TAX MANAGEMENT
PORTFOLIOS™

U.S. INCOME

Civil Tax Penalties

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TAX MANAGEMENT
PORTFOLIOS™

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Civil Tax Penalties

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Civil Tax Penalties*, No. 634-4th, analyzes the many civil tax penalties that can be imposed for various tax offenses. These penalties are designed to regulate the conduct of preparers, payors and tax-exempt entities, in addition to that of taxpayers. The Internal Revenue Service Penalty Handbook (Chapter 20.1 of the Internal Revenue Manual) is intended to ensure that the penalties are applied uniformly.

The civil tax penalties can be divided into seven major categories:

- The failure to file and failure to pay penalties (which are primarily set forth in §6651 relating to the general penalty and §6721–§6724 relating to certain information returns and payee statements);
- The accuracy-related penalties of §6662 and §6662A;
- The fraud penalty of §6663;
- The tax return preparer penalties under §6694–§6696;
- The promoter, protester and tax shelter penalties under §6700–§6703, §6707–§6708, and §6111–§6112;
- Penalties relating to compensation statements and exempt organizations; and
- Penalties relating to certain foreign persons.

The estimated tax penalties, trust fund recovery penalty, and criminal penalties are covered in other Tax Management Portfolios.

The Portfolio also describes the exception to many of the penalties for reasonable cause, including an analysis of the most common reasons advanced as constituting reasonable cause. In addition, the Portfolio summarizes how the various penalties can be assessed and collected by the IRS.

This Portfolio can be cited as Tarr, and Drucker, 634-4th T.M., *Civil Tax Penalties*.

This Bloomberg Tax Portfolio is not intended to provide legal, accounting, or tax advice for any purpose and does not apply to any particular person or factual situation. Neither the author nor the publisher assumes responsibility for the reader's reliance on information or opinions expressed in it, and the reader is encouraged to verify all items by reviewing the original sources.

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DETAILED ANALYSIS

I. Introduction

A. *The Growth of Penalties*

Penalties are an important part of our tax system. Tax collections rely primarily on self-assessment. Without penalties, there would be little or no voluntary compliance.

There are over 170 civil penalties[1] in the Code. They cover everything from the failure to file a tax return or pay a tax, to accuracy-related penalties, to information returns, to special penalties covering the activities of tax return preparers, to penalties relating to tax shelter activities, and beyond. Each new tax act seems to impose additional penalties or modify existing ones.

The number of penalties has grown more than 12-fold from the 14 penalties included in the Internal Revenue Code of 1954.[2] The number and amount of penalties imposed has grown exponentially. So has the abatement of penalties. For fiscal year 1978, the earliest year for which the data is available, the IRS assessed 15.4 million penalties, for a total of $1.3 billion. About $0.3 billion of penalties were abated in such year.[3] By 2023, the IRS assessed almost $65.6 billion in civil penalties and abated more than $13.0 billion during the year, including nearly $2.9 billion in abatements for individual and estate and trust income tax returns.[4]

B. *Basic Structure of Civil Penalties Under the Code*

The civil penalties, set forth in Chapter 68 of the Code (§6651–§6751) are divided into two types: (1) additions to tax; and (2) assessable penalties. Although there may have originally been some intention to distinguish the two categories, any distinction has disappeared.[5]

Taxpayers have challenged the IRS's ability to impose civil penalties on constitutional grounds — most often by taxpayers previously convicted of criminal tax offenses. Taxpayers in such situations typically assert that the imposition of a civil penalty violates the Double Jeopardy Clause of the U.S. Constitution, which forbids a second "punishment" for the same offense. Courts consistently have held, however, that civil tax penalties do not constitute an impermissible second punishment as long as they serve only a remedial purpose.[6]

Taxpayers also have challenged the IRS's ability to impose a particular penalty on the grounds that repeal or amendment of the specific penalty after occurrence of an event triggering liability under the penalty bars the IRS from later seeking to collect the liability incurred under the repealed statute. Courts generally have found that liability under the old provision is not extinguished by its repeal or amendment under the U.S. Code's General Savings Statute, 1 U.S.C. §109.[7]

Taxpayers also are increasingly challenging agency and court actions with respect to penalties under the Administrative Procedures Act (APA). For example, in *United States v. Schwarzbaum*,[8] the Fourth Circuit vacated and remanded the case back to the district court to instruct the IRS to recompute FBAR penalties after the district court itself had re-computed the IRS's original penalties to achieve what it thought was the correct result.[9] The government argued that when the district court reduced the new penalties it had imposed against the taxpayer, it thereby reimposed and upheld the IRS's original penalties. But in its orders, the district court explained that it was reducing the penalties it had imposed only because the government was seeking a smaller penalty than it had assessed.

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[1] National Taxpayer Advocate, 2014 Annual Report to Congress at 10, 94 (Dec. 31, 2014); Internal Revenue Service Advisory Council ("IRSAC"), General Report at 10 (Nov. 16, 2016). For purposes of this Portfolio, a penalty includes an addition to tax, but not taxes that are imposed to discourage certain actions (*e.g.*, §72(g), §72(t), §409A(a)(1)(B)(i)) or interest on a tax deficiency. Criminal tax penalties are also excluded. All section references are to the Internal Revenue Code of 1986, as amended ("Code"), and the regulations promulgated thereunder, unless otherwise indicated.

[2] National Taxpayer Advocate, 2014 Annual Report to Congress at 10, 94 (Dec. 31, 2014).

[3] *See* Letter from House Ways and Means Subcommittee on Oversight, Chairman J.J. Pickle to House Ways and Means Committee Chairman Dan Rostenkowski, dated June 16, 1989 ("Pickle Letter"), transmitting the Subcommittee's recommendations on penalty reform; IRS Executive Task Force, Report on Civil Tax Penalties (Feb. 22, 1989) ("IRS Penalty Report").

[4] 2023 IRS Data Book, Table 27 — Civil Penalties Assessed and Abated, by Type of Tax and Type of Penalty, Fiscal Year 2023. The penalties included in the table are those that were recorded in fiscal year 2023, regardless of the tax year to which they may relate.

[5] *See* S. Rep. No. 92-437, at 73–74 (1971) (indicating that assessable penalties as well as additions to tax in which the government bears the burden of proof of fraud are not deductible); *Uhlenbrock v. Commissioner*, 67 T.C. 818 (1977) (deduction denied for additions to tax imposed by §6651); *May v. Commissioner*, 65 T.C. 1114 (1976); Reg. §1.162-21(a), §1.162-21(b)(1)(ii) (civil penalties including additions to tax and assessable penalties under Chapter 68 are not deductible); §6751(c) (for purposes of this section (relating to procedure requirements for assessing penalties), the term "penalty" includes any addition to tax).

[6] *Helvering v. Mitchell*, 303 U.S. 391 (1938) (Double Jeopardy Clause prevents defendant who has already been punished in criminal prosecution from being subjected to additional civil sanction that cannot fairly be characterized as remedial, but only as deterrent or retribution; civil fraud penalties in instant case were permissible as they were remedial in nature and were intended by Congress to reimburse government for costs of discovering and recovering losses caused by fraud).

[7] *See Warden v. Marrero*, 417 U.S. 653 (1974) (unless Congress declares otherwise, a liability that arises under a later-repealed statute is preserved despite repeal, and may be enforced by a post-repeal action); *Hertz v. Woodman*, 218 U.S. 205 (1910) (predecessor to 1 U.S.C. §109 preserved liability under former federal inheritance tax statute even though statute was later repealed); *Korshin v. Commissioner*, 91 F.3d 670 (4th Cir. 1996) (rejecting taxpayer's assertion that IRS was barred from imposing various versions of former §6653 negligence penalty based on theory that each successive version of §6653 expressly or impliedly repealed the preceding version, thereby extinguishing any liabilities arising from old version); *Frey v. United States*, 558 F.2d 270 (5th Cir. 1977) (1 U.S.C. §109 allows post-repeal enforcement of tax liability arising under former §4741 — marijuana excise tax provision — for pre-repeal taxable sale).

[8] 24 F.4th 1355 (11th Cir. 2022).

[9] *See, e.g., Zhou Hua Zhu v. United States AG*, 703 F.3d 1303 (11th Cir. 2013) (remand is appropriate remedy when administrative agency makes error of law for it affords agency opportunity to receive and examine evidence in light of correct legal principle).

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The district court rejected the government's characterization that it was simply reinstating the original penalty assessment.

The Fourth Circuit explained that when the district court calculated and imposed new FBAR penalties against the taxpayer, it had overstepped its role as the APA requires a reviewing court to hold the action unlawful and set it aside and does not allow the court to do the agency's job.[10] The Fourth Circuit thus concluded that the district court lacked the power to recalculate the taxpayer's FBAR penalties, i.e., courts do not have original calculation jurisdiction over FBAR penalties and such power belongs to the IRS.[11]

Penalties, even if unassessed, may affect subsequent calculations, such as those for interest overpayments.[12]

This Portfolio describes the major civil tax penalties and the exception for reasonable cause, as well as statutory exceptions and administrative waivers, and the methods for appealing the assessment of a penalty. Certain penalties, however, are beyond the scope of this discussion (e.g., the penalty for underpayment of estimated tax that is described in detail in 581 T.M., *Estimated Tax*; criminal penalties that are described in 636 T.M., *Tax Crimes*; and the Trust Fund Recovery Penalty that is discussed in 639 T.M., *Responsible Person and Lender Liability for Trust Fund Taxes — Sections 6672 and 3505*).

C. Policy

By 1987, the Code contained 150 penalties. Separate and multiple penalties applied to different types of prohibited behavior. The ad hoc structure was complex, confusing, and often unduly harsh. Complaints caused Congress and the IRS to reconsider the whole penalty system. They agreed on several fundamental factors that formed the basis for reshaping tax penalties:[13]

• Penalties should exist solely for the purpose of encouraging voluntary compliance with the tax law. Although penalties do raise significant revenue for the government, penalties should not be imposed simply to raise revenue. Similarly, although penalties operate to punish noncompliant behavior, such punishment should be a mechanism to encourage voluntary compliance, and not a goal in and of itself;

• Penalties and the standards of conduct required by taxpayers should be readily known and easily understood. Voluntary compliance requires the taxpayer to understand what conduct is expected and be able to live up to those standards;

• Penalties should not treat taxpayers who make a good faith effort to comply with the tax laws as harshly as taxpayers who deliberately violate the laws. Penalties should distinguish between the substantive tax law and the standards of behavior that constitute voluntary compliance. For most taxpayers, voluntary compliance lies in making a good faith effort to prepare their tax returns in a manner that accurately determines their tax liabilities, file such returns and pay the taxes shown to be due. Taxpayers who make the required effort to comply generally should not be penalized, even if they do not actually succeed;

• Penalties should be fair. Similarly situated taxpayers should be treated similarly. In addition, the penalty should be proportional to the seriousness of the noncompliant behavior. The penalty should bear some relationship to the culpability of the taxpayer and the harm caused by the infraction. Penalties should be severe enough to deter the noncompliant behavior, without being so severe as to be difficult to enforce or perceived as disproportionate or unfair. Multiple penalties should not apply to the same misconduct;

• Penalties should be easily and properly administered. A penalty is administrable if it is easy for the IRS to determine when it should be imposed, while still allowing the IRS to exercise discretion in determining whether to waive it. The IRS should act in an impartial and honest manner and help taxpayers understand their obligations. Each case should be promptly processed and resolved;

• Penalties should not be asserted unless the situation warrants their imposition. A wrong decision, even if subsequently corrected, can negatively impact voluntary compliance;

• An adequate opportunity should exist for incorrect decisions to be corrected. Taxpayers should have an opportunity to have their interests heard and considered — ideally before the penalty is assessed; and

• Penalties should be reviewed periodically to see that they are achieving their desired effect. Systems must be developed to collect relevant data and assess each penalty's impact on compliance.

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[10] 5 U.S.C. §706(2). *See, e.g., SEC v. Chenery Corp.*, 332 U.S. 194 (S. Ct. 1947); *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402 (S. Ct. 1971) ("The court is not empowered to substitute its judgment for that of the agency.").

[11] *See* 31 C.F.R. §1010.810(g) (delegating to IRS authority to assess and collect civil penalties under 31 U.S.C. §5321).

[12] *See* CCA 201125033 (unassessed portion of delinquency penalty may be accounted for before determining amount of estate tax overpayment even though limitations period for assessing penalty has expired).

[13] Pickle Letter; House Ways and Means Subcommittee on Oversight Report, Recommendations Regarding the Improved Penalty Administration and Compliances Act of 1989; IRS Penalty Report.

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These criteria formed the basis for the Improved Penalty Administration and Compliance Act, which was included as part of the Omnibus Budget Reconciliation Act of 1989 (Pub. L. No. 101-239) ("1989 Act"), which reorganized and simplified the penalty regime. The fundamental principles also were adopted as part of the Internal Revenue Manual,[14] and reaffirmed by the Joint Committee on Taxation in its 1999 study.[15]

To implement these requirements, the IRS placed the overall responsibility for penalties in a single place — the Office of Servicewide Penalties ("OSP"). OSP is charged with coordinating policies and procedures concerning the administration of penalty programs, reviewing and analyzing penalty information, researching taxpayer attitudes and opinions and determining appropriate actions to encourage voluntary compliance.[16]

D. Criticisms of Penalty Policies

Notwithstanding the principles for designing penalties set forth by Congress and the IRS, and repeated by the Joint Committee on Taxation, numerous penalties have since been enacted that do not meet these criteria. Most of these penalties resulted from the government's efforts to combat tax shelters and reduce the tax gap. The enactment of these penalties marked a change in the policy of using penalties solely to enhance voluntary compliance, to one of ensuring that penalties are applied, especially if a "significant purpose" of the transaction was the avoidance or evasion of federal tax.[17]

This shift away from the fundamental principles for the design and administration of penalties has drawn criticism from tax professionals, including the American Bar Association, the American Institute of Certified Public Accountants, Internal Revenue Service Advisory Counsel and the National Taxpayer Advocate:[18]

> • The newer penalties reflected a trend away from voluntary compliance as the primary purpose of penalties. This was reflected by the significant amount of revenue projected to be raised by certain penalties, as well as the Government Accountability Office Report which indicated that the IRS was not asserting certain information reporting penalties because the cost of developing and asserting the penalty exceeded the revenue to be received;[19]
>
> • Some of the newer penalties did not articulate clear standards of conduct,[20] creating a trap, even for diligent taxpayers;
>
> • Some of the newer penalties were disproportionate to the harm resulting from the misbehavior.[21] The National Taxpayer Advocate, the IRS and members of Congress

[14] The IRS Penalty Handbook is found in Part 20 of the Internal Revenue Manual (IRM). IRM 20.1 provides the basic overview of the penalty scheme as follows:

> • Penalties exist to encourage voluntary compliance by supporting the standards of behavior expected by the Code. Although penalties also serve to bring additional revenue and indirectly fund enforcement costs, these results are not reasons for creating or imposing penalties. Nor should they be used as a bargaining point in resolving a taxpayer's other tax adjustments. IRM 20.1.1.2 (11-21-17), IRM 20.1.1.2.1 (11-25-11), Policy Statement 20-1 (Formerly P-1-18), printed in IRM 1.2.1.12.1 (06-29-04).
>
> • Voluntary compliance is achieved when taxpayers make a good faith effort to meet their tax obligations. IRM 20.1.1.2.1(6) (11-25-11).
>
> • To be fair and effective, penalties should be severe enough to deter noncompliance, encourage noncompliant taxpayers to comply, be objectively proportioned to the offense, and be used as an opportunity to educate taxpayers and encourage their future compliance. IRM 20.1.1.2.1(8) (11-25-11), Policy Statement 20-1 (Formerly P-1-18), printed in IRM 1.2.1.12.1 (06-29-04).
>
> • Penalty administration should ensure consistency, accuracy, impartiality and representation. The taxpayer should be given the opportunity to have its interest heard and considered. IRM 20.1.1.2.2 (11-25-11), IRM 20.1.1.2.1 (11-25-11). *See* IRM 20.1.1.1.3(4) (03-29-23), Policy Statement 20-1 (Formerly P-1-18), printed in IRM 1.2.1.12.1 (06-29-04).
>
> • IRS should collect information to evaluate penalties and penalty administration, and to determine the effectiveness of penalties in promoting voluntary compliance. The IRS continually evaluates the impact of the penalty program on compliance and recommends changes when the Code or penalty administration does not effectively promote voluntary compliance. Policy Statement 20-1 (Formerly P-1-18), printed in IRM 1.2.1.12.1 (06-29-04). *See* IRM 20.1.1.1.4 (11-21-17).

The IRM is the single official compilation of policies, delegated authorities, procedures, instructions and guidelines relating to the organization, functions, administration and operations of the IRS. IRM 1.11.2.2 (09-13-23). But it does not have the force of law, is not binding on the IRS, and confers no rights on taxpayers. *See, e.g.*, *Fargo v. Commissioner*, 447 F.3d 706 (9th Cir. 2006); *Carlson v. United States*, 126 F.3d 915 (7th Cir. 1997); *United States v. Will*, 671 F.2d 963 (6th Cir. 1982); *United States v. Jourdan*, 120 AFTR2d 6325 (D. Minn. 2017); *Qureshi v. United States*, 96 AFTR2d 5949 (Fed. Cl. 2005). It cannot be relied upon as authority for purposes of avoiding the substantial understatement of tax penalty under §6662(d). Reg. §1.6662-4(d)(3)(iii). See discussion at IV.C.3.b., below. We cite to the IRM, however, because it is an indication of the IRS's thinking about the issue, and because it is often cited by the court, including the Supreme Court.

[15] Joint Committee on Taxation, Study of Present Law Penalty and Interest Provisions as Required by §3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (JCS-3-99), July 22, 1999 (Tax penalties "should (1) encourage voluntary compliance, (2) operate fairly, (3) deter improper behavior, and (4) be designed in a manner that promotes efficient and effective administration of the provisions by the IRS").

[16] IRM 20.1.1.1.3(2) (03-29-23).

[17] National Taxpayer Advocate, *2008 Annual Report to Congress, A Framework for Reforming the Penalty Regime*, Vol. 2, at 11 (Dec. 31, 2008).

[18] *See, e.g.*, American Bar Association, Section of Taxation, *Statement of Policy Favoring Reform of Federal Civil Tax Penalties* (Apr. 19, 2009); American Institute of Certified Public Accountants, *Report on Civil Tax Penalties: The Need for Reform* (Aug. 28, 2009 updated Apr. 11, 2013) ("AICPA Report"); 2015 IRSAC Large Business and International Report (May 13, 2015) at www.irs.gov/tax-professionals/2015-irsac-large-business-and-international-report; National Taxpayer Advocate, 2008 Report to Congress at 414–15 (Dec. 31, 2008), National Taxpayer Advocate, 2013 Annual Report to Congress, *Do Accuracy Related Penalties Improve Future Reporting Compliance by Schedule C Filers?* Vol. 2, at 1 (Dec. 31, 2013), National Taxpayer Advocate, *2014 Annual Report to Congress* at 94–101 (Dec. 31, 2014), National Taxpayer Advocate, *2016 Annual Report to Congress* at 12–14, 50–63 (Dec. 31, 2016).

[19] Government Accountability Office, Report to the Committee on Finance, U.S. Senate, *Tax Administration: IRS Should Evaluate Penalties and Develop a Plan to Focus Its Efforts* (GAO-09-567) at 9 (June 5, 2009).

[20] *See, e.g.*, §6662A and §6707A (which impose harsher penalties for participation in a listed transaction or a transaction that is "substantially similar" to a listed transaction); §6662, §6662A and §6694 (which impose penalties on participation in a transaction that has a "significant purpose" of the avoidance or evasion of federal income tax). The terms "substantially similar," "significant purpose," "participation" and "transaction" however, are amorphous.

[21] *See, e.g.*, §6708 (penalty of $10,000 a day with no cap for failure to provide a list of advised clients, without regard to the number of persons omitted); §6662A (penalty is based on the underpayment computed at the highest marginal rate under §1 or 11, even if the taxpayer's actual rate is lower). Prior to its amendment in 2010, effective for penalties imposed after 2006, §6707A imposed a penalty as high as $200,000 for a single failure to disclose a listed transaction, regardless of the amount of the underpayment, if any, attributable to the transaction.

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have acknowledged that penalties should be commensurate with the transgression.[22] Moreover, multiple penalties could be imposed with respect to a single act;[23]

• There is a recent trend toward strict liability penalties.[24] In some cases, reasonable cause exceptions may not be allowed or may be severely limited (e.g., by requiring a higher level of confidence). Others may prohibit judicial review of the IRS's determination as to whether to abate the penalty. Such penalties appear to be intended more as punishment than to encourage compliance; and

• There is a trend toward automatic assessment of penalties. For example, negligence penalties are often asserted automatically if there is a mismatch between what the taxpayer reports and the information returns received by the IRS, without first considering whether the taxpayer was actually negligent or had reasonable cause for the failure to include such amount. This raises multiple concerns. First, it seems to violate Congress's mandate "to make a correct substantive determination in the first instance rather than mechanically assert penalties with the idea that they will be corrected later."[25] Second, automated and required assessments eliminate both IRS discretion to not impose the penalty, as well as the taxpayer's pre-assessment rights to contest the penalty.[26] In addition, having to challenge incorrect assessed penalties is a waste of both IRS and taxpayer resources.[27] In many instances, taxpayers will pay penalties even if they are unwarranted because it is so difficult and costly to challenge a penalty once it has been assessed.[28] Lastly, the Treasury has determined that the Automated Underreporter Program, which matches taxpayer income and deductions submitted or information retained by third parties (e.g., employers, banks, and brokerage firms) against amounts reported by taxpayers on their individual tax returns and automatically assesses additional tax and accuracy-related penalties, has increased significantly in recent years, but the penalties were often not properly assessed.[29] Moreover, in 42% of the cases studied, abatements were not made in accordance with Appeals criteria.[30] The National Taxpayer Advocate has criticized the IRS's over-reliance on automated systems, as increasing audit reconsiderations and abatement rates.[31] Taxpayers who were automatically assessed a penalty which was then abated actually showed decreased levels of future reporting compliance.[32]

The IRS also has been criticized by the National Taxpayer Advocate and the General Accounting Office for its failure to analyze the effectiveness of penalties.[33] IRS policy has long required OSP to collect information to evaluate penalties and penalty administration, and to determine the effectiveness of penalties in promoting voluntary compliance.[34] OSP, however, has failed to do so. For example, OSP does not identify:

• Penalties with high or low assessment and abatement rates (relative to the total that meet the criteria);

• Whether significant differences exist in the abatement rate for high-income taxpayers relative to low-income taxpayers;

• Whether significant differences exist in penalty size between taxpayers that negotiate an installment agreement relative to those who pay cash;

• Whether returns prepared by a paid preparer are more or less likely to have penalties assessed or abated;

• Whether penalties are assessed or abated at different rates based on the geographic location where the case is worked;

• Whether individual taxpayers receive more or fewer abatements than businesses for the same penalties;

• Whether the rate of abatements is higher or lower with respect to penalties that are required to be assessed, and the reason therefor; or

[22] National Taxpayer Advocate, 2008 Annual Report to Congress at 10–11, 414–418, 419–422 (Dec. 31, 2008); 2015 IRS Advisory Council Large Business and International Report; Testimony of IRS Commissioner Douglas Shulman before House Ways and Means Subcommittee on Oversight (June 4, 2009); Letter from Sen. Max Baucus, Sen. Charles Grassley, Rep. John Lewis, Rep. Charles Boustany, Jr. to IRS Commissioner Douglas Shulman (June 12, 2009); AICPA Report.

[23] For example, failing to disclose a listed transaction on Form 8918 can result in a penalty for failure to disclose under §6707A, and an increased accuracy-related penalty under §6662A(c). The penalty is imposed even though the IRS otherwise has actual notice of the taxpayer's participation in the transaction. In addition, the statute of limitations may be tolled, the suspension of interest provisions cannot apply, tax accrual work papers will automatically be requested and in the case of a public company, the penalties must be disclosed on the financial statements filed with the SEC. §6501(c)(10), §6404(g)(2)(E), §6707A(e); Announcement 2002-63. *See also* §6696, which provides that the penalties under §6694, §6695 and §6695A may be stacked on top of other penalties.

[24] *See, e.g.*, §6707, §6707A, §6662(b)(6), §6662(i), §6695A.

[25] H.R. Rep. (Conf.) No. 101-386 at 661 (1989).

[26] *See, e.g.*, §6662, §6676, §6707A. There is no pre-assessment review for penalties under §6038(b), §6038A, §6038B, or §6038C. See discussion at XII.B.1., below. Certain penalties enumerated in §6751(b)(2)(A) and penalties that are automatically calculated through electronic means are not required to be pre-approved by a manager. §6751(b)(2). See discussion at XII.A.1., below.

[27] *See, e.g.*, National Taxpayer Advocate, *2020 Annual Report to Congress* at 38 (Dec. 31, 2020) (discussing penalty assessments under §6038 and §6038A).

[28] *See, e.g.*, AICPA Report; National Taxpayer Advocate, *2016 Annual Report to Congress* at 73 (Dec. 31, 2016).

[29] Treasury Inspector General for Tax Administration, *Automated Underreporter Program Tax Assessments Have Increased Significantly; However Accuracy-Related Penalties Were Not Always Assessed When Warranted* (May 8, 2015). See discussion at XII.A.1., below.

[30] Treasury Inspector General for Tax Administration, *Additional Documentation Is Needed to Support Office of Appeals Penalty Abatement Decisions* (July 30, 2015).

[31] National Taxpayer Advocate, *2010 Annual Report to Congress* at 16 (Dec. 31, 2010).

[32] National Taxpayer Advocate, *2013 Annual Report to Congress, Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?* Vol. 2, at 3, 13 (Dec. 31, 2013).

[33] *See, e.g.*, National Taxpayer Advocate, *2008 Annual Report to Congress* (Dec. 31, 2008) at 415–18; National Taxpayer Advocate, *2013 Annual Report to Congress, Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?* Vol. 2, at 3 (Dec. 31, 2013); National Taxpayer Advocate, *2014 Annual Report to Congress* (Dec. 31, 2014) at 94–101; General Accounting Office, *Report to Senate Finance Committee: IRS Should Evaluate Penalties and Develop a Plan to Focus Its Efforts* (GAO-09-567) (June 5, 2009).

[34] IRM 1.2.1.12.1(12) (06-29-04) (IRS Policy Statement 20-1).

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• Whether the rate of erroneous penalty assessments is increasing or decreasing.

Without this information, the OSP cannot determine whether a penalty is serving its intended purpose, and what changes should be made to make the penalty more effective. OSP has not even analyzed the limited data that is maintained (e.g., the amount and type of penalties that are abated). At an even more basic level, the General Accounting Office found that controls over computer programs affecting penalty assessments do not ensure that the programs always function in accordance with IRS policies and procedures.[35] The National Taxpayer Advocate recognizes that the IRS's failure to address these issues' causes wastes resources and undermines taxpayer confidence in the tax system.[36]

In its 2016 Report to Congress, the National Taxpayer Advocate endorsed using insights from behavioral science to improve compliance, by appealing to motivations other than economic deterrence. For example, Taxpayer Advocate studies have shown that (1) "soft" notices which educate taxpayers as to what is expected, in easy to understand language, and which are sent directly to the taxpayers before the reporting seasons, and (2) specifically tailored notices highlighting errors so taxpayers can avoid the error in the future have increased compliance by making compliance easier and noncompliance more noticeable. The Report also recommends changing the metrics for evaluating collections and performance, so the cost and effect of the different enforcement initiatives can be evaluated.

[35] General Accounting Office, Letter to IRS Commissioner Douglas Shulman (June 4, 2008).

[36] National Taxpayer Advocate, *2011 Annual Report to Congress* at viii, 93–108 (Dec. 31, 2011), National Taxpayer Advocate, *2014 Annual Report to Congress* at 10 (Dec. 31, 2014).

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II. Failure to File Penalties

A. Introduction

The failure to file and failure to pay penalties were enacted to ensure the timely filing of tax returns and the prompt payment of the associated tax liability.[37] Although the due dates selected are somewhat arbitrary, fixed dates are considered essential to the workings of the government. As a result, the penalties are strictly applied (subject to the reasonable cause exception).

B. General Applicability of Failure to File Penalty

1. In General

Section 6651(a)(1) imposes a penalty if a required tax return is not filed on or before its due date, unless such failure is due to reasonable cause and not willful neglect.[38] The penalty applies to all returns required to be filed under subchapter A of Chapter 61 (relating to income tax returns of an individual, a corporation, and a fiduciary for a trust or estate; self-employment tax returns; and estate and gift tax returns), subchapter A of Chapter 51 (relating to distilled spirits, wines, and beer), subchapter A of Chapter 52 (relating to cigars, cigarettes, and cigarette paper and tubes), and subchapter A of Chapter 53 (relating to machine guns, destructive devices, and certain other firearms). The penalty also applies if a taxpayer is required to file its tax return electronically and fails to do so.[39] The penalty does not apply to information returns[40] or to payments of estimated tax.[41] The penalty applies where a net amount of tax becomes due as a result of a taxpayer failing to exercise an election under the nonrecognition provisions.[42]

The penalty applies to the failure to file excise tax returns required under §4975.[43]

Although §6651 imposes liability on the taxpayer, its application is not limited to a failure to file by the taxpayer if another party fails to file on behalf of the taxpayer.[44]

The notice must contain the name of the penalty, the Code section under which it is imposed, and a computation of the penalty.[45]

2. Timeliness of Filing

Generally a return is considered "filed" on the date it is delivered to the IRS. Nevertheless, a return delivered after its due date is considered to be timely filed if it was mailed to the proper IRS office within the time prescribed for filing (including extensions) under the "timely mailed, timely filed" rule.[46] The burden of proving the date of mailing, however, is on the taxpayer. The taxpayer can meet this burden by mailing the return by registered or certified mail. In such case, the postmark date is the date of registration or the U.S. postmark date stamped on the sender's certified mail receipt.[47] Taxpayers can also use "designated" private delivery services (e.g., Fed Ex or UPS) for filing purposes.[48]

If the taxpayer submits an electronically filed return, regulations govern the extent to which the prima facie evidence of delivery and postmark date rules for U.S. registered mail apply to electronic filings.[49] The regulations define an electronic postmark as a record of the date and time (in a particular time zone) that an authorized electronic return transmitter ("ERT") receives the transmission of the taxpayer's electronically filed document on its host system.[50] If the taxpayer and the ERT are in different time zones, the taxpayer's time zone controls the timeliness of the document.[51] The date of an electronic postmark given by an authorized ERT is deemed to be the filing date if the date of the electronic postmark is on or before the filing due date.[52] Both the person who transmits the electronic portion of a return to the IRS and the person who increases the transmission rate or line speed of formatted or reformatted information that is being sent to the IRS through a public switch telephone network are ERTs.[53] These rules apply to income tax returns filed through ERTs that are authorized to provide an electronic postmark.[54]

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[37] *United States v. Boyle*, 469 U.S. 241 (1985).

[38] The reasonable cause exception is described at II.B.5., and at XI., below.

[39] *See, e.g.,* Reg. §301.6011-5(c), §301.6033-4(c), §301.6037-2(c). *See also* PMTA 2022-05 (Chief Counsel's Office advised that upon finalization of proposed regulations, failure to file certain specified returns electronically may result in additions to tax under §6651 and §6652).

[40] Section 6651(a)(1) excludes information returns in part III of subchapter 61A (§6031–§6060). These returns are subject to a separate failure to file penalty described at II.C., and at VI., below.

[41] §6651(e).

[42] *See, e.g.,* TAM 9548005 (§6651(a)(1) penalty applies where tax becomes due because taxpayer decides not to replace involuntarily converted property under §1033); *Occhipinti v. Commissioner*, T.C. Memo 1969-190 (§6651(a)(1) penalty applies where deficiency arose after [former] §1034 deferral was disallowed by IRS).

[43] *See Janpol v. Commissioner*, 102 T.C. 499 (1994) (filing of Forms 5500-R and 5500-C does not preclude §6651(a)(1) liability for failure to file Form 5330).

[44] *See, e.g., Bassett v. Commissioner*, 100 T.C. 650 (1993), aff'd, 67 F.3d 29 (2d Cir. 1995) (child was liable for failure to file penalties because her guardians did not file for her).

[45] §6751, §3306. Although generally required before assessment, the written approval by the IRS supervisor of the initial determination of the assessment is not required for additions to tax under §6651. §6751(b)(2)(A).

[46] §7502(a); Reg. §301.7502-1(c). For a discussion of the timely mailed, timely filed rule, see 627 T.M., *Limitations Periods, Interest on Underpayments and Overpayments, and Mitigation.*

[47] §7502(c)(1); Reg. §301.7502-1(c)(2).

[48] *See* §7502(f). For a listing of designated private delivery services, see Tables, Charts & Lists > Designated Private Delivery Services > *Eligble Designated Private Delivery Services (PDS) Under §7502.*

[49] §7502(c)(2), authorizes the promulgation of regulations governing the extent to which the prima facie evidence of delivery and postmark date rules for U.S. registered mail apply to electronic filings. *See* Reg. §301.7502-1(d), §301.7502-1(g). *See* IRM 20.1.2.2.1 (02-27-24) on applying timely mailed/timely filed rules to electronic filing under §7502. In CCA 201545017, the Chief Counsel's Office advised that a taxpayer timely filed its amended income tax return when the paper return was postmarked within 10 days of electronic rejection notice. The taxpayer was not required to contact the e-Help desk and make a waiver request because the IRS could no longer electronically accept the form at issue. For guidance on timely filing rejected e-file returns, see the IRS website for the publications specific to each IRS electronic filing system. Notice 2024-18, *modifying* Notice 2023-60, and *obsoleting* Notice 2010-13 (availability of administrative exemptions from the requirement to file certain returns and other documents in electronic form).

[50] Reg. §301.7502-1(d)(3)(ii).

[51] Reg. §301.7502-1(d)(3)(ii).

[52] Reg. §301.7502-1(d)(1).

[53] Reg. §301.7502-1(d)(3)(i). *See* Rev. Proc. 2007-40, *superseding* Rev. Proc. 2005-60 (IRS e-file Program).

[54] Reg. §301.7502-1(g)(3).

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Practice Tip: If an electronic submission is rejected the taxpayer generally has a grace period within which they can resubmit electronically or mail in the return or extension. It is the taxpayer's (or preparer's) responsibility to ensure that electronically filed returns are accepted, otherwise failure to file and/or failure to pay penalties may be imposed.[55]

If the due date falls on a Saturday, Sunday, or legal holiday, the return is still considered to be timely filed if it is filed by the next business day.[56]

When a legal holiday falls on a Sunday, the next day is considered to be a holiday. Similarly, if a holiday (other than Inauguration Day) falls on a Saturday, the preceding day is a holiday.[57] In addition, for this purpose, a legal holiday includes any statewide legal holiday of the state where the return is required to be filed.[58]

Note: Emancipation Day, April 16, is a legal holiday in the District of Columbia, and thus affects taxpayers nationwide. When Emancipation Day falls on a Saturday, then Friday, April 15 is the observed date, and the filing deadline for all tax forms and payments required to be filed or completed on or before April 15 is Monday, April 18. When Emancipation Day falls on a Sunday, then Monday, April 17 is the observed date, and the filing deadline for all tax forms and payments required to be filed or completed on or before April 15 is Tuesday, April 18. When Emancipation Day falls on a Monday, the filing deadline for all forms and payments required to be filed or completed on or before April 15 is Tuesday, April 17.

