

A Review of Common IRS Penalties

Kimberley Peterson
SJSU MST Instructor

Spring 2023 Webinar
February 17, 2023



LUCAS GRADUATE SCHOOL
OF BUSINESS



Civil Penalties Overview

- IRS can assess penalties when there is a deficiency in tax
 - Increasingly, there are also certain penalties that don't need a deficiency
- Must be conduct by taxpayer that warrants penalties – either behavior or state of mind.
- Punishment and deterrent
 - “Muscle” behind our “voluntary” tax system



LUCAS GRADUATE SCHOOL
OF BUSINESS



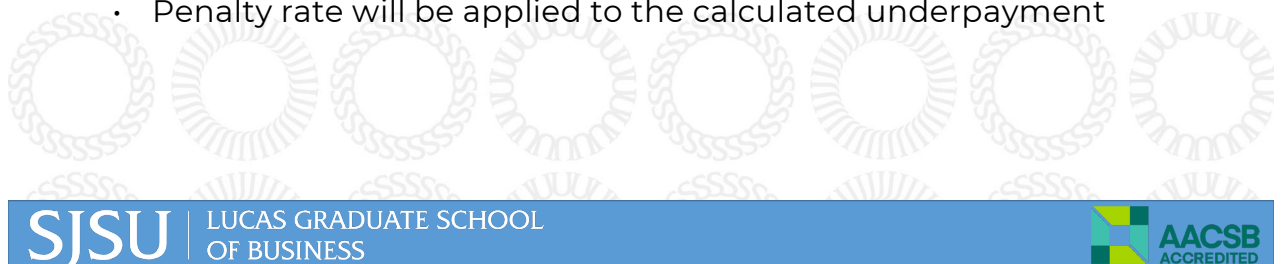
IRS Civil Penalties

- Certain penalties and additions to tax are treated as tax and subject to the deficiency process for assessment.
- Other penalties are assessable penalties for which the IRS only needs to provide notice and demand before trying to collect.



IRS Civil Penalties – Deficiency

- Calculation of penalty:
 - Deficiency (correct tax exceeds tax shown on return)
 - plus** (+) any additional assessments not shown on return
 - minus** (-) any amount of rebates (abatement, credit, refund, or other repayment)
 - equals** (=) underpayment
- Penalty rate will be applied to the calculated underpayment



IRS Civil Penalties – Possible Penalties

- Delinquency Penalties
- Accuracy-Related Penalties
- Foreign Financial Asset Reporting Penalties
- Reportable Transaction Penalties
- Practitioner Penalties
- Fraud Penalties



LUCAS GRADUATE SCHOOL
OF BUSINESS



IRS Civil Penalties – Delinquency Penalties

- Failure to File/Failure to Pay
 - IRC § 6651(a)(1) – Failure to File
 - IRC § 6651(a)(2) – Failure to Pay Tax Shown on Return
 - IRC § 6651(a)(3) – Failure to Pay Tax Not Shown on Return
 - IRC § 6698 - Failure to File Partnership Return
 - IRC § 6699 - Failure to File S Corporation Return
- Failure Pay Estimated Tax
 - IRC § 6654 – Failure by Individual to Pay Estimated Income Tax
 - IRC § 6655 – Failure by Corporation to Pay Estimated Income Tax



LUCAS GRADUATE SCHOOL
OF BUSINESS



IRS Civil Penalties – Delinquency Penalties

- Failure to File/Failure to Pay (IRC § 6651)
 - Failure to file return on due date of return – Including extensions
 - 5% per month or part thereof
 - 25% maximum (i.e., 5 months)
 - Unless the failure is due to reasonable cause and not willful neglect
 - Fraudulent failure to file
 - 15% per month
 - 75% maximum



IRS Civil Penalties – Delinquency Penalties

- Failure to File/Failure to Pay (IRC § 6651)
 - Failure to pay on date prescribed for such payment – There are no extensions of time to pay
 - .5% per month or part thereof
 - 25% maximum (i.e., 50 months)
 - Unless the failure is due to reasonable cause and not willful neglect



IRS Civil Penalties – Delinquency Penalties

- Failure to File/Failure to Pay (IRC § 6651) – Can both apply? Yes!
 - For any month in which both penalties apply, the failure to file penalty is reduced by the amount of the failure to pay penalty
 - The 5% FTF penalty is permanently reduced by the .5% FTP penalty
 - Months 1 through 5 have 4.5% FTF penalty and .5% FTP penalty (= 5%)
 - Months 6 forward are .5%
 - Total penalty never exceeds 5% per month



