The IRS penalty maze: How did I get here?

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Assurance ▪ Tax ▪ Consulting

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Agenda

- Delinquency penalties
  - Failure to file
  - Failure to pay
  - Failure to make timely estimated tax payments
  - Failure to deposit

- Accuracy-related penalties
  - Negligence, disregard
  - Substantial understatement
  - Non-economic substance
  - Valuation

- Claim-related penalties

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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

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Failure to file (or late filing) of income, excise and employment tax returns

- Penalties are described in section 6651(a)(1)
- Penalty rate is five percent per month (or fraction thereof) based on the amount of tax required to be shown on the return
- Imposed on the net amount of tax due with return
  - Tax required to be shown on the return is reduced by tax payments made on or before the return due date (without extensions) and credits claimed on the return
- Penalty begins to accrue from the return due date (including extensions of time to file)

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Failure to file (or late filing) of income, excise and employment tax returns (cont.)

- Continues to accrue until the return is filed (or the maximum penalty is reached)
- Maximum penalty is 25 percent
- If the failure to pay penalty (section 6651(a)(2)) also applies, the failure to file penalty rate is reduced to 4.5 percent per month. The maximum combined failure to file and failure to pay penalty associated with a delinquent return is five percent per month.
- Can be avoided by filing a timely return (even if the tax is not paid with the return)
- Reasonable cause is a defense

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Penalties for failure to file information returns

- Partnership returns (Form 1065) and S corporation returns (Form 1120S)
  - $195/month per partner or shareholder up to 12 months
- Exempt organization returns (Form 990)
  - Gross receipts ≤ $1,000,000 - $20/day, maximum of $10,000
  - Gross receipts > $1,000,000 - $100/day, maximum of $50,000
- Failure to file with IRS (1099s, W-2s and 1042s) – required to be filed in 2012 and future
  - $30 per failure (max of $250,000) if filed within 30 days of due date
  - $60 per failure (max of $500,000) if filed after 31 days and before Aug. 1
  - $100 per failure (max of $1,500,000) for returns filed after Aug. 1
  - $250 per failure for intentional disregard

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Penalties for failure to file information returns (cont.)

- Failure to provide timely and correct information statement to payee/partner/shareholder – in 2012 and future
  - $100 per failure
  - $250 or more per failure if willful

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Failure to pay penalties

- Penalty applies in two circumstances
  - Failure to pay the tax shown on any return (section 6651(a)(2))
    - Income tax returns
    - Excise tax returns
  - Failure to pay tax pursuant to IRS notice and demand for payment (section 6651(a)(3))
    - Within 21 calendar days of IRS notice and demand, or
    - Within 10 business days of the IRS notice and demand for a tax if the amount on the notice is $100,000 or more

- Penalty rate is 0.5 percent per month
  - The section 6651(a)(2) penalty runs from the return due date (without extension) until the date the tax is paid
  - The section 6651(a)(3) penalty runs from the 11th or 22nd day from the notice (whichever applies) until the balance is paid
  - Penalty rate increases to one percent per month if receive a levy notice

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Computation of the failure to file and failure to pay penalties for late returns

- For late filing and payment associated with a return filing, the failure to pay penalty is credited against the failure to file penalty so that a combined total penalty of five percent per month accrues for the first five months of delinquency

- Thereafter, the failure to pay penalty continues to accrue at 0.5 percent per month, up to a maximum penalty accrual of 25 percent

- Example:

Failure to file penalty (5 months)	=	22.5 %
Failure to pay penalty (60 months)	=	25.0 %
Total maximum penalty	=	47.5 %

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Computation of the failure to file and failure to pay penalties for late returns (cont.)

- Pointers to minimize delinquency penalties:
  - Request automatic extension of return due date
  - Make a proper estimate of the liability
  - For corporations, pay the estimated liability
  - File the return on time, even if the liability is not paid with the return
  - Tax paid after the original return due date does not reduce the failure to pay penalty but not the failure to file penalty
  - Seek abatement of penalties under appropriate circumstances

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Failure to make timely estimated payments

- A penalty is imposed for failure to make timely payments of estimated tax
- This penalty applies to individuals (section 6654) and corporations (section 6655)
- Individuals who fail to have sufficient withholding from their income or fail to make adequate estimated tax payments are subject to the penalties
- The penalty is computed by applying the underpayment rate under section 6621 to the amount of the underpayment for the period of the underpayment

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Failure to make timely estimated payments (cont.)

