

The IRS penalty maze: A trail guide

June 19, 2012



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Agenda

- Delinquency penalties
 - Abatement process
 - Standards for abatement
 - Reliance on a tax advisor?
- Accuracy-related penalties
 - Abatement process
 - Standards for abatement
 - Reliance on a tax advisor?
- Special penalty situation

Delinquency penalties

Delinquency penalties

- There are four basic delinquency penalties:
 - Failure to file (or late filing)
 - Income tax returns
 - Excise tax returns
 - Payroll tax returns
 - Information returns
 - Failure to pay tax
 - With return
 - Shown on an IRS notice
 - Failure to pay estimated tax
 - Income tax
 - Failure to deposit
 - Income taxes
 - Payroll taxes
 - Withholding taxes

Delinquency abatement approaches

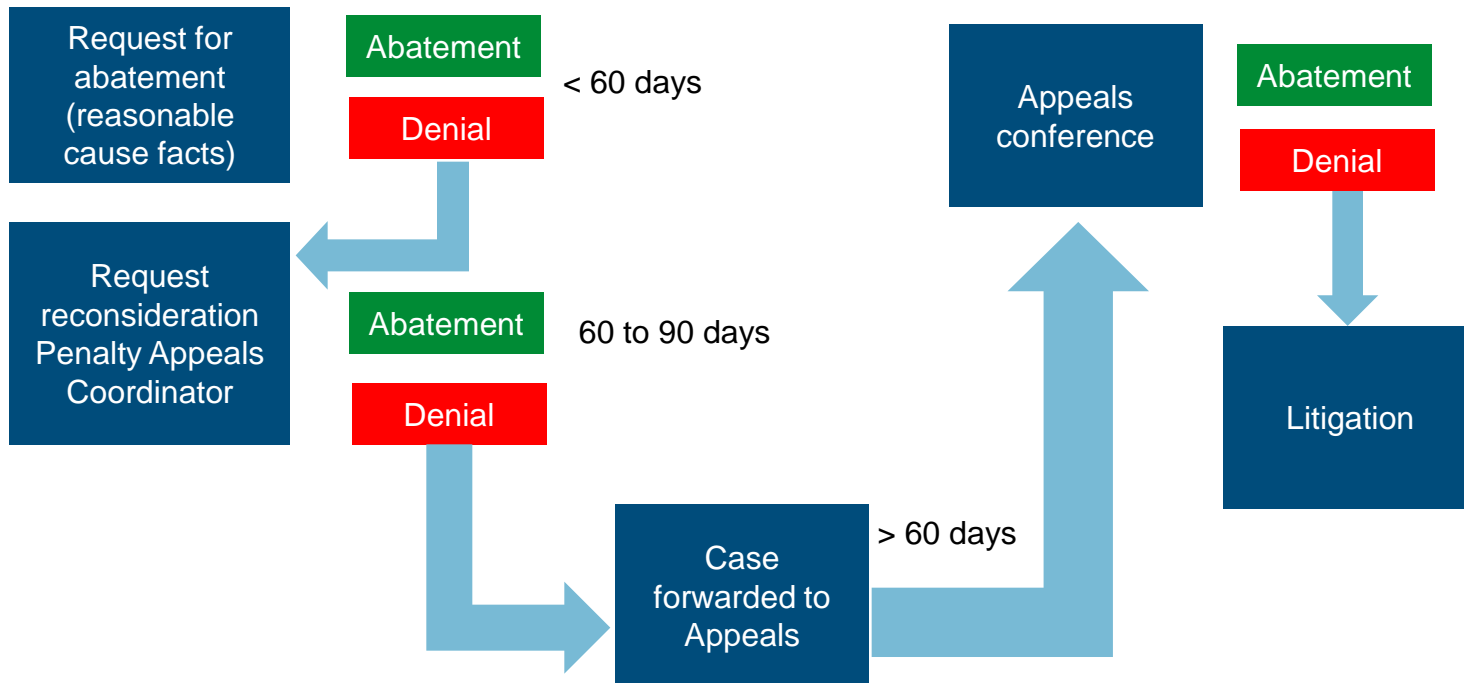
- Administrative waiver
 - First-time filer
 - Clean compliance history
- Reasonable cause – taxpayer exercised ordinary business care and prudence and was unable to file or pay on time. The failure is not due to willful neglect
 - Facts and circumstances
 - Events outside of the control of the taxpayer
 - Reliance on a tax advisor?