Patriots' Day is celebrated on the third Monday in April by taxpayers living in Massachusetts and Maine. For such taxpayers, if the April 15 filing deadline falls on Patriots' Day, they have until the next day, Tuesday, April 16 to file their income tax return. However, because taxpayers living in these states must make deposits of estimated taxes to depositories in states which do not recognize Patriots' Day, the due date for the first installment of estimated tax remains April 15.

What happens to Massachusetts and Maine residents when April 15 falls on the third Friday in April, coinciding with Emancipation Day, a legal holiday in the District of Columbia, and the following Monday, April 18, is Patriots' Day, a legal state holiday? The IRS has provided guidance addressing the impact of Patriots' Day and Emancipation Day.[59] The IRS explained that, in such situation, residents of Massachusetts and Maine have until Tuesday, April 19 to file their income tax return (but must make their first quarter estimated payment on or before April 18).

If the return is mailed after the due date (including extensions), the timely mailed/timely filed rule of §7502 does not apply and the filing date is the date the return is received by the IRS, not the mailing date.[60]

Filing extensions are taken into account in determining whether a return is timely filed.[61] For an extension to be valid, it must be submitted using the proper form on or before the date prescribed for filing the return, and must show the full amount "properly estimated" as the tax for the year.[62]

Extensions can be terminated by the IRS "at any time" by mailing notice of termination at least 10 days before the termination date stated in the notice.[63] If the tax is not properly estimated, courts have allowed the IRS to invalidate the extension.[64]

Comment: Neither the Code nor the regulations describe what constitutes a "proper estimate." Courts evaluating the IRS's denial of an extension generally require only that the taxpayer make a "bona fide and reasonable" estimate of the tax liability based on the information available at the time the extension is requested.[65] Furthermore, the taxpayer must make a bona fide and reasonable attempt to locate, gather, and consult information that will enable him to make a proper estimate of his tax liability.[66] While the tax must be estimated carefully, an exact calculation is not required, and the mere fact that the actual tax differs significantly from the estimate does not mean it is improper.[67]

If the extension is proper, it does not become invalid merely because the return is filed after the extended due date.[68] Rather, the penalty is computed for the period from the due date as so extended.[69]

Note: Generally, extensions to file are not extensions to pay taxes and therefore even if a taxpayer obtains an extension to file, they must still pay what they owe by the filing deadline

[55] *See Spottiswood v. United States*, No. 3:17-cv-00209-MEJ (N.D. Cal. Apr. 24, 2018) (taxpayers' electronically submitted return was rejected for lack of correct dependent social security number; the court held that because the taxpayers made no effort to check on the status of their return, the taxpayers did not exercise reasonable cause and upheld the failure to file and failure to pay penalties and denied their abatement request).

[56] §7503; Reg. §301.7503-1(b); D.C. Code §28-2701. For a list of legal holidays, see Tables, Charts & Lists > *Legal Holidays*.

[57] D.C. Code §28-2701.

[58] Reg. §301.7503-1(b).

[59] *See* Rev. Rul. 2015-13, *clarifying and superseding* Rev. Rul. 90-5 (addressing the date for filing returns and paying estimated tax when April 15 falls on a Saturday, Sunday or legal holiday), *clarifying and superseding* Notice 2002-12 (addressing return filing in Massachusetts when Patriots' Day falls on April 15), and *clarifying and amplifying* Notice 2011-17 (addressing Emancipation Day).

[60] *Emmons v. Commissioner*, 92 T.C. 342 (1989), aff'd, 898 F.2d 50 (5th Cir. 1990).

[61] §6651(a)(1).

[62] Reg. §1.6081-4(b), Reg. §1.6081-5(b). The length of the extension varies depending on required return. *See* Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, and Form 7004 and Instructions, *Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns.*

[63] Reg. §1.6081-4(d).

[64] *Berlin v. Commissioner*, 59 F.2d 996 (2d Cir. 1932); *Condor Int'l, Inc. v. Commissioner*, 98 T.C. 203 (1992), aff'd on other grounds, 78 F.3d 1355 (9th Cir. 1996); *Crocker v. Commissioner*, 92 T.C. 899 (1989); *Pflug v. Commissioner*, T.C. Memo 1989-615. Only the IRS, not the taxpayer, can initiate the process for terminating an automatic extension. *Kimball v. United States (In re Kimball)*, 2002-1 USTC ¶50,307 (D. Mass. 2002).

[65] *Crocker v. Commissioner*, 92 T.C. 899 (1989).

[66] *Berlin v. Commissioner*, 59 F.2d 996 (2d Cir. 1932); *Condor Int'l, Inc. v. Commissioner*, 98 T.C. 203 (1992), aff'd on other grounds, 78 F.3d 1355 (9th Cir. 1996); *Crocker v. Commissioner*, 92 T.C. 899 (1989).

[67] *Crocker v. Commissioner*, 92 T.C. 899 (1989); *Cannata v. Commissioner*, T.C. Memo 1990-502 (estimate was bona fide and reasonable and extension valid, despite fact that taxpayer's tax attorney inadvertently overlooked $195,826 of income on Form 1099-MISC when estimating taxpayer's liability). *But see McPike v. Commissioner*, T.C. Memo 1996-46 (estimate was not bona fide and reasonable where estimate was based on deductions and credits arising from container leasing tax shelter that Tax Court later disallowed).

[68] *See, e.g., Belk v. Commissioner*, 93 T.C. 434 (1989); *Solomon v. Commissioner*, T.C. Memo 1978-41.

[69] The penalty period is described at II.B.4.b., below.

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to avoid the §6651(a)(2) failure to pay penalty.[70] For a discussion of the failure to pay penalty, see III.A., below.

In addition, in determining whether the taxpayer filed the return in a timely manner, the time during which the taxpayer is serving in the Armed Forces of the United States (or in support of such Armed Forces) in an area designated by the President as a combat zone, or in qualifying deployment in a contingency operation during the period designated as the period of combatant activities in such zone or at any time during the period of the contingency operation, or hospitalized as a result of injury received while serving in such area or operation during such time, and the next 180 days thereafter, is disregarded under §7508(a).[71]

In the case of a taxpayer affected by a federally declared disaster (defined in §165(i)(5)), state-declared disaster, significant fire, or terroristic or military action (§692(c)(2)), the Treasury Secretary may specify a period of up to one year that may be disregarded in determining in respect of any tax liability of an affected taxpayer (1) whether certain acts were timely performed for periods after the date of the disaster, fire, or action, (2) the amount of any interest, penalty, additional amount, or addition for periods after that date, and (3) the amount of any credit or refund.[72] For qualified taxpayers affected by a federally declared disaster (and state-declared disaster), certain tax-related deadlines are statutorily postponed for a 120-day period.[73]

For further discussion of §7508, see XI.D.12., below. For further discussion of §7508A, see XI.D.14., below.

3. Sufficiency of a Return

The delinquency penalty imposed by §6651(a)(1) is for the failure to file a timely return that sufficiently complies with the Code, regulations, and IRS forms.[74] To constitute a return, several elements must be present:

- The document must purport to be a return;
- The return must be signed under penalties of perjury;
- There must be an honest and reasonable attempt to satisfy the requirements of the tax law; and
- The return must contain data sufficient to calculate the tax liability.[75]

A return that meets these four requirements generally is considered valid for purposes of beginning the statute of limitations even if it contains inaccuracies or omissions. However, for tax years 2020 and later, failure to include an issued Identity Protection Personal Identification Number (IP PIN) on an electronic return will result in an invalid signature and therefore an invalid return.[76]

a. Proper Form

The document must purport to be a return.[77] The return generally must be on the proper official form.[78] Regulations allow the IRS to accept a handmade statement disclosing gross income and deductions as a tentative return that, if filed by the due date for the return, will protect the taxpayer from the late filing penalty so long as the taxpayer, "without unnecessary delay," files a return using the proper form.[79] The Tax Court has pointed out, however, that the IRS is "certainly not required to accept any document submitted in lieu of a proper official form."[80] Courts have held that filing a return on a plain piece of paper does not qualify as a return.[81] A return filed on the proper form, but which has been altered, generally does not qualify.[82] On the other hand, the inadvertent use of an improper form (e.g., as a result of an inadvertent misclassification of an entity) does not necessarily render the return a nullity.[83]

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[70] *See* IRS News Release IR-2023-44 (Mar. 9, 2023).

[71] §7508(a). See Tables, Charts & Lists > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions* for an updated list of acts whose deadlines are postponed under §7508. Only five years of hospitalization in the United States can be disregarded. §7508(g)(2). The provisions also apply to the taxpayer's spouse, except that it does not apply for any tax year beginning more than two years after the date designated as the date of termination of combatant activities in the combat zone (other than Vietnam) and the spouse is not entitled to an extension based on the taxpayer's continued hospitalization. §7508(c), §7508(g).

For the portion of the first tax year ending after June 9, 2015, which begins on such date, and any subsequent tax year beginning before January 1, 2026, a qualified hazardous duty area is treated as if it were a combat zone. The Sinai Peninsula of Egypt is a qualified hazardous duty area. TCJA, Pub. L. No. 115-97, §11026.

[72] §7508A, amended by the Filing Relief for Natural Disasters Act, Pub. L. No. 119-29, §2(a).

[73] §7508A(e), redesignated and amended by the Filing Relief for Natural Disasters Act, Pub. L. No. 119-29, §2(a), effective for disasters declared after July 24, 2025. Former §7508A (60-day mandatory period for disasters declared after November 15, 2021, and before July 25, 2025).

[74] *See Beard v. Commissioner*, 82 T.C. 766 (1984), aff'd per curiam, 793 F.2d 139 (6th Cir. 1986).

[75] *See* §6011(a); §6065; Reg. §1.6011-1(b); *Beard v. Commissioner*, 82 T.C. 766 (1984), aff'd per curiam, 793 F.2d 139 (6th Cir. 1986).

[76] Instructions for Form 1040; SBSE-25-0723-0012 (interim guidance on statute of limitations impacting IRM 25.6.23).

[77] *Badaracco v. Commissioner*, 464 U.S. 386 (1984); *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172 (1934); *Beard v. Commissioner*, 82 T.C. 766 (1984), aff'd, 793 F.2d 139 (6th Cir. 1986). *See* SCA 200242036 (Form 1041 that may erroneously, fraudulently, or frivolously claim a refund for lifetime social security tax withholdings is considered valid for starting assessment statute of limitations unless return entries or attachments negate intent to file), *on recons.*, CCA 200304032. A paper or electronic return that is altered by a return preparer after the taxpayer has signed/acknowledged it is not considered to have been executed under penalties of perjury and thus does not meet the *Beard* requirements to constitute a valid return. *See* PMTA 2011-020.

[78] Reg. §1.6011-1; *Commissioner v. Lane-Wells Co.*, 321 U.S. 219 (1944); *Parker v. Commissioner*, 365 F.2d 792 (8th Cir. 1966). *But see* TAM 9022002 (Form 870, with accompanying schedules and signed by taxpayer is return and is deemed filed on date received by IRS).

[79] *See* Reg. §1.6011-1(b).

[80] *Andrews v. Commissioner*, T.C. Memo 1999-281 (court found that the statement filed purporting to be an individual tax return was not a valid return and denied the imposition of an accuracy-related negligence penalty under §6662, which requires a return to be filed before such a penalty can be imposed; taxpayer had conceded to §6651(a) penalties).

[81] *Parker v. Commissioner*, 365 F.2d 792 (8th Cir. 1966) (failure to file penalty assessed where taxpayer filed his return on a plain piece of paper, provided no reason for doing so and failed to file a proper return after being contacted by the IRS).

[82] *Beard v. Commissioner*, 82 T.C. 766 (1984), aff'd, 793 F.2d 139 (6th Cir. 1986) (tax protestor found not to have filed a return due to the numerous modifications to Form 1040 made to create a zero tax liability). *But see Bachner v. Commissioner*, 81 F.3d 1274 (3d Cir. 1996) (taxpayer modified Form 1040 and Tax Court accepted IRS contention that a valid return was not filed, however, upon appeal, the IRS conceded that a valid return was filed on the grounds that taxpayer's modifications were not as extensive nor as obfuscatory as those made by the taxpayer in *Beard*).

[83] *See* §6501(g); *Germantown Tr. Co. v. Commissioner*, 309 U.S. 304 (1940) (taxpayer filed a nontaxable fiduciary return rather and a corporate return, but all information required to compute the tax liability was included); *McKinley Corp. of Ohio v. Commissioner*, 36 T.C. 1182 (1961). *See* SCA

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b. Signature Requirement

A return must be signed by the taxpayer under penalties of perjury.[84] A return that requires a signature must be signed under the following rules:

1. An individual return must be signed by the individual taxpayer.[85]

2. A corporate return must be signed by the president, vice president, treasurer, chief accounting officer, or any other officer authorized to act.[86]

3. A partnership or other unincorporated organization return must be signed by a responsible and duly authorized member or partner.[87]

4. A trust or estate return must be signed by the fiduciary.[88]

An unsigned return, even if the taxpayer's signature is only inadvertently omitted, is not a return.[89] Similarly, a return in which the jurat clause is altered or deleted does not constitute a valid filing.[90]

A return may be signed by an authorized agent of the taxpayer in certain circumstances, and it must be accompanied by a power of attorney (or copy thereof) authorizing the agent to represent the taxpayer in making, executing, or filing the return.[91] If the agent signs the return, the taxpayer and the agent are responsible for the return as made and incur liability for the penalties provided for erroneous, false, or fraudulent returns.[92] In some instances a faxed signature on a faxed return may be accepted by the IRS, provided the signatures are reliably authenticated by direct contact with the IRS.[93] Moreover, revisions made to a return generally by the return preparer without the taxpayer's knowledge may nullify a return.[94] A return signed by an unauthorized person, even a spouse, is not a valid return.[95]

c. Data Sufficient to Calculate Tax Liability

The return must contain sufficient data from which the IRS can calculate the taxpayer's tax liability.[96] This does not require perfect accuracy or completeness. Rather, the return must represent an honest and genuine endeavor to satisfy the law.[97] In

199929036 (use of Form 1120 instead of Form 1120S, or vice versa, does not make return invalid or constitute failure to file). *But see Glover v. Commissioner*, T.C. Memo 2010-228 (taxpayer filed Form 1041 rather than Form 1040 and failed to report all of his gross income; court agreed with IRS that taxpayer did not file a valid return, finding that the taxpayer did not make an honest and reasonable attempt to comply with the tax law and did not provide sufficient data to calculate his tax liability)

[84] §6065. *See Lucas v. Pilliod Lumber Co.*, 281 U.S. 245 (1930) (return not supported by oath); *Morgan v. Commissioner*, 807 F.2d 81 (6th Cir. 1986) (Fifth Amendment return filed by tax protester is not valid return); *Beatty v. Commissioner*, 676 F.2d 150 (5th Cir. 1982) (Form 1040 with taxpayer's name and address and constitutional objections to income tax is not a return); *Beard v. Commissioner*, 82 T.C. 766 (1984), aff'd, 739 F.2d 139 (6th Cir. 1986); *Cupp v. Commissioner*, 65 T.C. 68 (1975), aff'd, 559 F.2d 1207 (3d Cir. 1977). This verification requirement does not apply to notices issued by the IRS. *See Davis v. Commissioner*, 115 T.C. 35 (2000).

[85] Reg. §1.6061-1(a). A parent or guardian of a minor who is not able to sign a return may sign the child's name in the proper place of the return followed by the words "By (*signature*) Parent (or guardian) for minor child." Rev. Rul. 82-206.

[86] §6062; Reg. §1.6062-1.

[87] §6063; Reg. §1.6063-1.

[88] Reg. §1.6061-1(a).

[89] *See* IRM 1.2.1.4.5 (07-26-11), IRS Policy Statement P-3-5. *Vaira v. Commissioner*, 52 T.C. 986 (1969), rev'd on other grounds, 444 F.2d 770 (3d Cir. 1971); *Dixon v. Commissioner*, 28 T.C. 338 (1957); *Sullivan v. Commissioner*, T.C. Memo 2017-2; *Plunkett v. Commissioner*, 41 B.T.A. 700 (1940), aff'd, 118 F.2d 644 (1st Cir. 1941); *Fitch v. Commissioner*, T.C. Memo 1975-36; *Deese v. Commissioner*, T.C. Memo 1958-89; *Estate of Stewart v. Commissioner*, T.C. Memo 1955-107. However, where an income tax return is intended by both spouses as a joint return, the absence of the signature of one spouse does not prevent the return from being valid. *Estate of Temple v. Commissioner*, 67 T.C. 143 (1976); *Estate of Campbell v. Commissioner*, 56 T.C. 1 (1971), acq., 1971-2 C.B. 2; *Howell v. Commissioner*, 10 T.C. 859 (1948), aff'd per curiam, 175 F.2d 240 (6th Cir. 1949).

[90] *Letscher v. United States*, 2000-2 USTC ¶50,723 (S.D.N.Y. 2000) (Form 1040 signed by taxpayer under altered jurat does not constitute a valid claim for refund where additions altered meaning of jurat, violating requirement that return be made under penalty of perjury), *aff'd*, 28 Fed. App'x 110 (2d Cir. 2000); *Williams v. Commissioner*, 114 T.C. 136 (2000) (disclaimer statement attached to tax return that stated that no taxes were owed was not a valid return); *Sloan v. Commissioner*, 102 T.C. 137 (1994) (Forms 1040 containing "denial and disclaimer" statements as part of jurat do not constitute valid returns), *aff'd*, 53 F.3d 799 (7th Cir. 1995); *Schroeder v. Commissioner*, T.C. Memo 1989-110. *Cf.* SCA 200107035 (advising that IRS may treat document as nullity where taxpayer strikes portions of preprinted Form 1040 jurat or substitutes own language in place of jurat; however, mere addition of language requires IRS's consideration of whether addition negates or casts doubt upon jurat). *But see Todd v. United States*, 849 F.2d 365 (9th Cir. 1988) (addition of "signed involuntarily under penalty of statutory punishment" below jurat did not make Form 1040 frivolous return); *McCormick v. Peterson*, 94-1 USTC ¶50,026 (E.D.N.Y. 1993) (addition of "under protest" to jurat did not alter meaning of jurat and, thus, did not invalidate 1040 as return), *acq.*, 1998-2 C.B. xix; *Berger v. Commissioner*, T.C. Memo 1996-76 (addition of disclaimer that return was signed "under duress by court order" did not alter jurat so as to invalidate return).

[91] *See* Reg. §1.6012-1(a)(5); CCA 201945027 (CFO of partner-corporation signed Form 8879-PE (e-signature authorization) using a different title he held; so long as the signer has actual authority to sign the return, the e-file is valid); *Lombardo v. Commissioner*, 99 T.C. 342 (1992), aff'd sub nom., *Davies v. Commissioner*, 68 F.3d 1129 (9th Cir. 1995); *Elliott v. Commissioner*, 113 T.C. 125 (1999) (Form 1040 submitted and signed by attorney on behalf of taxpayer did not constitute a signed return as there was no power of attorney attached to it when originally submitted).

[92] *See* Reg. §1.6012-1(a)(5) (flush language).

[93] *See* SCA 200137053, SCA 200117036.

[94] PMTA 2011-009 (while use of invalid taxpayer identification number on its own will not invalidate return, return changed by preparer without taxpayer's knowledge is a nullity; if tax return with misappropriated SSN otherwise meets established criteria for valid return, filing of return will start period for assessment, despite false identifying number); PMTA 2011-013 (where return preparer inflates deduction amounts without taxpayer's knowledge, return is nullity; Form 1040X should not be filed because no return has been filed by taxpayer); PMTA 2011-020 (tax return signed by taxpayer that is altered, without taxpayer's knowledge, by tax return preparer by overstating income, deductions, credits, or withholding and submitted to IRS by preparer is not valid tax return).

[95] CCA 200923028. *See* PMTA 2015-19 (Business Masterfile return filed by individual who used stolen EIN or EIN obtained by using stolen information, is not valid return).

[96] *Commissioner v. Lane-Wells Co.*, 321 U.S. 219 (1944); *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172 (1934); *McCaskill v. Commissioner*, 77 T.C. 689 (1981), acq. in part and nonacq. in part, 1984-2 C.B. 2; *White v. Commissioner*, 72 T.C. 1126 (1979); *Durovic v. Commissioner*, 54 T.C. 1364 (1970), aff'd on this issue, 487 F.2d 36 (7th Cir. 1973); Rev. Rul. 72-161. *See also Law Office of John H. Eggertsen P.C. v. Commissioner*, 143 T.C. 265 (2014), aff'd, 800 F.3d 758 (6th Cir. 2015) (neither Form 1120S, U.S. Income Tax Return for an S Corporation, nor Form 5500, Annual Return/Report of Employee Benefit Plan, qualify as a return for §4979A(a) excise tax purposes within meaning of §6501(a) because they do not contain necessary information to calculate tax liability); CCA 200233003 (valid tax return filed where 1040 contains correct individual taxpayer identification number but attached Form W-2 contains incorrect social security number).

[97] *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172 (1934); *Florsheim Bros. Drygoods Co. v. United States*, 280 U.S. 453 (1930).

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addition, the Tax Court has held that the failure to include an item that is otherwise disclosed on or with the return does not prevent a filing from being considered a valid return for this purpose.[98] Similarly, where it is only a nontaxable transaction that is not disclosed, the penalty does not apply.[99]

On the other hand, a return that fails to disclose, in detail, information pertaining to the source of a taxpayer's income or the nature and amount of his expenses or deductions, is not a return for purposes of §6651(a).[100] Similarly, an unverified form containing obviously incomplete information does not suffice.[101]

The majority of the courts hold that a "zero return" (i.e., a return that contains all zeros in the spaces for the taxpayer's income and loss and shows zero income and zero tax liability), generally filed by tax protestors, does not constitute a valid return for purposes of §6651(a).[102]

4. Computation of the Penalty

The IRS must include a computation of the penalty in any notice imposing a penalty.[103]

a. Rate

The amount of the failure to file penalty under §6651(a)(1) is generally equal to 5% of the net tax amount required to be shown on the tax return for each month (or fraction of a month) that the return is late, up to a maximum of 25% of such net tax amount.[104]

If the failure to file is fraudulent, the penalty is increased to 15% for each month (or part thereof), up to a maximum of 75%.[105]

The burden of proof of the fraud element is on the IRS and must be carried by clear and convincing evidence.[106] In determining whether there is clear and convincing evidence that the failure was done fraudulently (i.e., with the intent to evade tax), the IRS considers the following factors:[107]

- The taxpayer refuses or is unable to explain his failure to file;
- The taxpayer's statement does not comport with the facts;
- The taxpayer has a history of failing to file or to file timely, but an apparent ability to pay;
- The taxpayer fails to reveal or tries to conceal assets;
- The taxpayer pays personal and business expenses in cash when cash payments are not usual or cashes, rather than deposits, checks that are business receipts; and
- The taxpayer is aware of the filing requirement.[108]

For case law applying the relevant factors to determine whether there was fraud, see V.D., below.

If the IRS does not sustain its burden of proof, the basic failure to file penalty will be imposed if it also is asserted as an alternative in the notice of deficiency.[109] If the IRS first raises the regular penalty in its answer, the burden of proof with respect to that penalty is also on the IRS. If the IRS fails to meet its burden of proof with respect to the fraudulent failure to file penalty and failed either to make an alternative determination in the notice of deficiency or to assert the basic penalty in its answer, the taxpayer is not liable for any failure to file penalty under §6651 for that period.[110]

Comment: Both the fraudulent failure to file penalty and the 75% fraud penalty under §6663 can apply to the same late-

[98] *See, e.g., Blount v. Commissioner*, 86 T.C. 383 (1986), acq. in result in part, 1986-2 C.B. 1; *Deats v. Commissioner*, T.C. Memo 1986-220; *Venni v. Commissioner*, T.C. Memo 1984-17.

[99] *Newbury v. Commissioner*, 31 B.T.A. 41 (1934), nonacq., XIII-2 C.B. 31, aff'd without discussion of this issue, 80 F.2d 631 (7th Cir. 1935).

[100] *Ferrando v. United States*, 245 F.2d 582 (9th Cir. 1957); *White v. Commissioner*, 72 T.C. 1126 (1979); *Sanders v. Commissioner*, 21 T.C. 1012 (1954), aff'd, 225 F.2d 629 (10th Cir. 1955); *Bell v. Commissioner*, T.C. Memo 1957-201. *See also United States v. Johnson*, 577 F.2d 1304 (5th Cir. 1978); *Schroeder v. Commissioner*, 291 F.2d 649 (8th Cir. 1961), aff'g T.C. Memo 1957-162, as amended by 1959 PH TC Order ¶59,906.

[101] *United States v. Moore*, 627 F.2d 830 (7th Cir. 1980) (tax protestor did not include any income or expenses on his return, provided only limited information when contacted by the IRS, and obliterated the signature lines; court held the taxpayer did not file a return; *Glover v. Commissioner*, T.C. Memo 2010-228 (court held that taxpayer, having failed to report all of his gross income, did not make an honest and reasonable attempt to comply with the tax law and did not provide sufficient data to calculate his tax liability).

[102] See, e.g., *Caton v. Commissioner*, T.C. Memo 2012-92, in which the court noted that a majority of the circuit courts have held that a return containing only zeros generally is not a valid return. *See also United States v. Edelson*, 604 F.2d 232 (3d Cir. 1979) (tax protestor subject to §7203 penalty where no amounts were included on the return, subject to §7203 penalty); *Cabirac v. Commissioner*, 120 T.C. 163 (2003) (tax protestor subject to §6651(a) penalty where zeros were entered on return); *United States v. Rickman*, 638 F.2d 182 (10th Cir. 1980) (tax protestor subject to §7203 penalty where zeros were placed on the return); *United States v. Kimball*, 925 F.2d 356, 358 (9th Cir. 1991) (tax protestor placed only asterisks on the return, subject to §7203 penalty), and *Halcott v. Commissioner*, T.C. Memo 2004-214 (2000) (zero return does not meet requirement). In PMTA 2013-23, the IRS Chief Counsel concluded that a late-filed Form 1040 containing all zeros in the spaces for the taxpayer's income and loss figures was not a valid return that had to be accepted under the IRS's audit reconsideration program.

[103] §6751.

[104] §6651(a)(1).

[105] §6651(f). *See Clayton v. Commissioner*, 102 T.C. 632 (1994) ; *Niedringhaus v. Commissioner*, 99 T.C. 202 (1992) ; *Flynn v. Commissioner*, T.C. Memo 2021-43; *Batsch v. Commissioner*, T.C. Memo 2016-140 (courts look to same elements as §6663), *aff'd sub nom., Hyde v. Commissioner*, 695 Fed. Appx. 166 (8th Cir. 2017). For a discussion of §6663, see V., below.

[106] §7454(a); Tax Court Rule 142(b); *United States v. Hahn*, 98-2 USTC ¶50,541 (E.D. Tenn. 1998) aff'd 182 F.3d 919 (6th Cir. 1999) (failure to file return despite income from smuggling, earlier drug conviction, prior fugitive status, lack of bank account, concealment of assets, and ownership of property under alias before transfer to brother-in-law was clear and convincing evidence of fraudulent intent to avoid paying taxes on illegal income); *Kerbaugh v. Commissioner*, 29 B.T.A. 1014 (1934), nonacq., XIII-1 C.B. 25, aff'd, 74 F.2d 749 (1st Cir. 1935); *Arlette Coat Co., Inc. v. Commissioner*, 14 T.C. 751 (1950). Fraud of a sole or dominant shareholder can be attributed to a corporation. *See* CCA 200937025 (conduct of married sole owners of corporation that failed to pay over employment taxes withheld and file payroll tax returns can be attributed to corporation to determine if corporation could be subject to §6651(f) penalty for fraudulent failure to file, as well as §6651(a) penalty for failure to file quarterly returns and pay required withholding tax, §6656 penalty for failure to deposit employment taxes, and §6672 penalty for failure to collect and pay over FICA taxes). A taxpayer's guilty plea under 18 U.S.C. §287 does not collaterally estop the taxpayer from litigating the §6651(f) fraudulent failure to file penalty. CCA 201545016.

[107] IRM 20.1.2.3.7.5(3) (07-02-13). For case law applying the relevant factors to determine whether there was fraud, see V.D., below.

[108] The Internal Revenue Manual cautions that this factor should be used in conjunction with one of the other listed factors. IRM 20.1.2.3.7.5(3) (07-02-13).

[109] H.R. Rep. No. 247, 101st Cong., 1st Sess. ("1989 Act House Report") 1402 (1989).

[110] H.R. Rep. No. 247, 101st Cong., 1st Sess. ("1989 Act House Report") 1402 (1989).

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filed return.[111] As a result, the taxpayer could be subject to penalties equal to 150% of the deficiency.

If the failure to pay penalty under §6651(a)(2) also applies for the same month (or fraction thereof), the failure to file penalty for that month is reduced by the amount of the failure to pay penalty.[112] In most cases, this results in an effective failure to file penalty of 4.5% a month and a simultaneous failure to pay penalty of .5% a month, and effectively limits the maximum failure to file penalty to 22.5%.[113] There is no reduction for a failure to pay penalty assessed under §6651(a)(3), because it applies only after the IRS assesses a deficiency and issues a notice and demand for payment.

Note: Due to the temporary closure of IRS printing services during the COVID-19 pandemic, the IRS temporarily was unable to print and mail notice and demand letters to taxpayers. In PMTA 2020-007,[114] the Chief Counsel's Office advised that the IRS exercise administrative discretion in granting relief to taxpayers by deeming the notice and demand letters to be sent out on a date later than the date actually shown on the letter in order to grant relief from penalties and interest.

Where an income tax return is more than 60 days late (taking into account any extensions of time to file), the failure to file penalty cannot be less than the lesser of $435, adjusted for inflation, or the tax required to be shown on the return, unless the failure is due to reasonable cause and not willful neglect.[115] Moreover, when the minimum penalty provision applies, the failure to file penalty cannot be reduced by the failure to pay penalty below the minimum amount.[116]

b. Penalty Period

The penalty period runs from the due date of the tax return (including extensions of time to file) to the date the IRS actually receives the return.[117] The date of receipt generally is the date stamped by the IRS on the return.[118] The "timely mailed-timely filed" rule of §7502 does not apply to delinquent returns. Accordingly, a return that is mailed three months after its due date and received the next day (i.e., the beginning of a fourth month) is four months late.[119]

A §6020(b) substitute return is disregarded for the failure to file penalty, which accrues until the IRS receives the actual return.[120] In addition, the filing of a delinquent non-fraudulent return does not prevent the IRS from assessing a §6651(f) penalty.[121]

The IRS is not required to follow the deficiency procedures of §6211 to assess the §6651(f) penalty if the penalty is based on tax shown on a delinquent return.[122]

The penalty period must be expressed as the number of months (including any fraction of a month) during which the failure to file continues. If the date prescribed for filing the return is the last day of a calendar month, each calendar month (or portion thereof) is considered a month.[123] For any other due date, a month is the period that ends with the numerically corresponding day in the following month.[124] If there is no corresponding date, the month ends on the last day of the next calendar month.

Example: Taxpayer T is required to file its return on January 30. For purposes of §6651(a), the first month ends on the last day of February, and the succeeding months end on March 30, April 30, etc.

If a return is not timely filed, the fact that the date prescribed for filing the return falls on a Saturday, Sunday, or legal holiday is irrelevant in determining the number of months for which the penalty applies.[125] It is not an extension of time to file. On the other hand, if the last day for filing to avoid an additional penalty for another month falls on a Saturday, Sunday, or holiday, the additional penalty does not apply if the return is filed by the next business day.[126]

Example: Taxpayer T's return was due April 15, 20XX. Since the due date fell on a Sunday, the return could be filed on or before April 16, 20XX, without incurring a penalty. T mailed the return on May 15, 20XX, but the IRS did not receive it until May 16, 20XX. As a result, the return was considered two months late — i.e., one month through May 15 and one month for May 16, which was a fraction of the next month. If, however, T filed the return on Monday, July 16, 20XX, he would have been liable for three months late filing penalty. Since the month ended on July 15, 20XX, a Sunday, no additional penalty was imposed if the return was filed by the next business day (i.e., Monday, July 16).

c. Net Tax Amount

The penalty is a percentage of the "net tax amount" required to be shown on the tax return. For this purpose, the net tax amount is the tax required to be shown on the return reduced by allowable credits (e.g., the general business credit, the

[111] As discussed at V.A., below, the §6663 fraud penalty applies only where a return is filed. §6664(b).

[112] §6651(c)(1).

[113] Reg. §301.6651-1(f) *Ex.* (2). The maximum combined regular failure to file and failure to pay penalties under §6651(a)(1) and §6651(a)(2) is 47.5%. Reg. §301.6651-1(f) *Ex.* (2); *DiSimone v. Commissioner*, 580 F. Supp. 221 (S.D.N.Y. 1983). *Cf. Smith v. United States*, 571 F. Supp. 664 (S.D.N.Y. 1983); *Gerdes v. United States*, 498 F. Supp. 385 (N.D. Cal. 1980).

[114] (May 21, 2020).

[115] §6651(a) and §6651(j). For returns required to be filed before January 1, 2020, the penalty cannot be less than $205, adjusted for inflation, or the tax required to be shown on the return (whichever is the lesser), unless the failure is due to reasonable cause and not willful neglect. For inflation-adjusted amounts, see Tables, Charts &Lists > Penalties > *Failure to File Return.*

[116] §6651(c)(1).

[117] Rev. Rul. 73-133.

[118] *Ende v. Commissioner*, T.C. Memo 1975-256.

[119] *But see Custom Component Switches, Inc. v. United States*, 396 F.2d 514 (9th Cir. 1968) (such return is only three months late, disregarding extra day as de minimis, considering that §7502 was amended in 1966 to regard mailing date as filing date).

[120] *See* §6651(g)(1); Reg. §301.6651-1(g).

[121] However, the penalty must be assessed within three years of when the nonfraudulent return was filed. Rev. Rul. 79-178.

[122] However, a taxpayer may be able to challenge an assessed §6651(f) penalty in a CDP hearing. *See, e.g., Dingman v. Commissioner*, T.C. Memo 2011-116 (reviewing de novo §6651(f) penalty assessed without deficiency notice because taxpayer did not have prior opportunity to dispute penalty).

[123] Reg. §301.6651-1(b)(1).

[124] Reg. §301.6651-1(b)(2).

[125] Reg. §301.6651-1(b)(3).

[126] *Label-Matic, Inc. v. United States*, 74-1 USTC ¶9380 (N.D. Cal. 1974).

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foreign tax credit, and the earned income credit) and by any tax payments made on or before the due date of the return without regard to any extensions of time (e.g., withholding credits, tax deposits, estimated tax payments, and overpayments from prior periods).[127] The tax required to be shown on the return is the correct net tax amount on the return's due date. As a result, net operating loss carryovers[128] and allowable but unclaimed deductions[129] are taken into account. Similarly, unreported income increases the net tax amount.[130] Amounts paid after the date prescribed for filing the return (without regard to any extension), however, do not reduce the net tax amount. In addition, the tax required to be shown on the return is not reduced by any net operating loss, capital loss or credit carrybacks.[131]

> *Example:* Individual taxpayer T is required to file his 20X1 income tax return on April 15, 20X2. During the year, T made $11,000 of estimated tax payments and paid an additional $4,000 on April 15, 20X2, with his application for an automatic extension of time to file the return. T paid the balance of his $18,000 of income and self-employment tax with his return on September 10, 20X2. For 20X2, T incurred a loss that he carried back to reduce his 20X1 tax liability to $15,000. For purposes of §6651(a)(1) with respect to 20X1, the net tax amount is $3,000 — i.e., $18,000 (tax required to be shown on the 20X2 return unreduced by the carryback) minus $15,000 (payments made on or before the due date of the return).