- The period of any underpayment runs from the due date of the installment to the earlier of:
  - The due date (without extension) of the income tax return, or
  - The date on which the portion is paid

- Failure by individual – section 6654
  - Penalty exceptions – The penalty applies to individuals who have not evenly paid tax estimates and/or who have insufficient withholding amounts equal to the lesser of:
    - 90 percent of the tax shown on the current year's return (including SE tax if self-employed), or
    - 100 percent of the tax shown on the return for the preceding year (110 percent if taxpayer(s) has adjusted gross income for the prior year exceeding $150,000)

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Failure to make timely estimated payments (cont.)

- Penalty exceptions (cont.)
  - A taxpayer who has uneven income throughout the year may use an annualized income installment method that may result in a smaller installment being required for one payment with a subsequent increase in a latter payment
  - Individuals who owe less than $1,000 with their return are not subject to the penalty
  - Individuals who filed a return for the preceding taxable year (and that return was for a period of 12 months) reflecting no tax liability are not subject to the penalty

- Calculations for the penalty and the use of the annualization method are made by completing IRS Form 2210 and attaching it to 1040. Or, the taxpayer may allow the IRS to assess the penalty by not filing Form 2210. In the latter case, interest and late payment penalty do not begin to accrue until 21 days after the IRS has notified the taxpayer that it owes the penalty.

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Failure to make timely estimated payments (cont.)

- Failure by corporation to pay estimated tax – section 6655
  - Under current law, the required quarterly installment payment is either:
    - 25 percent of the tax shown on the current year return, or in the case of corporations with less than $1,000,000 of taxable income in any of the three preceding tax years, the required payment is the lesser of 25 percent of the tax on the current year return or 25 percent of the tax for the preceding tax year
    - An amount calculated using an annualized income or adjusted seasonal installment amount (Form 2220)
  - Penalty exception
    - No penalty is assessed if the tax for the year is less than $500
    - Calculations of the penalty and the use of the annualization method are made by completing Form 2220 and attaching it to the 1120. The taxpayer may allow the IRS to assess the penalty by not filing Form 2220.
    - In the latter case, interest and late payment penalty do not begin to accrue until 21 days after the IRS has notified the taxpayer that it owes the penalty

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Failure to deposit penalty

- Applies to failure to deposit taxes by any person who is required to deposit taxes (e.g., corporate income taxes, excise taxes, withholding taxes, employment taxes) (section 6656)

- Penalties are imposed against an underpayment on a sliding scale
  - 2 percent if the deposit is not more than five days late
  - 5 percent if the deposit is more than five days late, but not more than 15 days late
  - 10 percent if the deposit is more than 15 days late

- The IRS will apply deposits to the earliest liability, often creating a cascading penalty

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Failure to deposit penalty (cont.)

- Taxpayers can reallocate the deposits to specific liability dates and minimize the penalties (section 6656(e))

- Penalty exception for first-time depositors of employment taxes (section 6656(c)) – failure must be inadvertent and must meet certain criteria

- Pointers:
  - Apply late deposits to minimize penalties by providing instructions with the deposit
  - Use EFTPS system, if required, to avoid 10 percent penalty for not using EFTPS, even for timely payments
  - Seek abatement for reasonable cause or for administrative waiver

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Accuracy-related penalty – section 6662

- Accuracy-related penalty – 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
  - Substantial estate or gift tax valuation understatement
- Penalty amount – 20 percent of underpayment (40 percent in the case of certain “gross” valuation misstatements or undisclosed transactions to which the ESD would apply)
- No stacking of section 6662 accuracy-related penalties
- Reasonable cause and good faith exception

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Accuracy related penalty – standards of authority

Based on probability of a position succeeding on its merits if challenged by the taxing authority:

- Will: $\geq$ 95 percent
- Should: $\geq$ 70 percent
- More likely than not: > 50 percent
- Substantial authority: Authority in support of position is substantial in relation to authority against (approximately 40 percent)
- Realistic possibility of success: 33 percent
- Reasonable basis: Reasonably based on one or more authorities (approximately 20 percent)
- Not frivolous
- Frivolous

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Negligence penalty

- Penalty applies if an underpayment is due to the taxpayer's negligence
- Negligence includes a failure to make a reasonable attempt to comply with the tax law or to exercise ordinary and reasonable care in preparing a tax return
- Negligence can include failure to substantiate items on the return or failure to keep adequate records
- *Reasonable basis* standard applies (i.e., position is reasonably based on one or more authorities)
- No disclosure exception

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Disregard penalty

- Penalty applies if an underpayment results from the reckless or intentional disregard of a rule or regulation
- "Rule" includes Internal Revenue Code, revenue rulings and notices
- "Regulation" includes final or temporary, but not proposed, regulations
- Penalty does not apply if taxpayer discloses position and position has a reasonable basis
  - Form 8275 (contrary to a rule)
  - Form 8275-R (contrary to a regulation)
    - Position must be a good faith challenge to the validity of the regulation
  - Also must disclose on a Form 8886 if position relates to a reportable transaction

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Disregard penalty (cont.)

