

CIVIL TAX PENALTIES UNDER THE INTERNAL REVENUE CODE

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SECTION ONE - Overview

I. Background.

A. The return-related penalties include:

1. IRC § 6662, *Imposition of Accuracy-Related Penalty on Underpayments,*
2. IRC § 6663, *Imposition of Fraud Penalty,*
3. IRC § 6662A, *Imposition of Accuracy-Related Penalty on Understatements with Respect to Reportable Transactions,*
4. IRC § 6707A, *Penalty for Failure to include Reportable Transaction Information with Return, and*
5. IRC § 6676, *Erroneous Claim for Refund or Credit penalty.*

B. IRC § 6662 imposes an accuracy-related penalty on any portion of an underpayment attributable to one or more of the following:

1. Negligence or disregard of the rules or regulations. See IRC § 6662(c).
2. Substantial understatement of income tax. See IRC § 6662(d).
3. Substantial valuation misstatement. See IRC § 6662(e).
4. Substantial overstatement of pension liability. See IRC § 6662(f).
5. Substantial estate or gift tax valuation understatement. See IRC § 6662(g).
6. Gross valuation misstatement. See IRC § 6662(h).
7. Disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of IRC § 7701(o)) or failing to meet the requirements of any similar rule of law. See IRC § 6662(b)(6).
8. Non-disclosed noneconomic substance transactions. See IRC § 6662(j).
9. Undisclosed foreign financial asset understatement. See IRC § 6662(b)(7), IRC § 6662(i).

C. IRC § 6663 imposes a penalty on any portion of an underpayment attributable to fraud.

D. IRC § 6662A imposes an accuracy-related penalty on a reportable transaction understatement.

E. IRC § 6707A imposes a penalty for failure to include reportable transaction information with return.

F. IRC § 6676 imposes a penalty for erroneous claim for refund or credit with respect to income tax.

G. See IRC § 6664, *Definitions and Special Rules*, for the accuracy-related penalties.

II. Common Features of Accuracy-Related and Civil Fraud Penalties.

A. The accuracy-related and civil fraud penalties apply only if a return is filed.

B. The accuracy-related and civil fraud penalties do not apply in the case of a return prepared by the IRS under IRC § 6020(b).

C. The accuracy-related and civil fraud penalty issues are developed separately from the tax law issues that gave rise to the tax understatement.

D. Return Filing Requirements:

1. The accuracy-related penalties and the civil fraud penalty apply when a return is filed.

2. These penalties cannot be asserted on a substitute-for-return (“SFR”) under IRC § 6020(b). See IRC § 6664(b).

3. The accuracy-related and fraud penalties can be asserted on a secured delinquent return, e.g., an original return obtained after the taxpayer is contacted by the IRS; however, the accuracy-related penalties cannot be applied to a delinquent return after an assessment is made under SFR procedures.

E. IRC § 6664(a) provides a common definition of “underpayment”. The accuracy-related and civil fraud penalties are calculated only on the underpayment (or portion of the underpayment) of tax attributable to the misconduct or fraud.

F. The accuracy-related and civil fraud penalties cannot be asserted on the same portion of the same underpayment, except as an alternative penalty position. However, the accuracy-related penalty and the civil fraud penalty may be asserted on the same return when civil fraud applies to

one portion of the underpayment and the accuracy-related penalty applies to another portion of the underpayment.

G. The accuracy-related penalty attributable to a reportable transaction understatement and the civil fraud penalty cannot be asserted on the same portion of the same understatement (a reportable transaction understatement is treated as an underpayment for purposes of determining the fraud penalty). However, the accuracy-related penalty attributable to a reportable transaction understatement and the civil fraud penalty may be asserted on the same return when civil fraud applies to one portion of the underpayment and the accuracy-related penalty attributable to a reportable transaction understatement applies to another portion. See IRC § 6662A(e).

H. Under IRC § 6601(e)(c)(B), interest on civil fraud and accuracy-related penalties is imposed from the due date of the return, including extensions, until the date of payment. IRC § 6601(e)(3) provides, however, that if payment is made within 21 calendar days after notice and demand (10 business days if the amount for which the notice and demand is equal or exceeds \$100,000), interest on the amount paid is not imposed for the period after the date of the notice and demand.

I. If the underlying tax is subject to deficiency procedures, the penalty is as well; in such a case, the accuracy-related and fraud penalties follow the guidelines for examination 30-day letters and statutory notices of deficiency.

SECTION TWO - Failure to File Returns § 6651(a)(1) and Failure to Pay Tax § 6651(a)(2)

- I. IRC § 6651 (a)(1) - Failure to file tax return.
- A. In case of failure to file an income tax return on the due date *with extensions*, the penalty for failure to file is:
1. Five (5%) percent of the amount of the tax due if the failure is for not more than 1 month,
 2. With an additional five (5%) percent for each additional month or fraction thereof during which such failure continues.¹
 3. The penalty cannot exceed twenty-five (25%) percent in the aggregate.
- B. In the case of a failure to file an income tax return within 60 days of the date prescribed due (with extensions), the penalty is not be less than the lesser of \$135 or 100 percent of the amount required to be shown as tax on such return.
- C. If any failure to file any return is “*fraudulent*”, the penalty is applied—
1. By substituting “15 percent” for “5 percent” each place it appears, and
 2. By substituting “75 percent” for “25 percent”.
- D. The penalty does not apply if the failure is shown to be due to *reasonable cause and not due to willful neglect*.

¹ For purposes of applying the penalties under section 6651, a “month” is defined as follows: (1) If the date prescribed for filing the return or paying tax is the last day of a calendar month, each succeeding calendar month or fraction thereof during which the failure to file or pay tax continues will constitute a month for purposes of section 6651. (2) If the date prescribed for filing the return or paying tax is a date other than the last day of a calendar month, the period which terminates with the date numerically corresponding thereto in the succeeding calendar month and each such successive period will constitute a month for purposes of section 6651. If, in such successive period will constitute a month for purposes of section 6651. If, in the month of February, there is no date corresponding to the date prescribed for filing the return or paying tax, the period from such date in January through the last day of February will constitute a month for purposes of section 6651. Thus, if a return is due on January 30, the first month will end on February 28 (or 29 if a leap year), and the succeeding months will end on March 30, April 30, etc. (3) If a return is not timely filed or tax is not timely paid, the fact that the date prescribed for filing the return or paying tax, or the corresponding date in any succeeding calendar month, falls on a Saturday, Sunday, or a legal holiday is immaterial in determining the number of months for which the addition to the tax under section 6651 applies.

II. IRC § 6651 (a)(2) - Failure to pay tax shown on the return.

A. Penalty for Failure to Pay Tax Shown on the Return.

1. In case of failure to pay the amount shown as tax on any return, the penalty is:

a. One-half of one (0.5%) percent of the amount of the tax due if the failure is for not more than 1 month,

b. With an additional one-half of one (0.5%) percent for each additional month or fraction thereof during which such failure continues.

c. The penalty cannot exceed twenty-five (25%) percent.

2. The penalty does not apply if the failure is shown to be due to *reasonable cause* and *not due to willful neglect*.

B. Penalty for Failure to Pay Tax Shown on the Return.

1. In the case of failure to pay any amount of any tax required to be shown on a return *that is not so shown (i.e. additional taxes due to an audit)* within 21 calendar days from the date of the IRS notice and demand (10 business days if the amount assessed and shown on the notice and demand equals or exceeds \$100,000), a penalty is also imposed in an amount equal to:

a. One-half of one (0.5%) percent of the amount stated in the IRS notice and demand if the failure is for not more than 1 month, with an additional five (5%) percent for each additional month or fraction thereof during which the failure continues.

b. The penalty cannot exceed twenty percent in the aggregate.

2. The "*taxes required to be shown*" include any assessment made pursuant to section 6213(b), with certain exceptions.²

3. The penalty does not apply if the failure is shown to be due to *reasonable cause* and *not due to willful neglect*.

² IRC § 6213(b) provides certain exceptions to restrictions on assessment, including: (1) assessments arising out of mathematical or clerical errors; (2) assessments arising out of tentative carryback or refund adjustments; (3) assessment of amount paid; and (4) certain orders of criminal restitution.

C. Increase in Penalty Due to Fraud.

1. If any part of any underpayment of tax required to be shown on a return is due to fraud, there will be added to the tax an amount equal to seventy-five percent (75%) of the portion of the underpayment which is attributable to fraud.³

2. In the context of the penalty at issue, “*fraud*” is a taxpayer’s intentional wrongdoing with the specific intent to avoid a tax that he or she knew was owed.⁴

3. Such intent can be inferred from strong circumstantial evidence, but cannot be sustained when there is only a suspicion of fraud.⁵

D. Increase in Penalty for Failure to Pay Tax in Certain Cases.

The penalty for failure to pay is increased to from one-half of one percent (0.5%) to one percent (1%): (i) on the day 10 days after the date on which *notice of intention to levy* is given⁶; and (ii) on the day on which *notice and jeopardy demand for immediate payment* is given.⁷

E. Returns Prepared by the Secretary. In certain cases a Secretary of a person may fail to file a return but disclose the information necessary to prepare that return.⁸ In those cases the return will be disregarded for purposes of determining failure to file penalty, but, will be treated as the return filed by the taxpayer for purposes of determining the amount of the failure to pay penalty.

F. Reduction of Failure to Pay Penalty. If a return is filed by an individual on or before the due date for the return (including extensions), during the period an installment agreement is in effect for the payment of such tax, the penalty is reduced to one-quarter of one percent (0.25%) instead of one-half of one percent (0.5%).⁹

III. Showing of “Reasonable Cause”.

A. In General.

1. With certain exceptions a taxpayer who wishes to avoid the failure to file penalty or the failure to pay penalty may do so

³ See IRC § 6663

⁴ *Akland v. Commissioner*, 767 F.2d 618, 621, 56 AFTR 2d 85-5649 (9th Cir. 1985).

⁵ *Christianson v. Comm.* 87 AFTR 2d 2001-813

⁶ See IRC § 6331(d).

⁷ See IRC § 6331(a).

⁸ See IRC § 6020(b)

⁹ This reduction applies for purposes of determining additions to tax for months beginning after December 31, 1999.

by establishing a “*reasonable cause*” for the failure to file or to pay the tax on time.

2. The taxpayer must provide the facts supporting his or her claim in a written statement containing a declaration that it is made under penalties of perjury.

3. The statement is filed with the district director or the director of the service center with whom the return was required to be filed.

B. Ordinary Business Care and Prudence.

1. If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause.

2. A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship if he or she paid on the due date.

3. Ordinary business care and prudence includes making provisions for business obligations to be met when reasonably foreseeable events occur. A taxpayer may establish reasonable cause by providing facts and circumstances showing that they exercised ordinary business care and prudence (taking that degree of care that a reasonably prudent person would exercise), but nevertheless were unable to comply with the law.