IRS Civil Penalties – Delinquency Penalties

- Failure to File/Failure to Pay (IRC § 6651) – What happens if FTF and FTP extend for 50+ months?
 - Total cumulative penalty of 47.5%!
 - 22.5% (4.5% (reduced for failure to pay penalty) times 5 months)) maximum failure to file penalty, plus
 - 2.5% (.5% times 5 months) failure to pay penalty, plus
 - 22.5% (.5% times 45 months) maximum failure to pay penalty
 - Equals 47.5 % maximum combined penalty



IRS Civil Penalties – Delinquency Penalties

- Failure to Pay Estimated Tax (IRC § 6654 and § 6655)
 - Individuals: applies if the total of withholding and timely estimated tax payments did not equal at least the lesser of:
 - 90% of individual's current year tax (110% for "higher income taxpayers"); or
 - 100% of individual's prior year tax.
 - Corporations: applies if the total of quarterly and timely estimated tax payments did not equal at least:
 - 100% of current year tax; or
 - 100% of prior year tax (large corporations must pay 100% of current year tax)



IRS Civil Penalties – Delinquency Penalties

- Failure to Deposit (IRC § 6656)
- Provides for the failure to deposit penalty if a taxpayer does not deposit tax in the correct amount, within the prescribed time period, and/or in the required manner.
- Applies to employment and other taxes
- Penalty escalates from 2% to 15%, depending on how late
 - Encourages taxpayer to make a delinquent deposit as soon as possible after the due date
- Reasonable cause is available



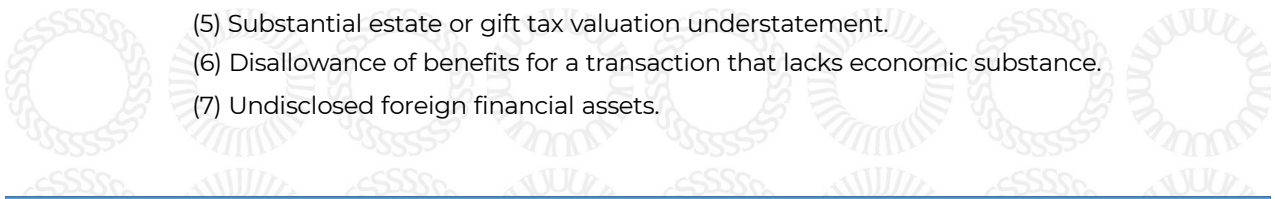
IRS Civil Penalties – Accuracy-related Penalties

- Accuracy-related penalties (IRC § 6662)
- Designed to penalize certain types of inaccurate return reporting.
- Penalty rate is 20% of the underpayment
 - 40% for certain egregious conduct
- Can only be applied once to each portion of the understatement



IRS Civil Penalties – Accuracy-related Penalties

- Accuracy-related penalties (IRC § 6662)
- The law consolidates the following penalties into one section:
 - (1) Negligence or disregard of rules or regulations.
 - (2) Substantial understatement of income tax.
 - (3) Substantial valuation misstatement under chapter 1.
 - (4) Substantial overstatement of pension liabilities.
 - (5) Substantial estate or gift tax valuation understatement.
 - (6) Disallowance of benefits for a transaction that lacks economic substance.
 - (7) Undisclosed foreign financial assets.



IRS Civil Penalties – Accuracy-related Penalties

- Accuracy-related penalties (IRC § 6662)
- Increase in penalty (to 40%) in case of:
 - gross valuation misstatements,
 - nondisclosed noneconomic substance transactions,
 - undisclosed foreign financial asset understatements
- Reasonable cause relief is available



IRS Civil Penalties – Preparer Penalties

- Understatement of taxpayer's liability by tax return preparer (IRC § 6694)
- If a return preparer prepares return or claim for refund:
 - Any part of an understatement of liability is due to:
 - No substantial authority or, if disclosed and there is no reasonable basis
 - If tax shelter or reportable transaction, no reasonable belief the position would more likely than not be sustained on merits
 - Knew or reasonably should have known of the position
 - Penalty = greater of \$1,000 or 50% of income derived



IRS Civil Penalties – Preparer Penalties

- Understatement of taxpayer’s liability by tax return preparer (IRC § 6694)
- If a return preparer prepares return or claim for refund:
 - Any part of an understatement of liability is due to:
 - a willful attempt to understate the liability, or
 - a reckless or intentional disregard of rules or regulations
 - Penalty = greater of \$5,000 or 75% of income derived
- No penalty if questionable position is disclosed or reasonable cause and good faith
 - Preparer has burden of proof