- Special rule for undisclosed position contrary to a revenue ruling or notice:
  - No penalty applies if position has a 1-in-3 possibility of being sustained on its merits if challenged (provided position does not relate to a reportable transaction)

Substantial understatement penalty

- Penalty applies if there is an understatement of *income* tax and the understatement is substantial

- C corporation – understatement is substantial if it exceeds the lesser of:
  - 10 percent of tax required to be shown on the return (or $10,000, if greater), or
  - $10 million

- All other taxpayers – understatement is substantial if it exceeds the greater of:
  - 10 percent of tax required to be shown on the return, or
  - $5,000

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Substantial understatement penalty (cont.)

- A potential understatement is reduced by the tax attributed to a position that either:
  - Meets the ***<u>substantial authority</u>*** standard; **or**
  - Meets the reasonable basis standard and is adequately disclosed on the return (Form 8275)

- No reduction for understatements related to “corporate tax shelters,” even if disclosed

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What is “adequate disclosure”?

- Form 8275
- Form 8275-R
- Schedule M-3
- Schedule UTP
- Rev. Proc. 94-69

- Questions:
  - Can a white paper disclosure be “adequate”?
  - Can disclosure on Form 8886 be “adequate”?

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Qualified amended returns – substantial understatement penalty

- QAR: The amount shown as tax on a return includes the additional tax shown on a QAR

- Must file before date:
  - Taxpayer is contacted for examination of return
  - Pass-through entity is contacted concerning an examination of the return relating to the pass-through item
  - Any person is contacted for a section 6700 return examination related to the claimed benefit
  - John Doe summons is served on third person
  - IRS contacts tax shelter organizer, promoter, seller or material adviser about listed transaction
  - IRS announces settlement initiative for listed transaction

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Standards of authority for substantial understatement penalty (non-tax shelter)

- Substantial authority
  - The weight of authorities supporting a position must be substantial in relation to the weight of authorities supporting the contrary position
  - Quantified – approximately a 40 percent chance of prevailing on the merits

- Reasonable basis (plus disclosure)
  - Return position that is reasonably based on one or more authorities
  - Quantified – approximately a 20 percent chance of prevailing on the merits

- Reasonable Cause
  - Taxpayer must establish that it exercised ordinary business care and prudence in taking the offending return position
  - Reasonable reliance on the advice of a tax adviser may support reasonable cause. See *United States v. Boyle*, 469 U.S. 241 (1985)

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Standards of authority for substantial understatements attributable to a tax shelter

- A higher standard of authority must be met to avoid the substantial understatement penalty for positions related to a tax shelter.
  - Tax shelter is defined as
    - A partnership or other entity
    - Any investment plan or arrangement, or
    - Any other plan or arrangement
    - If a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of federal income tax

- The position must have substantial authority and the taxpayer must reasonably believe that the position would more likely than not be sustained if challenged by the IRS. Negative factors can destroy the "reasonable belief" required to meet this standard.

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Penalty for disallowed tax benefits by reason of a transaction that lacks economic substance

- Section 6662(b)(6) enacted in 2010
- Effective for transactions entered into after March 30, 2010
- For a transaction that "does not have economic effect or lacks a business purposes" (section 7701(o))
- Penalty equal to 20 percent of the underpayment
- Penalty increased to 40 percent if the taxpayer does not adequately disclose the transaction (section 6662(i))
- "Reasonable cause" may not apply
- Can avoid penalty by filing a qualified amended return that concedes the issue
- Can avoid the increased penalty by filing a qualified amended return that discloses the transaction that does not have economic substance

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Valuation misstatement penalties

- Valuation misstatements come in several flavors
  - Substantial valuation misstatements under Chapter 1 of the Internal Revenue Code
  - Substantial overstatements of pension liabilities
  - Substantial estate or gift tax valuation understatements

- Penalty increased to 40 percent for gross valuation misstatements

- Avoid penalty by documentation and reasonable cause
  - Use of qualified appraisal
  - Good faith investigation of property value

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Claim-related penalties – section 6676

- 20 percent penalty for claims in an "excessive amount"
  - Applies to claims for refund or credit of income tax via an amended return, Form 843, or an original return
  - Avoided if claim meets the reasonable basis standard, unless relates to a transaction without economic substance (as defined in section 6662)
  - Cannot be combined with the section 6662 or section 6663 penalty

- Applies to claims filed after May 25, 2007

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