4. According to the IRS Manual, in determining if the taxpayer exercised ordinary business care and prudence, the Service will review available information including the following:

a. Taxpayer’s Reason. In order to prove reasonable cause, the taxpayer’s reasons should address the penalty imposed, for dates and explanations which correspond with events on which the penalties are based.

b. Compliance History. A first- time failure to comply does not by itself establish reasonable cause. The same penalty, previously assessed or abated, may indicate that the taxpayer is not exercising ordinary business care.

c. Length of Time. The IRS will also consider the length of time between the event cited as a reason for the noncompliance and subsequent compliance.

d. Circumstances Beyond the Taxpayer's Control.

(1) Reasonable cause is generally established when the taxpayer exercises ordinary business care and prudence, but, due to circumstances beyond the taxpayer's control, the taxpayer was unable to timely meet the tax obligation.

(2) Ordinary business care and prudence requires that the taxpayer continue to attempt to meet the requirements, even though late.

C. Undue Hardship/Inability to Pay.

1. Overview. An undue hardship may support the granting of an extension of time for paying a tax or deficiency.

a. Reg. 1.6161-1(b), provides that an undue hardship must be more than an inconvenience to the taxpayer. The taxpayer must show that they would sustain a substantial financial loss if required to pay a tax or deficiency on the due date.

b. Undue hardship generally does not affect a person's ability to file and therefore would not provide a basis for penalty relief in a failure to file situation. However, each request is considered on a case-by-case basis.

c. Undue hardship may also support relief from the addition to tax for failure to pay tax if the explanation for the noncompliance supports such a determination.

d. However, the mere inability to pay *does not*, ordinarily provide the basis for granting penalty relief.

e. Under Treas. Reg. 301.6651-1(c), the taxpayer must also show that they exercised ordinary business care and prudence in providing for the payment of the tax liability.

2. Inability to Pay Tax.

a. In determining whether the taxpayer was unable to pay the tax in spite of the exercise of ordinary business care and prudence in providing for payment of his tax liability, consideration will be given to all the facts and circumstances of the taxpayer's financial situation, including the amount and nature of the taxpayer's expenditures in light of the income (or other amounts) he or she could, at the time of such expenditures, reasonably expect to receive prior to the date prescribed for the payment of the tax.

b. Thus, for example, a taxpayer who incurs lavish or extravagant living expenses in an amount such that the remainder of his or her assets and anticipated income will be insufficient to pay his tax has not exercised ordinary business care and prudence in providing for the payment of his tax liability.

c. Further, a taxpayer who invests funds in speculative or illiquid assets has not exercised ordinary business care and prudence in providing for the payment of his tax liability unless, at the time of the investment, the remainder of the taxpayer's assets and estimated income will be sufficient to pay his tax or it can be reasonably foreseen that the speculative or illiquid investment made by the taxpayer can be utilized (by sale or as security for a loan) to realize sufficient funds to satisfy the tax liability.

d. A taxpayer will be considered to have exercised ordinary business care and prudence if he made reasonable efforts to conserve sufficient assets in marketable form to satisfy his tax liability and nevertheless was unable to pay all or a portion of the tax when it became due.

D. Type of Tax.

1. In determining if the taxpayer exercised ordinary business care and prudence in providing for the payment of his tax liability, consideration will be given to the nature of the tax which the taxpayer has failed to pay.

2. Thus, for example, facts and circumstances which, because of the taxpayer's efforts to conserve assets in marketable form, may constitute reasonable cause for nonpayment

of income taxes may not constitute reasonable cause for failure to pay over taxes described in section 7501 that are collected or withheld from any other person.

E. Automatic Extension.

1. Individuals. If, for a taxable year ending on or after December 31, 1995, an individual taxpayer satisfies the requirements for obtaining an automatic extension of time for filing an individual income tax return, reasonable cause will be presumed, for the period of the extension of time to file, with respect to any underpayment of tax if:

a. The excess of the amount of tax shown on the individual income tax return over the amount of tax paid on or before the regular due date of the return (by virtue of tax withheld by the employer, estimated tax payments, and any payment with an application for extension of time to file) is no greater than 10 percent of the amount of tax shown on the individual income tax return; and

b. Any balance due shown on the individual income tax return is remitted with the return.

2. Corporate Taxpayers. If, for a taxable year ending on or after December 31, 1972, a corporate taxpayer satisfies the requirements for obtaining an automatic extension of time for filing a corporation income tax return, reasonable cause will be presumed, for the period of the extension of time to file, with respect to any underpayment of tax if:

a. The amount of tax (determined without regard to any prepayment thereof) shown on the Form 7004 (Application for Automatic Extension to File), or the amount of tax paid on or before the regular due date of the return, is at least ninety (90%) percent of the amount of tax shown on the taxpayer's Form 1120, and

b. Any balance due shown on the Form 1120 is paid on, or before the due date of the return, including any extensions of time for filing.

F. Death, or Serious Illness.

1. Death, serious illness, or unavoidable absence of the taxpayer, or a death or serious illness in the taxpayer's immediate

family, may establish reasonable cause for filing, paying, or depositing late.

2. In the case of individual taxpayers if there was a death, serious illness, or unavoidable absence of the taxpayer or a death or serious illness in the taxpayer's immediate family (e.g., spouse, sibling, parents, grandparents, children); or

3. In the case of an entity taxpayer (such as a corporation, estate, trust, etc.), if there was a death, serious illness, or other unavoidable absence of the taxpayer (person responsible), or a member of such taxpayer's immediate family, and that taxpayer had sole authority to execute the return, make the deposit, or pay the tax.

G. Records Unavailable.

1. Explanations relating to the inability to obtain the necessary records may constitute reasonable cause in some instances, but may not in others. The IRS will consider the facts and circumstances relevant to each case and evaluate the request for penalty relief.

2. If the taxpayer was unable to obtain records necessary to comply with a tax obligation, the taxpayer may or may not be able to establish reasonable cause. Reasonable cause may be established if the taxpayer exercised ordinary business care and prudence, but due to circumstances beyond the taxpayer's control, they were unable to comply.

3. Information to consider when evaluating such a request includes, but is not limited to, an explanation as to:

- a. Why the records were needed to comply,
- b. Why the records were unavailable and what steps were taken to secure the records,
- c. When and how the taxpayer became aware that they did not have the necessary records,
- d. If other means were explored to secure needed information,
- e. Why the taxpayer did not estimate the information,
- f. If the taxpayer contacted the IRS for instructions on what to do about missing information,

g. If the taxpayer promptly complied once the missing information was received, and

h. Supporting documentation such as copies of letters written and responses received in an effort to get the needed information.

H. Ignorance of the Law.

1. A taxpayer's failure to file or pay because of a mistake of law may be considered reasonable cause, depending upon the surrounding facts and circumstances.

2. A failure to seek competent advice is generally inconsistent with reasonable cause. On the other hand, a reasonable misinterpretation of a complex or ambiguous statute has been recognized as reasonable cause for failure to file a return.

3. The ordinary business care and prudence standard requires that taxpayers make reasonable efforts to determine their tax obligations.

4. Reasonable cause may be established if the taxpayer shows ignorance of the law in conjunction with other facts and circumstances.

5. For example, the IRS will consider:

a. The taxpayer's education,

b. If the taxpayer has previously been subject to the tax,

c. If the taxpayer has been penalized before,

d. If there were recent changes in the tax forms or law which a taxpayer could not reasonably be expected to know, and

e. The level of complexity of a tax or compliance issue.

f. Reasonable cause should never be presumed, even in cases where ignorance of the law is claimed.

g. The taxpayer may have reasonable cause for noncompliance due to ignorance of the law if:

h. A reasonable and good faith effort was made to comply with the law, or

i. The taxpayer was unaware of a requirement and could not reasonably be expected to know of the requirement.

I. Mistake or Forgetfulness.

1. Forgetfulness or oversight on the part of the taxpayer generally does not establish reasonable cause.

2. The taxpayer may however try to establish reasonable cause by claiming that a mistake was made. Generally, this is not in keeping with the ordinary business care and prudence standard and does not provide a basis for reasonable cause.

3. However, the reason for the mistake may be a supporting factor if additional facts and circumstances support the determination that the taxpayer exercised ordinary business care and prudence but nevertheless was unable to comply within the prescribed time.

4. Information to consider when evaluating a request for an abatement or non-assertion of a penalty based on a mistake or a claim of ignorance of the law includes, but is not limited to:

a. When and how the taxpayer became aware of the mistake,

b. The extent to which the taxpayer corrected the mistake,

c. The relationship between the taxpayer and the subordinate (if the taxpayer delegated the duty),

d. If the taxpayer took timely steps to correct the failure after it was discovered, and

e. The supporting documentation.

J. Erroneous Advice.

1. The taxpayer may try to establish reasonable cause by claiming they relied on another party to comply on their behalf or that another party provided erroneous advice.

2. This section discusses the three basic types of advice that may qualify for Statutory, Regulatory, or Administrative penalty relief:

a. Written advice provided by IRS;

b. Oral advice provided by IRS; and

c. Advice provided by a tax professional.

3. Generally, reliance on advice is *not* a basis for reasonable cause, particularly for filing or paying obligations, since the taxpayer is responsible for meeting their tax obligations and that responsibility cannot be delegated.

4. Information to consider when evaluating a request for abatement or non-assertion of a penalty due to reliance on advice includes, but is not limited to, the following:

a. Was the advice in response to a specific request and was the advice received related to the facts contained in that request?

b. Did the taxpayer reasonably rely on the advice?

5. Written Advice from the IRS.

a. The IRS is required by IRC 6404(f) and Treas. Reg. 301.6404-3 to abate any portion of any penalty attributable to erroneous written advice furnished by an officer or employee of the IRS acting in their official capacity.

b. If the taxpayer does not meet the criteria for penalty relief under IRC 6404(f), the taxpayer may qualify for other penalty relief. For instance, taxpayers who fail to meet all of the IRC 6404(f) criteria may still qualify for relief under reasonable cause if the IRS determines that the taxpayer exercised ordinary business care and prudence in relying on the IRS's written advice.

c. The following instances address some situations where penalty relief may not be appropriate even though the taxpayer relied on written advice from the IRS regarding an item on a filed return:

(1) The taxpayer did not reasonably rely on the advice regarding an item included on a return if the advice was received after the date the return was filed¹⁰;

(2) A taxpayer may not be considered to have reasonably relied on written

¹⁰ Note: A taxpayer may be considered to have reasonably relied on advice received after the return was filed if they then filed an amended return that conformed with such written advice.

advice unrelated to an item included on a return, such as advice on the payment of estimated taxes, if the advice is received after the estimated tax payment was due.

(3) Did the taxpayer, or their authorized representative, provide the IRS or the tax professional with adequate and accurate information?