If there is no net amount due, there is no late filing penalty.[132]

In *Liftin v. United States*,[133] the Court of Claims requested briefs, but declined to decide because the taxpayer failed to raise the issue, whether the IRS correctly used the full tax due as the base to determine the penalty, where the taxpayer made an estimated estate tax payment (in excess of its actual liability) after the unextended due date for filing the return and paying the tax, but before the extended due date. Section §6651(b)(1) provides that the late-filing penalty is a percentage of the "net tax amount" required to be shown on the tax return. The net amount is calculated by subtracting from the base the amount of any part of the tax which is paid on or before "the date prescribed for payment of the tax." The IRS argued that §6651(b)(1) was inapplicable to the estimated payment because it was made after the original, un-extended due date, though before the extended due date. The IRS relied on §6151(c), which states that certain language in Title 26 referring to a date fixed for payment should be read to refer to "the last day fixed for such payment (determined without regard to any extension of time for paying the tax)."

The dissenting opinion in *Liftin* argued that, applying §6651(b)(1), the penalty calculated pursuant to §6651(a)(1) is zero because the amount required to be shown as tax on the return was zero. Further, the dissent stated that the IRS's statutory interpretation, which excludes from the netting process amounts paid after the unextended due date of the return, is without support. Such a statutory interpretation, the dissent argued, renders meaningless the provisions for extension of time as well as the purpose of permitting and requiring estimated payments. It cannot be correct, the dissent reasoned, to interpret the statute as imposing a penalty of 25% of the tax that was already paid; such an interpretation contradicts the legislative record for §6651, because both the House and Senate Reports explain that the penalty is based on the tax due on the return, not the amount previously estimated and paid.[134]

5. Reasonable Cause Exception

Section 6651(a)(1) imposes a penalty for failure to timely file tax returns unless it is shown that such failure is due to reasonable cause and not willful neglect. Both elements are required to qualify for the exception. The absence of willful neglect alone is not sufficient.[135]

A delay is due to reasonable cause if the taxpayer exercised ordinary business care and prudence but was, nevertheless, unable to file the return within the prescribed period.[136] To claim a reasonable cause exception, the taxpayer must file a written statement, signed under penalties of perjury, that affirmatively shows facts sufficient to indicate the existence of a reasonable cause for failing to timely file the return.[137]

A private foundation generally will not be subject to a failure to file penalty for omitting the excise tax on self-dealing if the return was filed in good faith. The exception, however, does not apply if the disqualified person had knowledge that, if known by the foundation, would have precluded the foundation from filing such return in good faith.[138]

The reasonable cause exception is discussed in greater detail at XI., below.

C. Certain Information Returns and Payee Statements

Any person who fails to file an information return[139] with the IRS on or before the required filing date or who fails to in-

[127] §6651(b)(1); *Crocker v. Commissioner*, 92 T.C. 899 (1989). *See In re Pransky*, 304 B.R. 671 (Bankr. D.N.J. 2004) (debtor cannot defensively use 1984 and 1985 overpayments claimed on 1986 return, that were time-barred under §6532(a), to reduce net tax for purposes of tax year 1986 penalty calculations).

[128] *Goodwyn Crockery Co. v. Commissioner*, 37 T.C. 355 (1961), aff'd, 315 F.2d 110 (6th Cir. 1963).

[129] *Pehlke v. Commissioner*, T.C. Memo 1978-254.

[130] *See* IRM 20.1.2.3.8.5.1 (07-18-16).

[131] *C.V.L. Corp. v. Commissioner*, 17 T.C. 812 (1951) (net operating loss carryback); *Blanton Coal Co., Inc. v. Commissioner*, T.C. Memo 1984-397 (net operating loss and credit carrybacks); *Texas Mobile Home Ass'n v. Commissioner*, T.C. Memo 1962-95 (net operating loss carryback), *rev'd on other grounds*, 324 F.2d 691 (5th Cir. 1963); Rev. Rul. 72-484.

[132] *See* H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 571 (1982). *See also Patronik-Holder v. Commissioner*, 100 T.C. 374 (1993), acq., 1993-2 C.B. 1 (where taxpayer fails to file but withholding credits exceed tax liability, no §6651 penalty — not even $100 minimum penalty — is imposed because net amount due is zero).

[133] 754 F.3d 975 (Fed. Cir. 2014).

[134] H.R. Rep. No. 83-1337, at 419 (1954); S. Rep. No. 83-1635, at 591 (1954).

[135] *Charles E. Pearsall & Son v. Commissioner*, 29 B.T.A. 747 (1934); *Hornsby v. Commissioner*, 26 B.T.A. 591 (1932); *St. Germain v. Commissioner*, T.C. Memo 1959-73.

[136] Reg. §301.6651-1(c)(1). *See George v. Commissioner*, 821 Fed. Appx. 76 (3d Cir. 2020) (reasonable cause does not exist where taxpayer was incarcerated, yet did not make arrangements for filing of return nor filing of extension).

[137] Reg. §301.6651-1(c)(1).

[138] Reg. §53.6651-1(b).

[139] For the definition of "information return," *see* §6724(d)(1).

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clude any required information on such return is subject to a penalty of $250 (adjusted for inflation) for each return ($100 per return for returns required to be filed before 2016), up to a maximum of $3 million (adjusted for inflation) in any calendar year ($1.5 million for returns required to be filed before 2016).[140] A similar penalty is imposed for failing to furnish a copy of the payee statement[141] to the payee or to include any required information thereon.[142] In each case, however, the penalty is not imposed if the failure is due to reasonable cause and not willful neglect.[143]

Note: In response to the COVID-19 (Coronavirus) pandemic, the IRS granted administrative relief from penalties under §6721(a)(2)(A) for the failure to timely file any information return as defined under §6724(d)(1) that meets the following criteria:[144]

- 2019 returns that were filed on or before August 1, 2020, with an original due date of January 31, 2020; February 28, 2020 (if filed on paper) or March 31, 2020 (if filed electronically); or March 15, 2020; or
- 2020 returns that were filed on or before August 1, 2021, with an original due date of January 31, 2021; February 28, 2021 (if filed on paper) or March 31, 2021 (if filed electronically); or March 15, 2021.

There is no need to apply for this waiver as relief will be applied automatically, with the relevant penalties waived, or to the extent previously assessed, abated, refunded or credited.[145] Should this penalty waiver cause a refund to generate, the overpayment is not subject to the overpayment interest provision of §6611(e)(3).[146]

Such information returns and payee statements are discussed further at VI., below.

D. Partnership Returns

1. Required Returns

Every partnership must file an information return on Form 1065, *U.S. Return of Partnership Income*, setting forth its income and deductions for the tax year[147] unless otherwise excluded from the filing requirements.[148] For calendar year filers, the return must be filed on or before March 15. For fiscal year filers, the return must be filed on or before the 15th day of the third month following the close of the partnership's tax year.[149] A partnership required to file Form 1065 or Form 8804 may obtain one automatic six-month an extension of time to file.[150]

Section 6226(b)(4)[151] provides for the passing through of the so-called "push-out" amount through direct partners that are pass-through partners. The provision specifically applies to direct partners that are partnerships or S corporations[152] and requires promulgation of similar rules for trusts.[153] If a partnership or S corporation receives a pass-through statement, it must file a partnership adjustment tracking report that includes such information as the IRS may require.[154] It then must either compute and pay an imputed underpayment or furnish pass-through statements to its own partners or shareholders.[155] These requirements must be completed no later than the due date for the return for the adjustment year of the audited partnership.[156]

For purposes of filing information returns, a partnership is defined as an unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and that is not a corporation, a trust, or an estate.[157] It does not, however, include certain unincorporated organizations that elect to be excluded from the partnership provisions of subchapter K and that operate: (1) only for investment purposes rather than the active conduct of a trade or business; or (2) for the joint production, extraction, or use of property and not for the purpose of selling services or the property produced or extracted.[158]

The election must be made on a timely filed Form 1065 for the first tax year for which the exclusion is desired. Once

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[140] §6721(a). The penalty amounts in §6721(a) are adjusted for inflation. §6721(f). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Failure to File Correct Information Returns.*

[141] For the definition of "payee statement," see §6724(d)(2).

[142] §6722(a). The penalty amounts in §6722(a) are adjusted for inflation. §6722(f). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Failure to Furnish Correct Payee Statements.*

[143] §6724(a).

[144] Notice 2022-36, §3.

[145] Notice 2022-36, §3.

[146] IRM 20.1.1.3.3.2.2(1) (03-29-23). *See* IRM 20.2.4.8.3.4 (03-15-24), IRM 20.2.4.8.3.5 (03-15-24).

[147] §6031(a).

[148] For instances in which a domestic partnership may qualify for an exception to the partnership return filing requirement, see Reg. §1.6031(a)-1(a)(3) and §1.6031(a)-1(c).

[149] §6072(a) and §6072(b). *See* Reg. §1.6031(a)-1(e)(2), applicable to returns filed on or after January 30, 2020. For returns filed before January 30, 2020, the temporary regulation removed by T.D. 9892 (former Reg. §1.6031(a)-1T) applies. Reg. §1.6031(a)-1(f). Previously partnership returns were due on or before the 15th day of the fourth month following the close of the partnership's tax year (April 15th for calendar filers). Former §6072.

This filing deadline may be postponed under §7508 and §7508A if the IRS publishes guidance providing relief related to a specific combat zone, qualifying deployment in a contingency operation, federally declared disaster, significant fire, or terroristic or military action. §7508A was amended by the Infrastructure Investment and Jobs Act to include significant fires for which assistance is provided after November 15, 2021. Pub. L. No. 117-58, §80504. See Tables, Charts & Lists > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions* for an updated list of acts whose deadlines may be postponed under §7508 and §7508A.

[150] §6081. *See* Reg. §1.6081-2(a), applicable to applications for an automatic extension of time to file on or after January 30, 2020. For extensions before January 30, 2020, former Reg. §1.6081-2T applies. Reg. §1.6081-2(h).

[151] Added with retroactive effect by Pub. L. No. 115-141, Div. U, §204(a).

[152] §6226(b)(4)(A).

[153] §6226(b)(4)(E). *See* Prop. Reg. §301.6226-3(e)(5).

[154] §6226(b)(4)(A)(i).

[155] §6226(b)(4)(A)(ii). The imputed underpayment is calculated under rules similar §6225 except for §6225(c)(2), §6225(c)(7), and §6225(c)(9). §6226(b)(4)(A)(ii)(II).

[156] §6226(b)(4)(B).

[157] §761(a).

[158] Reg. §1.761-2(a). The electing entity generally must timely file the partnership return for the tax year for which the election is made, but not in subsequent years. Reg. §1.6031(a)-1(c). Members must also be able to compute their income without needing to compute partnership taxable income. In November 2024, the IRS expanded the circumstances in which a joint venture that owns "applicable credit property" (an "applicable unincorporated organization") can elect to be excluded from subchapter K under §761(a). Reg. §1.761-2(a)(4)(ii)(A)–§1.761-2(a)(4)(ii)(F), Reg. §1.761-2(f), T.D. 10012, 89 Fed. Reg. 91,552 (Nov. 20, 2024), applicable to tax years ending after March 10, 2024. For in-depth discussion of the rules regarding "direct pay elections" by applicable unincorporated organizations under §6417, see 512-2nd T.M., *Tax Incentives for Production and Conservation of Energy and Natural Resources*, at XI.A.

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made, the election cannot be revoked without the consent of the IRS.[159]

Foreign partnerships generally are excluded from this filing requirement.[160] However, unless excepted from filing by regulations, a foreign partnership generally must file an information return under §6031 for any tax year in which the partnership has other gross income derived from sources within the United States or gross income that is effectively connected with the conduct of a trade or business within the United States.[161]

Partnerships with *more than* 100 partners must file their partnership returns electronically, regardless of the number of different types of information returns filed for a particular calendar year. A partnership is considered to have more than 100 partners if, over the course of the partnership's year, the partnership had more than 100 partners, regardless of whether a partner was a partner for the entire year or whether the partnership had over 100 partners on any particular day in the year.[162] Partnerships with *100 or fewer* partners also generally must file their partnership return electronically if they have to file 10 or more returns of any type during the calendar year ending with or within the tax year of the partnership, effective for returns required to be filed during calendar years beginning after December 31, 2023.[163] For purposes of calculating the number of returns, the term *returns* includes returns of any type, including income, employment, and excise tax returns, as well as information returns (i.e., Forms W-2 and Forms 1099).[164]

Example 1: Partnership P had five general partners and 90 limited partners on January 1, 2023. On March 15, 2023, 10 more limited partners acquired an interest in P. On September 29, 2023, the 10 newest partners sold their individual partnership interests to C, a corporation which was one of the original 90 limited partners. On December 31, 2023, P had the same five general partners and 90 limited partners it had on January 1, 2023. P had a total of 105 partners over the course of partnership taxable year 2023. Therefore, P must file its 2023 partnership return electronically.[165]

Example 2: Partnership G is a general partnership with 100 partners on January 1, 2023. There are no new partners added to G in 2023. One of G's partners, A, is a partnership with 53 partners. A is one partner, regardless of the number of partners A has. Therefore, G has 100 partners and is not required to file its 2023 partnership return electronically.[166] However, given the same facts, if G is also required to file 9 Forms 1099 during calendar year 2023 in addition to its 2022 partnership return, then G will meet the threshold of 10 returns of any type filed during calendar year 2023, meaning G must file its 2023 partnership return electronically[167]

2. Penalty

A penalty may be imposed on a partnership that fails to timely file a required information return or fails to include the required information on such return.[168] Although the penalty is assessed against the partnership, the partners are individually liable to the extent of their liability for partnership debts generally.[169]

The amount of the penalty is $195 (adjusted for inflation) times the number of partners in the partnership during the tax year, for each month (or fraction thereof) that the delinquency continues, up to a maximum of 12 months.[170] There is, however, no statutory maximum amount for the penalty. The exception for reasonable cause is described at II.D.3., below.

Note: Due to the COVID-19 (Coronavirus) pandemic, the IRS granted administrative relief from failure to file penalties with respect to tax returns and certain information returns for the 2019 and 2020 tax years that are filed on or before September 30, 2022.[171] As part of this relief, the IRS will waive, or to the extent previously assessed, abate, refund, or credit penalties under §6698(a)(1) for failure to timely file, and under §6698(a)(2) for failure to show the required information on Form 1065, *U.S. Return of Partnership Income*.[172] No taxpayer action is necessary, as this relief will be applied automatically. Should this penalty waiver result in a refund, the overpayment is not subject to the overpayment interest provision of §6611(e)(3).[173]

All persons who were partners at any time during the tax year are counted. As a result, the transfer of a partnership interest during the tax year can increase the penalty. The number of months are computed in the same manner as under the general failure to file penalty. See II.B.4.b., above.

Note: A partnership will not be subject to penalty under §6698, §6721, or §6722 due to the inclusion of incorrect information in reporting its partners' beginning capital account balances on the 2020 Schedules K-1 if the partnership can show that it took ordinary and prudent business care in following the 2020 Form 1065 Instructions to report its partners' beginning capital account balances using the tax basis method, the modified outside basis method, the modified previously-taxed capi-

[159] Reg. §1.761-2(b).

[160] §6031(e).

[161] §6031(e)(2). *See* Reg. §1.6031(a)-1(b). For further discussion of the return filing requirements of foreign partnerships, see 6680 T.M., *Partners and Partnerships — International Tax Aspects* (Foreign Income Series).

[162] *See* §6011(e)(6), as re-designated by the Taxpayer First Act, Pub. L. No. 116-25, §2301(b), effective July 1, 2019; Reg. §301.6011-3(a)(1)(ii), §301.6011-3(d)(6), as amended by T.D. 9972, 88 Fed. Reg. 11,754 (Feb. 23, 2023).

[163] *See* Reg. §301.6011-3, as amended by T.D. 9972, 88 Fed. Reg. 11,754 (Feb. 23, 2023). The IRS may grant waivers of the electronic filing requirement in cases of undue hardship, and may provide exemptions from this requirement in order to promote effective and efficient tax administration. Reg. §301.6011-3(b)(1), §301.6011-3(b)(2).

[164] *See* Reg. §301.6011-3(d)(5).

[165] *See* Reg. §301.6011-3(e)(1) *Ex.* 1.

[166] *See* Reg. §301.6011-3(e)(3) *Ex.* 3.

[167] *See* Reg. §301.6011-3(e)(4) *Ex.* 4.

[168] §6698. The §6699 penalty for failure to file an S corporation return is discussed below. TAM 9627004.

[169] H.R. Rep. No. 1800, 95th Cong., 2d Sess. 221 (1978); IRM 20.1.2.4 (03-09-22).

[170] §6698(a), §6698(b). Beginning in 2015, the $195 penalty in §6698(b)(1) is adjusted for inflation. §6698(e). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Failure to File Partnership Return.*

[171] Notice 2022-36.

[172] Notice 2022-36, §3.

[173] IRM 20.1.1.3.3.2.2(1) (03-29-23). *See* IRM 20.2.4.8.3.4 (03-15-24), IRM 20.2.4.8.3.5 (03-15-24).

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tal method, or the §704(b) method.[174] In addition, a partnership will not be subject to a penalty under for including incorrect information in reporting its partners' ending capital account balances on Schedules K-1 in taxable year 2020 or its partners' beginning or ending capital account balances on Schedules K-1 in taxable years after 2020 to the extent the incorrect information is attributable solely to the incorrect information reported as the beginning capital account balance on the 2020 Schedule K-1.[175] A partnership that fails to timely file a 2020 Form 1065, Form 8865, and Schedules K-1 or that fails to include a partner's beginning capital account balance on the Schedule K-1 is not eligible for relief.[176] Further, the IRS will waive any accuracy-related penalty under §6662 for any taxable year with respect to any portion of an imputed underpayment that is attributable to an adjustment to a partner's beginning capital account balance reported by the partnership for the 2020 taxable year to the extent the adjustment arises from the inclusion of such incorrect information.[177]

For tax years beginning in 2022, the IRS provides a new domestic filing exception for filing and furnishing Schedule K-2, *Partners' Distributive Items — International*, and Schedule K-3, *Partners' Share of Income, Deductions, Credits, etc. — International*, for Form 1065 if certain requirements are met. For further guidance on the domestic filing exception, see the Partnership Instructions for Schedules K-2 and K-3 (Form 1065) on the IRS website.

Note: Notice 2021-39 provides transition relief from §6698, §6721, and §6722 penalties for taxable years that begin in 2021 (processing year 2022) with respect to new Schedules K-2 and K-3 to Form 1065.[178] During this transition period, a partnership required to file Form 1065 (Schedule K-2 or K-3 filer) will not be subject to the relevant penalties for any incorrect or incomplete reporting on the Schedules K-2 and K-3 if the filer establishes to the satisfaction of the IRS that it made a good faith effort to comply with the Schedules K-2 and K-3 filing requirements (and the Schedule K-3 furnishing requirements) per the instructions. For purposes of determining whether a Schedule K-2 or K-3 filer makes a good faith effort to complete Schedules K-2 and K-3, the IRS will take into account the extent to which a Schedule K-2 or K-3 filer has made changes to its systems, processes, and procedures for collecting and processing information relevant to filing the Schedules K-2 and K-3[179] and the extent to which a Schedule K-2 or K-3 filer has obtained information from partners or applied reasonable assumptions when information is not obtained.[180] The IRS will also take into account the steps taken by the Schedule K-2 or K-3 filer to modify the partnership agreement to facilitate the sharing of information with partners that is relevant to determining whether and how to file Schedules K-2 and K-3.[181] A Schedule K-2 or K-3 filer that does not establish that it made a good faith effort to comply with the new requirements will not be eligible for such penalty relief.

The IRS provided additional 2021 taxable year transition relief with respect to certain domestic partnerships obligated to file Schedules K-2 and K-3 to Form 1065.[182] To qualify for this relief:

- In taxable years beginning in 2021, the direct partners in a domestic partnership must not be foreign partnerships, foreign corporations, foreign individuals, foreign estates or foreign trusts, and the domestic partnership must have no foreign activity, including foreign taxes paid or accrued or ownership of assets that generate, have generated or may reasonably expected to generate foreign source income;

- In taxable years beginning in 2020, a qualifying domestic partnership must not have provided its partners, and the partners must not have requested information regarding:

  - Line 16, Form 1065, Schedules K and K-1, and

[174] Notice 2021-13. For purposes of Notice 2021-13, "ordinary and prudent business care" means the standard of care that a reasonably prudent person would use under the circumstances in the course of its business in handling account information.

[175] Notice 2021-13. This penalty relief is in addition to the reasonable cause exception to penalties for failing to properly report the partners' beginning capital account balances.

[176] Notice 2021-13. Notice 2021-13 does not relieve a partner of its obligation under Reg. §1.705-1(a)(1) to determine the adjusted basis of its interest in the partnership for purposes of determining its tax liability or that of any other person.

[177] Notice 2021-13.

[178] The IRS released the new Schedules K-2 and K-3 for Forms 1065, 1120-S, and 8865 for tax year 2021 (filing season 2022). The redesigned forms and instructions give useful guidance on how to provide international tax information. Recognizing the transitional challenges with the adoption of Schedules K-2 and K-3 by affected pass-through entities and their partners and shareholders, the IRS issued Notice 2021-39 providing certain penalty relief for the 2021 tax year. IRS News Release IR-2021-140 (June 30, 2021). This penalty relief is in addition to the reasonable cause exception to the relevant penalty. Notice 2021-39.

[179] The IRS is aware that a Schedule K-2/K-3 filer may not currently have systems or procedures in place to obtain information about its partners to determine whether it must file a part of Schedules K-2 and K-3 or how to complete a part that must be filed. In general, in the taxable year 2021 instructions, unless the Schedule K-2/K-3 filer has knowledge to the contrary, it must file or complete certain parts assuming that the information would be relevant to the partner. During the transition period, a Schedule K-2/K-3 filer will not be subject to the relevant penalties for any incorrect or incomplete reporting on Schedules K-2 or K-3 if it establishes to the satisfaction of the IRS that it made a good faith effort to determine whether it must file a part and how to complete a part that it files. Notice 2021-39.

[180] With respect to information about partners that is relevant to determine whether to file and how to complete a part, the IRS will assess the effort the Schedule K-2 or K-3 filer made to obtain this information and the reasonableness of any assumptions, taking into account the relationship between the Schedule K-2 or K-3 filer and its partners. For example, the appropriate level of diligence and/or the reasonableness of an assumption may differ with respect to a partner that manages or controls the partnership, or a partnership with a partner with a significant interest in the partnership, such as a partner with a 10% interest, as compared to partners holding small interests for which there may not be the same ease of access to information. Nevertheless, a Schedule K-2 or K-3 filer may have made a good faith effort despite being unsuccessful in obtaining information from its partners. Notice 2021-39.

[181] In several instances, certain information about partners is relevant for determining the applicability of a part of Schedules K-2 and K-3 (e.g., a partnership with a direct or indirect partner that is a nonresident alien individual or a foreign corporation). Information about the partners is also relevant for determining how to report some amounts. For example, for taxable years beginning in 2021, the instructions for Form 1065, Schedule K-2 and K-3 state that a partnership is expected to collaborate with its partners to identify the foreign related parties of each partner. Notice 2021-39.

[182] IRS News Release IR-2022-38 (Feb. 16, 2022). For the most current information about the adoption of Schedules K-2 and K-3 by affected pass-through entities and their partners and shareholders, see the *IRS Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865).*

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o Line 20c, Form 1065, Schedules K and K-1 (Controlled Foreign Corporations, Passive Foreign Investment Companies, 1120-F, §250, §864(c)(8), §721(c) partnerships, and §7874).

• The domestic partnership must not have knowledge that the partners requested such information for tax year 2021.

If a domestic partnership qualifies for this exception, the domestic partnership does not need to file Schedules K-2 and K-3 with the IRS or with its partners. However, if the partnership is subsequently notified by a partner that all or part of the information contained on Schedule K-3 is needed to complete their tax return, then the partnership must provide the information to the partner. If a partner notifies the partnership before the partnership files its return, the conditions for the exception are not met and the partnership must provide the Schedule K-3 to the partner and file the Schedules K-2 and K-3 with the IRS.[183]

In Notice 2017-71 the IRS announced penalty relief[184] for certain late filed returns and certain late acts required to be completed by the due date of the return, but only for the *first* tax year of any partnership (and any other entity that may properly file a Form 1065) that began in 2016, if the partnership took the act by the date that would have been timely under §6072 before amendment by the Surface Transportation Act (calendar-year filers — April 15 (April 18 for 2017); fiscal year filers — fourth month following the close of the tax year).[185] If the requirements for relief are met, the IRS grants the relief automatically and abates penalties that were previously assessed. Any relief under Notice 2017-71 is not treated as first-time abatement under the IRS's administrative penalty waiver program.[186] Additionally, although Notice 2017-71 provides penalty relief, partnerships (and other entities that may properly file a Form 1065) will still be liable for any interest due under §6601.

The IRS provided penalty relief for missing negative tax basis account information for tax years that began after December 31, 2017, but before January 1, 2019. Form 1065 reporting updates required that a partnership that did not report tax basis capital accounts to its partners to report — on line 20 of Schedule K-1 (Form 1065) using code AH — the amount of such partner's tax basis capital both at the beginning of the year and at the end of the year if either amount was negative (i.e., negative tax basis capital account information). (The Instructions for Form 8865, Schedule K-1, incorporated this requirement by reference to the Instructions for Form 1065). Aware that certain persons and partnerships might be unable to comply timely with this requirement, the IRS advised that it would waive penalties for failing to file or provide Schedule K-1 to recipients under §6722, §6698, §6038, and under any other Code section for failing to file or furnish a Schedule K-1 or any other form or statement, for any penalty that arose solely as a result of failing to include negative tax basis capital account information if (1) the Schedule K-1 or other applicable form or statement was timely filed, including extensions, with the IRS; was timely furnished to the appropriate partner, if applicable; and contains all other required information, and (2) the person or partnership required to file the Schedule K-1 or other applicable form *no later than one year after the original, unextended due date* of the form to which the Schedule K-1 or other applicable form or statement must be attached, a schedule captioned "Filed Under Notice 2019-20" setting forth certain information for each partner for which negative tax basis capital account information is required as outlined in the notice.[187]

If a domestic partnership or S corporation satisfies the notification and reporting requirements in Prop. Reg. §1.951A-1(e)(2)(iii), the domestic partnership or S corporation may apply the rules in Prop. Reg. §1.951A-1 as if Prop. Reg. §1.951A-5 had been finalized in its entirety, for taxable years ending before June 22, 2019.[188] Under Prop. Reg. §1.951A-1(e)(2)(ii), relief from §6698(a), §6699(a), and §6722(a) penalties is available for domestic partnerships or S corporations that acted consistently with Prop. Reg. §1.951A-5 before June 22, 2019, and satisfy notification and reporting requirements under Prop. Reg. §1.951A-1(e)(2)(iii). Proposed regulations require a domestic partnership or S corporation must provide notification to each partner or shareholder (1) that the Schedule K-1 provided to the partner or shareholder is consistent with Prop. Reg. §1.951A-5; (2) whether the domestic partnership or S corporation filed a Form 1065 or Form 1120S consistent with Prop. Reg. §1.951A-5 or the final regulations; and (3) that the notification is being provided in accordance with Notice 2019-46.[189] Notice must be provided no later than the extended due date of the domestic partnership's or S corporation's tax return (September 16, 2019 for a calendar-year filer), and may be provided through any reasonable method.[190] In the absence of a filing extension, notice must be provided by the date on which the return would have been due had an extension been properly requested.[191] Additionally, if a domestic partnership or S corporation furnished a Schedule K-1 based on Prop. Reg. §1.951A-5, the domestic partnership or S corporation must separately state on Schedules K-1 for subsequent tax years the partner's or shareholder's distributive share or pro rata share of a foreign corporation's distributions to the domestic partnership or S corporation of earnings and profits that relate to the global intangible low-taxed income inclusion amount of the partnership or S corporation that was reflected on the first Schedule K-1.[192] For a discussion of §951A and the potential penalty relief, see 6200 T.M., *CFCs — General Overview* (Foreign Income Series).

[183] IRS News Release IR-2022-38 (Feb. 16, 2022).

[184] For example, the relief applies to the following penalties: §6038, §6651, §6679, §6698, §6721, §6722, and other penalties for partnerships that fail to file additional returns that they are required to file by the due date of their Form 1065 or Form 1065-B. For tax years beginning after December 31, 2017, Form 1065-B is obsolete. See Instructions for Form 1065-B. Notice 2017-71.

[185] The relief applies to: Form 1065, Form 1065-B, Form 1066, Form 5471, Form 8804, Form 8805, and any other returns for which the due date is tied to the due date of Form 1065 or Form 1065-B. Certain other acts that the relief may apply to include an election to establish one or more mixed straddle accounts or a PFIC election under §1295(b). Notice 2017-71 contains a nonexclusive list of certain actions that will not be considered untimely filed provided they are taken by the time that would have been timely prior to amendments made by the Surface Transportation Act and Veterans Health Care Choice Improvement Act of 2015 ("Surface Transportation Act").

[186] See XI.D.16., below.

[187] *See* Notice 2019-20.

[188] Prop. Reg. §1.951A-1(e)(2)(i), REG-118250-20, 87 Fed. Reg. 3890 (Jan. 25 2022).

[189] Prop. Reg. §1.951A-1(e)(2)(iii)(A).

[190] Prop. Reg. §1.951A-1(e)(2)(iii)(A).

[191] Prop. Reg. §1.951A-1(e)(2)(iii)(A).

[192] Prop. Reg. §1.951A-1(e)(2)(iii)(B).

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The IRS also granted relief in Notice 2019-66. Under Notice 2019-66, relief from §6722, §6698, and §6038 penalties is potentially available for failure to report partners' shares of partnership capital on the tax basis method for partnership tax years beginning in calendar year 2019 if the requirements of the notice are followed. Additionally, the notice provides guidance on reporting under §704(c) and §465.[193]

The penalty is in addition to any criminal penalty that may be imposed under §7203 for willfully failing to file a return or supply information.[194] The Chief Counsel's Office stated in PMTA 2013-15 that it will not impose the §6698(a) penalty at the same time as the §6651(a) penalty.

The deficiency procedures do not apply to the assessment or collection of the civil penalty.[195] As a result, the partnership cannot seek relief from the penalty in the Tax Court, but must first pay the penalty and sue for a refund. The entire penalty amount must be paid; the fact that the penalty is computed based on the number of months it is late and the number of partners does not make it divisible for purposes of the full payment rule.[196]

In addition, a penalty may be imposed on a partnership that fails to file using magnetic media as required by §6011(e)(2), as discussed in II.D.1., above. If a partnership with more than 100 partners fails to file a Series 1065 form, accompanying Schedules K-1, and all other related forms and schedules in the manner required, the partnership is deemed to have failed to file correct information returns for purposes of the information reporting penalty under §6721.[197] Penalties for failure to file correct information returns apply for each Schedule K-1 that is not filed electronically when required.[198] For a discussion of waiver of the penalty, see VI.C., below.

3. Reasonable Cause Exception

The failure to file penalty does not apply if there is reasonable cause for the partnership's failure to file or supply the required information.[199] In the case of a "small partnership," reasonable cause is presumed if, upon request by the IRS, it is shown that all the partners have fully reported their share of the partnership income, deductions, and credits on their timely filed income tax returns.[200] However, according to the Office of Chief Counsel, the reasonable cause relief is not automatic.[201]

For purposes of Rev. Proc. 84-35, a small partnership is:

- a partnership;[202]
- comprised of 10 or fewer partners; and
- each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner.[203]

In determining whether a partner has fully reported his share of partnership income, deductions, and credits, all relevant facts and circumstances are taken into account, including the nature and materiality of any error or omission.[204] For example, a partner is considered to have fully reported his share for this purpose, notwithstanding an isolated inadvertent error that results in a de minimis understatement of his net income tax payable. If, however, the error is material, the small partnership exception does not apply.

Note: A "small partnership" was defined under former §6231(a)(1)(A), as in effect for returns filed for partnership tax years beginning before January 1, 2018. The Bipartisan Budget Act of 2015 (Pub. L. No. 114-74, §1101), repealed the TEFRA partnership audit rules, effective for returns filed for partnership tax years beginning after December 31, 2017, and replaced them with new partnership audit provisions. In PMTA 2020-01, the Chief Counsel addressed the issue of whether Rev. Proc. 84-35 was obsolete in light of the BBA repeal of the TEFRA provisions. The Chief Counsel concluded that the revenue procedure is not obsolete and continues to apply. The Chief Counsel explained that the reference to former §6231(a)(1)(B) in the revenue procedure was a means by which to define small partnerships for purposes of the relief provided by the guidance. Thus, it was irrelevant that there no longer exists any current §6231(a)(1)(B) that is generally effective and applicable to partnerships seeking relief under the revenue procedure. The legislative history on which the guidance was based remains relevant, and the scope of the penalty has not been affected by the repeal of the TEFRA provisions, the Chief Counsel noted.

Failure to meet the requirements for the small partnership exception does not prevent the partnership from showing other reasonable cause for its failure to file a timely or complete partnership return.[205] For example, there is reasonable cause for failing to include a balance sheet in the partnership's return if the partnership can show it is extremely difficult or impossible to complete a balance sheet (e.g., due to the use of single-entry

[193] For a discussion of §704(c) and §465 as it relates to partnerships, see 711 T.M., *Partnerships — Formation and Contributions of Property or Services*, and 712 T.M., *Partnerships — Taxable Income; Allocation of Distributive Shares; Capital Accounts*. For a discussion of §465 generally, see 550 T.M., *At-Risk Rules*.

[194] §6698(a).

[195] §6698(d). *See also* §6665 and §6671(a), discussed at XII., below.

[196] *Christian Laymen in P'ship, Ltd. v. United States*, 90-1 USTC ¶50,042 (W.D. Okla. 1989).

[197] Reg. §301.6011-3(c).

[198] *See* Reg. §301.6721-1(a)(2)(ii), T.D. 9972, 88 Fed. Reg. 11,754 (Feb. 23, 2023) (failure to file corrected information return in same manner as corresponding original deemed failure to correct corresponding original information return such that filer will not receive benefit of reduced penalty under Reg. §301.6721-1(b) for that corrected information return).

[199] §6698(a).

[200] Rev. Proc. 84-35; H.R. Rep. No. 1800, 95th Cong., 2d Sess. 221 (1978). *See also* SCA 200135029 (discussing the application of Rev. Proc. 84-35).

[201] CCA 201733013 (must meet requirements of Rev. Proc. 84-35 and IRM 20.1.2.4.3.1).

[202] "Partnership" is defined in former §6231(a)(1)(A), as in effect for returns filed for partnership tax years beginning before January 1, 2018. The Bipartisan Budget Act of 2015, Pub. L. No. 114-74, §1101, repealed the TEFRA partnership audit rules codified at §6221–§6234, effective for returns filed for partnership tax years beginning after December 31, 2017, and replaced them with new partnership audit provisions. Partnerships may elect to apply the amended partnership audit provisions to any partnership return filed for partnership tax years beginning after November 2, 2015, and before January 1, 2018. Pub. L. No. 114-74, §1101(g)(4).

[203] Rev. Proc. 84-35; former §6231(a)(1)(B); Reg. §301.6231(a)(1)-1(a)(1), §301.6231(a)(1)-1(a)(3). A partner that is a §501(a) tax-exempt organization that meets the definition of a C corporation or that is a foreign corporation is considered a C corporation for these purposes. Rev. Rul. 2003-69. A partner that is a disregarded entity for federal tax purposes is treated as a pass-through partner for this purpose; thus, the small partnership exception does not apply. Rev. Rul. 2004-88. In counting the number of partners for this purpose, a husband and wife (and their estates) are treated as one person.