IRS Civil Penalties – Preparer Penalties

- Understatement of taxpayer’s liability by tax return preparer (IRC § 6694)
- Who is a return preparer?
 - Penalty applies to preparers: persons who prepare a substantial portion of a return or refund claim for compensation, or who employ others to do so
 - Signing preparer: has primary responsibility for overall substantive accuracy of return
 - Non-signing preparer: prepares or advises on a substantial portion of a return
 - From same firm? IRS assesses penalty against preparer with primary responsibility.
 - “Duty to supervise”
- Don’t forget Circular 230



IRS Civil Penalties – Information Return Penalties

- Penalties apply for failure to file information returns and for failure to include correct information on such returns (IRC § 6721)
- Not necessarily any tax owing
- Examples:
 - 1099 1098 W-2
 - Reports of cash payments Reports of tip income
- Penalty applies to each failure and can add up!
 - Starts at \$50 and goes to \$580 (2023 rate)
- Reasonable cause is available



IRS Civil Penalties – International Information Return Penalties

- International information return penalties are civil penalties assessed on a U.S. person for failure to timely file complete and accurate international information returns required by specific IRC sections.
- IRC Sections:
 - 6038 6038A 6038C 6038B 6038D 66776679
- Forms:
 - 5471 5472 3520 3520-A 8858 926 8865
- Penalty rates from \$10,000 to \$25,000
 - Some have continuation penalties
- Reasonable cause may apply



IRS Civil Penalties – Penalty Procedures

- Procedural requirements (IRC § 6751)
- Each notice of penalty shall include:
 - Penalty name
 - Penalty section, and
 - Penalty computation
- Managerial approval in writing is required.
 - Exception for penalties under IRC §§ 6651, 6654, 6655 or any other penalty calculated through electronic means (i.e. assessed free of any independent determination).



LUCAS GRADUATE SCHOOL
OF BUSINESS



IRS Civil Penalties Relief!

- Ways to avoid or abate penalties
 1. Be accurate and timely!
 2. Appropriate combination of reasonable basis, substantial authority, and/or disclosure
 3. Reasonable Cause and Good Faith
 4. First Time Abatement



LUCAS GRADUATE SCHOOL
OF BUSINESS



IRS Civil Penalties Relief!

- Confidence in return reporting positions

Confidence Level	Probability of Winning	Probability of Losing
Not frivolous	10%	90%
Reasonable basis	20% (some say 30%)	80% (70%)
Realistic possibility of success	33 1/3%	66 2/3%
Substantial authority	40% (some say 35%)	60% (65%)
More likely than not	50+%	49%

Source: Townsend, John A. and Townsend, John A., Federal Tax Procedure (2022 Practitioner Ed.) (August 3, 2022). Available at SSRN: <https://ssrn.com/abstract=4180710> or <http://dx.doi.org/10.2139/ssrn.4180710>

IRS Civil Penalties Relief!

- Accuracy-related penalties – Disclosure & authority standards to avoid penalties

Penalty	With Disclosure ¹	Without Disclosure
Negligence	Reasonable Basis	Reasonable Basis
Disregard of Rulings or Notices (Non-Reportable Transaction)	Reasonable Basis	Realistic Possibility of Success ²
Disregard of Regulations (Non-Reportable Transaction)	Good Faith Challenge and Reasonable Basis	No Protection Available
Substantial Understatement – Non-Tax Shelter	Reasonable Basis	Substantial Authority ³
Substantial Understatement – Lack of Economic Substance	20%	40%
Substantial Understatement – Tax Shelter (Non-Reportable Transaction)	Protection not available under § 6662	Protection not available under § 6662 ²
Reportable/Tax Shelter (§ 6662A)	Penalty is no greater than 20% ³	30% No Protection Available

¹ Form of disclosure varies depending on type of penalty. See instructions for Form 8275, Form 8275-R, and Form 8886

² Penalty relief may be available under IRC § 6664(c) - reasonable cause and good faith exception

³ Penalty may be avoided if requirements of IRC § 6664(d) are satisfied

IRS Civil Penalties Relief!

- Qualified Amended Return
 - Relief granted by regulations
 - Filed after the original due date but before:
 - Contacted for examination
 - Contacted about tax shelter examination
 - Passthrough entity contacted for examination
 - John Doe Summons issued
 - Certain tax shelter initiatives identified by IRS
 - Similar to voluntary disclosure (but civil)
 - Penalty rate will be applied to any remaining Underpayment



IRS Civil Penalties Relief!

