to the Americans Jobs Creation Act of 2004 (effective October 22, 2004), civil penalties were imposed on willful violations of the reporting requirement. The penalty was the greater of \$25,000 or the account balance, not to exceed \$100,000.

After October 2004, there is now a penalty of up to \$10,000 for a non-willful failure to file the FBAR. If, however, the amount of the transaction or the balance of the foreign account is reported on the taxpayer's Form 1040, the penalty may be eliminated as

a result of the reasonable cause exception. Nevertheless, Form 1040, Schedule B, Part III instructs a taxpayer who indicates that he or she has a financial account in a foreign country to review the FBAR. To satisfy the reporting necessitated for the reasonable cause exception, the taxpayer must be certain to include on the Form 1040 any income generated by the foreign account and to the extent possible a detailed explanation of the transaction.

After October 2004, for a willful violation of the FBAR reporting requirement, the penalty is now equal to the greater of \$100,000 or 50 percent of the amount of the transaction or of the balance of the account at the time of the offense. Violations that are deemed to be willful are not subject to the reasonable cause exception.

Civil penalties can be assessed anytime up to six years after the date of the violation.

10. Preparer Penalty Standard Modified to “Substantial Authority”

The preparer penalty standard has been modified to “substantial authority” except for items relating to tax shelters or listed transactions, for which the standard remains “more likely than not.” H.R. 1424 enacted October 3, 2008. The modification is effective retroactive to May 25, 2007. The relevant provisions as enacted are set forth below:

SEC. 506. Modification Of Penalty On Understatement Of Taxpayer’s Liability By Tax Return Preparer.

(a) In General - Subsection (a) of section 6694 is amended to read as follows:

“(a) Understatement Due to Unreasonable Positions –

(1) IN GENERAL – If a tax return preparer –

(A) prepares any return or claim of refund with respect to which any part of an understatement of liability is due to a position described in paragraph (2), and

(B) knew (or reasonably should have known) of the position, such tax return preparer shall pay a penalty with respect to each such return or claim in an amount equal to the greater of \$1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

(2) UNREASONABLE POSITION –

(A) IN GENERAL – Except as otherwise provided in this paragraph, a position is described in this paragraph unless there is or was substantial authority for the position.

(B) DISCLOSED POSITIONS – If the position was disclosed as provided in section 6662(d)(2)(B)(ii)(I) and is not a position to which subparagraph (C) applies, the position is described in this paragraph unless there is a reasonable basis for the position.

(C) TAX SHELTERS AND REPORTABLE TRANSACTIONS – If the position is with respect to a tax shelter (as defined in section 6662(d)(2)(C)(ii)) or a reportable transaction to which section 6662A applies, the position is described in this paragraph unless it is reasonable to believe that the position would more likely than not be sustained on its merits.

(3) REASONABLE CAUSE EXCEPTION – No penalty shall be imposed under this subsection if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith.”

(b) Effective Date – The amendment made by this section shall apply –

(1) in the case of a position other than a position described in subparagraph (C) of section 6694(a)(2) of the Internal Revenue Code of 1986 (as amended by this section), to returns prepared after May 25, 2007, and

(2) in the case of a position described in such subparagraph (C), to returns prepared for taxable years ending after the date of the enactment of this Act.