[204] Rev. Proc. 84-35; IRM 20.1.2.4.3.1 (03-09-22).

[205] Rev. Proc. 84-35; IRM 20.1.2.4.3.1 (03-09-22).

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accounting). Reasonable cause is discussed in greater detail at XI., below.

E. REMIC Return

1. Income Tax Return

A real estate mortgage investment conduit (a "REMIC") is treated as a partnership, and the holders of the residual interests are treated as the partners, for purposes of subtitle F of the Code (relating to procedure and administration).[206] As a result, the REMIC must file a return on Form 1066 (U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return) for each tax year on or before the 15th day of the third month after the end of the tax year (plus any extension of time to file) or, in the case of a final return, by the 15th day of the third month after the REMIC ceases to exist, and the REMIC is subject to a penalty under §6651(a) and §6698 if the return is not timely filed.[207] The amount of the §6651(a) failure to file penalty is discussed at II.B.4., above. The amount of the §6698 failure to file penalty is discussed at II.D.2., above.

Note: Due to the COVID-19 (Coronavirus) pandemic, the IRS granted administrative relief from failure to file penalties with respect to tax returns and certain information returns for the 2019 and 2020 tax years that are filed on or before September 30, 2022.[208] As part of this relief, the IRS will waive, or to the extent previously assessed, abate, refund, or credit penalties under §6651(a)(1) for failure to timely file Form 1066, *U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return.*[209] No taxpayer action is necessary, as the relief will be applied automatically. Should this penalty waiver result in a refund, the overpayment is not subject to the overpayment interest provision of §6611(e)(3).[210]

2. Information Return

A REMIC must also report its startup date, the name and address of its representative, and the CUSIP number assigned to each class of its regular interest within 30 days after the startup date on Form 8811, *Information Return for Real Estate Mortgage Investment Conduits (REMICs) and Issuers of Collateralized Debt Obligations.*[211] A new Form 8811 must be filed within 30 days after any of this information changes.[212] In addition, a REMIC must report its interest payments aggregating $10 or more to a regular interest holder on Form 1099-INT.[213] The penalty for failing to file an information return is described at VI., below.

F. Certain Corporate Transactions

Section 6043(c) allows the IRS to prescribe regulations requiring corporations to report changes in control, recapitalizations, and other substantial changes in capital structure.[214] IRS regulations address reporting by both corporations and brokers with respect to transactions described in §6043.[215] The regulations require reporting by large domestic corporations that undergo an acquisition of control (i.e., an acquisition of stock with a fair market value of $100 million or more) or a substantial change in capital structure (i.e., a change where the amount of cash and the fair market value of any property, including stock, provided to the shareholders, is $100 million or more), if the reporting corporation or any shareholder must recognize gain as the result of the application of §367(a).[216] The regulations also require brokers that hold stock on behalf of a customer in the corporation that the broker knows or has reason to know has engaged in a reportable transaction to file Form 1099-B (Proceeds From Broker and Barter Exchange Transactions).[217] A reporting corporation must file Form 8806 (Information Return for Acquisition of Control or Substantial Change in Capital Structure)[218] and Form 1099-CAP (Changes in Corporate Control and Capital Structure)[219] with respect to each shareholder that is not an exempt recipient.[220]

Section 6652(l) imposes a penalty for failing to timely file the required reports. The penalty is $500 for each day the report is late, unless the failure is due to reasonable cause.[221] The amount of the penalty with respect to any return, however, can-

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[206] Reg. §1.860F-4(a). A REMIC, however, is not subject to the rules of subchapter 63C (relating to the tax treatment of partnership items), and the REMIC's tax return must be signed by the person who could sign the return if the REMIC election had not been made. Reg. §1.860F-4(a).

[207] Reg. §1.860F-4(b); IRM 20.1.2.4 (03-09-22); Instructions for Form 1066. REMICs may file for a single, automatic six-month filing extension on Form 7004, *Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns. See* Reg. §1.6081-7(a). Taxpayers do not have to sign the Form 7004 or provide an explanation to receive the extension.

[208] Notice 2022-36.

[209] Notice 2022-36, §3.

[210] IRM 20.1.1.3.3.2.2(1) (03-29-23). *See* IRM 20.2.4.8.3.4 (03-15-24), IRM 20.2.4.8.3.5 (03-15-24).

[211] Reg. §1.6049-7(b)(1).

[212] Reg. §1.6049-7(b)(1).

[213] Reg. §1.6049-7(b)(2). The returns must be filed by February 28 or, if filed electronically, March 31 of the following year. Reg. §1.6049-7(b)(2)(iv); §6071(b). The REMIC may request an automatic 30-day extension of the time to file Form 1099-INT with the government, but not with the interest holder, on Form 8809, *Application for Extension of Time to File Information Returns.* Reg. §1.6081-8(a)(1), T.D. 9838, 83 Fed. Reg. 38,212 (Aug. 3, 2018). The IRS may allow one additional 30-day extension if the REMIC submits a signed request, containing a detailed explanation, before the automatic extension period expires. Reg. §1.6081-8(a)(2); Reg. §1.6081-8(c). The request for extension of time to furnish the statements to recipients is made using Form 15397, *Application for Extension of Time to Furnish Recipient Statements.*

[214] In addition, the acquiring corporation in a tax acquisition must provide information returns and payee statements according to forms or regulations prescribed by the IRS. §6043A, added by the American Jobs Creation Act of 2004, Pub. L. No. 108-357 ("2004 AJCA"), §805(a), effective for acquisitions after October 22, 2004. Thus, §6043A supplements the information reporting provisions of §6043(c) and §6045. In Notice 2005-7, the IRS indicated that it was considering the proper implementation of the information reporting provisions under §6043A, including coordination with §6043(c) and the regulations thereunder, as discussed below.

[215] T.D. 9230, 70 Fed. Reg. 232 (Dec. 5, 2005), effective for acquisitions of control and substantial changes in capital structure that occur after December 5, 2005. The temporary and proposed regulations under §6043(c) and §6045 issued in 2003 (T.D. 9101, 68 Fed. Reg. 75,119 (Dec. 30, 2003)) (and corrected on February 14, 2004) remain outstanding with respect to transactions not covered by the final regulations. The 2003 temporary regulations were effective only for acquisitions of control and substantial changes in capital structure occurring after December 31, 2002.

[216] *See* Reg. §1.6043-4(a)(1), §1.6043-4(c), and §1.6043-4(d).

[217] Reg. §1.6045-3(a).

[218] Reg. §1.6043-4(a)(1).

[219] Reg. §1.6043-4(b)(1).

[220] Exempt recipients are defined in Reg. §1.6043-4(b)(5).

[221] §6652(l); Reg. §1.6043-4(g). A failure to file also includes a failure to file on magnetic media as required by §6011(e) and Reg. §1.6011-2.

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not exceed $100,000.[222] The penalty does not apply if the failure is due to reasonable cause.[223] Until regulations are promulgated under §6652(l), the IRS will use the reasonable cause standards set forth in Reg. §301.6724-1.[224]

G. Low Income Housing Bonds

Operators of low income housing projects financed with exempt facility bonds, and other types of projects financed with bonds treated as exempt facility bonds (e.g., Gulf Opportunity Zone Bonds under §1400N) must provide an annual certification to the IRS.[225] Although a failure to file the certification does not affect the tax-exempt status of the bond, it does subject the operator to a $100 penalty, unless the failure is due to reasonable cause and not willful neglect.[226]

H. S Corporation Returns

Any S corporation that fails to timely file its information return, Form 1120-S (U.S. Income Tax Return for an S Corporation), or whose return is incomplete may be subject to a penalty. The penalty is $195 adjusted for inflation) times the number of S corporation shareholders in the entity during any part of the tax year, for each month or fraction of a month that the failure continues, not to exceed 12 months.[227] The penalty may be assessed against the corporation without the issuance of a deficiency notice, i.e., the penalty must be paid before a refund claim/suit can be initiated.[228] The IRS may abate the penalty if the corporation can show that the failure was due to reasonable cause.[229]

For tax years 2022 and 2023, the IRS provides an exception for filing and furnishing Schedule K-2, *Shareholders' Pro Rata Share Items — International*, and Schedule K-3, *Shareholder's Share of Income, Deductions, Credits, etc. — International*, for Form 1120-S if certain requirements are met. For further guidance on the domestic filing exception, see the *S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S)* on the IRS website.

Note: Due to the COVID-19 (Coronavirus) pandemic, the IRS granted administrative relief from failure to file penalties with respect to tax returns and certain information returns for the 2019 and 2020 tax years that are filed on or before September 30, 2022.[230] As part of this relief, the IRS will waive, or to the extent previously assessed, abate, refund, or credit penalties under §6699(a)(1) for failure to timely file, and under §6699(a)(2) for failure to show the required information on Form 1120-S, *U.S. Income Tax Return for an S Corporation*.[231] No taxpayer action is necessary, as the relief will be applied automatically. Should this penalty waiver result in a refund, the overpayment is not subject to the overpayment interest provision of §6611(e)(3).[232]

Note: Notice 2021-39 provides transition relief from the §6699 penalty for taxable years that begin in 2021 (processing year 2022) with respect to new Schedules K-2 and K-3 to Form 1120-S.[233] During this transition period, an S corporation required to file Form 1120-S (Schedule K-2 or K-3 filer) will not be subject to the §6699 penalty for any incorrect or incomplete reporting on the Schedules K-2 and K-3 if the filer establishes to the satisfaction of the IRS that it made a good faith effort to comply with the Schedules K-2 and K-3 filing requirements (and the Schedule K-3 furnishing requirements) per the instructions. For purposes of determining whether a Schedule K-2 or K-3 filer makes a good faith effort to complete Schedules K-2 and K-3, the IRS will take into account the extent to which a Schedule K-2 or K-3 filer has made changes to its systems, processes, and procedures for collecting and processing information relevant to filing the Schedules K-2 and K-3[234] and the extent to which a Schedule K-2 or K-3 filer has obtained information from shareholders or applied reasonable assumptions when information is not obtained.[235] The IRS will also take

[222] §6652(l). For transactions occurring in 2002, the IRS announced that it would not impose penalties on corporations and brokers that complied with certain transition rules. Announcement 2003-7.

[223] §6652(l).

[224] Such standards are described at VI.C., below. Reg. §301.6724-1, T.D. 9984, 88 Fed. Reg. 87,696 (Dec. 19, 2023), effective for information returns required to be filed and payee statements required to be furnished after December 31, 2023.

[225] §142(d)(7). The submission of this certification is among the acts that may be postponed under §7508 and §7508A when the IRS publishes guidance providing relief related to a specific combat zone, qualifying deployment in a contingency operation, federally declared disaster, significant fire, or terroristic or military action. §7508A was amended by the Infrastructure Investment and Jobs Act to include significant fires for which assistance is provided after November 15, 2021. Pub. L. No. 117-58, §80504. For an updated list of acts whose deadlines may be postponed under §7508 and §7508A, see Tables, Charts & Lists, *Listing of Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions.*

[226] §6652(j).

[227] §6699. Beginning in 2015, the $195 penalty in §6699(b)(1) is adjusted for inflation. §6699(e). For inflation-adjusted amounts, see Tables, Charts & Lists, *Failure to File S Corporation Return.*

[228] §6699(d).

[229] *See* §6699(a) (flush language). *See ATL & Sons Holdings, Inc. v. Commissioner*, 152 T.C No. 8 (Mar. 13, 2019) (§6699 penalty applies where shareholders requested filing extension, but S corporation did not). *See also* Prop. Reg. §1.951A-1(e)(2)(ii) (penalty relief for §6699(a) failures related to §951A if notification and reporting requirements are met), as discussed at II.D., above, and in 6200 T.M., *CFCs — General Overview* (Foreign Income Series).

[230] Notice 2022-36.

[231] Notice 2022-36, §3.

[232] IRM 20.1.1.3.3.2.2(1) (03-29-23). *See* IRM 20.2.4.8.3.4 (03-15-24), IRM 20.2.4.8.3.5 (03-15-24).

[233] In June 2021, the IRS released the new Schedules K-2 and K-3 for Forms 1065, 1120-S, and 8865 for tax year 2021 (filing season 2022). The redesigned forms and instructions give useful guidance on how to provide international tax information. Recognizing the transitional challenges with the adoption of Schedules K-2 and K-3 by affected pass-through entities and their partners and shareholders, the IRS issued Notice 2021-39 providing certain penalty relief for the 2021 tax year. IRS News Release IR-2021-140 (June 30, 2021). This penalty relief is in addition to the reasonable cause exception under §6699. Notice 2021-39.

[234] The IRS is aware that a Schedule K-2/K-3 filer may not currently have systems or procedures in place to obtain information about its shareholders to determine whether it must file a part of Schedules K-2 and K-3 or how to complete a part that must be filed. In general, in the taxable year 2021 instructions, unless the Schedule K-2/K-3 filer has knowledge to the contrary, it must file or complete certain parts assuming that the information would be relevant to the shareholders. During the transition period, a Schedule K-2/K-3 filer will not be subject to §6699 for any incorrect or incomplete reporting on Schedules K-2 or K-3 if it establishes to the satisfaction of the IRS that it made a good faith effort to determine whether it must file a part and how to complete a part that it files. Notice 2021-39.

[235] With respect to information about shareholders that is relevant to determine whether to file and how to complete a part, the IRS will assess the effort the Schedule K-2 or K-3 filer made to obtain this information and the reasonableness of any assumptions, taking into account the relationship between the Schedule K-2 or K-3 filer and its shareholders. For example, the appropriate

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into account the steps taken by the Schedule K-2 or K-3 filer to modify the S corporation agreement to facilitate the sharing of information with shareholders that is relevant to determining whether and how to file Schedules K-2 and K-3. A Schedule K-2 or K-3 filer that does not establish that it made a good faith effort to comply with the new requirements will not be eligible for such penalty relief. The IRS will also take into account the steps taken by the Schedule K-2 or K-3 filer to modify the S corporation agreement to facilitate the sharing of information with shareholders that is relevant to determining whether and how to file Schedules K-2 and K-3. A Schedule K-2 or K-3 filer that does not establish that it made a good faith effort to comply with the new requirements will not be eligible for such penalty relief.

The IRS provided additional 2021 taxable year transition relief with respect to certain S corporations obligated to file Schedules K-2 and K-3 to Form 1120-S.[236] To qualify for this relief:

- In taxable years beginning in 2021, the S corporation must have no foreign activity, including foreign taxes paid or accrued or ownership of assets that generate, have generated or may reasonably expected to generate foreign source income;
- In taxable years beginning in 2020, the S corporation must not have provided its shareholders, and the shareholders must not have requested information regarding:
  - Line 14 of Form 1120-S, Schedules K and K-1, and
  - Line 17d, Form 1120-S, Schedules K and K-1 (controlled foreign corporations, passive foreign investment companies, 1120-F, §250, §864(c)(8), §721(c) partnerships, and §7874).
- The domestic S corporation must not have knowledge that the shareholders requested such information for tax year 2021.

If a domestic S corporation qualifies for this exception, the S corporation does not need to file Schedules K-2 and K-3 with the IRS or with its shareholders. However, if the S corporation is subsequently notified by a shareholder that all or part of the information contained on Schedule K-3 is needed to complete their tax return, then the S corporation must provide the information to the shareholder. If a shareholder notifies the S corporation before the S corporation files its return, the conditions for the exception are not met and the S corporation must provide the Schedule K-3 to the shareholder and file the Schedules K-2 and K-3 with the IRS.[237]

The Chief Counsel's Office stated in PMTA 2013-15 that it will not impose the §6699(a) penalty at the same time as the §6651(a) penalty.

I. Corporation Returns

Any corporation that fails to timely file its tax return, Form 1120, *U.S. Corporation Income Tax Return,* or whose return is incomplete may be subject to a late filing penalty. The penalty may be assessed against the corporation without the issuance of a deficiency notice, i.e., the penalty must be paid before a refund claim/suit can be initiated. The IRS may abate the penalty if the corporation can show that the failure was due to reasonable cause and not willful neglect.[238] The amount of the failure to file penalty under §6651(a)(1) generally is equal to 5% of the net tax amount required to be shown on the tax return for each month (or fraction of a month) that the return is late, up to a maximum of 25% of such net tax amount.[239] If the failure to file is fraudulent, the penalty is increased to 15% for each month (or part thereof), up to a maximum of 75%.[240]

If the failure to pay penalty under §6651(a)(2) also applies for the same month (or fraction thereof), the failure to file penalty for that month is reduced by the amount of the failure to pay penalty.[241]

Where an income tax return is more than 60 days late (taking into account any extensions of time to file), the failure to file penalty cannot be less than $435, adjusted for inflation, or the tax required to be shown on the return (whichever is the lesser), unless the failure is due to reasonable cause and not willful neglect.[242] Moreover, when the minimum penalty provision applies, the failure to file penalty cannot be reduced by the failure to pay penalty below the minimum amount.[243]

C corporation tax returns generally are due on or before the fifteenth day of the fourth month following the close of the tax year (i.e., April 15 for calendar-year taxpayers). For tax years beginning before January 1, 2026, for fiscal-year C corporations with a tax year ending June 30th, the due date is the 15th day of the third month after the end of its tax year (i.e., September 15).[244]

C corporations filing on a calendar basis can obtain one automatic six-month extension of time to file. In the case of fis-

level of diligence and/or the reasonableness of an assumption may differ with respect to a shareholder that manages or controls the S corporation, or a S corporation with a shareholder with a significant interest in the S corporation, such as a shareholder with a 10% interest, as compared to shareholders holding small interests for which there may not be the same ease of access to information. Nevertheless, a Schedule K-2 or K-3 filer may have made a good faith effort despite being unsuccessful in obtaining information from its partners. Notice 2021-39.

[236] IRS News Release IR-2022-38 (Feb. 16, 2022). For the most current information about the adoption of Schedules K-2 and K-3 by affected pass-through entities and their partners and shareholders, see the *IRS Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865).*

[237] IRS News Release IR-2022-38 (Feb. 16, 2022).

[238] *See* §6651(a)(1). The reasonable cause exception is described at II.B.5., above, and is discussed further at XI., below.

[239] §6651(a)(1).

[240] §6651(f).

[241] §6651(c)(1).

[242] §6651(a), as amended by the Setting Every Community Up for Retirement Enhancement Act of 2019, Pub. L. No. 116-94, Div. O, §402, applicable to returns required to be filed after December 31, 2019. For returns required to be filed before January 1, 2020, the penalty cannot be less than $205, adjusted for inflation, or the tax required to be shown on the return (whichever is the lesser), unless the failure is due to reasonable cause and not willful neglect. Beginning in 2015, the dollar amount is adjusted for inflation. §6651(j). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties >*Failure to File Return.*

[243] §6651(c)(1).

[244] §6072, as amended by the Surface Transportation and Veteran's Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, §2006(a); Reg. §1.6072-2(a)(1)(i). For returns filed before January 30, 2020, the temporary regulation removed by T.D. 9892 (Reg. §1.6072-2T) applies. Reg. §1.6072-2(g). Previously, returns for corporations were due on or before the 15th day of the third month following the close of the tax year, i.e., March 15 for calendar-year taxpayers. Former §6072.

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cal-year corporation with a tax year that ends on June 30 (for tax years beginning before January 1, 2026) a taxpayer may obtain an automatic seven month extension.[245]

[245] §6081(b), as amended by Pub. L. No. 114-41, §2006(c), effective for returns for tax years beginning after December 31, 2015; Reg. §1.6081-3(a), Reg. §1.6081-3(e); *see generally* Instructions for Form 7004, *Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns*; IRM 3.11.212.8.1. For extensions before January 30, 2020, the temporary regulation removed by T.D. 9892 (Reg. §1.6081-3T) applies. Reg. §1.6081-3(g).

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III. Failure to Pay Penalties

A. Tax Shown on Return

1. In General

Section 6651(a)(2) penalizes a taxpayer who fails to timely pay the amount shown as tax on any return required by subchapter 61A (relating to income, self-employment, estate, and gift tax returns) or subchapter 51A, 52A or 53A (relating to alcohol, tobacco and firearms, respectively). Section 6651(i) penalizes a taxpayer that fails to either timely provide a push-out statement or pay an imputed underpayment.[246] The penalty does not apply, however, if the failure is due to reasonable cause and not willful neglect.[247] The penalty also does not apply to any failure to pay estimated tax[248] and is limited for certain taxes that the taxpayer properly elects to pay in installments.[249] Additionally, the Chief Counsel's Office advised the statute of limitations for assessing the §6651(a)(2) penalty is not subject to the §6501(a) three year period of limitations for assessment. Instead, the penalty assessment is subject to the §6502(a)(1) ten-year collection period of limitations.[250]

Note: Notice 2024-7 provides automatic penalty relief from §6651(a)(2) and §6651(a)(3) for eligible taxpayers who filed certain income tax returns for tax years 2020 and 2021. The penalty relief is designed to help eligible taxpayers affected by the COVID-19 pandemic to meet their federal tax obligations. The penalty relief for the failure to pay taxes owed will be waived or, to the extent previously assessed or paid, will be abated, refunded, or credited to other outstanding tax liabilities. Taxpayers do not need to request this relief because the IRS will issue a notice to each eligible taxpayer that reflects the updated amount owed and any refund or credit resulting from the automatic abatement. Although the notice grants relief for failures to pay taxes owed, such relief does not apply to any amount of interest that accrues as a result of any underpayment.[251]

Comment: A return prepared by the IRS under §6020(b) will be treated as a return filed by the taxpayer for purposes of the failure to pay the tax shown penalty of §6651(a)(2).[252]

Under Reg. §301.6020-1(b)(2), a document (or set of documents) signed by an authorized IRS official or employee is a return for purposes of §6020 if the document(s): (1) identifies the taxpayer by name and TIN; (2) contains sufficient information to compute the taxpayer's tax liability; and (3) purports to be a return. Form 13496 or any other form that an authorized IRS official or employee signs and uses to identify a set of documents as a §6020(b) return, and the documents identified, constitute a §6020(b) substitute for return.[253] To address situations where the IRS prepares and signs §6020(b) returns by hand or through automated means, the regulations provide that the name or title of an internal revenue officer or employee appearing on the return is sufficient as a subscription by that officer or employee to adopt the document as a return for the taxpayer without regard to whether the name or title is handwritten, stamped, typed, printed, or otherwise mechanically affixed to the document. The document(s) and subscription may be in written or electronic form.[254]

Note: The IRS Chief Counsel indicated that, if IRS processing procedures do not meet the criteria described above, the IRS will concede the failure to pay addition to tax and may seek an increase in the failure to file addition to tax.[255]

Rev. Rul. 2005-59 addresses the issues of whether documents prepared by the IRS under §6020(b) for spouses are joint returns when executed/not executed by both spouses, and whether a Form 870, *Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment*, prepared by the IRS and executed by spouses, is a joint return. The IRS concluded that documents prepared by an IRS revenue agent under §6020(b) that satisfy the test described in the regulations discussed above are not returns for purposes of

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[246] §6651(i).

[247] §6651(a)(2).

[248] §6651(e); IRM 20.1.2.3.8.4(4) (02-27-24). Such failure is subject to its own penalty under §6654 or §6655, which are discussed further in 581 T.M., *Estimated Tax*.

[249] §6651(h); IRM 20.1.2.3(2) (02-27-24). This includes, for example, installment payments of estate tax under §6166. Note, however, that while §6651 specifically provides a reasonable cause exception to those taxpayers who fail to pay the tax shown on the return when due, there is no similar reasonable cause exception under §6166. Accordingly, the IRS's position is that there is no reasonable cause exception for a denial of a §6166 election made in connection with an untimely filed estate tax return. However, it may be possible for a taxpayer to seek Reg. §301.9100-1 relief. CCA 200628042.

[250] CCA 201713001 (statute of limitations for assessment remained open following erroneous First Time Abatement for amounts initially assessed less than 10 years ago).

[251] IRS News Release IR-2023-244 (Dec. 19, 2023).

[252] §6651(g); Reg. §301.6651-1(g); IRM 20.1.2.3.8.4 (04-19-11); *see Flynn v. Commissioner*, T.C. Memo 2021-43 (additions to tax under §6651(a)(2) sustained where taxpayer did not pay any of his tax liabilities for years at issue, IRS proved it submitted substitutes for returns satisfying §6020(b) requirements, and taxpayer presented no evidence that would establish failure to pay was due to reasonable cause and not willful neglect); *Riggins v. Commissioner*, T.C. Memo 2017-106, aff'd by unpub. op., 748 Fed. App'x. 970 (11th Cir. 2018) (IRS met its burden of production to impose penalty under §7491(c) by showing that taxpayer failed to file return before IRS issued deficiency notice based on substitute for return showing an amount of tax; there is no requirement in §6651 that taxpayer receive notice that substitute return has been prepared for IRS to assess addition for failure to timely pay); *Gleason v. Commissioner*, T.C. Memo 2011-154 (addition to tax upheld where substitute return was prepared six days before deficiency notice was issued). Compare this to the failure to file penalty. §6651(g)(1). *See also Connors v. Commissioner*, T.C. Memo 2006-239.

[253] *See* Reg. §301.6020-1(b)(2). A §6020(b) Certification (Form 13496), the income tax examination changes (either Form 4549-A or Form 4549), and an explanation of the changes (Form 886-A) combined are sufficient to constitute a valid substitute for return under §6020(b). *Rader v. Commissioner*, 143 T.C. 376 (2014).

[254] *See* Reg. §301.6020-1(b)(2). A return made in accordance with the regulations and signed by an authorized IRS official or employee is considered prima facie good and sufficient for all legal purposes, except insofar as any federal statute expressly provides otherwise (e.g., 11 U.S.C. §523(a), which specifically provides that a §6020(b) return is not a return for dischargeability purposes). Also, such a return is sufficient for purposes of determining the additions to tax under §6651(a)(2) and §6651(a)(3). Reg. §301.6020-1(b)(3).

[255] See Chief Counsel Notice CC-2007-005, in which the IRS reiterated its position in Chief Counsel Notice CC-2004-009 that the IRS would not concede the §6651(a)(2) addition to tax if it can introduce a Form 13496 package into evidence or if it otherwise meets the criteria for §6020(b) returns set forth in Tax Court opinions, and further advised that it would not concede the addition to tax in cases of an Automated Substitute for Return Certification package satisfying the requirements set forth in Chief Counsel Notice CC-2007-005 and dated on or after July 18, 2005. However, the Chief Counsel indicated that it would not defend a document as a §6020(b) return if no Form 13496 package or ASFR package had been prepared and the case did not closely parallel the facts in *Millsap v. Commissioner*, 91 T.C. 926 (1988), acq. in result in part, 1991-2 C.B. 1.

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§6013 if they are not signed by both spouses under penalties of perjury, nor do such documents constitute valid elections to file a joint return. The IRS further concluded that a Form 870, although signed by both spouses, is not verified by a written declaration made under the penalties of perjury, and thus is not a return.[256]

The exceptions to the §6651(a)(2) penalty are discussed at III.A.3., below.

2. Computation of the Penalty

The IRS must include the computation of the penalty in the notice imposing the penalty.[257] In addition, each penalty notice must contain the name of the penalty and the Code section under which it is imposed. Although an IRS supervisor generally must approve the initial determination of the assessment of all non-computer-generated penalties, approval is not required for additions to tax under §6651.[258]

a. Rate

The late payment penalty is generally 0.5% of the late payment for each month (or part of a month) that the payment is late, up to a maximum of 25%.[259]

The rate, however, is increased to 1% per month commencing with the first month that begins after either (1) 30 days after a notice of levy is sent by the IRS to the taxpayer under §6331(d), or (2) the date notice and demand for immediate payment is given pursuant to the jeopardy assessment rules of §6331(a).[260] Generally, the increased rate is imposed only after the IRS has made repeated demands for payment from the taxpayer.[261] Once the penalty rate is increased, it applies for all subsequent months. Thus, the increased rate continues to apply even if the taxpayer later files a delinquent return; however, the increased rate does not apply to the spouse of a delinquent joint return filer if that spouse was not given the notice required under §6331.[262]

Note: Due to the February 2022 suspension of certain automated collection notice mailings, certain taxpayers were issued a first balance due notice, but subsequent reminder notices were not issued. For those taxpayers, subject to the criteria below, the failure to pay penalty is automatically waived and any overpayment amount will be automatically refunded or credited as appropriate. The waiver applies to:

- tax years 2020 and 2021;
- for filers of Form 1040 series, Form 1041 series, Form 1120 series, and Form 990-T;
- with assessed tax liabilities less than $100,000; and
- in certain collection notice statuses.[263]

Comment: Section 6651(d) only increases the monthly penalty rate. It does not increase the maximum penalty that may be imposed under §6651(a)(2).[264]

In the case of an installment payment agreement, the monthly rate is .25% for any month in which an installment agreement is in effect if the individual taxpayer filed the tax return in a timely manner, including extensions.[265]

b. Penalty Period

The penalty period is the number of months (or part thereof) from the payment's due date (determined with regard to extensions of time to pay) through the date on which the IRS received payment. The due date of a tax payment is generally the date on which the return is required to be filed.[266] If the last day prescribed for payment falls on a Saturday, Sunday, or holiday, the payment can be made on the next business day.[267]

Extensions of time to file a return do not extend the due date for payment.[268] As a result, they generally do not affect the period for computing the penalty. An automatic extension of time to file an individual income tax return on Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, however, is treated as an extension of time to pay the tax if at least 90% of the tax shown on the return was paid by the due date (without regard to the extension) and the balance is paid with the return.[269] If the balance due is more than 10% of the total tax or is not paid with the return, the penalty applies to the total balance due from the original due date. Similarly, an automatic extension to file a corporate income tax return on Form 7004, *Application for Automatic 6-Month Extension of Time to File Certain Business Income Tax, Information, and Other Returns*, extends the payment date if the tentative tax shown on the extension request is at least 90% of the tax shown on the corporation's return and the balance is paid with the return.[270]

[256] In Rev. Rule. 2005-59, the IRS indicated that Rev. Rul. 74-203, in which it determined that a Form 870 signed by husband and wife was a return for purposes of §6020(a) and a valid election to file a joint return under §6013, was revoked, and its holding also applied to Form 1902, *Report of Individual Income Tax Audit Changes* (obsoleted in 1988), and Form 4549, *Income Tax Examination Changes*, and any successor forms to these forms, because these documents did not purport to be returns and did not contain a jurat with a penalties of perjury clause.

[257] §6751. For a discussion of the content of the notice of deficiency if the §6651(a)(2) addition to tax is imposed pursuant to a §6020(b) return, see IRM 20.1.2.3.10 (03-19-19) and SCA 200102048.

[258] §6751(b). For a discussion of the §6751(b) requirements, see XII.A., below.

[259] §6651(a)(2).

[260] §6651(d).

[261] H.R. Rep. No. 841, 99th Cong., 2d Sess. II-779 (1986).

[262] SCA 200004033, *reconsidered on other grounds by* SCA 200102048 (addressing dollar amount and language to be included for addition to tax under §6651(a)(2) in a notice of deficiency for a §6020(b) return).

[263] *See* IRM 20.1.1.3.3.2.3.

[264] *See* IRM 20.1.2.3.8.1.1 (04-19-11).

[265] §6651(h). *See* Reg. §301.6651-1(a)(4) (applying reduced rate if agreement is in effect at any time during the month). For a discussion of when an installment agreement is considered in effect and no longer in effect for purposes of a reduction under §6651(h) in the failure to pay penalty, see SCA 200135025 and CCA 200051038.

[266] §6151(a).

[267] §7503. See discussion at II.B.2., above.

[268] Because extensions to file generally are not extensions to pay taxes, the IRS reminds taxpayers that there are payment plan options available for those having trouble paying their taxes in full by the filing deadline. IRS News Release IR-2023-44 (Mar. 9, 2023). For a discussion of payment plan options, see 638 T.M., *Federal Tax Collection Procedure — Defensive Measures.*

[269] Reg. §301.6651-1(c)(3). The regulation treats the payment of 90% of the tax shown on the return as presumed reasonable cause. See discussion of reasonable cause at III.A.3.a., below.

[270] Reg. §301.6651-1(c)(4).

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Example: Individual T has obtained an automatic extension of time to file her 201x tax return from April 15, 201y, until October 15, 201y. She files on August 30, 201y, and pays the $1,500 tax shown on the return. T is liable for a late payment penalty of $37.50 (.5% × 5 months × $1,500). Even though T has a six-month extension of time to file her return, she does not have any extension of time to pay. The "timely mailed-timely paid" rule of §7502 does not apply to delinquent payments.

In applying the failure-to-pay penalty, each fraction of a month is counted as an entire month. For this purpose, a month is measured from the date in a calendar month to the date numerically corresponding to it in the succeeding calendar month.[271] If a return is due on the last day of a calendar month, each succeeding calendar month constitutes a month for purposes of the failure to pay penalty.[272] In determining the number of months, the fact that the date prescribed for filing the return falls on a Saturday, Sunday, or legal holiday is irrelevant.[273]

c. Delinquent Amount

The failure-to-pay penalty is based on the lesser of the tax shown on the return as filed, or the amount of tax required to be shown on the return.[274]

The IRS generally treats the "amount shown as tax on [the] return" as the amount of total tax shown on total tax line of Form 1040, *U.S. Individual Income Tax Return*.[275] In calculating the §6651(a)(2) penalty, the IRS treats most credits as included in the calculation of the total tax and considers them to be nonrefundable ("above the line") credits; thus, later reductions of the credits directly affect the calculation of the total tax and do not trigger the §6651(a)(2) penalty. However, because the IRS treats §31, §32, §33 and §34 credits as refundable ("below the line") credits, subsequent reductions of these credits do not directly affect the calculation of the total tax. These reductions are treated like payments; therefore, they trigger an increase to the §6651(a)(2) penalty because there has been a failure to pay the amount of tax shown on the return. Instead of distinguishing refundable from nonrefundable credits, the IRS Chief Counsel's office would apply the §6211 definition for a deficiency to determine when subsequent reductions to credits should result in a §6651(a)(2) penalty, because, if there is a deficiency on a taxpayer's return, this amount is an adjustment to the amount of tax shown on the return.[276] Using this rationale, §6211(a)(1) specifically excludes only credits for tax withheld under §31 and §33 in calculating a deficiency; thus, only later adjustments to these credits, and not the credits under §32 and §34, should trigger the §6651(a)(2) penalty.[277]

Comment: Although the late payment penalty can be avoided by never filing a return, no benefit is achieved. As discussed at II.B.4.a., above, the late filing penalty is reduced by the amount of the late payment penalty under §6651(a)(2) for any month in which both penalties apply (unless the $100 minimum penalty applies).

For purposes of computing the late payment penalty for any month, the tax liability is reduced by any credit claimed on the return and any payments of tax made on or before the beginning of each month.[278]

Example: Taxpayer T filed his 201x income tax return on its due date, April 15, 201y, showing a tax liability of $3,000. The tax was reduced by credits of $500 and timely estimated tax payments of $1,500. T paid an additional $500 on July 23, 201y, and the balance on August 23, 201y. It is ultimately determined that T's 201x tax is $3,500. In this case, the §6651(a)(2) penalty is $22.50:

.5% × 4 months × ($3,000 tax shown on return − $500 credit − $1,500 payments before July 16, 201y);

plus

.5% × 1 month × ($3,000 tax shown on return − $500 credit − $2,000 payments before August 16, 201y).

On the other hand, if the tax was ultimately determined to be only $2,500, the penalty would be $10:

.5% × 4 months × ($2,500 tax − $500 credit − $1,500 payments before July 16, 201y).