(4) The taxpayer is entitled to penalty relief for the period during which they relied on the advice. The period continues until the taxpayer is “placed on notice” that the advice is no longer correct or no longer represents the Service’s position.¹¹

6. Oral Advice from IRS.

a. The IRS may also provide penalty relief based on a taxpayer’s reliance on erroneous oral advice from the IRS.

b. Administratively, the IRS has extended this relief to include erroneous oral advice when appropriate.

c. In determining whether penalty abatement is appropriate consider the following:

(1) Did the taxpayer exercise ordinary business care and prudence in relying on that advice?

(2) Was there a clear relationship between the taxpayer’s situation, the advice provided, and the penalty assessed?

(3) What is the taxpayer’s prior tax history and prior experience with the tax requirements?

¹¹ The taxpayer is considered “placed on notice” as the result of any of the following events that present a contrary position and occur after the issuance of the written advice: (i) written correspondence from the IRS that its advice is no longer correct or no longer represents the IRS’s position; (ii) enactment of legislation or ratification of a tax treaty; (iii) a U.S. Supreme Court decision; (iv) the issuance of temporary or final regulations; or (v) the publication of a revenue ruling, revenue procedure, or other statement in the Internal Revenue Bulletin.

(4) Did the IRS provide correct information by other means (such as tax forms and publications)?

(5) What type of supporting documentation is available?

d. The following is supporting documentation:

(1) A notation of the taxpayer's question to the IRS,

(2) Documentation regarding the advice provided by the IRS,

(3) Information regarding the office and method by which the advice was obtained,

(4) The date the advice was provided, and

(5) The name of the employee who provided the information.

7. Form 843, Claim for Refund and Request for Abatement.

a. Generally, Form 843, *Claim for Refund and Request for Abatement*, is required to be filed to request penalty abatement based on erroneous written advice by the IRS.

b. However, if Form 843 is not filed and the information provided demonstrates that abatement of the penalty is warranted, the penalty should be abated, whether or not a Form 843 is provided.

c. Information required to be provided includes:

(1) The taxpayer's written request for advice,

(2) The erroneous written advice furnished by the Service to the taxpayer and relied on by the taxpayer, and

(3) The report (if any) of tax adjustments that identifies the penalty or addition

to tax and the item relating to the erroneous written advice.

8. Advice from a Tax Advisor.

a. Reliance on the advice of a tax advisor generally relates to the reasonable cause exception in IRC § 6664(c) for the accuracy-related penalty under IRC § 6662. See IRM 20.1.5, *Return Related Penalties*, and Treas. Reg. 1.6664-4(c).

b. However, in very limited instances, reliance on the advice of a tax advisor may provide relief from other penalties when the tax advisor provides advice on a substantive tax issue.

c. *Example:*

The employer researched all available IRS publications on the subject of contract labor, provided clear and convincing documentation as to the duties of the workers to the tax advisor, and requested an opinion from the tax advisor as to whether the workers were “contract labor” or “employees.” As a result, the tax advisor advised the employer that the workers were “contract labor.” However, the IRS later determined that the workers were “employees” and not “contract labor.”

d. Penalty relief based on reliance on the advice of a tax advisor is limited to issues generally considered technical or complicated. The taxpayer’s responsibility to file, pay, or deposit taxes cannot be excused by reliance on the advice of a tax advisor.

e. Because the IRC and Treasury Regulations sections that provide penalty relief criteria for erroneous advice from a tax advisor are generally limited to the accuracy-related penalty, relief from other penalties must meet the reasonable cause standards.

K. Service in a Combat Zone/Disaster Relief.

1. In General.

a. IRC § 7508 provides that a certain period relating to duty in a combat zone as designated by the President by executive order (or in a contingency operation designated by the Secretary of Defense) is to be disregarded in determining whether a taxpayer has

complied with statutory requirements to perform certain acts by a given date.

b. IRC § 7508A provides that the Secretary of the Treasury *may* specify a period of up to one year to be disregarded with respect to acts required to be performed by taxpayers determined *by the Secretary* to have been affected by a federally declared disaster, a terroristic action, or military action.

c. In order for the period to be disregarded to impact either the penalty for filing late or the penalty for paying late, the due date for filing or paying must fall within the disaster period as determined by the Secretary.

d. If the normal due date for filing or paying falls within the disaster period, the taxpayer's return or payment will be considered on time if it is mailed by the date published by IRS for timely filing or paying for the covered disaster area.

2. Disaster Relief.

a. The IRS will first determine if the taxpayer could not comply timely because the taxpayer was an "affected person" eligible for disaster relief.

b. For taxpayers not considered an "*affected person*," reasonable cause relief from a penalty may be requested if there was a failure to timely comply with a requirement to file a return or pay a tax as the result of a fire, casualty, natural disaster, or other disturbance. However, one of these circumstances by itself does not necessarily provide penalty relief.

c. Penalty relief may be appropriate if the taxpayer exercised ordinary business care and prudence, but due to circumstances beyond the taxpayer's control, they were unable to comply with the law.

d. Factors to consider include:

- (1) Timing;
- (2) Effect on the taxpayer's business;
- (3) Steps taken to attempt to comply; and

(4) If the taxpayer complied when it became possible.

e. The determination to grant relief from each penalty must be based on the facts and circumstances surrounding each individual case.

L. Ideological and Philosophical Beliefs. Persons refusing to pay taxes, failing to file returns, or filing incomplete returns based on various ideological and philosophical beliefs, including religious or moral grounds, or because the funds are used for government programs which the taxpayer opposes, do not have reasonable cause and may be prosecuted both civilly and criminally.

M. Requesting Penalty Relief.

1. The initial request for relief may occur either during or after an examination (but before a penalty is actually assessed), with a return that is either filed or paid late, or after assessment of the penalty(s) and notification issued to the taxpayer.

2. When the request is received, the IRS will analyze the taxpayer's reasons to determine if penalty relief is warranted. The burden of proving entitlement to relief is generally upon the taxpayer.

3. Each request will be evaluated by the Service on its own merit, including:

a. The events or parties involved, and

b. If the taxpayer exercised ordinary business care and prudence, but due to circumstances or events beyond the taxpayer's control the taxpayer was unable to meet the tax requirement, or

c. If other penalty relief criteria apply (such as a Statutory or Regulatory Exception or an Administrative Waiver).

4. The IRS will also determine if the taxpayer's explanation addresses the penalty(s) imposed.

a. The dates and explanations should clearly correspond with events on which the penalties are based to show that the taxpayer is entitled to relief from the penalty.

b. Request additional information from the taxpayer to clarify any explanations if the dates and

explanations do not correspond with the events on which the penalty is based.

5. In considering the request for penalty abatement, the IRS will review available information in determining whether or not the taxpayer exercised ordinary business care and prudence, and check the preceding tax years (go back at least three years or twelve quarters) for payment patterns and the taxpayer's overall compliance history. Assertion of the same penalty(s) in the taxpayer's history may indicate that the taxpayer is not exercising ordinary business care.

6. If this is the taxpayer's first incident of noncompliant behavior, the IRS will weigh this factor with other reasons the taxpayer gives for relief, since a first time failure to comply does not by itself establish reasonable cause.

7. The Service will also consider the length of time between the event cited as a reason for the noncompliance and subsequent compliance. The length of time between events may serve to cancel or reduce the event's effect. Penalty relief may not be appropriate if, after considering all facts and circumstances, the taxpayer failed to correct their noncompliant behavior within a reasonable period of time.

8. The following are examples where penalty relief may not be appropriate:

a. The taxpayer claims that he was unable to comply with the filing requirement due to a death in the family. The death occurred several months prior to the due date of the return. The return was not filed until a year after the due date of the return.

b. Taxpayer claims that he was unable to comply with the filing requirement because the records necessary for filing were in the control of a third party, e.g., a bankruptcy trustee or an accountant. The records were returned to the taxpayer well in advance of the time the return was required to be filed. The return was not filed until several months after the records were returned.

c. In both of the examples, the timing of the event may prevent the taxpayer from receiving penalty relief unless other factors justify the delay in filing.

d. Consider if the taxpayer could have anticipated the event that caused the non-compliance.

9. Subsequent Requests for Penalty Relief.

a. A second or subsequent request for penalty relief may be received after the initial request for relief has been denied. The request is generally considered an appeal of the previous penalty relief denial.

b. If the penalty was previously sustained in Appeals, forward the request to the appropriate Appeals office.

c. If the review of the account indicates that the taxpayer's request for penalty relief was previously disallowed (and not sustained in Appeals), review the circumstances of the previous denial:

IV. Penalty imposed on net amount due.

A. Credits against the tax. The amount of tax required to be shown on the return for purposes of failure to file penalty and the amount shown as tax on the return for purposes of the failure to pay penalty is reduced by the amount of any part of the tax which is paid on or before the prescribed due date for payment of the tax and by the amount of any credit against the tax which is claimed on the return.

B. Partial payments.

1. The amount of tax required to be shown on the return will, for the purpose of computing the addition for any month, be reduced by the amount of any part of the tax which is paid after the date prescribed for payment and on or before the first day of such month.

2. The amount of tax stated in the notice and demand will, for the purpose of computing the addition for any month, be reduced by the amount of any part of the tax which is paid before the first day of such month.

V. No addition to tax if fraud penalty assessed.

No addition to the tax under section 6651 will be assessed with respect to an underpayment of tax if a fifty (50%) percent addition to the tax for fraud is assessed with respect to the same underpayment under section 6653(b).¹²

¹² See IRC § 6653(d).

SECTION THREE - Failure to Pay Estimated Income Tax § 6654

- I. Failure by individual to pay estimated income tax.
- A. Addition to the tax.
1. IRC § 6654 provides that, with exceptions, in the case of any underpayment of estimated tax by an individual, a penalty is added to the income tax, the self-employment tax, and the unearned Medicare contribution.
2. The penalty is an amount determined by applying: (i) the “*underpayment rate*”, (ii) to the “*amount of the underpayment*”, (iii) for the “*period of the underpayment*”.
- B. The “Underpayment Rate”. The “*underpayment rate*” is the rate established under section 6621(a)(2).¹³
- C. The “Amount of Underpayment”. The “*amount of the underpayment*” is the excess of—(i) the required installment, over (ii) the amount (if any) of the installment paid on or before the due date for the installment.
- D. The “Period of Underpayment”.
1. The period of the underpayment runs from the due date for the installment to whichever of the following dates is the earlier—(i) the 15th day of the 4th month following the close of the taxable year, or (ii) with respect to any portion of the underpayment, the date on which such portion is paid.
2. Payments of estimated tax are credited against unpaid required installments in the order in which such installments are required to be paid.
- E. Number of required installments. For purposes of this section there are four required installments for each taxable year.

¹³ The underpayment rate established under that Code section is the sum of (A) the Federal short-term rate determined under subsection (b), plus (B) 3 percentage points.