Delinquency penalty abatement process – reasonable cause

- Written response to notice outlining reasonable cause factors
 - Generally, the IRS expects this statement to be signed under penalty of perjury
 - Must set forth all facts and circumstances that show that the taxpayer acted reasonably, in good faith, and without willful neglect for its responsibilities
 - Must demonstrate that the taxpayer exercised ordinary care and prudence
 - Facts may show inadvertent failure despite reasonable attempts to comply with the law
 - Information may include the taxpayer's history of good compliance
- Additional responses to denial of initial request for abatement may be required for a final resolution

Delinquency penalty abatement process

IRS penalty letter received, then:



Reasonable cause for delinquency

- Whether the taxpayer acted with reasonable cause and in good faith is determined based on the factual circumstances of the particular situation
- Failure to file or pay – Reg. section 301.6651(c)
 - Evaluate events surrounding the delinquency – what, how, when and where questions should be considered
 - Were there facts beyond the taxpayer's control that prevented timely compliance (e.g., a weather-related event prevented timely mailing or a failed electronic transmission occurred and was not immediately discovered)
 - How did those events prevent timely compliance? (e.g., the weather caused road closures affecting mail service)
 - What remedial efforts were made to prevent the re-occurrence of the delinquency?
 - Did the taxpayer provide for payment of the tax but was prevented from paying or would suffer undue hardship if paid?

Reasonable cause for delinquency (cont.)

- Delinquent tax deposit penalties can be abated if the failure is inadvertent
 - Example – The taxpayer timely mailed a check to the IRS rather than using EFT, and the taxpayer has not used EFT before
 - Reg. section 1.301-6656-1
- Delinquent or incorrect information return penalties can be abated for reasonable cause
 - Reg. section 1.301-6723-1(d)
 - Exception for incorrect information returns for dividends and interest, which can be waived for due diligence

Is reliance on tax advisor reasonable cause for delinquency?

- Generally, reliance on a tax advisor does not constitute reasonable cause for the delinquency penalty
- *United States v. Boyle*, 469 U.S. 241 (1985) – “The failure to make a timely filing of a tax return is not excused by the taxpayer’s reliance on an agent and such reliance is not ‘reasonable cause’ for a late filing under section 6651(a)(1)”
- However, even under the *Boyle* standard, tax advice from an advisor may constitute reasonable cause
- Example – A taxpayer seeks advice regarding a return filing deadline from a qualified tax advisor, and the advisor provides erroneous advice on which the taxpayer reasonably relies (See *Boyle* at 251)