3. Exceptions

a. Reasonable Cause for Failure to Pay

There is an exception to the §6651(a)(2) failure to pay penalty if the failure to pay is due to reasonable cause and not willful neglect. To claim the exception, the taxpayer must set out the facts on which he relies in a written statement that contains a declaration that it is made under penalties of perjury.[279]

A failure to pay is considered to be for reasonable cause to the extent the taxpayer shows 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 paid the tax on its due date.[280] In determining whether a taxpayer exercised ordinary business care and prudence, all of the facts and circumstances

[271] *See* Reg. §301.6651-1(b)(2).

[272] *See* Reg. §301.6651-1(b)(1).

[273] *See* Reg. §301.6651-1(b)(3).

[274] §6651(c)(2). *See Cabirac v. Commissioner*, 120 T.C. 163 (2003) (§6651(a)(2) penalties for failure to pay tax shown on returns could not be imposed against pro se taxpayer who for years filed only invalid "zero returns" with no tax shown).

[275] *See* IRM 20.1.2.3.1.1 (07-02-13); IRM 20.1.2.3.3 (04-19-11); IRM 20.1.2.3.4 (02-27-24).

[276] SCA 200001037. This position (not treating refundable and nonrefundable tax credits differently in determining delinquent amounts) appears to be in flux at the IRS. In SCA 200113028, Chief Counsel advised that a subsequently disallowed frozen §32 credit increased the underpayment amount, seemingly contrary to SCA 200001037, where Chief Counsel advised that the IRS must cease imposing penalties on disallowed §32 credits. Conversely, an innocent spouse cannot, after receiving relief under §6015 for unreported income by the other spouse, "reclaim" the §32 credit on the ground that his income has again fallen below the phaseout threshold for that provision. Chief Counsel advised that the statutory intent is for that credit to phase out at certain higher levels of joint income, regardless of the innocent spouse's knowledge thereof. SCA 200112001.

[277] SCA 200001037. *See* SCA 200239028.

[278] §6651(b)(2).

[279] Reg. §301.6651-1(c)(1).

[280] Reg. §301.6651-1(c)(1).

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of the taxpayer's financial situation are considered, including the amount and nature of his expenditures in light of his assets, the funds he could reasonably expect to receive, and his investment practices.[281] The type of tax itself also is taken into account. In addition, the rules are stricter with respect to "trust fund" taxes — i.e., taxes that the taxpayer is required to collect or withhold from others.[282]

Reasonable cause must exist throughout the delinquency period, which is different among penalties. For example, for the §6651(a)(2) penalty, reasonable cause must exist from the time of the original due date until payment is made. However, for the §6651(a)(3) penalty, reasonable cause must exist from 21 days from the date of notice and demand for the newly assessed amount, if the amount shown on the notice and demand is under $100,000 (10 days from the date of notice and demand if the assessed amount equals or exceeds $100,000) until payment is made.[283]

Example 1: Taxpayer T incurs lavish and extravagant living expenses, so that the remainder of his assets and anticipated receipts are insufficient to pay his tax by the due date. T did not exercise ordinary business care and prudence in providing for his tax liability.

Example 2: Taxpayer B invests funds in speculative and illiquid assets. At the time of the investment, however, B retained marketable securities in what she reasonably believed to be a sufficient amount to satisfy her tax liability. Due to unexpected expenses and an unforeseen downturn in the market, B is unable to pay her tax. B exercised ordinary business care and prudence.[284]

"Undue hardship" requires more than an inconvenience to the taxpayer. Rather, it requires that the taxpayer will suffer a substantial financial loss if he is forced to make the tax payment on the due date.[285] Having to sell property at its current market price does not ordinarily constitute undue hardship.[286]

In the case of a taxpayer who files an extension request but has an underpayment, reasonable cause for a late payment exists if:

- The excess of the amount of tax shown on the return over the amount of tax paid on or before the regular due date of the return through withholding, estimated taxes, and any payment made with the extension request, does not exceed 10% of the amount of tax shown on the return; and
- Any balance due shown on the return is remitted with the return.[287]

Reasonable cause can also arise in the context of a disaster affecting many taxpayers, and the IRS may abate penalties upon request by a taxpayer affected by a federally declared disaster. The reasonable cause exception in general is discussed in greater detail at XI., below.

b. Bankruptcy

The IRS cannot impose the failure to pay penalty against a bankrupt estate under the Bankruptcy Code (Title 11 of the U.S. Code) if, in not paying, the estate was following a court order finding probable insufficiency of funds of the estate to pay administrative expenses.[288] In addition, no penalty is imposed with respect to the failure to pay a tax incurred by the debtor before commencement of the bankruptcy case (or the appointment of a trustee in an involuntary case), if the petition in bankruptcy was filed either (1) before the return's due date (including extensions) or (2) on or before the date for imposing the penalty.[289]

The bankruptcy exception, however, does not apply to any tax required to be withheld or collected from a third party and paid to the IRS.[290]

c. Postponement of Deadline

For the purpose of determining whether the taxpayer paid the tax in a timely manner, the period during which the taxpayer is serving in the Armed Forces of the United States in an area designated as a combat zone or in qualifying deployment in a contingency operation is disregarded.[291]

In the case of a taxpayer affected by a federally declared disaster (defined in §165(i)(5)), state-declared disaster, significant fire,[292] or terroristic or military action,[293] the Treasury Secretary may specify a period of up to one year that may be disregarded in determining in respect of any tax liability of an affected taxpayer (1) whether certain acts were timely performed for periods after the date of the disaster, fire, or action, (2) the amount of any interest, penalty, additional amount, or addition for periods after that date, and (3) the amount of any credit or refund.[294] For qualified taxpayers affected by a federally declared disaster, certain tax-related deadlines are statutorily postponed for a 120-day period.[295]

For further discussion of §7508, see XI.D.12., below. For further discussion of §7508A, see XI.D.14., below.

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[281] Reg. §301.6651-1(c)(1). *See, e.g., Q.E.D., Inc. v. United States*, 55 Fed. Cl. 140 (2003).

[282] *See, e.g., Fran Corp. v. United States*, 164 F.3d 814 (2d Cir. 1999) (financial difficulties not reasonable cause for failures to pay and deposit employment taxes where electrical contractor made payments to president, to employees, and to creditors not directly related to projects it was trying to complete).

[283] *Cotto-Vázquez v. United States*, No. Civ. No.: 16-2807 (SCC), 2021 BL 91523 (D.P.R. Mar. 11, 2021) (parties incorrectly relied on §6651(a)(2) instead of §6651(a)(3) regarding reasonable cause exception for purposes of refund claim, and thus, summary judgment denied for refund claim because court needed more facts on record to determine whether reasonable cause applied during §6651(a)(3) delinquency period).

[284] Reg. §301.6651-1(c)(2).

[285] Reg. §1.6161-1(b); IRM 20.1.1.3.3.3(1) (08-05-14).

[286] Reg. §1.6161-1(b). *See, e.g., Estate of Hartsell v. United States*, T.C. Memo 2004-211.

[287] *See* Reg. §301.6651-1(c)(3).

[288] §6658(a)(1); S. Rep. No. 1075, 96th Cong., 2d Sess. 51 (1980).

[289] §6658(a)(2).

[290] §6658(b).

[291] §7508(a). *See also* Reg. §301.7508-1.

[292] §7508A, amended by the Filing Relief for Natural Disasters Act, Pub. L. No. 119-29, §2, effective for disasters declared after July 24, 2025.

[293] *See* §692(c)(2).

[294] For taxpayers to be entitled to a postponement of any act, the IRS generally will publish a notice or other guidance with respect to a specific federally declared disaster, significant fire, or terroristic or military action. *See* Tables, Charts and Lists (Federal) > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions.*

[295] §7508A(e), redesignated and amended by the Filing Relief for Natural Disasters Act, Pub. L. No. 119-29, §2(a), effective for disasters declared after July 24, 2025. Former §7508A (60-day mandatory period for disasters declared after November 15, 2021, and before July 25, 2025).

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d. IRS Extensions of Time to Pay

The IRS may grant a taxpayer a short-term extension (between 60 days and 180 days) within which to pay a tax liability if the taxpayer merely needs some extra time to get funds together to pay the tax. These extensions are not considered installment agreements. There are, therefore, no forms to be filled out by the taxpayer. The IRS simply informs the taxpayer of the extension (after a request by the taxpayer) by letter.[296]

If a taxpayer can establish that timely payment of a tax liability will result in undue hardship, the IRS can grant an extension of time for paying any tax for a reasonable period not to exceed six months from the date payment is due tax (12 months in the case of estate tax).[297] If a taxpayer is abroad, the extension can exceed six months.[298] For purposes of an extension, undue hardship means that a taxpayer will definitely incur substantial financial loss if forced to pay the tax when due.[299]

Taxpayers may use Form 1127, *Application for Extension of Time for Payment of Tax Due to Undue Hardship*, to apply for an extension of time to pay tax shown on the return. Taxpayers also may use Form 1127 to request an extension of time to pay certain taxes determined as a deficiency, provided the deficiency is not the result of negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax. The IRS must be satisfied that payment of the deficiency on the date fixed for payment would result in undue hardship. If granted, the extension may not exceed six months (12 months in the case of estate tax and also may exceed six months in the case of a taxpayer who is abroad).[300]

If an extension of time to pay is granted, the failure to pay penalty for the underlying tax will not begin to accrue until after the expiration of the extension period.

The IRS also uses its statutory authority to grant extensions to provide relief to groups of taxpayers in a variety of situations, including taxpayers affected by federally declared disasters (as discussed above).[301]

B. Tax Not Shown on Return

1. In General

A taxpayer who fails to pay a tax that is required to be (but was not) shown on a return within 21 days after the date of the IRS's notice and demand for that tax is subject to a penalty under §6651(a)(3). The notice is the IRS's notice to the taxpayer that it has assessed an additional amount in excess of the amount that has been shown on the return and its demand that the taxpayer pay this assessed amount. The grace period is only 10 business days if the amount for which the notice and demand is made is $100,000 or more.[302] The penalty does not apply if the taxpayer shows that the failure to timely pay the deficiency was due to reasonable cause and not willful neglect.

Note: Absent authority under §7508A, PMTA 2020-007[303] authorizes the IRS to deem that notice and demand letters that were mailed out late due to the temporary closure of IRS printing services during the COVID-19 pandemic were sent out on a date later than the date shown on the notice in order to grant relief from penalties and interest.

Comment: If the IRS prepares a substitute return under §6020(b), §6651(g) treats that return as a return filed by the taxpayer for purposes of the failure to pay the tax required to be (but not) shown penalty of §6651(a)(3).[304]

2. Computation of the Penalty

a. Rate

The penalty is imposed at the rate of .5% for each month (or part thereof) that the assessment remains unpaid, up to a maximum of 25%.[305] Where the tax is being paid in installments pursuant to an installment agreement with the IRS, the rate is reduced to .25% for any month in which the installment agreement is in effect if the individual taxpayer filed the tax return in a timely manner, including extensions.[306]

The rate is increased under §6651(d) following receipt of a notice of levy or a notice of a jeopardy assessment. See discussion at III.A.2.a., above.

b. Penalty Period

Unlike interest on the same deficiency, which runs from the due date of the return, the §6651(a)(3) penalty runs from 21 calendar days (10 business days if the amount shown on the notice and demand is $100,000 or more) after the date of the notice and demand. The penalty period ends when the IRS receives payment of the penalty. See III.A.2.b., above, for the rules on computing the number of months in the penalty period.

Note: Absent authority under §7508A, PMTA 2020-007[307] authorizes the IRS to deem that notice and demand letters that were mailed out late due to the temporary closure of IRS printing services during the COVID-19 pandemic were sent out on a date later than the date shown on the notice in order to grant relief from penalties and interest.

[296] IRM 5.19.1.6.3.

[297] §6161(a)(1); Reg. §1.6161-1(a), §1.6161-1(a)(b).

[298] §6161(a)(1).

[299] Reg. §1.6161-1(b).

[300] IRM 20.1.2.2.3.2.

[301] Additional guidance on disaster relief for specific events is available on the IRS's website, and additional guidance on federally declared disasters (including affected counties) is available on FEMA's website.

[302] The payment date for purposes of calculating the §6651(a)(3) penalty is the date specified on the notice and demand for payment. CCA 200543058.

[303] (May 21, 2020).

[304] §6651(g); PMTA 2020-009 (when IRS exercises its authority to make a substitute return for Form 945, such return is treated as filed by taxpayer for purposes of determining addition to tax under §6651(a)(2) and (3)).

[305] §6651(a)(3).

[306] §6651(h); Reg. §301.6651-1(a)(4) (applying reduced rate if agreement is in effect at any time during the month). For a discussion of when an installment agreement is considered in effect and no longer in effect for purposes of a reduction under §6651(h) in the failure to pay penalty, see CCA 200051038.

[307] (May 21, 2020).

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c. Net Amount Due

The penalty for each month is computed on the net deficiency as of the beginning of such month.[308] The tax stated in the notice and demand is reduced by subsequent payments that are made before the beginning of the month in question.

3. Exceptions

As in the case of the late payment penalty under §6651(a)(2), there is an exception where the failure is due to reasonable cause and not willful neglect. *See* III.A.3.a., above, and XI., below. In addition, the penalty does not apply in certain bankruptcy cases under the Bankruptcy Code (Title 11 of the U.S. Code). *See* III.A.3.b., above.

Note: Notice 2024-7 provides automatic penalty relief from §6651(a)(2) and §6651(a)(3) for eligible taxpayers who filed certain income tax returns for tax years 2020 and 2021. The penalty relief is designed to help eligible taxpayers affected by the COVID-19 pandemic to meet their federal tax obligations. The penalty relief for the failure to pay taxes owed will be waived or, to the extent previously assessed or paid, will be abated, refunded, or credited to other outstanding tax liabilities. Taxpayers do not need to request this relief because the IRS will issue a notice to each eligible taxpayer that reflects the updated amount owed and any refund or credit resulting from the automatic abatement. Although the notice grants relief for failures to pay taxes owed, such relief does not apply to any amount of interest that accrues as a result of any underpayment.[309]

C. Stamp Tax

Tax stamps are required to be used with respect to certain alcohol, firearm, and tobacco products. Any person who does not timely pay any tax that is payable by stamp, coupon, ticket, books, or other method or who willfully attempts to evade such tax or its payment is subject to a penalty equal to 50% of the total amount of the underpayment.[310] The penalty is in addition to any other penalty that may apply.

The stamp tax penalty applies not only to the taxpayer but, in the case of an entity, to an employee, officer, or partner who is under a duty to pay the tax.[311]

D. Federal Tax Deposits

1. Deposit Requirement

Certain federal taxes must be paid by making deposits on prescribed dates based on the amount of the tax due. Deposits are required for the following taxes:[312]

- Quarterly payroll taxes (e.g., income, OASDI and Medicare) reported on Form 941, *Employer's Quarterly Federal Tax Return*;
- Annual payroll taxes (e.g., income, OASDI and Medicare) reported on Form 944, *Employer's Annual Federal Tax Return*;[313]
- Nonpayroll taxes (e.g., backup withholding and withholding on pensions, annuities, IRAs and certain other deferred income) reported on Form 945, *Annual Return of Withheld Federal Income Tax*;
- Federal Unemployment Tax ("FUTA") reported on Form 940, *Employer's Annual Federal Unemployment Tax Return*;
- Payroll taxes for agricultural employees reported on Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*;
- Railroad retirement and unemployment repayment taxes reported on Form CT-1, *Employer's Annual Railroad Retirement Tax Return*;
- Federal excise taxes (e.g., environmental taxes, communications taxes, air transportation taxes, fuel taxes, retail taxes, ship passenger taxes, other excise taxes, the luxury tax, manufacturers taxes, and foreign insurance taxes) reported on Form 720, *Quarterly Federal Excise Tax Return*; and
- Withholding on U.S. source income of foreign persons reported on Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons.*

Each tax has its own deposit requirements and due dates.[314] In addition, certain deposits have "safe harbor" rules for substantial compliance.[315]

Note that special deposit rules potentially apply due to COVID-19 (coronavirus) pandemic.[316] For a further discussion of withholding and deposit of payroll and nonpayroll taxes, including special rules related to COVID-19 (Coronavirus), see 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation.*

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[308] §6651(b)(3). The "month" is determined under the rules described in III.A.2.b., above.

[309] IRS News Release IR-2023-244 (Dec. 19, 2023).

[310] §6653.

[311] §6653, §6671(b).

[312] *See* §6302.

[313] *See* T.D. 9440, 73 Fed. Reg. 79,354 (Dec. 29, 2008). Employers whose estimated annual employment tax liability is $1,000 or less generally may file Form 944, rather than Form 941, and deposit or remit their accumulated employment taxes annually with their Form 944 if they satisfy the de minimis deposit rule of Reg. §31.6302-1(f)(4). Guidance on procedures employers should follow to receive notice of the qualification to file Form 944 or to be able to continue filing Form 941, is set forth in Rev. Proc. 2009-13. For further discussion of the Form 944 program, see 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation.* Deposits must be made through the Electronic Federal Tax Payment System (EFTPS). See III.D.2.b., below, for further discussion.

[314] *See* Reg. §31.6071(a)-1, §40.6071(a)-1.

[315] *See, e.g.,* Reg. §31.6302-1(f), §31.6302-2, §31.6302-3, §31.6302(c)-1(a)(1)(i)(b)–§31.6302(c)-1(a)(1)(ii)(e); Reg. §40.6302(c)-1–§40.6302(c)-3; Notice 2023-28, §3(b), extending relief under Notice 2022-15 §3(b) (providing together, that during all four calendar quarters of 2023, through the second calendar quarter of 2024, the IRS will not exercise its authority under Reg. §40.6302(c)-1(b)(2)(v) to withdraw the taxpayer's right to use the Reg. §40.6302(c)-1(b)(2) deposit safe harbor due to a failure to make deposits of Superfund chemical taxes as required).

[316] *See* Families First Coronavirus Response Act, Pub. L. No. 116-127, Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. No. 116-136, COVID-related Tax Relief Act of 2020, Pub. L. No. 116-260, Div. N, Taxpayer Certainty and Disaster Tax Relief Act of 2020, Pub. L. No. 116-260, Div. EE, and American Rescue Plan Act of 2021, Pub. L. No. 117-2.

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2. Methods for Making Deposits

a. Federal Tax Deposit Coupon Method

Before January 1, 2011, certain taxpayers could make deposits with an authorized government depository by the required deposit date. Deposits were accompanied by Form 8109, *Federal Tax Deposit Coupon.* The funds were then transferred by the depository to the Treasury.[317] As of January 1, 2011, the Federal Tax Deposit Coupon method was eliminated and most taxpayers must make deposits by electronic funds transfer (EFT).[318] See III.D.2.b., below, for further discussion of mandatory use of EFT for federal tax deposits (FTDs).

Note: Generally, tax deposits that are mailed to the authorized depository are considered received on the date stamped on the FTD Coupon by the authorized depository.[319] A deposit that is mailed on or before the second day before the due date for the deposit (including extensions of time for making the deposit) by U.S. mail, postage prepaid and properly addressed to the authorized depository, but which is received after such due date, is considered to be received on the date the deposit was mailed.[320] The timely mailing rule, however does not apply with respect to any deposit of $20,000 or more by any person who is required to deposit any tax more than once a month.[321]

Comment: Mailing deposits directly to the IRS or an unauthorized depository can result in a failure to deposit penalty.

b. EFT Deposit Method ("EFTPS")

The Electronic Federal Tax Payment System ("EFTPS") is the electronic remittance processing system for making federal tax deposits ("FTDs") and federal tax payments ("FTPs").[322]

All taxpayers must use EFT (i.e., EFTPS) except those who qualify for the de minimis rules.[323] Under the de minimis rules, taxpayers with a deposit liability of less than $2,500 for a return period may (1) remit employment taxes with their quarterly or annual tax return, (2) voluntarily make deposits by EFT, or (3) use other methods of payment as provided by the instructions relating to the return.[324]

There are two primary payment options under EFTPS — the Automated Clearing House ("ACH") debit entry method and the ACH credit entry method. Taxpayers may also use the Electronic Tax Application ("ETA") method for making deposits.[325]

Under the ACH debit and credit methods, a deposit is deemed made when the amount is withdrawn from the taxpayer's account, provided the U.S. government is the payee and the amount is not returned or reversed.[326] An ETA payment is deemed to have been made on the date payment is received by the Federal Reserve Bank.[327]

For payments made under the ACH debit or credit entry method, a taxpayer may prove payment by obtaining from the taxpayer's financial institution a statement showing the amount and date of the transfer, and identifying the U.S. Government as the payee.[328] For ETA payments, a taxpayer may prove payment by requesting that their financial institution obtain the statement described above from the Federal Reserve Bank that executed the transfer.[329]

Absent reasonable cause, a taxpayer that must deposit taxes via EFT is subject to the failure-to-deposit penalty if other means are used to deposit the taxes, even if such deposits are otherwise in full and on time.[330]

Example 1: Improper Deposit Method, Late Payment — Taxpayer D was required to make a federal tax deposit of $100x by EFT on or before January 5. D did not make the deposit by EFT; instead, D used a Form 8109 (Federal Tax Deposit Coupon) to make the deposit on January 5 at Bank Z, an authorized depository. D's deposit was not made in the manner required. Thus, absent reasonable cause, D is subject to the 10% failure-to-deposit penalty because D failed for more than 15 days to make the $100x federal tax deposit in the manner required. D is not subject to the 15% penalty, however, because the $100x deposit is credited to D's account as of January 5.[331]

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[317] 31 C.F.R. Part 203.

[318] *See* T.D. 9507, 75 Fed. Reg. 75,897 (Dec. 7, 2010); IRM 20.1.4.2.2.1 (02-09-18).

[319] Reg. §31.6302-1(i)(5).

[320] §7502(e). If the deposit is sent by registered or certified mail, the date of registration or the date of the postmark on the taxpayer's receipt is considered the date of mailing. Reg. §301.7502-2(c)(3).

[321] §7502(e)(3).

[322] §6302(h); Reg. §31.6302-1; IRM 20.1.4.2.2.2 (02-09-2018).

[323] Reg. §1.1461-1(a), §31.6302-1, §1.6302-2, §31.6302-3, §1.6302-4, §31.6302-0, §31.6302-1(h)(2)(iii), §31.6302-1T, §31.6302-2, §1.6302-4, §31.6302(c)-3, §40.6302(c)-1, §40.6302(c)-2, §301.6302-1, §301.6656-1. The required use of EFTPS was effective January 1, 2011. The regulations were in response to the decision of the Financial Management Service (now consolidated into the Bureau of the Fiscal Service) to discontinue the system that processes FTD coupons after December 31, 2010. Information on EFTPS can be found at www.eftps.gov.

[324] *See* Reg. §31.6302-1(h).

[325] *See* Rev. Proc. 97-33, §2.05. ETA is a "same day payment" subsystem of the EFTPS that taxpayers access through their financial institution. *See* Rev. Proc. 97-33, §3.07.

[326] Reg. §31.6302-1(h)(8); Rev. Proc. 97-33, §7.05, §8.10. An EFT deposit is considered to be paid on the later of the day the amount is withdrawn from the taxpayer's account or the last day prescribed for filing the applicable return for the applicable period (determined without regard to extensions). *See* Reg. §31.6302-1(h)(9).

[327] *See* Rev. Proc. 97-33, §9.03.

[328] Rev. Proc. 97-33 at §10.01.

[329] Rev. Proc. 97-33 at §10.02.

[330] *See* Rev. Rul. 95-68; *F.E. Schumacher Co. v. United States*, 308 F. Supp. 2d 819 (N.D. Ohio 2004) (finding statutory authority for imposition of penalties where taxpayer remits taxes other than by EFTPS). *See also Fallu Prods., Inc. v. United States*, 2008-1 USTC ¶50,199 (S.D.N.Y. 2008) (company that paid taxes on time and in full still may be penalized for failing to deposit electronically, as prescribed by regulation).

[331] *See* Rev. Rul. 95-68.

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Example 2: Proper Deposit Method, Late Payment — The facts are the same as in Example 1, above, except that D made the $100x deposit by EFT on January 6, one day late. Absent reasonable cause, D is subject to the 2% penalty because the deposit was not more than five days late.[332]

The regulations require all FTDs of the following taxes to be made by EFT:

- Corporate income and corporate estimated taxes;
- Unrelated business income taxes of tax-exempt organizations under §511;
- Private foundation excise taxes under §4940;
- Taxes withheld on nonresident aliens and foreign corporations;
- Estimated taxes on certain trusts;
- FICA taxes and withheld income taxes;
- Railroad retirement taxes;
- Nonpayroll taxes, including backup withholding;
- Federal Unemployment Tax Act (FUTA) taxes; and
- Excise taxes reported on Form 720, *Quarterly Federal Excise Tax Return.*

If the day an FTD is due is a Saturday, Sunday or legal holiday under §7503, the taxes will be treated as timely deposited if deposited on the next succeeding day that is not a Saturday, Sunday or legal holiday. The regulations do not change already existing rules for determining a depositor's status as either a monthly or semi-weekly depositor for employment taxes, nor change existing rules on whether a taxpayer can remit taxes with a return in lieu of making an FTD.

Users of EFTPS can make tax payments 24 hours a day, seven days a week either online or by telephone. EFTPS can be used to schedule payments up to 120 days in advance of the desired payment date. In addition, EFTPS provides a confirmation number to guarantee that a deposit has been scheduled and allow the deposit to be traced if necessary.

3. How the IRS Applies Deposits

Unless a depositor specifies otherwise, §6656(e)(1) mandates that the IRS apply a deposit to the most recent period or periods within the tax period for which the deposit is made. Thus, for penalty purposes, if the taxpayer has not made deposits sufficient to satisfy the cumulative deposit obligations as of at least one deposit due date, the IRS generally applies a tax deposit to the most recently ended deposit period or periods within the specified tax period to which the deposit relates.[333] The IRS then applies any excess to deposit periods that end on or after the date of the deposit in period-ending-date order.[334]

If the deposit safe harbor rule of Reg. §31.6302-1(f) applies, but the depositor deposits insufficient taxes for a deposit period, the IRS treats the shortfall as a liability for the deposit period (the make-up period) ending immediately before the shortfall makeup date and after the end of any other deposit period ending before the shortfall make-up date.[335] If a shortfall make-up date is the same as the date a deposit is due for another deposit period, the IRS applies a deposit made on that make-up date to the shortfall liability first and applies any excess to deposit periods other than the make-up period beginning with the most recently ended period. If the depositor makes a deposit before the shortfall make-up date but after the end of a deposit period for which the deposit obligation has not been satisfied, the IRS applies the amount to the liability for that deposit period first. The IRS then applies any excess to the shortfall.[336]

Note: Under the EFT deposit method, when third parties are submitting tax deposits, they are depositing funds withdrawn from the taxpayer's account. The funds should then pass through the third party's account to an authorized depository. Removal of the funds from a taxpayer's account does not necessarily constitute a tax deposit, and the taxpayer remains liable for the deposit until funds have been placed in the control of either the Treasury or its authorized depository.[337]

4. Penalty

Section 6656 imposes a penalty upon the failure to timely make a required deposit in the manner required, unless the delay is due to reasonable cause and not willful neglect. To encourage depositors to correct their failures as promptly as possible, §6656 employs a four-tier penalty structure under which the amount of the penalty varies with the length of time within which the failure is corrected.[338]

The amount of the penalty is equal to the "applicable percentage" of the underpayment. For penalty purposes, an "underpayment" is defined as the excess of the amount required to be deposited over the amount, if any, that was actually deposited on or before the deposit's due date.[339]

The "applicable percentage" is:

[332] Rev. Rul. 95-68.

[333] Rev. Proc. 2001-58.

[334] Rev. Proc. 2001-58.

[335] *See* Rev. Proc. 2001-58, §4.03, §5.04.

[336] Rev. Proc. 2001-58, §4.03.

[337] *See* IRM 20.1.4.24.3.1 (04-20-10).

[338] IRM 20.1.4.7.1(1) (07-17-15). As a person must be an employer to be liable for the failure to deposit penalty under §6656, the IRS Chief Counsel concluded in CCA 200604001 that a bank could not be held liable for a §6656 penalty when one of its employees stamped certain federal tax deposit coupons as "paid" but did not process the checks.

[339] §6656(b)(2). Where an employer fails to withhold income or social security taxes from wages paid to an employee, the failure to deposit penalty does not apply to the amounts that were not in fact withheld, although the employer may be subject to other penalties. *See* Rev. Rul. 75-191; IR-87-8 (Jan. 21, 1987). In CCA 200914044, the IRS Chief Counsel addressed whether to allow the day after Thanksgiving to be excepted from the calculation of the due date for federal tax deposits (FTDs) for Federal Insurance Contributions Act (FICA) deposit obligations. The Chief Counsel's Office advised that the day after Thanksgiving is not excepted from the calculation of due dates for FTDs. Although noting that the different deposit rules generally contain exceptions for nonbanking days, The IRS Chief Counsel explained that, while the day after Thanksgiving is a nonbanking day in some states and jurisdictions, this determination is made independently from any consideration of state holidays. The Chief Counsel's office rejected Rev. Rul. 66-230, as obsolete and inapposite in that the ruling did not hold that state holidays would be excepted from the calculation of FTD due dates. See T.D. 9507, 75 Fed. Reg. 75,897 (Dec. 7, 2010), which, in light of the requirement for FTDs to be made by electronic funds transfer (EFT), eliminated the reference to "banking days" in the rules regarding timeliness of deposits and replaces it with reference to "business days," meaning every calendar day that is not a Saturday, Sunday, or legal holiday under §7503.

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• 2% if the failure continues for not more than five days;

• 5% if the failure continues for six to 15 days; and

• 10% if the failure is for more than 15 days.[340]

If the required deposit is not made by the 10th day after the IRS issues its first notice and demand for payment or on the date notice and demand for immediate payment is given under the jeopardy assessment rules, the applicable percentage is increased to 15%.[341] However, to a certain extent, the taxpayer can reduce the amount of the penalty through an abatement request in which the taxpayer timely designates the periods to which deposits are applied.

Note: Absent authority under §7508A, PMTA 2020-007[342] authorizes the IRS to deem that notice and demand letters that were mailed out late due to the temporary closure of IRS printing services during the COVID-19 pandemic were sent out on a date later than the date shown on the notice in order to grant relief from penalties and interest. Additionally, the IRS announced that some employers who claimed COVID-19 related credits are inadvertently receiving notice and demand letters. The IRS advised that no action is necessary and that the IRS is correcting accounts.[343]

Note: Section 2302 of the CARES Act allows employers to defer the deposit of applicable employment taxes until December 31, 2021 and December 31, 2022 (the "applicable installment dates"), provided that all deferred amounts are deposited by the applicable installment dates.[344] The Chief Counsel's Office advised that if any portion of the required deposit is not made by the applicable installment date (whether it be the December 31, 2021 or December 31, 2022 installment), then the entire deferral is invalid and the §6656 penalty is determined by reference to the usual deposit due dates under Reg. §31.6302-1 and §31.6302-2.[345] Said differently, the penalty in such case applies to the entire deferred amount, assuming no available exception.

The taxpayer may designate, during the 90-day period beginning on the date of an IRS penalty notice, the period to which each deposit of tax is applied for purposes of the penalty for failure to deposit taxes.[346] A failure of deposit notice is first required before a taxpayer can designate the period to which remittances should be applied.[347] This designation would allow the taxpayer to mitigate any penalty amount arising from multiple failure-to-deposit penalties that may arise if, for example, a depositor inadvertently misses a deposit early in a return period but makes all succeeding deposits in a timely fashion.[348]

The taxpayer may make this designation for all taxes that must be deposited and reported on Form 720, Form 940, Form 941, Form 943, Form 945, Form CT-1, or Form 1042. The taxpayer does so by calling the toll-free number shown on the penalty notice, or writing the Accounts Management Unit at the appropriate IRS Service Center, within 90 days of the date of the notice and designating the deposit period or periods within the return period to which the taxpayer wants the deposits of, or credits against, the tax to be applied. The IRS notifies the taxpayer in writing of any adjustment it has made.[349]

Example (1): C, a semi-monthly employment tax depositor, makes all of its deposits in a timely fashion, but deposits insufficient amounts on two dates. C accumulates the following employment tax deposit liabilities for its semi-monthly pay dates and makes deposits on the deposit due dates as follows:

Deposit Due Date	Required Deposit	Actual Deposit
April 15	$8,000	$6,000
April 30	$6,000	$6,000
May 15	$5,000	$5,000
May 31	$7,000	$7,000
June 15	$8,000	$7,000
June 30	$9,000	$9,000

During July, C completes its Form 941 for the second quarter and discovers the two underdeposits. C files Form 941 on its July 31 due date and deposits $3,000. The IRS applies the deposits actually made to the most recently ended deposit periods, then mails a notice to C dated October 21, advising that C is subject to a $300 failure-to-deposit penalty calculated as follows:

[340] §6656(b)(1)(A).

[341] §6656(b)(1)(B).

[342] (May 21, 2020).

[343] IRS Statement, Failure to deposit penalties on some employers claiming new tax credits (Aug. 21, 2020).

[344] Pub. L. No. 116-136, §2302. As relevant, the applicable employment taxes include the employer's portion of social security taxes under §3111(a) and so much of the taxes imposed under §3221(a) as are attributable to the rate in effect under §3111(a).

[345] *See* PMTA 2021-07.

[346] §6656(e)(2). This designation is among the acts that may be postponed under §7508 and §7508A once the IRS publishes guidance providing relief related to a specific combat zone, qualifying deployment in a contingency operation, federally declared disaster, significant fire, or terroristic or military action. §7508A was amended by the Infrastructure Investment and Jobs Act to include significant fires for which assistance is provided after November 15, 2021. Pub. L. No. 117-58, §80504. See Tables, Charts and Lists (Federal) > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions*, for an updated list of acts whose deadlines may be postponed. Note that in CCA 200613030, the IRS Chief Counsel concluded that interest on delinquent payroll taxes of a partnership whose principal partner served in a combat zone was not suspended for the period the partner served in a combat zone and for the next 180 days thereafter because (1) pre-KETRA §7508 did not provide a postponement for, or suspend interest on, payroll taxes, and (2) a partnership is not an individual for purposes of §7508.

[347] See *Valteau v. Commissioner*, T.C. Memo. 2014-144.

[348] *See* Rev. Proc. 2001-58, obsoleting Rev. Proc. 99-10.

[349] Rev. Proc. 2001-58, obsoleting Rev. Proc. 99-10.

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Deposit Due Date	Under-deposits	Days Late	Penalty Rate	Penalty Amount
April 15	$2,000	106	10%	$200
April 30	$0	0	N/A	$0
May 15	$0	0	N/A	$0
May 31	$0	0	N/A	$0
June 15	$1,000	45	10%	$100
June 30	$0	0	N/A	$0
TOTAL PENALTY				$300

The penalty due is $300. C has 90 days from October 21st to designate the deposit period(s) within the specified tax period to which C wants the deposits applied. In this case, however, the IRS's application of the deposits avoids cascading penalties and minimizes the failure-to-deposit penalty for the quarter.[350]

The application of deposits to the most recently ended deposit period may, but will not always, eliminate cascading penalties.