F. Required Due Dates. The due date is for the installments:

1st	April 15
2nd	June 15
3rd	September 15
4th	January 15

G. Amount of required installments.

1. In general. The amount of any required installment is twenty-five (25%) percent of the “*required annual payment*”.¹⁴

2. Required annual payment.

a. The term “*required annual payment*” means the lesser of

(1) Ninety (90%) percent of the tax shown on the return for the taxable year (or, if no return is filed, ninety (90%) percent of the tax for such year), or

(2) One-hundred (100%) percent of the tax shown on the return of the individual for the preceding taxable year.

b. This provided that the preceding taxable year was not a taxable year of 12 months or if the individual did not file a return for such preceding taxable year.

3. Limitation on use of preceding year's tax.

a. In general. If the adjusted gross income shown on the return of the individual for the preceding taxable year beginning in any calendar year exceeds \$150,000, the required annual payment is determined by substituting the “*applicable percentage*” for “100 percent”.

b. For purposes of the preceding sentence, the *applicable percentage* is determined in accordance with the following table:

¹⁴ There is an exception in a case where an individual establishes an annualized income installment is less than otherwise required annual payment.

<i>If the preceding taxable year begins in:</i>	<i>The applicable percentage is :</i>
1998	105%
1999	108.6%
2000	110%
2001	112%
2002 or thereafter	110%

c. This rule *does not apply* in the case of a preceding taxable year beginning in calendar year 1997.

4. Separate Returns.

In the case of a married individual who files a separate return for the taxable year for which the amount of the installment is being determined, subparagraph 3a will be applied by substituting “\$75,000” for “\$150,000”.

H. Special rules.

1. Annualization. The taxable income, alternative minimum taxable income, and adjusted self-employment income will be placed on an annualized basis under regulations prescribed by the Secretary.

2. Applicable percentage. In the case of the following required installments:

The applicable percentage is:

1 st	22.5%
2 nd	45%
3 rd	67.5%
4 th	90%

3. Adjusted self-employment income. The term “*adjusted self-employment income*” means “*self-employment income*” as defined in section 1402(b); except that “*wages*” for months in the taxable year ending before the due date for the installment on an annualized basis consistent with the above.

II. Exceptions.

A. Where tax is small amount. No penalty addition to tax will be imposed if the tax shown on the return for such taxable year (or, if no return is filed, the tax), is less than \$1,000.

B. Where no tax liability for preceding taxable year. No penalty is imposed for any taxable year if—(i) the preceding taxable year was a taxable year of 12 months, (ii) the individual did not have any liability for tax for the preceding taxable year, and (iii) the individual was a citizen or resident of the United States throughout the preceding taxable year.

C. Waiver in certain cases.

1. In general. No penalty is imposed with respect to any underpayment to the extent the Secretary determines that by reason of casualty, disaster, or other unusual circumstances the imposition of such addition to tax would be against equity and good conscience.

2. Newly retired or disabled individuals. No penalty is imposed with respect to any underpayment if the Secretary determines that—(i) the taxpayer (I) retired after having attained age 62, or (II) became disabled in the taxable year for which estimated payments were required to be made or in the taxable year preceding such taxable year, and (ii) such underpayment was due to reasonable cause and not to willful neglect.

III. Tax computed after application of credits against tax.

For purposes of this section, the term “tax” means: (i) the normal income taxes and surtaxes; plus (ii) the self-employment tax; plus (iii) the unearned income Medicare contribution; minus (iv) the credits against those taxes (other than the credit relating to tax withheld on wages).

IV. Application of section in case of tax withheld on wages.

A. In general. For purposes of applying this section, the amount of the credit for tax withheld on wages for the taxable year will be deemed a payment of estimated tax, and an equal part of such amount will be deemed paid on each due date for such taxable year, unless the taxpayer establishes the dates on which all amounts were actually withheld, in which case the amounts so withheld will be deemed payments of estimated tax on the dates on which such amounts were actually withheld.

B. Separate application. The taxpayer may apply paragraph IV A, above separately with respect to—(i) wage withholding, and (ii) all other amounts withheld for which credit is allowed under section 31.

V. Special rule where return filed on or before January 31.

If, on or before January 31 of the following taxable year, the taxpayer files a return for the taxable year and pays in full the amount computed on the return as payable, then no penalty is imposed with respect to any underpayment of the 4th required installment for the taxable year.

VI. Special rules for farmers and fishermen.

A. In general.

1. If an individual is a “*farmer*” or “*fisherman*” for any taxable year only one installment is required for the year,
2. The due date for the installment is January 15 of the following taxable year,
3. The amount of the installment is equal to the required annual payment determined under paragraph IG2 (a)(1), above by substituting “66 2/3 percent” for “90 percent” and without regard to limitation on the use of the preceding year’s tax as provided in IRC § 6654 (d)(1)(C) will be applied—(i) by substituting “March 1” for “January 31”, and (ii) by treating the required installment as the 4th required installment.

B. Farmer or fisherman defined.

An individual is a “*farmer*” or “*fisherman*” for any taxable year if:

1. The individual's gross income from farming or fishing (including oyster farming) for the taxable year is at least 66 2/3 percent of the total gross income from all sources for the taxable year, or
2. Such individual's gross income from farming or fishing (including oyster farming) shown on the return of the individual for the preceding taxable year is at least 66 2/3 percent of the total gross income from all sources shown on such return.

VII. Special rules for nonresident aliens.

A. In the case of a nonresident alien there are three required installments for the taxable year.

B. Time for payment of installments. The due dates for required installments under this subsection will be determined under the following table:

1 st	June 15
2 nd	September 15
3 rd	January 15

C. Amount of required installments.

1. First required installment. In the case of the first required installment, paragraph I.G.1., will be applied by substituting "50 percent" for "25 percent".

2. Determination of applicable percentage. The "applicable percentage" for purpose for Paragraph "1" will be determined under the following table: In the case of the following required installments:

1 st	45%
2 nd	67%
3 rd	90%

VIII. Fiscal years and short years.

A. Fiscal years. In applying this section to a taxable year beginning on any date other than January 1, there will be substituted, for the months specified in this section, the months which correspond thereto.

B. Short taxable year. This section will be applied to taxable years of less than 12 months in accordance with regulations prescribed by the Secretary.

IX. Estates and Trusts.

A. In general. With certain exceptions estimated tax payments will also be required of estates and trusts.

B. Exception for estates and certain trusts. With respect to any taxable year ending before the date 2 years after the date of the decedent's death, estimated payments will not be required of: (i) the estate of such decedent, or (ii) any trust—all of which was treated as owned by the decedent, and to which the residue of the decedent's will pass under his will (or, if no will is admitted to probate, which is the trust primarily responsible for paying debts, taxes, and expenses of administration).

C. Exception for charitable trusts and private foundations. This section will not apply to any trust which is subject to the tax on unrelated business income imposed by section 511 or which is a private foundation.

X. Special rule for Medicare tax.

For purposes of this section, the additional Medicare tax imposed under section 3101(b)(2) (to the extent not withheld) will be treated as the self-employment tax imposed under chapter 2 of the IRC .

SECTION FOUR - § 6662 – Accuracy Related Penalty

- I. § 6662 Imposition of accuracy-related penalty on underpayments.
- A. IRC § 6662 (a) imposes an underpayment of tax required to be shown on a return, there will be added to the tax an amount equal to twenty (20%) percent of the portion of the underpayment to which this section applies.
- B. IRC § 6662 (b) applies to the portion of any underpayment which is attributable to one or more of the following:
1. Negligence or disregard of rules or regulations;
 2. Any substantial understatement of income tax;
 3. Any substantial valuation misstatement under chapter 1;
 4. Any substantial overstatement of pension liabilities;
 5. Any substantial or gift tax valuation understatement;
 6. Any disallowance of claimed tax benefits by reason of a transaction lacking “economic substance”, or failing to meet the requirements of any similar rule of law; and
 7. Any undisclosed foreign financial asset understatement.
- C. The section does not apply to:
1. Any portion of an underpayment on which a penalty is imposed under section 6663 (fraud penalty).
 2. Except as provided in paragraph (1) or (2)(B) of section 6662A(e), to the portion of any underpayment which is attributable to a reportable transaction understatement on which a penalty is imposed under section 6662A.¹⁵

¹⁵ IRC § 6662A(e)(1) provides: “Coordination with penalties, etc., on other understatements. In the case of an understatement (as defined in section 6662(d)(2))—(A) the amount of such understatement (determined without regard to this paragraph) will be increased by the aggregate amount of reportable transaction understatements for purposes of determining whether such understatement is a substantial understatement under section 6662(d)(1) , and (B) the addition to tax under section 6662(a) will apply only to the excess of the amount of the substantial understatement (if any) after the application of subparagraph (A) over the aggregate amount of reportable transaction understatements.” IRC § 6662A(e)(2)(B), provides: Coordination with other penalties. (B) Coordination with certain increased underpayment penalties. This section will not apply to any portion of an understatement on which a penalty is imposed under section 6662 if the rate of the penalty is determined under subsections (h) or (i) of section 6662.

II. Negligence.

A. In general.

1. IRC § 6662(b)(1) imposes an accuracy related penalty in regard to an underpayment of tax due to (i) negligence, or (ii) disregard of rules or regulations.

2. For purposes of IRC § 6662, the term “*negligence*” includes any failure to make a reasonable attempt to comply with the provisions of the IRC, and the term “*disregard*” includes any careless, reckless, or intentional disregard.

B. Negligence/Reasonable Basis Exception.

1. Negligence is strongly suggested if a taxpayer fails to make a reasonable attempt to ascertain the correctness of a reported item “*which would seem to a reasonable and prudent person to be 'too good to be true,' under the circumstances.*”

Example:

The facts may establish that a taxpayer reported losses from a transaction that lacked economic substance or reported losses or deductions from assets with basis traceable to lease stripping transactions that would have seemed, to a reasonable and prudent person, to be "too good to be true." The accuracy-related penalty attributable to negligence may be applicable if the taxpayer failed to make a reasonable attempt to ascertain the correctness of the claimed losses or deductions by thoroughly investigating the bona fide economic or other relevant actual aspects of the transaction. Consultation with a tax advisor, regardless of the advisor's independence, is not, standing alone, conclusive evidence of a thorough investigation by the taxpayer. All relevant facts, including the nature of the tax investment, the independence of the tax advisor, the competence of the tax advisor, the quality of the opinion, and the sophistication of the taxpayer must be considered.

2. The penalty for negligence does not apply if the taxpayer’s position has a “*reasonable basis*”.

a. If a return position is reasonably based on one or more of the authorities in Treas. Reg. 1.6662-4(d)(3)(iii), the position will generally satisfy the reasonable basis standard even though it does not rise to the level of “*substantial authority*” (see below).

b. The Regulations in § 1.6662-4(d)(3)(iii) provide only the following qualify as “*authority*”:

- (1) Applicable provisions of the Internal Revenue Code and other statutory provisions;
- (2) Proposed, temporary and final regulations construing such statutes;
- (3) Revenue rulings and revenue procedures;
- (4) Tax treaties and regulations there under, and Treasury Department and other official explanations of such treaties;
- (5) Court cases;
- (6) Congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers;
- (7) General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book);
- (8) Private letter rulings and technical advice memoranda issued after October 31, 1976;
- (9) Actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin);
- (10) Internal Revenue Service information or press releases; and
- (11) Notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin.

c. The penalty for negligence may, however, apply if the taxpayer fails to keep adequate books and records to substantiate the items.