Accuracy-related penalties

Accuracy-related penalties under section 6662

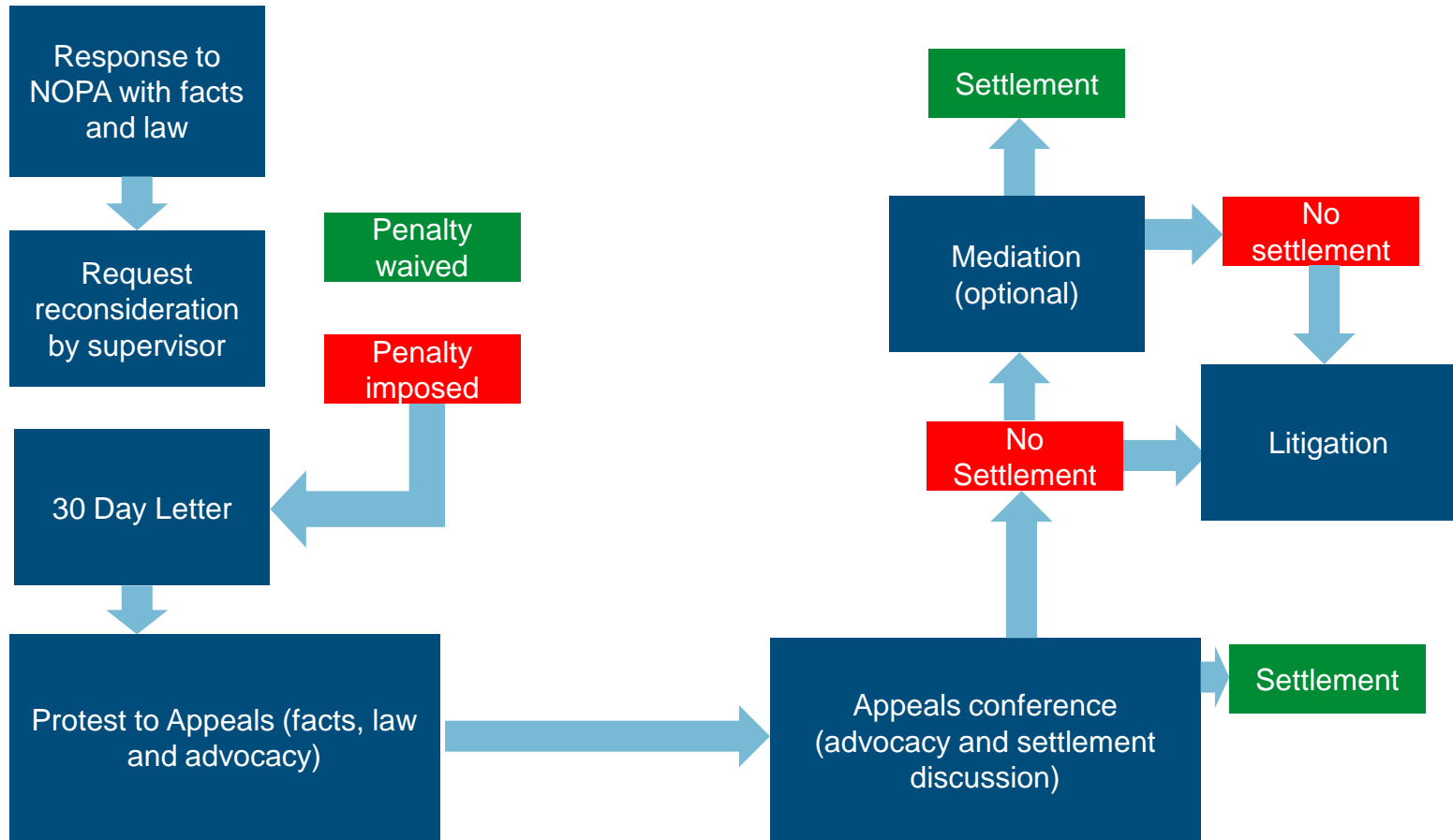
- Imposed on underpayments of tax for:
 - Negligence
 - Intentional disregard of rules or regulations
 - Substantial understatement of income tax
 - Substantial valuation misstatement under Chapter 1
 - Substantial overstatement of pension liabilities
 - Disallowed tax benefit due to lack of economic substance
 - Substantial estate or gift tax valuation understatement
- Penalty amount is 20 percent of underpayment (40 percent in the case of certain “gross” valuation misstatements or undisclosed transactions to which the ESD would apply)

Accuracy-related penalties

Penalty	Standard of Authority	Other
Negligence	Reasonable basis (approximately 20%)	Reasonable cause
Disregard of rule/regulation	Reasonable basis + disclosure	Good faith challenge to a regulation Reasonable cause
Substantial understatement (non-tax shelter)	Substantial authority (approximately 40%) or reasonable basis + disclosure. If a reportable transaction is involved, then also Form 8886	Reasonable cause
Substantial understatement (tax shelter)	Reasonable cause (substantial authority plus reasonable belief that taxpayer would MLTN prevail) MLTN = >50%	Reasonable cause (tax shelter standard only)
Substantial valuation overstatement	Reasonable cause and a qualified appraisal by a qualified appraiser with a good faith investigation of value by the taxpayer	Reasonable cause (as specified)
Substantial overstatement of pension liabilities	Reasonable cause	De minimis exception Reasonable cause
Substantial estate or gift tax valuation understatement	Reasonable cause and qualified appraisal	De minimis exception Reasonable cause
Disallowed tax benefit by reason of a non-ESD transaction	Strict liability – if underpayment results from a transaction with no economic substance	Reasonable cause
Undisclosed foreign financial statement understatement	Reasonable cause	Reasonable cause

Accuracy-related penalty abatement process

Examination Notice of Proposed Adjustment (NOPA) received, then:



The many shades of reasonable cause to avoid the accuracy-related penalty

- Reasonable cause in the non-tax shelter context may be determined based on a reasonable belief that the standard of authority is met, with no facts that would negate the taxpayer's reasonable belief
- Reasonable cause may be determined where the taxpayer inadvertently made a mistake on its return (e.g., an omission of an item of income) or relied on an information return that turned out to be erroneous
- Reasonable cause may be determined based on reliance on the advice of a qualified tax professional. In the tax shelter context, that professional must be unconnected with the marketing of the tax shelter transaction
- Reasonable cause for a tax shelter transaction requires that there be substantial authority (applying the standard objectively) supporting the return position and the taxpayer's reasonable belief (subjective standard) that it would more likely than not prevail on the merits of the transaction if challenged by the IRS

Reasonable cause and reasonable basis

- Reasonable cause refers to circumstances involving the taxpayer – did the taxpayer act in a reasonable manner?
- Reasonable basis refers to the position taken by the taxpayer – did the tax return position have a reasonable basis?

The foundation for reasonable cause

- Whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis
 - Honest misunderstanding of the facts or law
 - Isolated computational or transcription error
 - Reliance on information return, appraiser or tax professional if such reliance was reasonable and the taxpayer acted in good faith

What if I believed I had “substantial authority” for my position?

- If there is a substantial understatement resulting from a non-tax shelter transaction, a taxpayer may avoid the accuracy-related penalty if it reasonably believed it had substantial authority for its position
- Facts and circumstances surrounding the taxpayer’s reasonable belief will be evaluated
- This reasonable belief may constitute reasonable cause to defeat the penalty, even if there is not substantial authority supporting the tax return position
- The burden is on the taxpayer to show that it acted with ordinary business care and prudence and that it reasonably believed there was substantial authority supporting its position

What if I relied on advice of a “tax advisor?”

- Was the taxpayer’s reliance reasonable and in good faith?
- Facts and circumstances taken into account
 - Taxpayer’s education, sophistication and business experience
 - The complexity of the issue that caused the substantial understatement
- Minimum standards must be met
 - All facts and circumstances must be considered
 - The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings or agreements of the taxpayer or any other person
 - Cannot rely on an opinion or advice that a regulation is invalid unless the taxpayer adequately discloses the position that the regulation in question is invalid
- “Advice” includes any communication (including an opinion) setting forth analysis and conclusions of the advisor on which the taxpayer relies (directly or indirectly)
- Advice does not have to be in any particular form

Substantial understatement – special rules for corporate tax shelters

- Under section 6662(d), a tax shelter is any entity, plan, or arrangement with a significant purpose of avoiding or evading income tax
- More stringent reasonable cause standards
 - No reduction for items supported by substantial authority or reasonable basis plus disclosure
 - Penalty avoided only for **reasonable cause**
 - Position must be supported by substantial authority in fact
 - Taxpayer must reasonably believe that it would more likely than not prevail on the merits of the position if challenged by the IRS
 - MLTN = greater than 50 percent chance of success
 - No “negative factors”

Negative factors that can destroy reasonable cause

- Other factors may eliminate reasonable cause even if you meet the basic requirements:
 - Failure to disclose a reportable transaction
 - Reliance on opinion of the tax shelter promoter
 - Confidentiality agreement relating to tax shelter
 - Lack of significant business purpose
 - Claimed tax benefits that are unreasonable in relation to taxpayer's investment

Special penalty situation

Canal Corporation v. Commissioner

135 T.C. No. 9 (2010)

- Leveraged partnership transaction to avoid the disguised sales rules
- Facts
 - Taxpayer wants to sell his business (Chesapeake) and goes to a “tax advisor” for advice
 - Advisor recommends contributing the assets to an LLC for a 5 percent interest and a special cash distribution
 - Distribution is meant to be tax-free
 - Advisor provides a “should” level opinion

Canal Corporation v. Commissioner (cont.)

- Tax Court rules the transaction is a disguised sale and imposes the accuracy-related penalty for substantial understatement of tax under section 6662(d)(1)
- Taxpayer argues “reasonable cause” to avoid the penalty, as the taxpayer relied on a competent tax advisor

*Did the tax advisor have a “conflict of interest”
by acting as a promoter?*

Canal Corporation v. Commissioner (cont.)

“Chesapeake argues that it had every reason to trust PwC’s judgment because of its long term relationship with the firm. PwC crossed over the line from trusted advisor for prior accounting purposes to advocate for a position with no authority that was based on an opinion with a high price tag - \$800,000.”

Judge Kroupa

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