Example (2): For the second calendar quarter of the year, B, a monthly employment tax depositor, pays its employees on the first of every month. B normally makes deposits on the 25th (or next banking day thereafter) of each month in which the liability is incurred, instead of waiting until the 15th day of the following month. B pays its employees on April 1. B fails to make the deposit on April 25. For May, B pays its employees on May 1. On May 25, unaware of the underdeposit for April, B makes a deposit to cover its May liability. The IRS applies this deposit to the most recently ended deposit period — April — instead of the May liability as intended by B. This cycle of deposits continues until the end of the quarter. Instead of having a failure-to-deposit penalty only for April, B will be subject to a penalty for every month in the quarter. B can minimize cascading penalties and reduce the penalty amount by timely following the IRS's procedures to designate May and June as the deposit periods to which the deposits are to be applied.[351]

Example (3): For the second calendar quarter F, a weekly employment tax depositor, pays its employees every Friday. F accumulates $10,000 in employment tax deposit liability for each of its weekly pay dates. The IRS applies F's deposits to the most recently ended deposit period. Accordingly, as indicated in the table below, the IRS applies F's April 24 deposit and subsequent deposits through June 26, to deposit liabilities for periods that have ended, but for which the due dates have not occurred. Applying deposits in this manner, F's deposit liability for the period ending April 12 is not satisfied until F makes its June 26 deposit. Nonetheless, applying the deposits to the most recently ended deposit period avoids cascading penalties and minimizes the failure-to-deposit penalty for the quarter.[352]

Deposit Period Ending Date	Due Date of Deposit	Due Date of Deposit that IRS Applies to Deposit Period	Applicable Penalty
April 5	April 10	April 10	$0
April 12	April 17	June 26	$1,000
April 19	April 24	April 24	$0
April 26	May 1	May 1	$0
May 3	May 8	May 8	$0
May 10	May 15	May 15	$0
May 17	May 22	May 22	$0
May 24	May 29	May 29	$0
May 31	June 5	June 5	$0
June 7	June 12	June 12	$0
June 14	June 19	June 19	$0
June 21	June 26	June 26	$0
June 28	July 3	July 3	$0
TOTAL PENALTY			$1,000

5. *Reasonable Cause Exception for Failure to Make a Timely Required Deposit*

Penalty relief is provided if the depositor can show that the underpayment of a required deposit is due to reasonable cause and not willful neglect.[353]

The IRS considers the following situations in determining the existence of reasonable cause for a failure to deposit:[354]

- Death or serious illness of the person having sole responsibility for making the deposit;
- Unavoidable absence of the person having sole responsibility for making the deposit;
- The destruction of business records or place of business by fire or other casualty;

[350] Rev. Proc. 2001-58.

[351] Rev. Proc. 2001-58 at §5.02.

[352] §6656(e); Rev. Proc. 2001-58, §5.03.

[353] §6656(a). Reasonable cause penalty relief is generally granted when a taxpayer exercises ordinary care and prudence in determining his tax obligations, but nevertheless is unable to comply with those obligations. For a discussion of reasonable cause, see XI., below.

[354] *See* IRS Policy Statement 3-2 (12-29-70), at IRM 1.2.1.4.2; IRM 20.1.1.3.2 *et seq.* (11-21-17). The IRS may grant penalty relief in the form of an administrative waiver if the IRS delayed mailing forms. *See* IRM 20.1.1.3.3.2 (08-05-14). If a delay occurs after the authorized depository timely receives the deposit, the IRS will relieve the taxpayer of the portion of the penalty due to the delay, but the relief is not due to reasonable cause. IRM 20.1.4.24(1) (01-06-12). For other administrative waivers, see IRM 20.1.4.26.2 (03-11-24).

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• The taxpayer's ability to make deposits or payments is materially impaired by civil disturbance; and

• The taxpayer's inability to determine the amount of a deposit or tax due is for reasons beyond his control.

For illness to constitute reasonable cause, it must be present at the time the return is ordinarily prepared and must be of such a degree as to render the taxpayer physically or mentally incapable of preparing a return or conducting any activity, including business activity.[355]

In contrast, reasonable cause does not exist as a matter of law where the taxpayer uses trust funds to pay creditors other than the IRS.[356]

Note: The IRS is providing temporary relief from the penalty for failure to deposit Superfund chemical taxes through calendar year 2023. For semimonthly periods beginning in the third and fourth calendar quarters of 2022, through the first, second, third and fourth calendar quarters of 2023, a taxpayer owing Superfund chemical taxes will be deemed to have satisfied the reasonable cause standard, and thus no penalty under §6656 will be imposed, if: (i) the taxpayer makes timely deposits of applicable Superfund chemical taxes, even if the deposit amounts are computed incorrectly; and (ii) the amount of any underpayment of the applicable Superfund chemical taxes for each calendar quarter is paid in full by the due date for filing the Form 720, *Quarterly Federal Excise Tax Return*, for that quarter.[357] Furthermore, from the first calendar quarter beginning in 2022 through the second calendar quarter of 2024, the IRS will not exercise its authority under Reg. §40.6302(c)-1(b)(2)(v) to withdraw the taxpayer's right to use the deposit safe harbor rules of Reg. §40.6302(c)-1(b)(2) for a failure to make deposits of Superfund chemical taxes as required, provided the taxpayer meets those two criteria for the look-back quarter at issue.[358]

To claim the reasonable cause exception, the taxpayer must affirmatively show the facts necessary to constitute reasonable cause in a written statement, containing a declaration that it is made under penalties of perjury.[359] The statement must be filed with the IRS office where the taxpayer's return is required to be filed.[360]

The IRS provides guidance regarding how a taxpayer who makes EFT transfers establishes reasonable cause for purposes of abating the §6656 penalty.[361] In general, a taxpayer making an EFT through either a debit transaction or a credit transaction may establish reasonable cause by using the records of the bank instructed to initiate the EFT (whether a financial agent or the taxpayer's financial institution), and/or the taxpayer's own books and records (including a recording of telephone instructions or a saved electronic file of instructions) to establish that the following information was timely provided to the bank:[362]

• Payment instructions;

• The correct amount of tax to be deposited;

• The correct type of tax to be deposited;

• The correct tax period for which the deposit was made;

• The correct date the funds were to be transferred from the taxpayer's bank to the Treasury's general account; and

• The number of the taxpayer's bank account with sufficient funds to cover the EFT.

A taxpayer required to make payments by EFT is subject to the §6656 penalty if it fails to make such payments by EFT.[363] The penalty applies even if the taxpayer timely deposits the full payment with an authorized depository which timely transfers the payment to the IRS.

6. *Special Exception for First-Time Depositors*

A special exception is provided for first-time depositors of employment taxes.[364] Under this exception, the IRS may waive the penalty for first-time depositors of employment taxes, provided that:[365]

• the failure to deposit is inadvertent;

[355] *See, e.g.*, *In re Roberts Metal Fabrication, Inc.*, 147 B.R. 965 (Bankr. D. Kan. 1992) (citing *Ward v. United States*, 58-2 USTC ¶9922, at 69,706 (E.D. Tenn. 1958)). For further discussion of reasonable cause due to illness, see XI., below.

[356] *See Brewery, Inc. v. United States*, 33 F.3d 589 (6th Cir. 1994) (financial difficulties can never constitute reasonable cause to excuse §6656 penalties for nonpayment of withholding taxes by employer); *Collins v. United States*, 848 F.2d 740 (6th Cir. 1988); *Nesse v. IRS*, 305 B.R. 645 (D. Md. 2004) (agreement turning financial control of employer over to lender does not relieve employer of penalties under §6651 or §6656); *Norwalk Liquidating, Inc. v. United States*, 159 F. Supp. 2d 684 (N.D. Ohio 2001) (under bright-line rule of Brewery, company's use of withholding taxes to sustain itself during financial difficulties until it could get fair market price is not relevant); *BoStar Foods, Inc. v. United States*, 97-1 USTC ¶50,285 (W.D. Ky. 1997); *In re Frederick Savage, Inc.*, 179 B.R. 342 (Bankr. S.D. Fla. 1995) (financial difficulties do not establish reasonable cause, especially where taxpayer continues its business operations and chooses to pay creditors other than United States); *Q.E.D., Inc. v. United States*, 55 Fed. Cl. 140 (2003) (recognizing split of authority within circuit courts and holding that "the weight of the authority favors a factual inquiry into the circumstances of the particular case"; upholding penalty, in large part, because company paid almost $4 million in invoices to related parties during time it did not pay its employment taxes). *Cf. Diamond Plating Co. v. United States*, 390 F.3d 1035 (7th Cir. 2004) (financial hardship may constitute reasonable cause for abatement of penalties for nonpayment of taxes; taxpayer failed to show reasonable cause); *Van Camp & Bennion v. United States*, 251 F.3d 862 (9th Cir. 2001) (trial court must consider financial difficulties in assessing whether corporation had reasonable cause in failing to pay employment taxes, and such difficulties can be factor in determining whether to abate penalties); *East Wind Indus. Inc. v. United States*, 196 F.3d 499 (3d Cir. 1999) (financial hardship caused by bribery demands of government employees deemed reasonable cause under §6651(a) and §6656(a) for failure of government contractor to pay employment taxes; adopting facts and circumstances test and rejecting bright-line test of Brewery); *Fran Corp. v. United States*, 164 F.3d 814 (2d Cir. 1999) (financial difficulties not reasonable cause for failures to pay and deposit employment taxes where electrical contractor made payments to president, employees, and creditors not directly related to projects; however, failure to deposit trust fund taxes does not always preclude financial difficulties from constituting reasonable cause).

[357] Notice 2023-28, §3(a), extending relief under Notice 2022-15, §3(a).

[358] Notice 2023-28, §3(b), extending relief under Notice 2022-15, §3(b).

[359] *See* Reg. §301.6651-1(c)(1) (failure to file or to pay tax).

[360] Reg. §301.6651-1(c)(1).

[361] *See* Rev. Rul. 94-46.

[362] Rev. Rul. 94-46.

[363] *F.E. Schumacher Co. v. United States*, 308 F. Supp. 2d 819 (N.D. Ohio 2004); Rev. Rul. 95-68. *See* IRM 20.1.4.26.1.1 (03-11-24) (potential reasonable cause penalty relief for taxpayers who lost bank account or are unable to obtain bank account).

[364] *See* §6656(c) and §6656(d); Reg. §301.6656-1.

[365] §6656(c)(2).

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• it occurs during the first quarter that deposits are required or it relates to the first deposit required after the taxpayer is required to change its frequency of deposits; and

• the employment tax return is filed on or before its due date.

The penalty may also be abated where the deposit is inadvertently sent to the Secretary, instead of to the proper government depository.[366]

For a detailed discussion of first-time abatement, see XI.E., below.

7. One Time Refund of Penalty

To encourage employers to make deposits using EFTPS, the IRS instituted a program providing for an automatic one-time refund of a failure-to-deposit penalty. To qualify for the refund, the employer must:[367]

• Not be required to make deposits using EFTPS,

• Have been assessed a penalty for failure to make deposits relating to a Form 941 (Employer's Quarterly Federal Tax Return),

• Have previously fully paid the penalty,

• Use EFTPS for four consecutive quarters, and

• Make all Form 941 payments on time.

If a qualified employer meets the requirements, the IRS will automatically refund the penalty.[368]

8. COVID-19 (Coronavirus) Waivers

In response to the COVID-19 (coronavirus) crisis, Congress passed multiple relief packages[369] to provide extended deadlines for the payment of the employer's share of employment taxes and refundable credits applied against the employer's share of employment taxes. For a full discussion of these provisions, see 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation.*

The CARES Act waived §6656 penalties for failures due to anticipation of the employee retention credit,[370] the paid sick leave credit,[371] or the paid family leave credit.[372] Additionally, the IRS can waive §6656 penalties if the failure was due to anticipation of the continuation of coverage premium assistance credit.[373]

Notice 2020-22, *amplified by* Notice 2021-24, *modified by* Notice 2021-65, provides guidance on these waivers, as described below.

a. Paid Sick and Family Leave

For employment taxes related to paid sick and family leave, the §6656 penalty does not apply to a calendar quarter if:[374]

• The employer paid qualified leave wages, qualified health plan expenses, or qualified collectively bargained contributions to its employees in the calendar quarter before the time of the required deposit,

• The amount of employment taxes that the employer did not timely deposit was less than or equal to the amount of the employer's anticipated credits under Pub. L. No. 116-127, Div. G §7001 (paid sick leave) and Pub. L. No. 116-127, Div. G §7003 (paid family leave) or §3131 and §3132 for the calendar quarter as of the time of the required deposit, and

• The employer did not seek payment of an advance credit by filing Form 7200, *Advance Payment of Employer Credits Due to COVID-19*, with respect to the anticipated credits it relied upon to reduce its deposits.

This allows an employer to reduce, without a §6656 penalty, the amount of a deposit of employment taxes by the amount of paid sick or family leave credit anticipated for the calendar quarter as long as the employer does not also seek an advance credit with regard to the same amount. For purposes of Notice 2020-22, §3.a, *amplified by* Notice 2021-24, §3.a, the reduction amount cannot exceed the total amount of the employer's anticipated credit under Pub. L. No. 116-127, Div. G §7001 or Pub. L. No. 116-127, Div. G §7003, or §3131 or §3132 as of the time of the required deposit, minus any amount of such anticipated credits that had previously been used (1) to reduce a prior required deposit in the calendar quarter and obtain the relief provided by this notice, or (2) to seek payment of an advance credit.

b. COVID-19 Related Employee Retention Credit

Subject to the exclusion discussed below, for employment taxes related to wages paid under the employee retention credit for employers subject to closure due to COVID-19, the §6656 penalty does not apply to a calendar quarter if:[375]

• The employer paid qualified retention wages to its employees in the calendar quarter before the time of the required deposit,

• The amount of employment taxes that the employer does not timely deposit, reduced by the amount of employment taxes not deposited in anticipation of the credits claimed under Pub. L. No. 116-127, Div. G §7001 and Pub. L. No. 116-127, Div. G §7003 (paid sick and family leave) or §3131 and §3132 is less than or equal to the amount of the employer's anticipated credits under Pub. L. No. 116-136,

[366] §6656(d).

[367] IRS News Release IR-2004-70 (May 24, 2004).

[368] IRS News Release IR-2004-70 (May 24, 2004).

[369] Families First Coronavirus Response Act, Pub. L. No. 116-127; Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. No. 116-136; COVID-related Tax Relief Act of 2020, Pub. L. No. 116-260, Div. N; Taxpayer Certainty and Disaster Tax Relief Act of 2020, Pub. L. No. 116-260, Div. EE; American Rescue Plan Act of 2021, Pub. L. No. 117-2.

[370] §3134. See VIII.E., below, for a discussion of the §3134 promoter penalty.

[371] §3131.

[372] §3132.

[373] §6432(c)(2)(C). For a discussion of the continuation of coverage premium assistance credit, see 338 T.M., *COBRA — Consolidated Omnibus Budget Reconciliation Act of 1985.*

[374] Notice 2020-22, §3.a, *amplified by* Notice 2021-24, §3.a.

[375] Notice 2020-22, §3.b, *amplified by* Notice 2021-24, §3.b, *modified by* Notice 2021-65, §III.C.

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§2301 (employee retention credit) or §3134 for the calendar quarter as of the time of the required deposit, and

• The employer did not seek payment of an advance credit by filing Form 7200, *Advance Payment of Employer Credits Due to COVID-19*, with respect to the anticipated credits it relied upon to reduce its deposits.

Thus, after a reduction of a deposit of employment taxes by the amount of the anticipated paid sick or family leave credits, an employer could further reduce without a §6656 penalty, the amount of the deposit of employment taxes by the amount of qualified retention credit anticipated for the calendar quarter before the required deposit, as long as the employer did not also seek an advance credit with regard to the same amount. For purposes of Notice 2020-22, §3.b, *amplified by* Notice 2021-24, §3.b, the total amount of any reduction in any required deposit may not exceed the total amount of credits under Pub. L. No. 116-136, §2301 (employee retention credit) or §3134 as of the time of the required deposit, minus any amount of anticipated credit that had been previously used (1) to reduce a prior required deposit in the calendar quarter and obtain the relief provided by this notice, or (2) to seek payment of an advance credit.

However, due to termination of the employee retention credit with respect to wages paid in the fourth calendar quarter of 2021 (other than those paid by recovery startup businesses), the IRS will no longer waive the §6656 penalty for employers that reduce deposits in anticipation of the employee retention credit after December 20, 2021, unless the employer is a recovery startup business.[376]

For deposits due on or before December 20, 2021, with respect to wages paid between October 1, 2021, and December 31, 2021, an employer that is not a recovery startup business will *not* be subject to a §6656 penalty for failing to deposit employment taxes for the fourth calendar quarter of 2021 if the employer:[377]

• reduced its deposits in anticipation of the employee retention credit, consistent with §3.b of Notice 2021-24;

• deposits the amounts initially retained in anticipation of the credit on or before the due date for wages paid on December 31, 2021 (regardless of whether the employer actually pays wages on that date); and

• reports the tax liability resulting from termination of the credit on the employment tax return or schedule that includes the fourth calendar quarter of 2021.

If an employer does not qualify for penalty relief under Notice 2021-65, it can reply to an IRS penalty notice with an explanation and the IRS will consider reasonable cause relief under §6656(a).[378]

[376] Notice 2021-65, *modifying* Notice 2021-24; *see also* §3134(n) (termination of credit), as amended by the Infrastructure Investment and Jobs Act, Pub. L. No. 117-58, §80604; IRM 20.1.4.29 (03-11-24).

[377] Notice 2021-65, *modifying* Notice 2021-24. *See* IRM 20.1.4.29 (03-11-24).

[378] Notice 2021-65, *modifying* Notice 2021-24. Reasonable cause relief is discussed in III.D.5., above.

c. COBRA Continuation Coverage Premium Assistance Credit

For employment taxes related to the COBRA continuation coverage premium assistance credit, the §6656 penalty does not apply to a calendar quarter if:[379]

• The employer is a "person to whom premiums are payable" under §6432(b),

• The amount of employment taxes that the employer does not timely deposit, reduced by the amount of employment taxes not deposited in anticipation of the credits claimed under Pub. L. No. 116-127, Div. G §7001 and §7003 (paid sick and family leave) or §3131 and §3132, and Pub. L. No. 116-136, §2301 (employee retention credit) or §3134, is less than or equal to the amount of the employer's anticipated credits under §6432 for the calendar quarter as of the time of the required deposit, and

• The employer did not seek payment of an advance credit by filing Form 7200, *Advance Payment of Employer Credits Due to COVID-19*, with respect to the anticipated credits it relied upon to reduce its deposits.

Thus, after a reduction of a deposit of employment taxes by the amount of the anticipated paid sick or family leave credits and the anticipated employee retention credit, an employer may further reduce without a §6656 penalty, the amount of the deposit of employment taxes by the employer's COBRA continuation coverage premium assistance credit anticipated for the calendar quarter before the required deposit, as long as the employer did not also seek an advance credit with regard to the same amount. For purposes of Notice 2021-24, §3.c, the total amount of any reduction in any required deposit may not exceed the total amount of anticipated credits under §6432 in the calendar quarter as of the time of the required deposit, minus any amount of anticipated credit that had been previously used (1) to reduce a prior required deposit in the calendar quarter and obtain the relief provided by this notice, or (2) to seek payment of an advance credit.

E. Bad Checks

A penalty is imposed under §6657 on any person who tenders an instrument in payment, by any commercially acceptable means, for the payment of any amount due to the IRS if the instrument is not duly paid upon presentation.[380] The amount of the penalty is 2% of the amount of the dishonored check if the check is for $1,250 or more. If the dishonored check is for less than $1,250, the penalty is $25 or the amount of the check, whichever is less.[381] The penalty is payable upon notice and demand by the IRS in the same manner as a tax. This penalty is in addition to any other penalties provided by law.

The penalty does not apply, however, if the person tendering the check can establish that it was given in good faith and

[379] Notice 2021-24, §3.c.

[380] §6657.

[381] §6657.

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with reasonable cause to believe that it would be duly paid.[382] Reasonable cause is discussed further at XI., below.

Comment: There is nothing in either §6657 or the regulations that would preclude the imposition of the penalty on a person tendering a check on another's behalf.

Note: Due to the COVID-19 pandemic, the IRS will provide relief from §6657 penalties for dishonored checks due to delayed processing.[383] This relief is applicable for payments the agency received starting March 1, 2020 and intended to extend as late as December 31, 2020. However, interest and other penalties still may apply.

The penalty does not apply to payments made by electronic funds transfer (EFT) or by credit card, since they are not paid by check.[384] The fact that the IRS converts a payment by check into an EFT, however, does not prevent the prorating from applying if the check is rejected for lack of funds.[385]

[382] §6657. *See* IRM 20.1.10.7.4 (10-12-22) (providing for additional penalty relief reasons for dishonored payments).

[383] IRS Update on IRS Operations During COVID-19 (Oct. 13, 2020); *IRS Operations During COVID-19: Mission-critical functions continue*, https://www.irs.gov/newsroom/irs-operations-during-covid-19-mission-critical-functions-continue (initial relief for payments received between March 1 and July 15, 2020).

[384] PMTA 2008-01716.

[385] PMTA 2007-01189.

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IV. Accuracy-Related Penalties

A. General Rules

1. Scope of Penalty

The accuracy-related penalty for underpayments is imposed at the rate of 20% on the portion of any underpayment of tax required to be shown on a return attributable to any of the following:

- Negligence (§6662(b)(1));
- Substantial understatement of tax (§6662(b)(2));
- Substantial valuation misstatement (§6662(b)(3));
- Substantial overstatement of pension liabilities (§6662(b)(4));
- Substantial estate or gift tax valuation understatement (§6662(b)(5));
- Transactions lacking economic substance (§6662(b)(6));
- Undisclosed foreign financial asset (§6662(b)(7));
- Inconsistent estate basis (§6662(b)(8)); or
- Overstatement of §170(p) deduction (§6662(b)(9)).[386]

The penalty under §6662 applies only to that portion of the underpayment that is attributable to the particular type of misconduct.[387] The maximum accuracy-related penalty imposed on any portion of an underpayment is 20% (40% in the case of a gross valuation misstatement,[388] the inadequate disclosure of a transaction found to lack economic substance[389] or an undisclosed foreign financial asset understatement;[390] 50% in the case of an overstatement of the §170(p) deduction)[391] even if that portion of the underpayment is attributable to more than one type of misconduct.[392] Where a portion of an understatement is attributable to more than one type of misconduct, the highest applicable penalty rate applies.[393] Different portions of a single income tax return, however, may be subject to different aspects of the accuracy-related penalty.[394]

The accuracy-related penalty applies only when a return (other than one prepared by the IRS pursuant to §6020(b)) has been filed.[395] The accuracy-related penalty cannot be asserted on a return prepared by the IRS under §6020(b).[396] When no return has been filed, only the failure to file penalty applies. Thus, for example, no additional penalties are imposed as a result of a determination that the taxpayer's failure to file a return was negligent.[397] If a return is filed late, both the accuracy-related penalty and the failure to file penalty under §6651 may apply, but the fact that the return is filed late is not taken into account in determining whether the accuracy-related penalty should be applied.[398] The accuracy-related penalty also does not apply to any portion of an underpayment on which the fraud penalty is imposed.[399] The accuracy-related penalty similarly does not apply to the portion of an underpayment on which the reportable transaction penalty under §6662A is imposed.[400]

According to §6665, the deficiency assessment procedures apply to the accuracy-related penalty for income, estate, or gift tax. Thus, a taxpayer can challenge the assertion of the penalty in Tax Court before its assessment. Interest on the penalty begins to accrue on the due date (including extensions) of the return to which the penalty relates.[401]

2. Background

Before the 1989 Act, separate Code sections imposed separate penalties on understatements due to negligence or disregard of rules or regulations,[402] substantial understatements of tax liability,[403] valuation overstatements for income tax purposes,[404] overstatements of pension liabilities,[405] and valuation understatements for purposes of estate or gift taxes.[406] These penalties could be applied cumulatively, so that a single act or transaction was sometimes subject to multiple penalties. Congress believed that this "stacking" of penalties was inappropriate and created administrative difficulties for the IRS.[407] As a result, the 1989 Act revised and consolidated these penalties, effective for returns due (without regard to extensions) after December 31, 1989. In addition, the 1989 Act made uniform several rules and definitions that, under previous law, varied according to the particular penalty. The revised penalty provisions are found in §6662–§6664 (Part II of Chapter 68A). Additional penalties have been added over time.

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[386] §6662(b).

[387] §6662(a).

[388] *See* IV.E.2., below.

[389] *See* IV.H., below.

[390] *See* IV.I., below.

[391] §6662(l), added by the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Pub. L. No.116-260, Div. EE §212(b)(2), applicable to tax years beginning after December 31, 2020. *See* IV.M., below.

[392] Reg. §1.6662-2(c).

[393] Reg. §1.6662-2(c), §1.6664-3.

[394] See ordering rules at IV.A.3.c., below.

[395] §6664(b); Reg. §1.6662-2(a). *See Williams v. Commissioner*, 114 T.C. 136 (2000) (penalty not applicable where Form 1040 was not a valid return because statement denying all liability for tax was attached to form); *Andrews v. Commissioner*, T.C. Memo 1999-281 (penalty not applicable where document submitted by taxpayers disclaimed self-assessment of tax). Not all documents filed are "returns" for this penalty. For example, in FSA 200119001, the Chief Counsel's Office advised that Forms 1139 and 1045 requesting tentative carryback adjustments are not "returns" subject to imposition of the accuracy-related penalty.

[396] *See* §6664(b); IRM 20.1.5.3.2 (04-22-19).

[397] Section 6651 imposes increased failure to file penalties for fraudulent failures to file a return, but not for negligent failures to file a return.

[398] Reg. §1.6662-2(a).

[399] §6662(b) (flush language).

[400] §6662(b) (flush language).

[401] §6601(e)(2).

[402] Former §6653(a).

[403] Former §6661.

[404] Former §6659.

[405] Former §6659A.

[406] Former §6660.

[407] 1989 Act House Report at 1388.

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3. Amount of Penalty

a. Underpayment

An accuracy-related penalty under §6662 first requires an underpayment of tax required to be shown on a return.[408] For this purpose, the term "underpayment" means the amount by which the tax imposed exceeds the excess of:[409]

- The sum of the amount shown as the tax by the taxpayer on his return, plus amounts not shown previously assessed (or collected without assessment) over;
- The amount of any rebates made.

Comment: Although the regulations define an underpayment in the case of an income tax under subtitle A and make the computations by reference to subtitle A,[410] the §6662 penalty is not limited to underpayments of income tax (except as otherwise expressly provided).[411] The regulation is merely illustrative, and not exclusive.[412] Where a regulation that conflicts with the Code, the Code controls.

The amount of tax imposed is the correct amount of tax determined without regard to (a) credits for such tax that was withheld, (b) credits for taxes paid by the taxpayer (including as an estimated tax), (c) any credit resulting from the collection of amounts assessed under §6851 as a result of a termination assessment or under §6861 as a result of a jeopardy assessment, and (d) any tax that the taxpayer is not required to assess on the return.[413]

For this purpose, the amount shown as tax on the taxpayer's return is the tax liability shown on the return, without regard to items (a), (b) or (c) above, except that it is reduced to the extent any such credit claimed for withholding or payment exceeds the actual amount thereof.[414] The amount of tax shown on the return includes any additional tax shown on a qualified amended return, unless such additional tax relates to a fraudulent position on the original return.[415]

Before the 2015 PATH Act,[416] there was some confusion as to whether disallowed refundable credits (such as the earned income credit under §32 and the first-time homebuyer credit under §36) could reduce the tax shown on the taxpayer's return below zero. Initially, the IRS determined such credits could result in a negative tax, which therefore increased the underpayment.[417] Following *Rand v. Commissioner*,[418] which held that disallowed refundable credits do not reduce the tax shown on the return below zero, the IRS changed its position.[419] The 2015 PATH Act amended §6664(a) to require disallowed refundable credits in excess of the tax shown on the return (computed amount without regard to such credits) to be taken into account as a negative tax, effective for returns filed after December 18, 2015 or returns for which the assessment period was open at such time.[420] As a result, the 2015 PATH Act overruled *Rand*, and conformed the treatment of refundable credits for purposes of underpayments to the treatment for purposes of computing deficiencies.[421]

Generally, a return is a filing reporting the taxpayer's tax liability or claiming a refund or credit.[422] However, it does not include a tentative refund application on Form 1139, *Corporate Application for Tentative Refund*.[423]

Amounts not shown previously assessed means only amounts assessed before the return is filed that were not shown on the return. That would include termination assessments under §6851 and jeopardy assessments under §6861.[424]

The amount collected without assessment is the amount by which the total credits for taxes withheld and paid before the return is filed exceed the tax shown on the return, provided such excess has not been refunded or allowed as a credit to the taxpayer.[425]

A rebate means the portion of an abatement credit, refund or other repayment of tax that was made because the tax imposed was less than the excess of (a) the amount shown as tax by the taxpayer on his return, plus amounts not so shown previously assessed or collected without assessment, over (b) rebates previously made.[426] There is no rebate with respect to a requested refund that is disallowed.[427]

The portion of an underpayment attributable to proscribed conduct is not reduced because of a loss or credit carryback to the year.[428]

b. Qualified Amended Return

The amount shown as tax by the taxpayer includes the amount shown on a qualified amended return, except that such amount is not included if it relates to a fraudulent position taken on the original return.[429]

A "qualified amended return" is an amended return, or a timely request for administrative adjustment under §6227,[430] filed after the due date of the return for the year (including extensions), and before the earliest of the following dates:[431]

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[408] §6662(a).

[409] §6664(a). *See* Reg. §1.6664-2(a), §1.6664-2(e).

[410] *See, e.g.*, Reg. §1.6664-2(a), §1.6664-2(b).

[411] The substantial understatement penalty under §6662(b)(2) applies only to income tax. The substantial valuation misstatement penalty under §6662(b)(3) and the gross valuation misstatement penalty under §6662(h) apply only to chapter 1 taxes.

[412] *Abbey Carpet Co. v. United States*, 97-2 U.S.T.C. ¶50,740 (Fed. Cl. 1997); PMTA 2007-00205.

[413] Reg. §1.6664-2(b).

[414] Reg. §1.6664-2(c).

[415] Reg. §1.6664-2(c). Qualified amended returns are described at IV.A.3.b., below.

[416] The Protecting Americans from Tax Hikes Act of 2015 ("2015 PATH Act"), Pub. L. No. 114-113.

[417] SCA 200113028; PMTA 2010-001, PMTA 2011-003, PMTA 2012-016.

[418] 141 T.C. 376 (2013).

[419] *See* CC-2014-007; CCA 201504013.

[420] §6664(a) (flush language), added by 2015 PATH Act, Pub. L. No. 114-113, §209(a). As a result, the IRS declared CC 2014-007 obsolete. CC 2016-004.

[421] *See* §6211(b)(4).

[422] See discussion at II.B.3., above.

[423] FSA 200119001.

[424] Reg. §1.6664-2(d).

[425] Reg. §1.6664-2(d).

[426] §6664(a) (flush language).

[427] FSA 200119002.

[428] Reg. §1.6664-2(f).

[429] Reg. §1.6664-2(c)(2).

[430] For a discussion of administrative adjustment requests, see 624 T.M., *Audit Procedures for Pass-Through Entities*.

[431] Reg. §1.6664-2(c)(1). A return filed before the extended due date is generally considered the original return and not an amended return. *See Haggar Co. v. Helvering*, 308 U.S. 389 (1940). *See also* §6513(a) (a return filed before

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• The date the taxpayer is first contacted by the IRS about any audit (including a criminal examination) with respect to the return;[432]

• The date any person is first contacted by the IRS about an audit of that person under §6700 (the penalty for promoting abusive tax shelters) for an activity with respect to which the taxpayer directly or indirectly claimed a tax benefit on the return;[433]

• In the case of a "pass-through item," the date the pass-through entity is first contacted by the IRS about an audit of the return to which the pass-through item relates;[434]

• The date the IRS serves a third party with a John Doe summons described in §7609(f) relating to the tax liability of a person, group, or class that includes the taxpayer (or pass-through entity of which the taxpayer is a partner, shareholder, beneficiary, or holder of a residual interest in a REMIC), with respect to an activity for which the taxpayer claimed any tax benefit on the return directly or indirectly;[435] or

• The date the IRS announces, by guidance to be published in the Internal Revenue Bulletin, a settlement initiative to compromise or waive penalties in whole or in part with respect to a listed transaction.[436]

In the case of an undisclosed listed transaction[437] for which a taxpayer claims any direct or indirect tax benefits on its return (regardless of whether the transaction was a listed transaction at the time the return was filed), an amended return or request for administrative adjustment under §6227 will not be a qualified amended return if it is filed on or after the earliest of:

• The dates described in the preceding paragraph;

• The date on which the IRS first contacts any person regarding an examination of that person's liability for failing to furnish information regarding a reportable transaction under §6707(a)[438] with respect to the undisclosed listed transaction of the taxpayer; or

• The date the IRS requests, from any person who made a tax statement to or for the benefit of the taxpayer, or who is a material advisor (within the meaning of §6111) with respect to the taxpayer, the information required to be included on a list under §6112 relating to a transaction that is the same as, or substantially similar to, the undisclosed listed transaction, regardless of whether the taxpayer's information is required to be included on that list.[439]

Comment: Section 6662A specifically addresses reportable transaction understatements. In addressing the applicability of the qualified amended return rules, §6662A(e)(3) states that, except as provided in regulations, the IRS will not take into account any tax treatment included with an amendment or supplement to a tax return in determining the amount of any reportable transaction understatement if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by the IRS regarding the examination of the return or any other date specified by the IRS.[440] Similarly, the accuracy-related penalty specifically for transactions that lack economic substance under §6662(b)(6), provides that, in determining whether the 40% penalty applies, amendments or supplements to an already-filed return are not taken into account if the amendment or supplement is filed after the date the taxpayer is first contacted by the IRS regarding the examination of the return (or such earlier date as specified by regulations).[441]

its due date is treated as filed on the due date for purposes of §6511); Rev. Rul. 83-36 and Rev. Rul. 78-256 (an amended return filed by the due date of the original return is the return for estimated tax purposes). Rev. Rul. 2005-4 (with respect to suspension of penalties under §6404(g)).

[432] Reg. §1.6664-2(c)(3)(i)(A).

[433] Reg. §1.6664-2(c)(3)(i)(B). There is no requirement that a §6700 penalty actually be imposed. *Bergmann v. Commissioner*, 137 T.C. 136 (2011). The §6700 penalty is described at VIII.A.1., below.

[434] Reg. §1.6664-2(c)(3)(i)(C). For this purpose, a "pass-through item" is an item attributable to a pass-through entity, which is a partnership, S corporation, estate, trust, regulated investment company, real estate investment trust, or real estate mortgage investment conduit. Reg. §1.6664-2(c)(3)(i)(C); §1.6662-4(f)(5).

[435] Reg. §1.6664-2(c)(3)(i)(D)(1). The rule applies to any return on which the taxpayer claimed a direct or indirect tax benefit from the type of activity that is the subject of the summons, regardless of whether the summons seeks the production of information for the taxable period covered by such return. Reg. §1.6664-2(c)(3)(i)(D)(2). An understatement of income by omission is construed as a tax benefit within the meaning of Reg. §1.6664-2(c)(3)(i)(D). *See Lamprecht v. Commissioner*, T.C. Memo 2022-91, aff'd, 98 F.4th 1132 (D.C. Cir. 2024). In *Lamprecht*, an amended return filed after service of a John Doe summons was deemed not qualified. Per the court, the taxpayers' omission of foreign income provided a tax benefit either directly by maintaining implicitly they were entitled to the §911 foreign earned income exclusion, or indirectly by understating their tax liabilities thereby allowing for tax savings through underpayments and the claiming of itemized deductions to which they were otherwise not entitled.