3. The negligence penalty will not be asserted solely for filing a return late.

4. The negligence penalty will not be asserted solely due to the taxpayer's failure to appear for an audit or respond to an inquiry or notice.

5. However, the facts and circumstances from the return and the case file may warrant assertion of the accuracy-related penalty attributable to negligence.

Example:

An Information Return Processing (IRP) document shows the taxpayer received \$5,000 of interest income. The tax return reflects AGI of \$40,000 but no interest income. The taxpayer does not appear for the examination. The accuracy-related penalty attributable to negligence should be asserted based on the IRP document, information in the return and in the case file.

Example:

The Tax Year (TY) 2008 and TY 2009 examinations disallowed the auto expense deduction because the costs were commuting expenses. The TY 2010 return was filed and secured after these examinations and the taxpayer claimed the same deduction for commuting expenses. The taxpayer did not appear for the office appointment. Based on the prior year's disallowed deduction and the taxpayer's knowledge of the nondeductible expense, the penalty for negligence should be asserted on the TY 2010 return.

C. Disregard of Rules or Regulations.

1. "Disregard of rules or regulations" relates to the taxpayer's failure to follow the appropriate law in completing the return, and reflects a disregard of the IRC, temporary or final regulations, revenue rulings, or IRS notices (other than notices of proposed rulemaking). The term "disregard" includes careless, reckless, or intentional disregard.

2. Except for a reportable transaction, as defined in the regulations under IRC § 6011, entered into on or after January 1, 2003, and reported on a return filed after December 31, 2003, there is no penalty for a position contrary to a revenue ruling or IRS notice published in the Internal Revenue Bulletin (IRB) if the position has a *realistic possibility of being sustained* on its merits.

3. Disregard of rules or regulations are:
 - a. "*Careless*" if the taxpayer does not exercise reasonable care to determine the correctness of a tax return.
 - b. "*Reckless*" if the taxpayer makes little or no effort to determine if a rule or regulation exists, under circumstances demonstrating a substantial deviation from a reasonable standard of conduct.
 - c. "*Intentional*" if the taxpayer knows of a rule or regulation and ignores that rule or regulation.

D. Adequate Disclosure.

1. The penalty for disregard of rules or regulations does not apply if the taxpayer adequately discloses the position on Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, (as appropriate).

2. In the case of a transaction entered into on or after January 1, 2003, and reported on a return filed after December 31, 2003, taxpayers also must disclose reportable transactions on Form 8886, as required under the IRC § 6011.¹⁶

3. The penalty does not apply to a position that is contrary to a regulation if the taxpayer discloses the position and the position represents a good faith challenge to the regulation.

4. A good faith challenge to the validity of a regulation generally requires a showing that the taxpayer conducted a careful analysis of reasonably available authorities

- a. Relating to the issue, including statutory language,
- b. Legislative history,
- c. The underlying treasury decision,
- d. Relevant case law (including case law pertaining to the presumption of validity to which regulations are entitled), and
- e. The persuasiveness of the rationale supporting the contrary position.

¹⁶ IRC § 6011 provides that when required by regulations prescribed by the Secretary any person made liable for any tax imposed by this title, or with respect to the collection thereof, will make a return or statement of certain reportable transactions according to the forms and regulations prescribed by the Secretary.

5. The adequate disclosure exception does not apply if the position with respect to a rule or regulation does not have a reasonable basis or if the taxpayer fails to keep adequate books and records or fails to substantiate records properly.

6. Courts have also held that a disclosure statement is adequate if it reasonably apprises the IRS of the nature and amount of the potential controversy. This statement should include the following:

a. A caption identifying the statement as a disclosure under IRC § 6662,

b. An identification of the item with respect to which the disclosure is made,

c. The amount of the item, and

d. The facts affecting the tax treatment of the item sufficient to apprise the IRS of the nature of the potential controversy.

Note: If the disclosure statement fails to include all of the above, misrepresents the facts, or is too general to reasonably apprise the IRS of the potential controversy, the disclosure exception does not apply.

7. Adequate disclosure is an exception to the penalty attributable to disregard of rules or regulations. Since the penalty attributable to negligence is not subject to a disclosure exception, the distinction between negligence and disregard of rules and regulations will sometimes have to be made.

8. The applicability of the disclosure exception is determined for each item or group of similar items separately.

9. When the adequate disclosure exception is met, the tax attributable to the disclosed item is not included in the calculation of the underpayment for penalty purposes.¹⁷

E. Special Rules for Disclosure.

1. Coordinated Industry Case (CIC) Program. Rev. Proc. 94-69, 1994-2 C.B. 804, provides special rules for CIC taxpayers to meet the adequate disclosure exception by providing a written statement after receiving written notice from the IRS requesting such statement.

¹⁷ See Treas. Reg. 1.6662-3(c), Treas. Reg. 1.6662-4(f),(1), (3), (4), and (5) on methods of adequate disclosure.

2. Pass-through entities.

a. Generally, disclosure for items attributable to a pass-through entity should be made on Form 8275 or Form 8275-R, and attached to the return (or qualified amended return) of the entity.

b. Also, a taxpayer (e.g., partner, shareholder, beneficiary, or holder of a residual interest in a REMIC) may make adequate disclosure by filing Form 8275 or Form 8275-R.

c. See applicable form instructions for additional information on filing requirements for Form 8275 or Form 8275-R.

3. Recurring items. Disclosure with respect to a recurring item, such as the basis of recovery property, must be made with each return on which the item is taken into account.

4. Significant book-tax difference. In certain circumstances, a taxpayer is deemed to satisfy the disclosure requirements by disclosing on a Schedule M-3 each item of income, gain, loss, deduction, or credit for which the difference between the amount included in the taxpayer's financial statement net income (loss) for the taxable year and the amount included in taxable income for the taxable year is greater than \$10 million. See Rev. Proc. 2004-45, 2004-31 IRB 140 (August 2, 2004).

III. Substantial understatement of income tax.

A. In general. IRC § 6662(b)(2) imposes an accuracy related penalty in regard to an underpayment of tax due to any substantial understatement of income tax.

B. Substantial understatement.

1. In general. For purposes of this section, there is a “*substantial understatement of income tax*” for any taxable year if the amount of the understatement for the taxable year exceeds the greater of—(i) 10 percent of the tax required to be shown on the return for the taxable year, or (ii) \$5,000.

2. Special rule for corporations. In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the lesser of—(i) 10

percent of the tax required to be shown on the return for the taxable year (or, if greater, \$10,000), or (ii) \$10,000,000.

C. Understatement.

1. In general. The term “*understatement*” means the excess of:

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

b. The amount of the tax imposed which is shown on the return, reduced by any rebate (within the meaning of section 6211(b)(2)).¹⁸ The excess under the preceding sentence will be determined without regard to items to which section 6662A applies.

2. Reduction for understatement due to position of taxpayer or disclosed item.

a. The amount of the understatement will be reduced by that portion of the understatement which is attributable to:

(1) The tax treatment of any item by the taxpayer 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.

b. In no event will a corporation be treated as having a reasonable basis for its tax treatment of an item attributable to a multiple-party financing transaction if such treatment does not clearly reflect the income of the corporation.

3. Substantial Authority Exception.

a. “*Substantial authority*” is an objective standard involving an analysis and application of the law to the relevant facts. It is not determined with reference to

¹⁸ IRC § 6211(b)(2) defines the term “rebate” as follows: “The term “rebate” means so much of an abatement, credit, refund, or other repayment, as was made on the ground that the tax imposed by subtitle A or B or chapter 41, 42, 43, or 44 was less than the excess of the amount specified in subsection (a)(1) over the rebates previously made.”

what the taxpayer actually believed to be the correct treatment of the item. Every item must be separately evaluated to determine whether there is substantial authority for the tax treatment of an item.

b. Substantial authority for the tax treatment of an item will exist, if there is substantial authority at the time the return containing the item is filed or there was substantial authority on the last day of the taxable year to which the return relates.

c. There is substantial authority if the weight of the authorities supporting the treatment of the item is substantial in relation to the weight of the authorities supporting the contrary treatment.¹⁹

4. Tax Shelters.

a. For purposes of IRC § 6662(b)(2) the term “*tax shelter*” means—(i) a partnership or other entity, (ii) any investment plan or arrangement, or (iii) 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.

b. Treas. Reg. 1.6662-4(g) provides an exception to the penalty attributable to a substantial understatement when the substantial understatement relates to a tax shelter item of a taxpayer other than a corporation.

c. Specifically, the penalty should not be asserted if there is substantial authority for the tax treatment of an item or return position and the taxpayer reasonably believed that the tax treatment was more likely than not the proper tax treatment.²⁰

¹⁹ For taxable years beginning on or before October 22, 2004, a taxpayer is considered to reasonably believe that the tax treatment of an item is more likely than not the proper treatment if (i) the taxpayer analyzes the pertinent facts and authorities and, in reliance on that analysis, reasonably concludes in good faith that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld, if challenged by the IRS; or (ii) the taxpayer reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor’s analysis of the pertinent facts and authorities and unambiguously states that the tax advisor concludes that there is a better than 50 percent likelihood that the tax treatment of the item will be upheld, if challenged by the IRS.

²⁰ See Treas. Reg. 1.6662-4(g) for taxable years beginning after October 22, 2004.

d. In general, all tax shelter items of a corporation are taken into account in computing the amount of any understatement.²¹

e. Disclosure made with respect to a tax shelter item of either a corporate or non-corporate taxpayer does not affect the amount of an understatement.

D. Secretarial list.

1. The Secretary may prescribe a list of positions which the Secretary believes do not meet the substantial authority standard and the reasonable cause standard as it applies to reportable transactions.

2. Such list (and any revisions thereof) will be published in the Federal Register or the Internal Revenue Bulletin.

IV. Substantial valuation misstatement.

A. In general.

1. IRC § 6662(b)(3) imposes an accuracy related penalty in regard to an underpayment of tax due to any substantial valuation misstatement.

2. The amount of the penalty is 20 percent of the underpayment attributable to a substantial valuation misstatement and 40 percent in the case of a “*gross valuation misstatement*”.

B. Substantial Valuation Misstatement. For purposes of this section, there is a “*substantial valuation misstatement*” if:

1. The value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter I is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be), or

2. The price for any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of such price, or

3. The net section 482 transfer price adjustment for the taxable year exceeds the lesser of \$5,000,000 or 10 percent of the taxpayer's gross receipts.

²¹ The tax shelter items of a corporation arising in connection with transactions occurring prior to December 9, 1994 are treated in the same manner as non-corporate taxpayers.