- Reasonable Cause
- Abatement of penalties
 - IRS has become increasingly aggressive in asserting penalties; many penalties can be waived/abated for reasonable cause
 - Courts seem to be narrowing application of reasonable cause regarding positions on the income tax return
 - Failure to raise the defense, when it could have been raised, may evidence lack of professional due care



IRS Civil Penalties Relief!

- Reasonable Cause
 - Penalties may be waived
 - Failure to file (IRC §§ 6039, 6039A, 6651, 6652, 6721, 6698, 6699)
 - Failure to pay (IRC § 6651)
 - Failure to deposit (IRC § 6656)
 - Accuracy related (IRC §§ 6662, 6662A)
 - Preparer (IRC § 6694)
 - Penalties may not be waived
 - Estimated tax (IRC § 6654, 6655)
 - Erroneous claim for refund or credit (IRC § 6676)



IRS Civil Penalties Relief!

- Reasonable Cause
 - Differing statutory formulations -- is there a difference?
 - Reasonable cause
 - Reasonable cause and good faith
 - Reasonable cause and not due to willful neglect
 - Generally – implies an overall sincere and conscientious effort by taxpayer (or preparer) to meet obligations
 - Typical Code sections:
 - 6662, 6664 and associated Treasury Regulations
 - 6651 and associated Treasury Regulations
 - Certain information reporting
 - Note: Some penalties cannot be relieved through Reasonable Cause



IRS Civil Penalties Relief!

- Really high-level overview of Reasonable Cause request
- Facts and circumstances, case-by-case approach
 - Most important factor: Extent of taxpayer's effort to self-assess proper tax liability
 - Honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including taxpayer's experience, knowledge, and education
 - Isolated computational or transcriptional error
 - Reliance on an information return if taxpayer did not know or have reason to know that information was incorrect
 - Reliance on erroneous information in company books if internal controls and procedures designed to identify such factual errors were reasonable
 - Reliance on third-party, including competent advisor



IRS Civil Penalties Relief!

- Really high-level overview of Reasonable Cause request
- Not generally good enough:
 - Ignorance of law
 - Unavailability of records
 - Mistake or forgetfulness
 - Employee/agent malfeasance
 - Insufficient funds
 - Time and business pressures
 - Should have known "too good to be true"
 - Invalid extension
- Note line of cases holding the filing of a return is a non-delegable duty



IRS Civil Penalties Relief!

- First Time Abatement (FTA)
- May be able to obtain penalty relief for the failure to file, failure to pay, or failure to deposit penalties if
 - Taxpayer had no prior penalties (except estimated tax penalty) for the preceding 3 years; and
 - Taxpayer has filed (or is on extension) for all returns and paid or arranged to pay any tax due
- Does not apply to estate tax returns or accuracy related or fraud penalties
- Must request it
 - If denied, ask for supervisor or request in writing
 - Request taxpayer assistance



LUCAS GRADUATE SCHOOL
OF BUSINESS



IRS Civil Penalties

- Phew!
- Questions?
- Contact info:

Kimberley.Peterson@sjsu.edu
kjpmcquire@sbcglobal.net
 408-813-7508



LUCAS GRADUATE SCHOOL
OF BUSINESS



Advanced Certificate in International Taxation

WITH THE SILICON VALLEY EXPERIENCE



study.sjsu.edu/InternationalTax



DEEPEN YOUR TAX KNOWLEDGE AND ACCELERATE YOUR CAREER POTENTIAL

with an Advanced Certificate in International Taxation. If you have an interest in managing cross-border tax matters, earn this unique qualification through a post-graduate certificate designed for tax professionals. The program provides an in-depth study of this specialized area of tax to enhance your skills and knowledge around topics such as US and foreign corporations. Customize your three-course (9-unit) International Taxation Certificate by choosing from several courses specific to international tax.



“International taxation is a key practice area for all tax professionals and is a smart way to broaden your career options and gain confidence in a complex yet important area.”

– Steven K. Shee, VP of Tax Applied Materials

INTERNATIONAL TAX PROFESSIONALS CAN

Ensure compliance with tax regulations globally



Identify issues and provide solutions to clients



Run a business effectively on a global scale



ADMISSION REQUIREMENTS

A Master of Science in Taxation (or equivalent)
A 3.0 GPA or higher

FOR COMPLETE DETAILS
study.sjsu.edu/InternationalTax
lucas-school@sjsu.edu