[436] Reg. §1.6664-2(c)(3)(i)(E). This rule applies only to a taxpayer who participated in the listed transaction and for the tax years in which the taxpayer claimed any direct or indirect tax benefits from the listed transaction. The IRS may waive the requirements of this rule or identify a later date by which a taxpayer who participated in the listed transaction must file a qualified amended return in the published guidance announcing the listed transaction settlement initiative. Reg. §1.6664-2(c)(3)(i)(E).

[437] An undisclosed listed transaction is a transaction that is the same as, or substantially similar to, a listed transaction within the meaning of Reg. §1.6011-4(b)(2) (regardless of whether Reg. §1.6011-4 requires the taxpayer to disclose the transaction) and that was not previously disclosed by the taxpayer. Reg. §1.6664-2(c)(3)(ii). Whether there was previous disclosure by the taxpayer is determined under Reg. §1.6011-4 or former Reg. §1.6011-4T, or under Announcement 2002-2 by the deadline therein. Reg. §1.6664-2(c)(3)(ii).

[438] The §6707 penalty is described at VIII.A.3.b., below.

[439] Reg. §1.6664-2(c)(3)(ii)(C). The definition of a material advisor is described at VIII.A.3.a.(3), below, and the information requirements are described at VIII.A.3.a., below.

[440] The penalty under §6662A is discussed in 648 T.M., *Reportable Transactions*. The IRS has issued interim guidance, pending issuance of regulations, on §6662A. For purposes of determining the amount of any reportable transaction understatement, the IRS will not take into account an amendment or supplement to a return filed after the dates specified above under Reg. §1.6664-2(c)(3), which are the dates after which a taxpayer may not file a qualified amended return. Notice 2005-12.

[441] The accuracy-related penalty applicable to transactions that lack economic substance under §6662(b)(6) is discussed at IV.H., below.

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A qualified amended return includes an amended return that is filed to make a disclosure for purposes of avoiding the negligence or substantial understatement penalty, even though it does not report any additional tax.[442] Because the qualified amended return provisions do not work well for taxpayers subject to essentially continuous examinations under the Large Corporate Compliance (LCC) program (formerly the Coordinated Industry Case (CIC) program) and Large Partnership Compliance (LPC) program, the IRS maintains special procedures under Rev. Proc. 2022-39 that allow such taxpayers to submit the equivalent of a qualified amended return for penalty purposes.[443] Under the revenue procedure, a properly completed Form 15307, *Post-Filing Disclosure for Specified Large Business Taxpayers*, and its supporting information will be treated as a qualified amended return if the taxpayer submits the form to the IRS personnel conducting the examination in accordance with the requirements of the revenue procedure and form instructions.[444]

c. Portion of Underpayment Allocable to a Penalty

Where an underpayment is attributable to multiple adjustments, some of which are subject to a penalty and some are not or where different adjustments are subject to penalties at different rates, it is necessary to allocate the underpayment to the different adjustments.[445] In computing the portion of an underpayment subject to an accuracy-related penalty under §6662 or a fraud penalty under §6663, the regulations required adjustments to a return to be considered to be made in the following order:[446]

- Those with respect to which no penalty is imposed;
- Those with respect to which a 20% penalty under §6662 is imposed;
- Those with respect to which a 40% penalty under §6662 is imposed; and
- Those with respect to which a fraud penalty under §6663 is imposed.

The IRS Chief Counsel's Office advised that in cases where the IRS asserts accuracy-related penalties under §6662(h), §6662(i), and §6662(j), it should assert the penalty that is most strongly supported by the facts and circumstances and, in unagreed cases, include the other penalties as alternatives.[447]

Any withholding or payment of tax that was neither claimed on the return nor previously allowed as a credit against the tax that is allocable to a particular adjustment is applied to reduce the underpayment attributable to such adjustment.[448] To the extent the unclaimed credit is not allocable to a particular adjustment, it is applied in the order described above.[449]

Comment: Where tax rates are graduated, the ordering rules generally maximizes the penalty by increasing the underpayment attributable to the higher rate penalties.

Example: H and W file a joint income tax return, reporting taxable income of $15,800 and a tax liability of $2,374. No amounts were previously assessed, collected without assessment or rebated. Subsequently, the return was audited, and the following adjustments and penalties were agreed to:

Adjustment #1 (No penalty imposed)	$1,000
Adjustment #2 (Substantial underpayment penalty imposed)	$40,000
Adjustment #3 (Fraud penalty imposed)	$45,000
Total adjustments	$86,000
Taxable income shown on return	15,800
Taxable income as corrected	$101,800

The underpayment of $23,454, computed as follows:

Tax imposed		$25,828
Tax shown on return	$2,374	
Previous assessments	-0-	
Rebates	-0-	
Total		(2,374)
Underpayment		$23,454

The underpayment is allocable to the different adjustments as follows, starting with the adjustment for which no penalty is imposed and working up from the lowest to the highest penalty percentage:

Adjustment #1

Taxable income shown on return	$15,800
Adjustment #1	1,000
Adjusted taxable income	$16,800
Tax on adjusted taxable income	2,524
Tax shown on return	(2,374)
Underpayment attributable to Adjustment #1 for which no penalty is imposed	$150

[442] Reg. §1.6664-2(c)(4)(i). *See* Reg. §1.6662-3(c), §1.6662-4(f), and §1.6664-4(c) for rules relating to adequate disclosure.

[443] *See* Reg. §1.6664-2(c)(4)(ii); Rev. Proc. 2022-39, *obsoleting* Rev. Proc. 94-69. Rev. Proc. 2022-39 is generally effective for examinations of eligible taxpayers that begin after November 16, 2022. Previously, the qualified amended return procedures were set forth in Rev. Proc. 94-69, which continues to apply to taxpayers in LCC and CIC cases for tax years before 2021, while Rev. Proc. 2022-39 applies to taxpayers in LCC and LPC cases for tax years 2021 and later. Rev. Proc. 2022-39, §6.02. *See* IRM 4.50.3.3.2 (05-24-21).

[444] *See* Rev. Proc. 2022-39, §4.01.

[445] Reg. §1.6664-3(a).

[446] Reg. §1.6664-3(b). Presumably the IRS would adjust the 50% penalty under §6662 after the 40% penalty under §6662.

[447] PMTA 2010-055.

[448] Reg. §1.6664-3(c)(1).

[449] Reg. §1.6664-3(c)(2).

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Adjustment #2

Adjusted taxable income following Adjustment #1	$16,800
Adjustment #2	40,000
Adjusted taxable income	$56,800
Tax on adjusted taxable income	$11,880
Tax on adjusted taxable income following Adjustment #1	(2,524)
Underpayment attributable to Adjustment #2 for which a 20% penalty imposed	$9,356

Adjustment #3

Adjusted taxable income following Adjustment #2	$56,800
Adjustment #3	45,000
Adjusted taxable income	$101,800
Tax on adjusted taxable income	25,828
Tax shown on adjusted taxable income following Adjustment #2	(11,880)
Underpayment attributable to Adjustment #3 for which a 75% fraud penalty is imposed	$13,948

The underpayment attributable to the last adjustment can also be computed by subtracting the underpayments attributable to the lower tier adjustments from the total underpayment:

Total underpayment	$23,454
Underpayment attributable to Adjustment #1	(150)
Underpayment attributable to Adjustment #2	(9,356)
Underpayment attributable to Adjustment #3	$13,948

Example: If in the above example, H and W failed to claim a credit for $1,500 of income tax that was withheld with respect to the unreported income from Adjustment #2, the underpayment attributable to Adjustment #2 is reduced to $7,856 ($9,356 – $1,500). The portions of the underpayment attributable to Adjustment #1 and Adjustment #3 are not affected.

Example: If in the above example, the unclaimed $1,500 withholding credit was not attributable to any particular adjustment, it would first reduce the underpayment attributable to Adjustment #1 to zero, and the balance would reduce the underpayment attributable to Adjustment #2. As a result:

Underpayment attributable to Adjustment #1	$150
Unclaimed credit = min ($150, $1,500)	(150)
Adjusted underpayment attributable to Adjustment #1	-0-
Underpayment attributable to Adjustment #2	$9,356
Remaining unclaimed credit = min ($9,356, $1,350)	(1,350)
Adjusted underpayment attributable to Adjustment #2	$8,006
Underpayment attributable to Adjustment #3	$13,948
Remaining unclaimed credit	(0)
Adjusted underpayment attributable to Adjustment #3	$13,948

The court upheld the regulations as a reasonable methodology to allocate the underpayment to the different penalties, and accordingly rejected the method preferred by the taxpayer.[450]

4. General Exceptions to the Accuracy-Related Penalty

a. Coordination with Other Penalties

Only one penalty under §6662 may be applied with respect to any understatement.[451] The §6662 penalties cannot be stacked.

A §6662 penalty may not be imposed on any portion of an underpayment on which a fraud penalty under §6663 is imposed, or a reportable transaction penalty is imposed under §6662A.[452]

b. Reasonable Cause for the Accuracy-Related Penalties

(1) In General

The accuracy-related penalty under §6662 does not apply with respect to any portion of an underpayment with respect to which it is shown that there was reasonable cause and that the taxpayer acted in good faith.[453] Subject to §7491, the burden of

[450] *Lemishow v. Commissioner*, 110 T.C. 346 (1998). *See also* IRM 20.1.5.3.3 (04-22-19).

[451] §6662(a).

[452] §6662(b) (flush language). The adjustments under §6662A(e) prevent an increase in the penalty due to certain add backs with respect to reportable transactions. The fraud penalty is discussed at V., below. The reportable transaction penalty is discussed in 648 T.M., *Reportable Transactions.*

[453] §6664(c)(1); Reg. §1.6664-4(a). For a further discussion of reasonable cause, see XI., below.

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proving reasonable cause and good faith is on the taxpayer.[454] The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances.[455] The most important factor is the extent of the taxpayer's efforts to assess his proper tax liability.[456]

For a taxpayer's reliance on the advice of a tax advisor to be sufficiently reasonable so as possibly to negate a §6662(a) accuracy-related penalty, the taxpayer must prove by a preponderance of the evidence that the taxpayer satisfies a three-prong test: (1) the advisor was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer gave to the advisor the necessary and accurate information; and (3) the taxpayer actually relied in good faith on the advisor's judgment.[457]

The reasonable cause exception does not apply to gross valuation misstatements.[458] Special rules apply in the case of certain other penalties, for example, with respect to valuation overstatements of property contributed to a charity,[459] and substantial understatements with respect to a tax shelter item of a corporation.[460] Reasonable cause under §6664(c), discussed below, is specifically limited to penalties imposed under §6662 and §6663 for the accuracy-related penalty for reportable transaction understatements under §6662A.[461]

Example: C, an individual, sought advice from D, a friend who was not a tax professional, as to how C might reduce his federal tax obligations. D advised C that, for a nominal investment in Corporation X, D had received certain tax benefits that virtually eliminated D's federal tax liability. D also named other investors who had received similar benefits. Without further inquiry, C invested in X and claimed the benefits that he had been assured by D were due him. In this case, C did not make any good faith attempt to ascertain the correctness of what D had advised him concerning his tax matters, and is not considered to have reasonable cause for the underpayment attributable to the benefits claimed.[462]

Example: T, an individual who is retired from the United States military, excludes from income in Year 4 a portion of his military retirement benefits. Before submitting his Year 4 return, T had submitted three amended returns (Years 1, 2 and 3) that also excluded a portion of his military retirement benefits. The IRS accepted these returns and issued refunds before T's filing of his Year 4 return. T had reasonable cause and acted in good faith because the position on his Year 4 return is consistent with the position on his three previously submitted and accepted amended returns.[463]

Circumstances that may indicate reasonable cause and good faith include:[464]

- An honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge, and education of the taxpayer;[465] and
- Reliance on an information return, professional advice or other facts, if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.[466]

Uncertainty as to the state of the law also may be taken into account in determining whether the taxpayer had reasonable cause.[467]

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[454] §6664(c)(1); Reg. §1.6664-4(a); H.R. (Conf.) Rep. No. 105-599 at 241 (1998). *See, e.g., Higbee v. Commissioner*, 116 T.C. 438 (2001); *El v. Commissioner*, 144 T.C. 140 (2015). Section 7491 deals with the burden of production of evidence. Under §7491(c), the IRS has the burden of production with respect to penalties in any court proceeding relating to an individual's tax. See discussion at XII.A.3., below.

[455] *See* Reg. §1.6664-4(b)(1). For an updated list and discussion of relevant key factors used to determine if reasonable cause exists, see the LB&I Concept Unit on Reasonable Cause and Good Faith.

[456] Reg. §1.6664-4(b)(1). *See Brinkley v. Commissioner*, 808 F.3d 657 (5th Cir. 2015) (no good faith effort to assess tax liability because taxpayer failed to provide pertinent facts to essential advisers, such as amount of stock owned, determined value of such stock, and executed consent and merger agreement, rendering reliance on such advice unreasonable); *Compaq Computer Corp. v. Commissioner*, 113 T.C. 214 (1999) (sophisticated professionals with investment experience should have been alerted to questionable economic nature of American Depository Receipt transaction, but failed to take steps to investigate its bona fide economic aspects), *rev'd without discussion* of this issue, 277 F.3d 778 (5th Cir. 2001); *Barranti v. Commissioner*, T.C. Memo 1998-427 (husband and wife who each placed the responsibility for omitted income and excess deductions on the other did not make their best efforts in preparing the return).

[457] *See, e.g., Sarvak v. Commissioner*, No. 18-73296, 2020 BL 66774 (9th Cir. Feb. 20, 2020) (unpub. op.), aff'd, T.C. Memo 2018-68 (taxpayer failed to show reasonable and good faith reliance on professional advice because failed to provide return preparer accountant with details of claimed uncollectable debt); *Neonatology Assocs. P.A. v. Commissioner*, 115 T.C. 43 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002); *Babu v. Commissioner*, T.C. Memo 2020-121 (despite testimony that taxpayer received advice from tax professional that represented taxpayer in previous tax matters, such reliance is not reasonable where taxpayer is tax professional with years of experience in tax field); *King Solarman, Inc. v. Commissioner*, T.C. Memo 2019-103 (penalty not applicable to corporation that manufactured and sold solar equipment where sole shareholder and chief executive officer of corporation did not know of, and had no reason to know of, deficiencies in tax return; sole shareholder and chief executive officer, for whom English was second language, had no knowledge of tax law and retained CPA to prepare return; court found reasonable cause for corporation's underpayment of tax and that sole shareholder and chief executive officer acted in good faith with respect to underpayment).

[458] §6664(c)(3).

[459] See discussion at IV.E.8.b., below.

[460] See discussion at IV.A.4.b.(2), above.

[461] See discussion in 648 T.M., *Reportable Transactions*.

[462] *See* Reg. §1.6664-4(b)(2) *Ex.* 2.

[463] *See Taylor v. Commissioner*, T.C. Summ. Op. 2015-51 (citing *Matthews v. Commissioner*, 92 T.C. 351 (1989), aff'd, 907 F.2d 1173 (D.C. Cir. 1990).

[464] Reg. §1.6664-4(b)(1).

[465] *See, e.g., Williams v. Commissioner*, 123 T.C. 144 (2004) (no liability for accuracy-related penalty for substantial underpayments in case of first impression regarding interplay of tax and bankruptcy laws).

[466] For example, reliance on erroneous information (such as an error relating to the cost or adjusted basis of property, the date property was placed in service, or the amount of opening or closing inventory) inadvertently included in data compiled by the various divisions of a multidivisional corporation or in financial books and records prepared by those divisions generally indicates reasonable cause and good faith, provided the corporation employed internal controls and procedures, reasonable under the circumstances, that were designed to identify such factual errors. Reg. §1.6664-4(b)(1).

[467] *See, e.g., Patel v. Commissioner*, 138 T.C. 395 (2012) (no liability for accuracy-related penalties based on all facts and circumstances, including the uncertain state of law); *Patients Mutual Assistance Collective Corp. v. Commissioner*, T.C. Memo. 2018-208 (Dec. 20, 2018) (no liability given status of relevant contemporaneous caselaw during tax years of disputed returns, lack of IRS guidance regarding §280E, and in light of taxpayer's keeping good books and records substantiating all claimed deductions and attempts to comply with state and federal tax law). In AOD 2012-005, the IRS announced its nonac-

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Reliance on erroneous information reported on a Form W-2 (Wage and Tax Statement) or a Form 1099 indicates reasonable cause and good faith, provided the taxpayer did not know or have reason to know that the information was incorrect.[468] A taxpayer is considered to know or have reason to know that the information on an information return is incorrect if such information is inconsistent with other information that has been reported or otherwise furnished to her, or with her knowledge of the transaction. This knowledge includes, for example, the taxpayer's knowledge of the terms of her employment relationship or of the rate of return on a payor's obligation.[469]

Example: F, an individual, worked for Company X doing odd jobs and filling in for other employees when necessary. F worked irregular hours and was paid by the hour. The amount of F's paycheck differed from week to week. The Form W-2 furnished to F reflected wages for 2003 in the amount of $29,729. It did not, however, include compensation of $1,467 paid for some hours F worked. Relying on the Form W-2, F filed a return reporting wages of $29,729. F had no reason to know that the amount reported on the Form W-2 was incorrect. Under the circumstances, F is considered to have acted in good faith in relying on the Form W-2 and to have reasonable cause for the underpayment attributable to the unreported wages.[470]

However, the court has held that the nonreceipt of a Form W-2 did not excuse a taxpayer from his duty to report income and accordingly did not constitute reasonable cause.[471] The court determined that the taxpayer failed to exercise ordinary care because he never took steps to verify whether the income he reported represented the entire amount he actually received. This resulted in a failure to report almost $60,000 in wages, representing about 40% of his total income. The court concluded that the taxpayer should have known that at least some of that income was omitted from his tax return, given the amount of services he provided and especially after being surprised when he received a refund of approximately $10,000.

The commission of an isolated computational or transcriptional error generally will not negate the existence of reasonable cause and good faith.[472] On the other hand, reliance on an information return or on the advice of a professional (such as an appraiser, attorney or accountant) does not necessarily demonstrate reasonable cause and good faith.[473] Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect.[474]

Example: H, an individual, did not enjoy preparing his tax returns and procrastinated in doing so until April 15th. On April 15th, H hurriedly gathered together his tax records and materials, prepared a return, and mailed it before midnight. The return contained numerous errors, some of which were in H's favor and some of which were not. The net result of all the adjustments, however, was an underpayment of tax by H. Under these circumstances, H is not considered to have reasonable cause for the underpayment or to have acted in good faith in attempting to file an accurate return.[475]

In cases where the underpayment relates to a property transaction, the mere fact that property was appraised generally does not, by itself, indicate reasonable cause and good faith. Other factors to consider are the methodology and assumptions underlying the appraisal, the relationship between appraised value and purchase price, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer or to the activity in which the property is used.[476] For example, the Tax Court concluded that the appraisal in *Exelon Corp. v. Commissioner*,[477] did not support the legal opinions on which the taxpayer relied for penalty protection because the law firm interfered with the appraisal's integrity and independence by providing the appraiser with a list of conclusions to be included in the appraisals.

When an underpayment is related to an item on the return of a pass-through entity — i.e., a partnership, S corporation, estate, trust, regulated investment company (RIC), real estate investment trust (REIT) or real estate mortgage investment conduit (REMIC) — reasonable cause and good faith of the entity, or lack thereof, generally is imputed to the taxpayer who has the underpayment unless there are factors that indicate that the taxpayer did not act with reasonable cause and in good faith.[478] An entity's good-faith defense is addressed in the entity-level proceeding; subject to the post-2017 partnership audit rules, an

quiesence on the grounds that a taxpayer could not act in good faith and have reasonable cause on the basis of the unsettled state of the law if the taxpayer was unaware of the state of the law and did not make a reasonable attempt to become aware.

[468] Reg. §1.6664-4(b)(1). Reliance in good faith on a Form W-2 for the employee's Social Security number is reasonable cause for purposes of the §6721 penalty for filing an incorrect return. The IRS has clarified that employers that retain Forms W-4 will be able to document that they made an initial solicitation of an identification number and thus acted in a responsible manner. Letter from Thomas Dobbins, Director of IRS Partnership Outreach, Taxpayer Education and Communication, to Information Reporting Program Advisory Committee (Sept. 23, 2003), reproduced in BNA Tax Core (Oct. 3, 2003).

[469] Reg. §1.6664-4(b)(1).

[470] Reg. §1.6664-4(b)(2) *Ex.* 3.

[471] *Gilbert v. Commissioner*, T.C. Summ. Op. 2016-17 (citing *Du Poux v. Commissioner*, T.C. Memo 1994-448 and *Ashmore v. Commissioner*, T.C. Memo 2016-36).

[472] Reg. §1.6664-4(b)(1). *See, e.g., Olsen v. Commissioner*, T.C. Summ. Op. 2011-131 (taxpayer made isolated error in transcribing information from wife's Schedule K-1 while using tax return preparation software; mistake was isolated as taxpayer correctly reported source of income and did not repeat any similar error in preparing his tax return; citing *Thompson v. Commissioner*, T.C. Memo 2007-174). *See also* PMTA 2015-02 (can have reasonable cause and good faith where there is isolated computational or transcription error).

[473] Reg. §1.6664-4(b)(1).

[474] Reg. §1.6664-4(b)(1).

[475] Reg. §1.6664-4(b)(2) *Ex.* 4.

[476] Reg. §1.6664-4(b)(1).

[477] 147 T.C. 230 (2016).

[478] Reg. §1.6664-4(d). Under Reg. §1.6664-4(e), the determination of whether a corporate or noncorporate taxpayer acted with reasonable cause and in good faith with respect to an underpayment that is related to an item reflected on the return of a pass-through entity is made on the basis of all pertinent facts and circumstances, including the taxpayer's own actions, as well as the actions of the pass-through entity. *Cf.* Reg. §1.6662-4(f)(5) which requires disclosure in the case of items attributable to a pass-through entity to be made at the entity level.

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individual's defenses must be addressed in an individual-level proceeding.[479]

All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under federal tax law.[480] For example, the taxpayer's education, sophistication, and business experience are relevant in determining whether the taxpayer's reliance on the advice was reasonable and in good faith.[481]

The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances.[482] For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, reliance is not reasonable if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.[483]

The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner.[484] The courts have upheld penalties on taxpayers who relied on advisers involved in implementing Son-of-BOSS shelters.[485]

A taxpayer who takes a position that a regulation is invalid cannot rely on an opinion or advice of a tax advisor to satisfy the reasonable cause and good faith exception under §6664(c) with respect to any underpayment attributable to such position if the position was not adequately disclosed on a return.[486]

Comment: The fact that the above requirements are satisfied will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a professional tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of federal tax law.[487]

> *Example:* T, an individual, calendar-year taxpayer, engages B, a professional tax advisor, to advise T regarding the deductibility of certain state and local taxes. T provides B with full details concerning the taxes at issue. B advises T that the taxes are fully deductible. T, in preparing his own tax return, claims a deduction for the taxes. Absent other facts, and assuming the facts and circumstances surrounding B's advice and T's reliance on such advice satisfy the requirements of Reg. §1.6664-4(c), T is considered to have demonstrated good faith by seeking the advice of a professional tax advisor, and to have shown reasonable cause for any underpayment attributable to the deduction claimed for the taxes. However, if T had sought advice from someone that T knew, or should have known, lacked knowledge in the relevant aspects of federal tax law, or if other facts demonstrate that T failed to act reasonably or in good faith, T would not be considered to have shown reasonable cause or to have acted in good faith.[488]

If any portion of any underpayment is attributable to a reportable transaction under Reg. §1.6011-4, the taxpayer's failure to disclose the transaction is a strong indication that the taxpayer did not act in good faith with respect to that portion of the underpayment.[489] Withdrawing a ruling request to avoid the issuance of an adverse determination also indicates a lack of good faith.[490]

Reliance on the professional advice of tax shelter promoters is not reasonable.[491] In the case of a tax shelter, the IRS has

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[479] *See, e.g., NPR Invs., L.L.C. v. United States*, 740 F.3d 998 (5th Cir. 2014); *Shasta Strategic Inv. Fund, LLC v. United States*, No. 3:05 cv-03887, 2014 BL 212715 (N.D. Cal. July 31, 2014), op. amended, No. 3:04-cv-04264-RS, 2014 BL 260311 (N.D. Cal. Sept. 11, 2014) (district courts lack jurisdiction to adjudicate individual partners' defenses, including "reasonable cause," in a partnership proceeding). The new partnership audit rules are discussed at 624 T.M., *Audit Procedures for Pass-Through Entities.*

[480] *See* Reg. §1.6664-4(c)(1); *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004) (timing and stated purpose of law firm's opinion casts doubt on whether its contents served the purpose of providing a reasoned opinion on the application of tax law to the facts of the transaction for client guidance in future actions), *aff'd by unpub. op.*, 150 Fed. App'x 40 (2d Cir. 2005). Advice is any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the §6662 accuracy-related penalty. Advice does not have to be in any particular form. *See* Reg. §1.6664-4(c)(2).

[481] Reg. §1.6664-4(c)(1). *See, e.g., 106 Ltd. v. Commissioner*, 684 F.3d 84 (D.C. Cir. 2012) (improbable tax advantages offered by tax shelter — $1 million dollar loss from transaction that earned taxpayer $10,000, less adviser's fees — should have alerted person with taxpayer's business experience and sophistication as to shelter's illegitimacy); *Exelon Corp. v. Commissioner*, 147 T.C. 230 (2016) (court concluded taxpayer with Exelon's experience and sophistication would not have believed tax opinion's assumptions about transactions' counterparties).

[482] Reg. §1.6664-4(c)(1)(i).

[483] Reg. §1.6664-4(c)(1)(i).

[484] Reg. §1.6664-4(c)(1)(ii). *See, e.g., Exelon Corp. v. Commissioner*, 147 T.C. 230 (2016) (taxpayer knew or should have known that — contrary to assumptions underlying legal opinion on which taxpayer allegedly relied — transactions' counterparties were reasonably likely to exercise their cancellation/purchase options because they would not be able to return power plants to taxpayer without incurring significant expenses to meet return requirements); *Bergquist v. Commissioner*, 131 T.C. 8 (2008) (taxpayers cannot blindly rely on advice from advisors nor appraisal as they did not make good faith investigation as to value of their donated stock and did not act in good faith).

[485] *See, e.g., Palm Canyon X Invs., LLC v. Commissioner*, No. 16-1334 (D.C. Cir. Feb. 16, 2018) (Notice 2000-44 specifically identified almost exactly the same Son-of-BOSS variation as a prohibited transaction); *Stobie Creek Invs., LLC v. United States*, 82 Fed. Cl. 636 (2008), aff'd, 608 F.3d 1366 (Fed. Cir. 2010); *Murfam Farms, LLC v. United States*, 94 Fed. Cl. 235 (2010) (reliance on professional advice was unreasonable given fee structure of professional based on percentage of tax loss).

[486] Reg. §1.6664-4(c)(1)(iii). Adequate disclosure is discussed at IV.C.4., below.

[487] *See* Reg. §1.6664-4(c)(1).

[488] *See* Reg. §1.6664-4(b)(2) *Ex.* 1.

[489] Reg. §1.6664-4(d). Reportable transactions and the required taxpayer disclosure are described in VIII.A.2.a., below.

[490] *Roco v. Commissioner*, 121 T.C. 160 (2003).

[491] *Palm Canyon X Invs., LLC v. Commissioner*, No. 16-1334 (D.C. Cir. Feb. 16, 2018); *106 Ltd. v. Commissioner*, 684 F.3d 84 (D.C. Cir. 2012); *Van Scoten v. Commissioner*, 439 F.3d 1243 (10th Cir. 2006).

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warned that it does not consider a taxpayer's reliance on tax advice to be reasonable and in good faith if the advisor has a financial arrangement or referral agreement with the tax shelter promoters.[492] The IRS believes that the tax advisor's judgment is compromised by such arrangements and agreements. To establish reasonable belief under §6664(d), a taxpayer cannot rely on an opinion from a tax advisor who:[493]

- Is a material advisor[494] and participates in the organization, management, promotion or sale of the transaction (or is related to such a person);
- Has a disqualified compensation arrangement; or
- Has a disqualifying financial arrangement.

Treasury Department Circular 230 ("Circular 230"), which governs practice before the IRS, prevents a practitioner from willfully, recklessly or through gross incompetence advising a taxpayer to take a position that lacks reasonable basis or is an unreasonable position (as described in §6694(a)(2)), or is a willful attempt by the practitioner to understate the liability or a reckless or intentional disregard of rules or regulations (as described in §6694(b)(2)), or advising a taxpayer to file a document with the IRS that is frivolous (or contains a position that is frivolous), the purpose of which is to delay or impede the administration of the tax laws or that contains or omits information that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the taxpayer to submit evidence of a good faith challenge to the rule or regulation.[495] The practitioner must also inform the taxpayer of any penalties that are reasonably likely to apply, and any opportunity to avoid any such penalty.[496] In rendering any written advice (including an email), a practitioner must, among other things, use reasonable efforts to identify and ascertain the relevant facts, and may not unreasonably rely on any person's representations, statements, findings or agreements.[497] In evaluating whether a practitioner complied with these rules, the IRS applies a reasonable practitioner standard.[498] If the practitioner knows or has reason to know that the written advice will be used by another person in promoting, marketing or recommending an investment in a tax shelter, an emphasis is placed on the additional risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances.[499]

Comment: Many of the opinions the IRS is concerned about were written by prominent law and accounting firms. It is far from clear that each of them was swayed by the economic arrangement. At least some of the fault lies in poorly worded statutes and regulations.

In addition to the reasonable cause exception to the penalty, the Tax Court has applied an exception to the imposition of additions to tax for negligence for issues of first impression, i.e., in cases in which it appears that the issue was not previously considered by the court and the statutory language was not entirely clear.[500] The Tax Court also applied this exception to additions to tax for substantial understatement of income tax.[501] However, at least one court declined to extend the issue-of-first-impression exception to accuracy-related penalties for substantial understatement.[502]

(2) Reasonable Cause Exception to Accuracy-Related Penalty for Corporate Tax Shelter Items

In the case of an accuracy-related penalty, the determination of whether a corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item is generally based on all pertinent facts and circumstances.[503]

Under Reg. §1.6664-4(f), a corporation's legal justification may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item, but only if there is substantial authority (within the meaning of Reg. §1.6662-4(d)) for the treatment of the item and the corporation reasonably believed, at the time the return was filed, that such treatment was more likely than not the proper treatment.[504]

A corporation is considered to reasonably believe that the tax treatment of an item is more likely than not the proper treatment if — without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled — the corporation:[505]

- Analyzes the pertinent facts and authorities and reasonably concludes in good faith that there is a greater-than-50% likelihood that the tax treatment of the item will be upheld if challenged by the IRS; or
- Reasonably relies in good faith on the opinion of a professional tax advisor, provided that the opinion is based on the tax advisor's analysis of the pertinent facts and authorities and unambiguously states a conclusion that there is a greater-than-50% likelihood that the tax treatment of the item will be upheld if challenged by the IRS.

The greater-than-50% likelihood test is also referred to as the "more likely than not" standard.

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[492] Memorandum from IRS Commissioner Mark W. Everson dated December 29, 2003 regarding Penalty Policy Statement of the IRS. The statement is intended to apply retroactively. Statement of K. Steven Burgess, IRS Small Business/Self-Employed Division to American Bar Association Tax Section on January 31, 2004.

[493] Notice 2005-12.

[494] See discussion at VIII.A.3.a.(3), below.

[495] 31 C.F.R. §10.34(a)(ii), §10.34(b).

[496] 31 C.F.R. §10.34(c). The obligation applies even if the practitioner would not be subject to a penalty. 31 C.F.R. §10.34(c)(3).

[497] 31 C.F.R. §10.35(a).

[498] 31 C.F.R. §10.34(c)(1).

[499] 31 C.F.R. §10.34(c)(2).

[500] *See, e.g., Bunney v. Commissioner*, 114 T.C. 259 (2000); *Lemishow v. Commissioner*, 110 T.C. 110 (1998), supp'd by, 110 T.C. 346 (1998); *Hitchins v. Commissioner*, 103 T.C. 711 (1994). *See also Gee v. Commissioner*, 127 T.C. 1 (2006) (taxpayers made reasonable attempt to comply with Code in circumstances involving an issue of first impression). *Cf. Everson v. United States*, 108 F.3d 234 (9th Cir. 1997).

[501] *Mitchell v. Commissioner*, T.C. Memo 2000-145.

[502] *In re CM Holdings Inc.*, 254 B.R. 578 (D. Del. 2000), aff'd, 301 F.3d 96 (3d Cir. 2002).

[503] Reg. §1.6664-4(f)(1).

[504] Reg. §1.6664-4(f)(2)(i). Legal justification is defined as including any justification relating to the treatment or characterization under the federal tax law of the tax shelter item or of the entity, plan or arrangement that gave rise to the item. The taxpayer's belief regarding the merits of the taxpayer's underlying position, whether independently formed or based on the advice of others, is considered a legal justification. *See* Reg. §1.6664-4(f)(2)(ii).

[505] Reg. §1.6664-4(f)(2)(i)(B).

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While satisfaction of the substantial authority and reasonable belief requirements discussed above is an important factor to be considered in determining whether the taxpayer acted with reasonable cause and in good faith, it is not necessarily dispositive.[506] Facts and circumstances other than the corporation's legal justification may be taken into account in determining whether the corporation acted with reasonable cause and good faith with respect to a tax shelter item, regardless of whether the substantial authority and reasonable belief requirements are satisfied.[507]

Comment: The more likely than not standard does not apply to noncorporate taxpayers.[508] In the Preamble to Reg. §1.6664-4(f), the Treasury stated its belief that it had the power to promulgate different standards for corporate and noncorporate taxpayers.[509]

(3) Waiver of Privilege and Attorney Work Product

The attorney-client privilege applies to communications made to an attorney, in confidence, in connection with the provision of legal services, in the context of an attorney-client relationship.[510] Communications made to an attorney solely in connection with the preparation of a tax return are not covered.[511] In addition, the privilege may be waived in various ways, including by voluntary disclosure of the private communication to third parties.[512]

Privileged communications are beyond the scope of discovery. Initially, the party asserting the privilege bears the burden of establishing that the privilege applies. Once the application of the privilege is established, the party asserting an exception to the privilege bears the burden of showing the exception applies.[513] Whether fairness requires disclosure of otherwise privileged communications is decided on a case-by-case basis.[514]

Once the taxpayer asserts as an affirmative defense that his reliance on professional advice constituted reasonable cause, the taxpayer puts that advice "at issue" and waives the attorney-client privilege.[515] A waiver of the attorney-client privilege as to a particular communication waives the privilege as to all communications involving the same subject matter.[516] In *Ad Inv. 2000 Fund LLC v. Commissioner*,[517] the court held that the taxpayer had waived attorney-client privilege for tax opinions even though it had not disclosed or relied on the tax opinions in its penalty defense. According to the court, the taxpayer's claim of reasonable legal beliefs arrived at in good faith put its legal knowledge, understanding and beliefs into dispute, and therefore, the contents of the tax opinions were relevant.[518] However, the court also indicated that the taxpayer could continue to protect the tax opinions from disclosure if it abandons its reasonable cause defense based on such opinions. Moreover, the court indicated that the penalty for failing to disclose the opinions would likely be merely prohibiting the taxpayer from introducing evidence of the taxpayer's reasonable cause and good faith reliance on the contents of the opinion.