C. Gross Valuation Misstatement. A “*gross valuation misstatement*” exists:

1. If the value or adjusted basis of any property claimed on a return is 200 percent or more of the corrected amount,
2. If the price for any property or service (or for the use of property) claimed on a return is 400 percent or more (or 25 percent or less) of the amount determined under IRC 482 to be the correct price, or
3. If the net IRC 482 adjustment exceeds the lesser of \$20,000,000 or 20 percent of the taxpayer’s gross receipts.

D. Limitation. No penalty is imposed unless the portion of the underpayment for the taxable year attributable to substantial valuation misstatements under chapter 1 exceeds \$5,000 (\$10,000 in the case of a corporation other than an S corporation or a personal holding company (as defined in section 542)).

E. Net section 482 transfer price adjustment.

1. In general. IRC § 6662(e)(1)(B) imposes transfer pricing penalties on any underpayment attributable to a substantial valuation misstatement pertaining to transfer pricing under IRC § 482. These penalties are identified as the “*transactional penalty*” and the “*net adjustment penalty*”.

2. The Transactional Penalty.

a. This penalty applies when the price reported for any property or services is 200 percent or more (or 50 percent or less) of the amount determined under IRC § 482 to be the correct price.

b. The term “price for any property or services” encompasses all kinds of adjustments under IRC § 482, including purchase prices, fees, services, rents, interest, and advances.

3. The Net Adjustment Penalty. This penalty applies when the net IRC § 482 adjustment exceeds the lesser of \$5 million or 10 percent of the taxpayer’s gross receipts.

4. Exclusions. For the net IRC § 482 adjustments that are excluded from the penalty, see IRC § 6662(e)(3)(B).²²

²² That Code Section provides for certain adjustments excluded in determining threshold including the following: (i) Any portion of the net increase in taxable income due to a “net section 482 transfer price adjustment” which is attributable to any redetermination of a price if—(1) it is established that the taxpayer determined such price in accordance with a

F. Reasonable Cause Exception.

1. IRC § 6662(c) provides an exception to the penalty if the taxpayer has “*reasonable cause*” and acted in “*good faith*”.

2. The reasonable cause exception applies to the transfer pricing penalties only under certain circumstances.²³

3. In instances where a taxpayer has relied on a professional analysis in determining transfer pricing, the relationship of the professional is not determinative in evaluating whether the taxpayer reasonably relied in good faith on advice.

G. Charitable Deduction Property.

1. No penalty may be imposed under IRC § 6662 with respect to any portion of an underpayment upon a showing by the taxpayer that there was a reasonable cause for, and the taxpayer acted in good faith with respect to, such portion.

2. The taxpayer will not satisfy the good faith test by merely relying on an appraisal. The taxpayer will not be considered to have reasonably relied in good faith on advice unless the requirements of Treas. Reg. 1.6664-4(b) and (c) are met.²⁴

specific pricing method set forth in the regulations prescribed under section 482 and that the taxpayer's use of such method was reasonable, (II) the taxpayer has documentation (which was in existence as of the time of filing the return) which sets forth the determination of such price in accordance with such a method and which establishes that the use of such method was reasonable, and (III) the taxpayer provides such documentation to the Secretary within 30 days of a request for such documentation; (ii) any portion of the net increase in taxable income due to a “net section 482 transfer price adjustment” which is attributable to a redetermination of price where such price was not determined in accordance with such a specific pricing method if—(I) the taxpayer establishes that none of such pricing methods was likely to result in a price that would clearly reflect income, the taxpayer used another pricing method to determine such price and such other pricing method was likely to result in a price that would clearly reflect income, (II) the taxpayer has documentation (which was in existence as of the time of filing the return) which sets forth the determination of such price in accordance with such other method and which establishes that the requirements of sub-clause (I) were satisfied, and (III) the taxpayer provides such documentation to the Secretary within 30 days of request for such documentation; and (iii) any portion of such net increase which is attributable to any transaction solely between foreign corporations unless, in the case of any such corporations, the treatment of such transaction affects the determination of income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States.

²³ See IRC § 6662(e).

²⁴ Those Regulation sections outline generally the basis for asserting reasonable cause and good faith as a defense to the imposition of the penalty under IRC § 6662.

3. In addition, the taxpayer must meet the specific requirements in Treas. Reg. 1.6664-4(h) where charitable deduction property is involved.²⁵

4. When there is an underpayment due to overstated charitable deduction property, the reasonable cause exception under IRC § 6662(c)(2) applies only if the following two conditions are first met:

a. The claimed value of the property was based on a "qualified appraisal" made by a "qualified appraiser" and

b. The taxpayer made a good faith investigation of the value of the contributed property.

5. The Pension Protect Act of 2006 added a penalty provision under IRC § 6695A, if the claimed value of property based on an appraisal results in a substantial or gross valuation misstatement under IRC § 6662, the IRC § 6695A penalty is imposed on any person who prepared the appraisal and who knew, or reasonably should have known, the appraisal would be used in connection with a return or claim for refund.

V. Substantial overstatement of pension liabilities.

A. In general.

1. IRC § 6662(b)(4) provides a penalty in the case of "substantial overstatement of pension liabilities".

2. The penalty is imposed if the actuarial determination of the liabilities taken into account for purposes of computing the deduction for contributions to an employer sponsored retirement plan under paragraph (1) or (2) of IRC § 404(a) is 200 percent or more of the amount determined to be the correct amount of such liabilities.

B. Limitation. No penalty will be imposed unless the portion of the underpayment for the taxable year attributable to substantial overstatements of pension liabilities exceeds \$1,000.

²⁵ Under Treas. Reg. 1.6664-4(h) there may be reasonable cause and good faith with respect to a portion of an underpayment that is attributable to a substantial (or gross) valuation misstatement of charitable deduction property only if—(i) The claimed value of the property was based on a qualified appraisal by a qualified appraiser; and (ii) In addition to obtaining a qualified appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

VI. Substantial or gift tax valuation understatement.

A. In general. The amount of the substantial estate or gift tax valuation understatement penalty is 20 percent of the underpayment attributable to a substantial estate or gift tax valuation understatement or 40 percent of the underpayment attributable to a gross valuation misstatement.

B. Limitations. The penalty applies only to returns of tax imposed for estate or gift taxes.

C. Penalty Assertion.

1. There is a substantial estate or gift tax valuation understatement if the value of the property claimed on an estate or gift tax return is 65 percent or less of the corrected amount (or 40 percent or less in the case of a gross valuation misstatement).

2. The penalty does not apply unless the underpayment attributable to the substantial estate or gift tax valuation understatement (or gross valuation misstatement, if applicable) exceeds \$5,000.

D. Penalty Relief.

1. Penalty relief may be available under certain circumstances if a taxpayer acquired property from a decedent who died in 2010.

2. Special rules may apply in determining tax items including basis, gain, loss, holding period, and character of the acquired property.

3. Section 301(c) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P. L. 111-312, allows the executor of the estate of any decedent who died in 2010 to elect not to have the estate tax rules apply and instead to have modified carryover basis rules apply. This election could impact the amount of tax owed.

4. A taxpayer acquiring property from a decedent may not know whether the executor will elect not to have the estate tax rules apply to the decedent's estate.

a. Thus, a taxpayer may be entitled to penalty relief, for example, suppose a taxpayer acquired property from a decedent who died in 2010 and sold the same property in 2010.

b. If the taxpayer filed a timely extension to file their income tax return, estimated the gain or loss

from such a sale, and made any other estimates for the acquired property necessary to compute the tax, and it is later determined that the taxpayer owes additional tax because the estimate is incorrect, penalty relief will be considered if the estimate was based on a reasonable interpretation of the law.

VII. Penalty for Underpayments Attributable to Transactions Lacking Economic Substance.

A. An accuracy-related penalty is imposed on any transactions lacking economic substance as defined under IRC § 6662(b)(6).

B. The penalty applies on any disallowed tax benefits failing to meet the requirements of IRC § 7701(o), Clarification of Economic Substance Doctrine or any similar rule of law.

C. The penalty for underpayments attributable to transactions lacking economic substance is equal to 20 percent of the underpayment.

D. The penalty is effective and applies to transactions entered into on or after March 31, 2010.

VIII. Increase in penalty in case of nondisclosed noneconomic substance transactions.

A. In general. In the case of any portion of an underpayment which is attributable to one or more nondisclosed noneconomic substance transactions, the penalty is applied with respect to such portion by substituting “40 percent” for “20 percent”.

B. Nondisclosed noneconomic substance transactions. The term “*nondisclosed noneconomic substance transaction*” means any portion of a transaction lacking economic substance with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return.

C. Special rule for amended returns. In no event will any amendment or supplement to a return of tax be taken into account if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by the Secretary regarding the examination of the return or such other date as is specified by the Secretary.

IX. Undisclosed foreign financial asset understatement.

A. In general. The term “*undisclosed foreign financial asset understatement*” means, for any taxable year, the portion of the understatement for such taxable year which is attributable to any transaction involving an undisclosed foreign financial asset.

B. Undisclosed foreign financial asset. The term “*undisclosed foreign financial asset*” means, with respect to any taxable year, any asset with respect to which information was required to be provided under sections 6038, 6038B, 6038D, 6046A, or 6048 for such taxable year but was not provided by the taxpayer as required under the provisions of those sections.

C. Increase in penalty for undisclosed foreign financial asset understatements. In the case of any portion of an underpayment which is attributable to any undisclosed foreign financial asset understatement, the penalty is applied with respect to such portion by substituting “40 percent” for “20 percent”.

SECTION FIVE - § 6662A and § 6707A – Accuracy-Related Penalty on Understatements with Respect to Reportable Transactions

I. In General.

A. IRC § 6662A generally imposes an accuracy-related penalty on any reportable transaction understatement for tax years ending after October 22, 2004.

B. The penalty applies to:

1. Any listed transaction (which is one category of reportable transactions); and
2. Any other reportable transaction if a significant purpose of the transaction is the avoidance or evasion of federal income tax.

C. A reportable transaction understatement under IRC § 6662A differs from an underpayment for IRC § 6662(a) and IRC § 6662(b), accuracy-related penalties. The IRC § 6662A penalty does not apply to reportable transaction understatements attributable to transactions settled under IRB 2005-80.

D. The computation of the IRC § 6662A penalty is 20 percent of the reportable transaction understatement where the reportable transaction was properly disclosed, and 30 percent of the reportable transaction understatement where the transaction was not properly disclosed.

E. The disclosure requirements are explained in the section below.

II. Adequate Disclosure and Rescission of IRC § 6707A Impact on IRC § 6662A.

A. A taxpayer uses Form 8886, *Reportable Transaction Disclosure Statement*, to make the disclosure required under IRC § 6011 and the regulations.

1. Under Treas. Reg. 1.6011-4(e), the Form 8886 must be attached to the taxpayer's tax return (or amended return) for each taxable year for which a taxpayer participates in a reportable transaction.

2. In addition, when the first Form 8886 is filed by the taxpayer, a duplicate Form 8886 must be sent to the Office of Tax Shelter Analysis (OTSA).

B. Generally, a taxpayer should first file a Form 8886 beginning with the first year that it has participated in the reportable

transaction. Thus, the requirement to file a duplicate Form 8886 should arise during the first year of participation in the reportable transaction.

C. If, however, the taxpayer fails to file any Form 8886 in its first year of participation, the requirement to send a duplicate Form 8886 to OTSA will arise whenever the taxpayer first submits a Form 8886, regardless of how many years it has been engaged in the reportable transaction at issue.

D. A failure to submit either filing is a failure to satisfy the disclosure requirements.

1. If a taxpayer has entered into more than one reportable transaction, the taxpayer is required to meet the disclosure requirements with respect to each transaction.

2. A taxpayer is treated as meeting the disclosure requirements of IRC § 6011 and the associated regulations if the Commissioner (or the Commissioner's delegate) rescinds the penalty under IRC § 6707A.

E. IRC § 6707A provides a monetary penalty for the failure to include on any return or statement any information required to be disclosed under IRC § 6011 with respect to a reportable transaction.

F. IRC § 6707A authorizes the Commissioner to rescind the imposition of the penalty with respect to reportable non-listed transactions if it would promote compliance with the tax laws and effective tax administration.

1. The penalty cannot be rescinded with respect to a listed transaction.

2. The Commissioner's refusal to rescind the penalty may not be reviewed by Appeals or in any court proceeding.

G. If the transaction at issue is a listed transaction, however, IRC § 6707A does not permit rescission and, therefore, the potential rescission of an IRC § 6707A penalty and its impact on IRC § 6662A is not an issue.

III. Coordination with Other Penalties.

A. Generally, the IRC § 6662A penalty is in addition to any other accuracy-related penalty that may be imposed. However, the IRC § 6662A penalty does not apply to any portion of an understatement on which the fraud penalty is imposed.

B. Additionally, the IRC § 6662A penalty does not apply to any portion of an understatement on which an IRC § 6662 penalty is imposed at the increased rates determined under IRC § 6662(h) for gross valuation misstatements or under IRC § 6662(i) for nondisclosed, noneconomic substance transactions.

C. If the IRC § 6662A penalty is applied, the penalty under IRC § 6676 (erroneous claim for refund or credit) does not apply.

IV. Penalty Relief.

A. Reasonable cause with respect to transactions entered into on or after March 31, 2010, will not apply to any transaction lacking economic substance.

B. The accuracy-related penalty under IRC § 6662A does not apply with respect to any portion of a reportable transaction understatement if, pursuant to IRC § 6664(d), it is shown that there was reasonable cause and the taxpayer acted in good faith with respect to that portion of the understatement.

C. A taxpayer does not have reasonable cause and did not act in good faith unless:

1. The relevant facts affecting the tax treatment of the item are adequately disclosed in accordance with the regulations prescribed under IRC § 6011 (or the IRC § 6707A penalty for failure to disclose is rescinded in full);

2. There is or was substantial authority for the treatment of the item; and

3. The taxpayer reasonably believed that its treatment of the item was more likely than not the proper treatment.

SECTION SIX - § 6663 – Imposition of Fraud Penalty

I. Imposition of fraud penalty.

IRC § 6663 imposes a penalty if any part of any underpayment of tax required to be shown on a return is due to fraud, there will be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to “*fraud*”.

II. Determination of portion attributable to fraud.

A. If the Secretary establishes that any portion of an underpayment is attributable to fraud, the entire underpayment will be treated as attributable to fraud, except with respect to any portion of the underpayment which the taxpayer establishes (by a preponderance of the evidence) is not attributable to fraud.

B. In the case of a joint return, IRC § 6663 does not apply with respect to a spouse unless some part of the underpayment is due to the fraud of such spouse.

III. Indications of Fraud.

A. IRC § 6663 does not define “fraud.” Courts have long recognized that the essence of the fraud penalty is the state of mind. The state of mind has been described in various ways, but most definitions require “intent to evade tax.” Intent is distinguished from inadvertence, reliance on incorrect professional advice, honest difference of opinion, negligence, or carelessness.

B. Because direct proof of a taxpayer’s fraudulent intent is rarely available, fraud must be proven by circumstantial evidence and reasonable inferences. Fraud will generally involve one or more of the following elements:

1. Deception;
2. Misrepresentation of material facts;
3. False or altered documents;
4. Evasion (e.g., diversion or omission); and
5. Conspiracy.

C. “Badges of Fraud”.

“*Badges of fraud*” include the following:

1. Understatement of income (e.g., by omissions of specific items or entire sources of income, failure to report substantial amounts of income received);

2. Fictitious or improper deductions (e.g., overstatement of deductions, personal items deducted as business expenses);
3. Accounting irregularities (e.g., two sets of books, false entries on documents);
4. Acts of the taxpayer evidencing an intention to evade tax (e.g., false statements, destruction of records, transfer of assets);
5. A consistent pattern over several years of underreporting taxable income;
6. Implausible or inconsistent explanations of behavior;
7. Failure to cooperate with the examining agent;
8. Concealment of assets;
9. Engaging in illegal activities (e.g., drug dealing), or attempting to conceal illegal activities;
10. Inadequate records; and
11. Dealing in cash.

D. Recommendations for asserting the civil fraud penalty should be carefully reviewed to fully establish that the evidence supports the assertion. Fraud must be proven by clear and convincing evidence.

E. All statutory notices of deficiency asserting the civil fraud penalty must be reviewed by Area Counsel.

IV. Civil vs. Criminal Fraud.

A. The major difference between civil and criminal fraud is the degree of proof required to establish fraud on the part of the taxpayer.

B. Criminal fraud requires sufficient evidence to prove guilt beyond a reasonable doubt.

C. Civil fraud requires clear and convincing evidence of fraud with intent to evade tax.

D. Due to the lower standard of proof in civil cases, the civil fraud penalty may be imposed upon a taxpayer who was not convicted of criminal tax evasion. If the taxpayer is convicted of criminal tax evasion under IRC § 7201, the civil fraud penalty should be asserted for the same tax year.

E. Criminal conviction does not mean the civil penalty will be automatically sustained.

V. Penalty Assertion.

A. The civil fraud penalty will be asserted when there is clear and convincing evidence to prove that some part of the underpayment of tax was due to civil fraud. Such evidence must show the taxpayer's intent to evade tax which the taxpayer believed to be owing.

B. To assert the civil fraud penalty in a tax case, it is necessary to establish that a part of the deficiency is due to a knowingly false representation of facts by the taxpayer.

C. The IRS bears the burden of proving civil fraud by clear and convincing evidence. See IRC § 7454(a). The IRS must show that the taxpayer:

1. Knew the content of the return was false, and
2. Filed the return with the intent to evade tax.

D. The civil fraud penalty should be asserted on a case-by-case basis giving consideration to all factors which have a bearing on the taxpayer's fraudulent intent.

E. If a taxpayer submits an amended return, it does not cure the defects on the previously filed fraudulent return and the civil fraud penalty would apply.

F. The civil fraud penalty cannot be asserted on the same underpayment (or portion of an underpayment) on which accuracy-related penalties are asserted. Only one penalty can be applied to any portion of an underpayment of tax.²⁶

G. The criteria for proving fraudulent failure to file under IRC § 6651(f) and civil fraud under IRC § 6663 are the same.

1. Generally, if a fraudulent return is filed late, IRC § 6651(f) is the appropriate penalty to assert.
2. Although there is no specific prohibition against asserting penalties under both IRC § 6651(f) and IRC § 6663, the examiner should exercise caution.
3. The court is not likely to sustain the assertion of both penalties unless compelling facts support the IRS's position.

²⁶ See IRC §§ 6662, 6663.

SECTION SEVEN - § 6664 – Definitions and Special Rules

I. Definitions.

The following definitions apply:

A. The term “*underpayment*” means the amount by which any tax imposed by this title exceeds the excess of the sum of: (i) the amount shown as the tax by the taxpayer on his return, plus (ii) amounts not so shown previously assessed (or collected without assessment), over the amount of rebates made.

B. The term “*rebate*” means so much of abatement, credit, refund, or other repayment, as was made on the ground that the tax imposed was less than the excess of the amount specified in subparagraph I.A, above, over the rebates previously made.

C. The term “*charitable deduction property*” means any property contributed by the taxpayer in a contribution for which a deduction was claimed under IRC § 170. For these purposes the term does not include any securities for which (as of the date of the contribution) market quotations are readily available on an established securities market.

D. A tax advisor is a “*disqualified tax advisor*” if the tax advisor—(i) is a “*material advisor*” and participates in the organization, management, promotion, or sale of the transaction or is “*related*” (within the meaning of IRC § 267(b) or IRC § 707(b)(1)) to any person who so participates,²⁷ (ii) is compensated directly or indirectly by a material advisor with respect to the transaction, (iii) has a fee arrangement with respect to the transaction which is contingent on all or part of the intended tax benefits from the transaction being sustained, or (iv) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

E. For purposes of section IV.E.2, below, an opinion is a “*disqualified opinion*” if the opinion—(i) is based on unreasonable factual or legal assumptions (including assumptions as to future events), (ii) unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person, (iii) does not identify and consider all relevant facts, or (iv) fails to meet any other requirement as the Secretary may prescribe.

²⁷ IRC § 6111(b)(1) defines a “*material advisor*” as any person—(i) who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and (ii) who directly or indirectly derives gross income in excess of the threshold amount (or such other amount as may be prescribed by the Secretary) for such aid, assistance, or advice.

F. The term “*qualified appraisal*” means, with respect to any property, an appraisal of such property which: (i) is treated for purposes of this paragraph as a qualified appraisal under regulations or other guidance prescribed by the Secretary, and (ii) is conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed under sub-clause (i).

G. The term “*qualified appraiser*” means an individual who: (i) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary, (ii) regularly performs appraisals for which the individual receives compensation, and (iii) meets such other requirements as may be prescribed by the Secretary in regulations or other guidance.

II. Penalties applicable only where return filed.

The penalties provided in this part will apply only in cases where a return of tax is filed other than a return prepared by the Secretary (under the authority of IRC § 6020(b)).

III. Reasonable cause exception for underpayments.

A. In general. No penalty will be imposed under IRC § 6662 (Accuracy Related Penalty), or IRC § 6663 (Fraud Penalty) with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

B. Exception. The reasonable cause exception will not apply to any portion of an underpayment which is attributable to one or more transactions described in IRC § 6662(b)(6) (generally, dealing with transactions lacking economic substance).

C. Special rule for certain valuation overstatements.

1. In the case of any underpayment attributable to a substantial or gross valuation overstatement with respect to charitable deduction property, the reasonable cause exception will not apply.

2. The preceding sentence will not apply to a substantial valuation overstatement if: (i) the claimed value of the property was based on a “*qualified appraisal*” made by a “*qualified appraiser*” and (ii) in addition to obtaining such appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

IV. Reasonable cause exception for reportable transaction understatements.

A. In general. No penalty will be imposed under section 6662A with respect to any portion of a reportable transaction understatement if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

B. Exception. Section IV.A will not apply to any portion of a reportable transaction understatement which is attributable to one or more transactions described in IRC § 6662(b)(6) (generally, dealing with transactions lacking economic substance).

C. Special rules. The rule provided in section IV.A will not apply to any reportable transaction understatement unless:

1. The relevant facts affecting the tax treatment of the item are adequately disclosed,
2. There is or was substantial authority for such treatment, and
3. The taxpayer reasonably believed that such treatment was more likely than not the proper treatment.

D. A taxpayer failing to adequately disclose will be treated as if they did if the penalty for such failure was rescinded under IRC § 6707A(d).²⁸

E. Rules relating to reasonable belief.

1. In general. A taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief: (i) is based on the facts and law that exist at the time the return of tax which includes such tax treatment is filed, and (ii) relates solely to the taxpayer's chances of success on the merits of such treatment and does not take into account the possibility that a return will not be audited, such treatment will not be raised on audit, or such treatment will be resolved through settlement if it is raised.

2. Certain opinions may not be relied upon.

An opinion of a tax advisor may not be relied upon to establish the reasonable belief of a taxpayer if—(i) the tax advisor is “*disqualified tax advisor*”, or (ii) the opinion is a “*disqualified opinion*”.

²⁸ IRC § 6707A(d) provides that the Commissioner of Internal Revenue may rescind all or any portion of any penalty imposed if—(A) the violation is with respect to a reportable transaction other than a listed transaction, and (B) rescinding the penalty would promote compliance with the requirements of this title and effective tax administration.

SECTION EIGHT - § 6665 – Applicable Rules

I. Additions treated as tax.

A. The civil penalties are to be paid upon notice and demand and will be assessed, collected, and paid in the same manner as taxes.

B. References to “tax” imposed by this title will be deemed also to refer to the additions to the tax, additional amounts, and penalties provided by this chapter.

II. Procedure for assessing certain additions to tax.

A. For purposes of the deficiency procedures for income, estate, gift, and certain excise taxes, section I, above, does not apply to any addition to tax under IRC §§ 6651 (failure to file and failure to pay penalties), 6654 (failure by an individual to pay estimated income tax), or 6655 (failure by corporation to pay estimated income tax).

B. There is an exception that applies: (i) in the case of an addition described in IRC § 6651, to that portion of such addition which is attributable to a “deficiency” in tax (as defined in IRC § 6211); or (ii) to an addition described in IRC §§ 6654 or 6655, if no return is filed for the taxable year.

SECTION NINE - § 6672 – Failure to Collect Tax

I. General rule.

A. Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, will, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

B. No penalty will be imposed for the failure to pay stamp tax (under IRC § 6653), or the accuracy-related fraud penalties (under part II of subchapter A of chapter 68 – IRC §§ 6662-6664) for any offense to which this section is otherwise applicable.

II. Preliminary notice requirement.

A. In general. No penalty is imposed under section I.A, above, unless the Secretary notifies: (i) the taxpayer in writing by mail to an address (as determined under IRC § 6212(b)), or (ii) in person, that the taxpayer is subject to an assessment of such penalty.

B. Timing of notice. The mailing of the notice described in paragraph II.A (or, in the case of such a notice delivered in person, such delivery) will precede any notice and demand of any penalty under section I.A by at least 60 days.

C. Statute of limitations. If a notice described in section I.A with respect to any penalty is mailed or delivered in person before the expiration of the period otherwise provided for the assessment of such penalty, then in such case the period provided by for the assessment of such penalty under this section will not expire before the later of—(i) the date 90 days after the date on which such notice was mailed or delivered in person, or (ii) if there is a timely protest of the proposed assessment, the date 30 days after the Secretary makes a final administrative determination with respect to such protest.

D. Exception for jeopardy. This subsection will not apply if the Secretary finds that the collection of the penalty is in jeopardy.

III. Extension of period of collection where bond is filed.

A. In general.

1. If, within 30 days after the day on which notice and demand of any penalty under section I.A is made against any person, such person—(i) pays an amount which is not less than the minimum amount required to commence a proceeding in court with

respect to his liability for such penalty, (ii) files a claim for refund of the amount so paid, and (iii) furnishes a bond which meets the requirements of section III.C, no levy or proceeding in court for the collection of the remainder of such penalty will be made, begun, or prosecuted until a final resolution of a proceeding begun as provided in section III.B.

2. Notwithstanding the provisions of IRC § 7421(a) (which provides a general prohibition of suits to restrain assessment or collection), the beginning of such proceeding or levy during the time such prohibition is in force may be enjoined by a proceeding in the proper court.

3. Nothing in this paragraph will be construed to prohibit any counterclaim for the remainder of such penalty in a proceeding begun as provided in section III.B, below.

B. Suit must be brought to determine liability for penalty. If, within 30 days after the day on which his or her claim for refund with respect to any penalty under section I.A is denied, the person described in section III.A.1, above, fails to begin a proceeding in the appropriate United States district court (or in the Court of Claims) for the determination of his or her liability for such penalty, section III.A will cease to apply with respect to such penalty, effective on the day following the close of the 30-day period referred to in this section.

C. Bond. The bond referred to in section III.A will be in such form and with such sureties as the Secretary may by regulations prescribe and will be in an amount equal to 1½ times the amount of excess of the penalty assessed over the payment described in section III.B.

D. Suspension of running of period of limitations on collection. The running of the period of limitations on the collection by levy (as provided in IRC § 6502), or by a proceeding in court in respect of any penalty described in section III.B, will be suspended for the period during which the Secretary is prohibited from collecting by levy or a proceeding in court.

E. Jeopardy collection. If the Secretary makes a finding that the collection of the penalty is in jeopardy, nothing in this subsection will prevent the immediate collection of such penalty.

IV. Right of contribution where more than 1 person liable for penalty.

A. If more than 1 person is liable for the penalty under section IA with respect to any tax, each person who paid such penalty will be entitled to recover from other persons who are liable for such penalty an amount equal to the excess of the amount paid by such person over such person's proportionate share of the penalty.

B. Any claim for such a recovery may be made only in a proceeding which is separate from, and is not joined or consolidated with: (i) an action for collection of such penalty brought by the United States, or (ii) a proceeding in which the United States files a counterclaim or third-party complaint for the collection of such penalty.

V. Exception for voluntary board members of tax-exempt organizations.

A. No penalty will be imposed as provided in section I.A on any unpaid, volunteer member of any board of trustees or directors of an tax exempt organization if such member—(i) is solely serving in an honorary capacity, (ii) does not participate in the day-to-day or financial operations of the organization, and (iii) does not have actual knowledge of the failure on which such penalty is imposed.

B. The preceding sentence will not apply if it results in no person being liable for the penalty imposed by section I.A.

SECTION TEN - § 6676 – Erroneous Claim for Refund or Credit

I. Civil penalty. If a claim for refund or credit with respect to income tax (other than a claim for a refund or credit relating to the earned income credit under section 32) is made for an excessive amount, unless it is shown that the claim for such excessive amount has a reasonable basis, the person making such claim will be liable for a penalty under IRC § 6676 in an amount equal to 20 percent of the excessive amount.

II. Excessive amount. For purposes of this section, the term “*excessive amount*” means in the case of any person the amount by which the amount of the claim for refund or credit for any taxable year exceeds the amount of such claim allowable under this title for such taxable year.

III. Noneconomic substance transactions treated as lacking reasonable basis. For purposes of this section, any excessive amount which is attributable to any transaction described in IRC § 6662(b)(6) will not be treated as having a reasonable basis.

IV. Coordination with other penalties. This section will not apply to any portion of the excessive amount of a claim for refund or credit which is subject to a penalty imposed under part II of subchapter A of chapter 68.

SECTION ELEVEN - § 6698 – Failure to File Partnership Return

I. General rule.

A. In addition to the penalty imposed by IRC § 7203 (relating to willful failure to file return, supply information, or pay tax), if any partnership is required to file a return for any taxable year:

1. Fails to file such return at the time prescribed therefor (determined with regard to any extension of time for filing), or

2. Files a return which fails to show the information required under IRC § 6031 (Return of partnership income), such partnership will be liable for a penalty determined under section II, below, for each month (or fraction thereof) during which such failure continues (but not to exceed 12 months).

B. Unless it is shown such failure is due to reasonable cause.

II. Amount per month. The penalty assessed under IRC § 6698 is the product of (i) \$195, multiplied by (ii) the number of persons who were partners in the partnership during any part of the taxable year

III. Assessment of penalty. The penalty is assessed against the partnership.

IV. Deficiency procedures not to apply. Subchapter B of chapter 63 (relating to deficiency procedures for income, estate, gift, and certain excise taxes) will not apply in respect of the assessment or collection of any penalty imposed under IRC § 6698.

SECTION TWELVE - § 6702 – Frivolous Tax Submission

I. Civil penalty for frivolous tax returns.

A. A penalty of \$5,000 is imposed under IRC § 6702 in the case of filing a “frivolous tax return”.

B. A “frivolous tax return” is a return that purports to be a return of a tax imposed by this title but which either:

1. Does not contain information on which the substantial correctness of the self-assessment may be judged, or

2. Contains information that on its face indicates that the self-assessment is substantially incorrect, and

3. Is filed based on a position which the Secretary has identified as frivolous, or reflects a desire to delay or impede the administration of Federal tax laws.

II. Civil penalty for specified frivolous submissions.

A. A penalty of \$5,000 is imposed in the case of submitting a “frivolous submission”.

B. A “*specified frivolous submission*” means a specified submission if any portion of such submission which is based on a position which the Secretary has identified as frivolous, or reflects a desire to delay or impede the administration of Federal tax laws.

C. The term “specified submission” means—(i) a request for a hearing under (I) IRC § 6320 (relating to notice and opportunity for hearing upon filing of notice of lien), or (II) IRC § 6330 (relating to notice and opportunity for hearing before levy), and (ii) an application under (I) IRC § 6159 (relating to agreements for payment of tax liability in installments), (II) IRC § 7122 (relating to compromises), or (III) IRC § 7811 (relating to taxpayer assistance orders).

D. If the Secretary provides a person with notice that a submission is a specified frivolous submission and such person withdraws such submission within 30 days after such notice, the penalty imposed under IRC § 6702, will not apply with respect to such submission.

III. Penalties in Addition to Other Penalties.

The penalties imposed under IRC § 6698 will be in addition to any other penalty provided by law.

IV. Listing of frivolous positions.

A. The Secretary will prescribe (and periodically revise) a list of positions which the Secretary has identified as being frivolous for purposes of this subsection.

B. The Secretary will not include in such list any position that the Secretary determines that there is a "*reasonable basis*" for the tax treatment of such item.

V. Reduction of Penalty.

The Secretary may reduce the amount of any penalty imposed under this section if the Secretary determines that such reduction would promote compliance with and administration of the Federal tax laws.