Under §7525, the same privilege that applies to confidential communications between a client and her attorney also applies to communications between a taxpayer and a federally authorized tax practitioner with respect to tax advice. The line between a lawyer's work and that of an accountant is often blurry. At one end of the spectrum, the preparation of a tax return is an accounting, not a legal, service. On the other side, communications about legal questions raised in a litigation or in anticipation of litigation are legal.[519] Because the tax practitioner privilege is largely coterminous with the attorney-client privilege, waivers of the tax practitioner privilege occur on the same terms as waivers of the attorney-client privilege.[520] Relying on advice of an accounting firm to support the taxpayer's defense to tax penalties waives the privilege.[521] The waiver applies to all documents that relate to the same subject matter.[522]

The tax practitioner privilege, however, does not apply to any written communication between the tax practitioner and a director, shareholder, officer, employee, agent or representative of a corporation in connection with the promotion of a direct or indirect participation of such corporation in a tax shelter as defined in §6662(a)(2)(C)(iii).[523] For this purpose, promotion is broadly defined, but it is still limited to written communications that encourage participation in a tax shelter. Documents that merely inform a taxpayer about a scheme, assess the plan in a neutral fashion, or evaluate the soft spots in a tax shelter that the taxpayer has used are excluded.[524] The burden is on the IRS

[506] Reg. §1.6664-4(f)(3).

[507] Reg. §1.6664-4(f)(4).

[508] See discussion at IV.C.5., below.

[509] Preamble to T.D. 8617, 60 Fed. Reg. 45,661 (Sept. 1, 1995), relating to Reg. §1.6664-4(e), which was renumbered by T.D. 9109, 68 Fed. Reg. 75,126 (Dec. 30, 2003). Under Circular 230 as in effect before 2014, which did not distinguish between types of taxpayers, a practitioner who issued a tax opinion with respect to a tax shelter that does not reach a "more likely than not" conclusion with respect to a significant federal tax issue had to advise the taxpayer that the opinion could not be used by the taxpayer to avoid penalties that may be imposed on the taxpayer with respect to that issue. Pre-2014 31 C.F.R. §10.35(d)(4).

[510] *See, e.g., Evergreen Trading, LLC v. United States*, 80 Fed. Cl. 122 (2007); *United States v. BDO Seidman, LLP*, 492 F.3d 806 (7th Cir. 2007).

[511] *United States v. Abrahams*, 905 F.2d 1276 (9th Cir. 1980).

[512] *See, e.g., In re Lott*, 424 F.3d 446 (6th Cir. 2005); *New Phoenix Sunrise Corp. v. Commissioner*, 408 Fed. App'x 908 (6th Cir. 2010).

[513] *See Bernardo v. Commissioner*, 104 T.C. 677 (1995).

[514] *United States v. Doe*, 219 F.3d 175 (2d Cir. 2000).

[515] *Evergreen Trading, LLC v. United States*, 80 Fed. Cl. 122 (2007); *New Phoenix Sunrise Corp. v. Commissioner*, 408 Fed. App'x 908 (6th Cir. 2010); *In re G-I Holdings, Inc.*, 218 F.R.D. 428 (D.N.J. 2003). See also *In re Kidder Peabody Secs. Litig.*, 168 F.R.D. 459 (S.D.N.Y. 1996).

[516] *See, e.g., Fort James Corp. v. Solo Cup Co.*, 412 F.3d 1340 (Fed. Cir. 2005) cert. denied, 547 U.S. 1069 (2006); *United States v. Cote*, 456 F.2d 142 (8th Cir 1972); *United States v. Bilzerian*, 926 F.2d 1285 (2d Cir. 1991), cert. denied, 502 U.S. 813 (1991); *In re Kidder Peabody Sec. Lit.*, 168 F.R.D. 459 (S.D.N.Y. 1996).

[517] 142 T.C. 248 (2014).

[518] *See United States v. Owensboro Dermatology Assoc.*, 2017 BL 235266 (W.D. Ky. July 6, 2017); *United States v. Micro Cap KY Ins. Co.*, 246 F. Supp. 3d 1194 (E.D. Ky. 2017) (but in each case, the issue was premature). See also *Pritchard v. Cnty. of Erie*, 546 F.3d 222 (2d Cir. 2008); *United States v. Bilzerian*, 926 F.2d 1285 (2d Cir. 1991), cert. denied, 502 U.S. 813 (1991).

[519] *In re Grand Jury Proceedings*, 220 F.3d 568 (7th Cir. 2000); *United States v. Frederick*, 182 F.3d 496 (7th Cir. 1999).

[520] *Evergreen Trading, LLC v. United States*, 80 Fed. Cl. 122 (2007); *Salem Fin., Inc. v. United States*, 102 Fed. Cl. 793 (2012).

[521] *Salem Fin., Inc. v. United States*, 102 Fed. Cl. 793 (2012).

[522] *Salem Fin., Inc. v. United States*, 102 Fed. Cl. 793 (2012).

[523] §7525(b). Tax shelters are discussed at IV.C.5., below.

[524] *Valero Energy Corp. v. United States*, 569 F.3d 626 (7th Cir. 2009), aff'g 2007 BL 198440 (N.D. Ill. Aug. 23, 2007).

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to prove that the privilege does not apply.[525] To meet this burden, the IRS must introduce evidence that: (1) the communication relates to such a tax shelter, (2) the communication is with a director, shareholder, officer, employee, agent or representative of the corporation, and (3) the communication was made in connection with the promotion of the direct or indirect participation of the corporation in the tax shelter.[526] As a result, the mere fact that the taxpayer had significant losses with respect to the transaction was not sufficient to waive the privilege. Rather, the IRS has the burden of showing the waiver applies. Because the IRS has the burden of showing that the waiver applies, the fact that the taxpayer does not allege that tax avoidance was not a purpose of the transaction is not relevant. Moreover, a transaction is not a tax shelter under §6662(a)(2)(C)(iii) merely because tax avoidance is one of the purposes; rather, the IRS must show that tax avoidance was a significant purpose of the transaction.[527]

Under the work product doctrine, an attorney's assembly of information, preparation of legal theories and strategies and impressions about case, prepared in in anticipation of litigation, are protected from discovery.[528] Whether work product protection applies to tax reserves and related work papers prepared because of expect or potential litigation is still unsettled.[529] However, any such protection is waived if the taxpayer relies on such work product as a defense to a tax penalty.[530] Such waiver extends to all nonopinion work product concerning the same subject matter.[531] Although the application for a private letter ruling generally constitutes attorney work product; any protection would have been waived by filing it with the IRS.[532]

The waiver, however, does not apply to any document that was prepared after the taxpayer filed his return.[533] Although raising an affirmative defense may put in issue the taxpayer's subjective intent, good faith and state of mind in complying with the law, those items are only relevant as of the time the taxpayer files the return.[534]

Accountants' work papers are not subject to the Fifth Amendment privilege against self-incrimination.[535]

B. Negligence and Disregard of Rules Accuracy-Related Penalty

1. Statute and Regulations

a. Negligence

Under §6662(b)(1), a 20% accuracy-related penalty applies to any portion of an underpayment attributable to negligence or disregard of rules or regulations. For this purpose, "negligence" includes any failure to make a reasonable attempt to comply with the Code.[536] The regulations clarify that negligence includes any failure to make a reasonable attempt to comply with the tax laws, to exercise reasonable care in preparation of returns, to keep proper books and records, or to properly substantiate items. Negligence is "strongly indicated" when: (1) a taxpayer fails to report income shown on an information return; (2) a taxpayer fails to make a reasonable inquiry into the correctness of an item that seems "too good to be true"; or (3) a partner of a partnership or a shareholder of an S corporation fails to treat an item consistently with the entity and fails to notify the IRS of its inconsistent treatment.[537] Other indications of negligence include: (a) unreported or understated income; (b) significantly overstated deductions or credits; (c) careless, improper or exaggerated deductions; (d) misrepresented or miscategorized deductions in such manner as to conceal the true nature of the deduction; (e) unexplained items; (f) inadequate books and records; (g) cooperative state programs and state reports showing a negligence penalty (taking into account other factors and not relying entirely on the findings of the state agency); (h) substantial errors on an issue that has been adjusted in a prior year; and (i) incorrect or incomplete information provided to the return preparer for preparation of the tax return.[538]

The negligence penalty will not be asserted solely for filing a return late.[539] In addition, the negligence penalty will not be asserted due to the taxpayer's failure to appear for an audit or respond to an inquiry or notice, unless the taxpayer failed to include on an income tax return an amount of income shown on an information return.[540]

Comment: Before the 1989 Act, the statute expressly provided that failing to properly report an item shown on an information return would be treated as negligent absent clear and convincing evidence to the contrary.[541] Although the 1989 Act repealed this presumption, the legislative history states that

[525] *United States v. BDO Seidman*, 492 F.3d 806 (7th Cir. 2007), cert. denied *sub nom.*, *Cuillo v. United States*, 552 U.S. 1242 (2008); *Valero Energy Corp. v. United States*, 2007 BL 198440 (N.D. Ill. Aug. 23, 2007), aff'd, 569 F.3d 626 (7th Cir. 2009).

[526] *United States v. BDO Seidman*, 492 F.3d 806 (7th Cir. 2007), cert. denied *sub nom.*, *Cuillo v. United States*, 552 U.S. 1242 (2008); *Valero Energy Corp. v. United States*, 2007 BL 198440 (N.D. Ill. Aug. 23, 2007), aff'd, 569 F.3d 626 (7th Cir. 2009).

[527] *Valero Energy Corp. v. United States*, 2007 BL 198440 (N.D. Ill. Aug. 23, 2007) ("The fact that a person or entity may have considered minimization of its tax obligations does not make the transaction a 'tax shelter'." (citations omitted)), *aff'd*, 569 F.3d 626 (7th Cir. 2009).

[528] *Hickman v. Taylor*, 329 U.S. 495 (1947); Fed. R. Civ. P. 26(b)(3).

[529] *Compare Regions Fin. Corp. v. United States*, 2008 BL 305695 (N.D. Ala. May 8, 2008); *United States v. Deloitte*, LLP, 610 F.3d 129 (D.C. Cir. 2010); *Wells Fargo & Co. v. United States*, 112 AFTR 2d 2013-5380 (D. Minn. 2013) (protected) with *United States v. Textron, Inc.*, 577 F.3d 21 (1st Cir. 2009), cert. denied, 560 U.S. 924 (2010) (not protected).

[530] *Salem Fin. Inc. v. United States*, 102 Fed. Cl. 793 (2012).

[531] *Salem Fin. Inc. v. United States*, 102 Fed. Cl. 793 (2012); *In re EchoStar Communs. Corp.*, 448 F.3d 1294 (Fed. Cir. 2006), cert. denied, 549 U.S. 1096 (2006).

[532] *United States v. All Assets Held at Bank Julius Baer*, 315 F.R.D. 103 (D.D.C. 2016). The court also held that the private ruling was not work product.

[533] *Estate of Levine v. Commissioner*, No. 13370-13, 2017 BL 498701 (T.C. Oct. 26, 2017) (order) (with respect to documents created after the notice of deficiency was issued).

[534] See discussion at IV.A.4.b., above, and XI., below.

[535] *Warren v. Tate*, 65-2 USTC ¶9526 (W.D. Tenn. 1965).

[536] §6662(c).

[537] Reg. §1.6662-3(b)(1). The consistency requirement is imposed by §6222 for partners and by §6037(c) for S corporation shareholders. Although The Bipartisan Budget Act of 2015, Pub. L. No. 114-74, §1101, repealed the TEFRA provisions, including §6222, generally effective for partnership tax years beginning after 2017, and replaced them with new partnership audit provisions, the new §6662 also includes a consistency rule.

[538] IRM 20.1.5.8.1(2) (12-13-16).

[539] IRM 20.1.5.8.1(4) (12-13-16).

[540] IRM 20.1.5.8.1(5) (12-13-16).

[541] Former §6653(g).

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even in the absence of a statutory presumption, as a practical matter, evidence of such a failure is still strong evidence of negligence.[542]

b. Disregard of Rules or Regulations

"Disregard" is defined to include any careless, reckless, or intentional disregard.[543] It includes any careless, reckless, or intentional disregard of the Code, temporary or final regulations, revenue rulings or notices (other than notices of proposed rulemaking) issued by the IRS and published in the Internal Revenue Bulletin.[544] Revenue procedures may or may not be treated as "rules or regulations" depending on all of the facts and circumstances.[545] A disregard of the rules or regulations is "careless" if the taxpayer does not exercise reasonable diligence to determine the correctness of a return provision that is contrary to the rule or regulation. A disregard is "reckless" if the taxpayer makes little or no effort to determine whether a rule or regulation exists under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe. An "intentional" disregard exists when a taxpayer knows of the rule or regulation that is disregarded.[546] On the other hand, a taxpayer who takes a position (other than with respect to a reportable transaction, as defined in Reg. §1.6011-4(b)) contrary to a revenue ruling or notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on the merits.[547] Positions related to a reportable transaction are excluded from this "realistic possibility of being sustained" exception.[548]

2. Case Law

The 1989 Act amendments did not change the basic definition of negligence. As such, cases decided using the law in existence before the removal of the presumption that the failure to report an item was negligent generally are still valid for purposes of determining whether an underpayment is attributable to negligence.

Comment: Set forth below is a summary of the major principles found in the decided cases. There are numerous cases that have examined the application of the penalty in a myriad of situations; no attempt is made here to list or discuss all of the decided cases. Also, since the question whether a taxpayer was negligent is closely related to the question whether the taxpayer had reasonable cause for his actions, the cases on reasonable cause (discussed at XI., below) are also relevant to the issue of negligence.

Negligence has been defined as the failure to do what a reasonable and ordinarily prudent person would do under the circumstances.[549] The taxpayer has the burden of overcoming the presumption that the IRS's determination of negligence is correct, although the IRS's determination must be supported by some evidence.[550] Thus, if the IRS satisfies its initial burden, the taxpayer must establish that he was not negligent by a preponderance of the evidence.[551]

The negligence penalty may be imposed based solely on the record before the court where the penalty is properly asserted and approved by a supervisor following an audit and the taxpayer petitions but then fails to further prosecute the case, resulting in an order of default and entry of a decision sustaining the deficiencies.[552]

The penalty has been imposed when a deduction was claimed or an item of income omitted, and the deduction/omission was clearly incorrect[553] or was the result of inadequate or improper recordkeeping,[554] even when the understatement of tax liability was unintentional.[555] A taxpayer's disregard of the recordkeeping requirements supports the imposition of the penalty.[556]

[542] H. Rept. 101-386.

[543] §6662(c).

[544] Reg. §1.6662-3(b)(2).

[545] Preamble to T.D. 8381, 56 Fed. Reg. 67,492 (Dec. 31, 1991).

[546] Reg. §1.6662-3(b)(2).

[547] Reg. §1.6662-3(b)(2). *See, e.g.*, FAA 20125201F (IRS had legally sufficient basis to apply penalty for negligence or disregard of rules or regulations; although taxpayer had researched issue before reporting, its analysis was wrong and did not reflect an effort to determine its correct tax liability; taxpayer had no realistic possibility of being sustained on the merits). *See also* Reg. §1.6694-2(b), discussed at VII.C.4.a., below.

[548] Reg. §1.6662-3(a), §1.6662-3(b)(2). This exclusion applies to returns filed after December 31, 2002, with respect to transactions entered into on or after January 1, 2003. Reg. §1.6662-2(d)(5). Penalties relating to reportable transactions are discussed in 648 T.M., *Reportable Transactions.*

[549] *Neely v. Commissioner*, 85 T.C. 934, 947 (1985). *See Barlow v. Commissioner*, 301 F.3d 714 (6th Cir. 2002); *Howard v. Commissioner*, 931 F.2d 578 (9th Cir. 1991).

[550] §7491(c); *Barlow v. Commissioner*, 301 F.3d 714 (6th Cir. 2002). See discussion at XII.A.1., below. The large size of an unreported income item may be sufficient to establish negligence as an initial matter. *See Switzer v. Commissioner*, 20 T.C. 759 (1953), acq., 1953-2 C.B. 6, vacated as per stipulation (9th Cir. Sept. 17, 1954). *See also Kilborn v. Commissioner*, 29 T.C. 102 (1957) (omission of less than $1,000 in sales for each of three months out of average monthly sales total of $20,000 does not by itself establish negligence), *acq.*, 1958-2 C.B. 6, *aff'd in part and rev'd in part on other grounds*, 58-2 USTC ¶9847 (5th Cir. 1958).

[551] *Marcello v. Commissioner*, 380 F.2d 499 (5th Cir. 1967); *Estate of Mason v. Commissioner*, 64 T.C. 651 (1975), aff'd, 566 F.2d 2 (6th Cir. 1977). *But see* §7491(a), which, in any court proceeding, places the burden of proof on the IRS if the taxpayer introduces credible evidence and meets certain other conditions. §7491 is discussed at XII.A.1., below.

[552] *See, e.g., Kramer v. Commissioner*, T.C. Memo 2021-16 (taxpayers failed to report income from pensions, interest and dividends and such failures, in conjunction with their failure to provide any explanation for the omissions, suggested that they neither made a reasonable attempt to comply with the internal revenue laws nor exercised reasonable care in the preparation of their return; negligence was particularly compelling where income from pensions and annuities constituted bulk of their unreported income and taxpayers reported significant amounts of income from pensions and annuities for years not long preceding the year at issue).

[553] *Henry Schwartz Corp. v. Commissioner*, 60 T.C. 728 (1973), acq., 1974-2 C.B. 4, acq. withdrawn in part and nonacq. in part, 1981-2 C.B. 1; *R.M. Smith, Inc. v. Commissioner*, T.C. Memo 1977-23, aff'd, 591 F.2d 248 (3d Cir. 1979).

[554] *Marcello v. Commissioner*, 380 F.2d 509 (5th Cir. 1067). *See, e.g., Marcello v. Commissioner*, 43 T.C. 168 (1964); *Magnon v. Commissioner*, 73 T.C. 980 (1980).

[555] *Axelrod v. Commissioner*, 56 T.C. 248 (1971); *Mendelson v. Commissioner*, T.C. Memo 1961-319, aff'd, 305 F.2d 519 (7th Cir. 1962), cert. denied, 371 U.S. 877 (1962). Failure to keep adequate books and records may also be considered the intentional disregard of the recordkeeping regulations. *See Portillo v. Commissioner*, 932 F.2d 1128 (5th Cir. 1991); *Magnon v. Commissioner*, 73 T.C. 980 (1980), acq. in part and acq. in result in part, 1981-1 C.B. 1.

[556] *Sherman v. Commissioner*, T.C. Memo 1964-296. *But see Cundiff v. United States*, 93-2 USTC ¶50,650 (W.D. Va. 1993) (failure to keep adequate books and records does not constitute negligence per se for purposes of pre-1990 §6653, but may provide factual basis for finding of negligence; court denies government's summary judgment motion and orders trial on this issue).

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Negligence also has been found to exist where a taxpayer fails to file tax returns with balances due.[557] In *Hayden v. Commissioner*,[558] the Tax Court found negligence where an accountant who either prepared or directly supervised the preparation of his income tax return claimed to have taken his federal tax liability payment from the previous year as a Schedule C payroll deduction by mistake. The Seventh Circuit found no clear error in the Tax Court's findings that the income taxes deducted as "payroll" taxes, which constituted 17% of the taxable income of the accounting practice and 53% of the deduction claimed for payroll taxes, were sufficiently significant that the taxpayer should have questioned them.[559]

Comment: To determine the adequacy of a taxpayer's books and records, courts consider the type of business at issue and the need for a sophisticated accounting system. A small business may have adequate books and records if its accounting system consists of a checkbook and bank statements. A larger and more complex business may be negligent if it relies upon such a system.

In evaluating whether a taxpayer was negligent in claiming a deduction, courts generally examine both the legitimacy of the underlying investment and the due care exercised in the claiming of the deduction.[560]

3. Exceptions to Negligence Penalty

a. Reasonable Basis

A return position that has a reasonable basis is not attributable to negligence.[561] The regulations provide that, for this purpose, "reasonable basis" is a relatively high standard of tax reporting; it is significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim.[562] A return position that is reasonable based on one or more authorities described in Reg. §1.6662-4(d)(3)(iii), taking into account the relevance and persuasiveness of the authorities and any subsequent developments, will generally satisfy the reasonable basis standard, even if there is not substantial authority for the position.[563]

Comment: Despite the statement in the regulations that reasonable basis is a relatively high standard, it is clearly less than substantial authority.[564] In fact, the JCT Study defines reasonable basis as generally having a 20% or greater likelihood of success on the merits if challenged.[565]

Since substantial authority is an objective standard, and the reasonable basis standard applies the same analysis, it should also be an objective test. A reasonable basis must be based on the authorities under Reg. §1.6662-4(d)(3)(iii). However, it is not enough for such authorities to establish a reasonable basis. Rather, the taxpayer must actually be aware of and rely upon such authorities in preparing its tax return.[566]

Although the cases are divided as to whether there can be a reasonable basis for claiming tax benefits with respect to a transaction that lacks economic reality, most say no[567] In a recent case, the District Court in Massachusetts sided with the government.[568] Since the transaction was previously determined to be profitless and shaped solely by tax-avoidance features, and therefore lacked economic substance, the taxpayer could not rely on the same authorities that were rejected in the assessment of the transaction's economic substance to argue there was a reasonable basis for its position.

Comment: It is inconsistent to claim there can be a reasonable basis for a position that has no objective economic or subjective business purpose. Reasonable basis must be based on legal authority to support the position.

b. Adequate Disclosure

The negligence penalty may not be avoided by adequate disclosure.[569] However, the penalty for the disregard of rules and regulations does not apply to any portion of an underpayment that is attributable to a position contrary to a rule or regulation if the relevant facts affecting the item's tax treatment are

[557] *See Korshin v. Commissioner*, 91 F.3d 670 (4th Cir. 1996) (taxpayer's failure to file returns from 1983–1988 based on belief that deductions offset income and that IRS "would just bill him" for tax debt, demonstrated that, at most, he did not intentionally refuse to pay taxes, but did nothing to rebut IRS's determination that underpayment was negligent).

[558] 112 T.C. 115 (1999), aff'd, 204 F.3d 772 (7th Cir. 2000).

[559] *Hayden v. Commissioner*, 204 F.3d 772 (7th Cir. 2000).

[560] *See Sacks v. Commissioner*, 82 F.3d 918 (9th Cir. 1996) (investment and deduction for loss are not partitioned into separate compartments for negligence analysis; rejecting bifurcation analysis of Chamberlain (cited below); *Howard v. Commissioner*, 931 F.2d 578 (9th Cir. 1991). *Accord Keeler v. Commissioner*, 243 F.3d 1212 (10th Cir. 2001), aff'g *Leema Enters., Inc. v. Commissioner*, T.C. Memo 1999-18; *Chakales v. Commissioner*, 79 F.3d 726 (8th Cir. 1996), cert. denied, 519 U.S. 825 (1996); *Goldman v. Commissioner*, 39 F.3d 402 (2d Cir. 1994). *But see Chamberlain v. Commissioner*, 66 F.3d 729 (5th Cir. 1995), reh'g denied, 1995 U.S. App. LEXIS 33210 (applying bifurcated analysis, court found taxpayers were not negligent in claiming losses).

[561] Reg. §1.6662-3(b)(1).

[562] Reg. §1.6662-3(b)(3).

[563] Reg. §1.6662-3(b)(3). Reg. §1.6662-4(d)(3)(iii) is discussed at IV.C.3.b., below, and substantial authority is described at IV.C.3., below.

[564] Reg. §1.6662-4(d)(2). *See* Reg. §1.6662-3(b)(3).

[565] Joint Committee on Taxation, Study of Present Law Penalty and Interest Provisions as Required by §3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (JCS-3-99), July 22, 1999, at 160.

[566] *Wells Fargo & Co. v. United States*, 260 F. Supp. 3d 1140 (D. Minn. 2017), *aff'd*, No. 17-3578, 2020 BL 152882 (8th Cir. Apr. 24, 2020).

[567] Compare *Salem Fin. Inc. v. United States*, 112 Fed. Cl. 543 (2013), aff'd in part, rev'd in part, and rem'd, 786 F.3d 932 (Fed. Cir. 2015) (because the taxpayer engaged in an economically meaningless tax shelter, "the defenses of reasonable basis, substantial authority and reasonable cause and good faith are not available … ."); *Stobie Creek Invs., LLC v. United States*, 82 Fed. Cl. 636 (2008), aff'd, 608 F.3d 1366 (Fed. Cir. 2010) ("[N]o substantial authority exists to support recognition of tax results that are premised on transactions with no appreciable business purpose beyond conferring tax benefits."); *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004), aff'd, 150 Fed. App'x 40 (2d Cir. 2005) (with respect to §6662(b)(2) substantial understatement of income tax penalty, stating "Since the Court found that the … transaction is devoid of objective economic substance and subjective business purpose, [the taxpayer] has not and cannot cite any authority, much less substantial authority, for the proposition that a taxpayer may claim losses from a transaction in which the taxpayer intentionally expends far more than could reasonably be expected to be recouped through nontax economic returns in a transaction the sole motivation for which is tax avoidance."); *Jade Trading, LLC v. United States*, 80 Fed. Cl. 11 (2007), aff'd on this issue, 598 F.3d 1372 (Fed. Cir. 2010) (with respect to §6662(b)(2) substantial understatement of income tax penalty, "At bottom, the fictional nature of the transaction and its lack of economic reality outweigh Helmer in the substantial authority assessment."); *NPR Invs., LLC v. United States*, 740 F.3d 998 (5th Cir. 2014) (no authority), with *Wells Fargo & Co. v. United States*, 2013 BL 149935 (D. Minn. June 4, 2014) (rejected Government argument).

[568] *Santander Holdings USA, Inc. v. United States*, 2018 BL 252884 (D. Mass. July 17, 2018).

[569] Reg. §1.6662-7(b).

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adequately disclosed, there is a reasonable basis for the taxpayer's position, and the taxpayer maintains adequate books and records to substantiate the item.[570] If the position relates to a reportable transaction as defined in Reg. §1.6011-4(b), the transaction must be disclosed in accordance with Reg. §1.6011-4.[571] However, in the case of a position contrary to a regulation, the position must be disclosed and must represent a good faith challenge to the validity of the regulation.[572] Moreover, a taxpayer cannot rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith, unless the taxpayer adequately disclosed on his tax return the position that the regulation is invalid.[573]

The applicability of the disclosure exemption is determined separately for each item or group of similar items. For each item or group, the disclosure should reasonably apprise the IRS of the nature and amount of the potential controversy. It should include: (a) a caption identifying the statement as a disclosure statement under §6662; (b) an identification of the item with respect to which the disclosure is being 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. Otherwise, the disclosure exemption may not apply.[574]

Disclosure is considered "adequate" if it is made on a properly completed Form 8275, Disclosure Statement, or in the case of a position contrary to a regulation, a Form 8275-R (Regulation Disclosure Statement), attached to the return or a qualified amended return for the tax year.[575] Disclosure by a corporation on a Form 1120 Schedule UTP (Uncertain Tax Position Statement) is deemed to constitute disclosure on a Form 8275 or 8275-R, as applicable.[576] Reportable transactions must also be disclosed on Form 8886 (Reportable Transaction Disclosure Statement).[577] In the case of a recurring item, disclosure must be made for each tax year in which the item is taken into account.[578] Unlike disclosure with respect to a substantial understatement of income tax, disclosure cannot be made in accordance with the annual revenue procedure.[579]

In computing the penalty, the regulations treat adequately disclosed items as if they were properly reported.[580] As a result, disclosure does not reduce a substantial understatement penalty in cases where proper reporting would still have subjected the taxpayer to the penalty.[581] Despite this outcome, the court upheld the regulation.

The rules for disclosure in the case of items attributable to a pass-through entity and Large Corporate Compliance (LCC) taxpayers are described at IV.C.4.b., below.

c. Coordination with Other Penalties

The §6662(b)(1) penalty for negligence or disregard of rules or regulations does not apply to any portion of an underpayment on which a fraud penalty under §6663 is impact. In addition, nothing prevents a §6662(b)(1) penalty from being imposed even though the taxpayer is also subject to a penalty for failing to file a return.[582] Subsequently, filing the late return does not negate the taxpayer's negligence.[583]

d. Reasonable Cause for Negligence Penalty

The penalty does not apply to any portion of an underpayment of the taxpayer can show it had reasonable cause for such portion and that it acted in good faith with respect to such portion.[584] For example, The penalty is not imposed when the law concerning the correct treatment of a deduction at the time the deduction was taken is not settled,[585] or if the taxpayer acted reasonably and in good faith but on the basis of a mistake of law or fact.[586] In *Nkonoki v. Commissioner*,[587] the taxpayer's failure to provide a single document substantiating claimed deductions was not considered negligence. The Tax Court recognized that failure was only due to a sanction barring the taxpayer from producing such into evidence, and therefore, it was reluctant to uphold a penalty on the basis of speculation about the state of the record had it allowed the taxpayer to introduce those documents. Moreover, reasonable minds can differ over tax reporting, even when the IRS disallows certain transactions, and when a legal issue is reasonably debatable, an underpayment generally will not be found negligent.[588]

A taxpayer may not avoid his duty to file accurate returns by shifting responsibility to his bookkeeper or other employee, especially when the taxpayer makes no attempt to see that the employee is keeping the books and records correctly.[589] A taxpayer also is not automatically absolved of the penalty merely because he consults a tax advisor. Reliance on a tax advisor's

[570] §6662(d)(2)(B); Reg. §1.6662-3(c), §1.6662-7(c).

[571] Reg. §1.6662-3(c)(1). Reportable transactions and the taxpayer disclosure requirement with respect thereto are discussed at VIII.A.2., below.

[572] Reg. §1.6662-3(c)(1).

[573] Reg. §1.6664-4(c)(1)(iii). See discussion at IV.C., below.

[574] IRM 20.1.5.8.2.1.(5) (01-24-12).

[575] Reg. §1.6662-3(c)(2), §1.6662-4(f)(1). Qualified amended returns are discussed at IV.A.3.b., above.

[576] Announcement 2010-75; Instructions to Schedule UTP; IRM 20.1.5.8.2.1(1) (01-24-12).

[577] Reg. §1.6011-4(d); IRM 20.1.5.8.2.1(2) (01-24-12).

[578] Reg. §1.6662-3(c)(2), §1.6662-4(f)(2).

[579] Reg. §1.6662-3(c)(2).

[580] Reg. §1.6662-4(e)(1).

[581] *In re Craddock*, 149 F.3d 1249 (10th Cir. 1998) (understatement is not affected by proper reporting due to AMT).

[582] *Bagur v. Commissioner*, 66 T.C. 817 (1976), rev'd and rem'd on other issue, 603 F.2d 491 (5th Cir. 1979); *Robinson's Dairy, Inc. v. Commissioner*, 35 T.C. 601 (1961), aff'd, 302 F.2d 42 (10th Cir. 1962).

[583] *Estate of McClanahan v. Commissioner*, 95 T.C. 98 (1990); *Hesselink v. Commissioner*, 97 T.C. 94 (1991).

[584] §6664(c)(1).

[585] *Hummer v. Commissioner*, T.C. Memo 1988-528.

[586] *Henry v. Commissioner*, 170 F.3d 1217 (9th Cir. 1999) (where taxpayer was repeatedly told that stock option proceeds should be treated as long-term capital gain, and accountant confirmed this when preparing returns, reliance on experienced and long-time accountant's tax treatment of proceeds was reasonable), *rev'g* T.C. Memo 1997-29; *Larotonda v. Commissioner*, 89 T.C. 287 (1987), nonacq., 1988-2 C.B. 1, nonacq. withdrawn, 1999-1 C.B. 332; *Dillin v. Commissioner*, 56 T.C. 228 (1971), *acq.*, 1975-2 C.B. 1; *Del Drago v. Commissioner*, 12 T.C.M. (CCH) 745 (1953), aff'd, 214 F.2d 478 (2d Cir. 1954).

[587] T.C. Memo 2016-93.

[588] *See Mortensen v. Commissioner*, T.C. Memo 2004-279, aff'd, 440 F.3d 375 (6th Cir. 2006); *Bergersen v. Commissioner*, T.C. Memo 1995-424, aff'd, 109 F.3d 56 (1st Cir. 1997); *Everson v. United States*, 108 F.3d 234 (9th Cir. 1997).

[589] *Leroy Jewelry Co. v. Commissioner*, 36 T.C. 443 (1961); *Franklin v. Commissioner*, 34 B.T.A. 927 (1936).

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advice must be reasonable.[590] Generally, that requires the tax advisor to be competent and independent.[591] In addition, the advisor must have knowledge of the pertinent facts.[592] The penalty may also be imposed on the taxpayer as a result of the advisor's error.[593] Nevertheless, when the taxpayer relies on an expert with respect to a complex substantive issue, the taxpayer does not act negligently.[594]

Where no reliable evidence exists in the record suggesting the nature of any advice given, a finding of negligence is not erroneous.[595]

Where a prospectus contains a favorable tax opinion but also warnings regarding the income tax risks, negligence may be found if the taxpayer fails to investigate further.[596]

The Court of Federal Claims provides a fairly comprehensive analysis of the approach of the various federal circuits regarding the issue of when taxpayers may reasonably rely on professional advice. In *Allison v. United States*,[597] the Court of Federal Claims held that the former §6653 negligence penalty was not warranted after concluding that the taxpayers had acted reasonably in investigating and understanding the business prospects and tax consequences of a partnership and in relying on their advisers. The taxpayers asserted that good faith reliance on an adviser was always reasonable, negating any charge of negligence, whereas the government asserted that it was unreasonable to rely on advisers who were not experts concerning the subject matter of the investment or who had any connection with the promoters of the investment. The court opted to follow the Fifth Circuit's approach in *Durrett v. Commissioner*,[598] which considers professional investment advisers to be "experts" without regard for their particular expertise concerning the industry or the transaction that is the topic of the advice. However, the court noted that reliance on an investment adviser was not reasonable if the taxpayer possessed information casting such doubts on the investment that personal investigation would be required. Addressing whether it was per se unreasonable to rely on advisers who were known to possess some sort of conflict of interest, the court, in rejecting a per se rule, concluded that an adviser's connections with the promoters of an investment, including a financial interest in the subject matter of the advice, while certainly one factor to be considered, was not necessarily a decisive factor. The court observed that even where a conflict is present, other considerations may make a taxpayer's expectation of loyalty reasonable under the circumstances.

Reasonable cause and good faith are discussed in greater detail at IV.A.4.b., above, and XI., below.

4. Carrybacks and Carryovers

The §6662(b)(1) penalty applies to any portion of an underpayment for a tax year to which a loss, deduction, or credit is carried, to the extent the underpayment is attributable to negligence or disregard in the tax year in which the carryback or carryover of the loss, deduction, or credit arises.[599] As a result, if a negligent deduction becomes part of a loss carryback or carryover, the penalty applies in the year to which the loss is carried.

Adequate disclosure is considered to be made with respect to an item which is included in a loss, deduction or credit that is carried to another year only if disclosure was made on the return or qualified amended return for the tax year in which the carryback or carryover arises.[600] Disclosure is not required in connection with the tax return for the year to which the loss, deduction or credit is carried. Adequate disclosure is discussed in IV.B.3.b., above.

C. Substantial Understatement of Income Tax Penalty

1. Application of the Penalty Under §6662(b)

A 20% penalty applies to any portion of an underpayment for which there is a substantial understatement of income tax.[601]

[590] *See, e.g.*, *Freytag v. Commissioner*, 89 T.C. 849 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990), aff'd, 501 U.S. 868 (1991).

[591] *Freytag v. Commissioner*, 89 T.C. 849 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990), aff'd, 501 U.S. 868 (1991). *See also Mortensen v. Commissioner*, T.C. Memo 2004-279, aff'd, 440 F.3d 375 (6th Cir. 2006).

[592] *Barlow v. Commissioner*, 301 F.3d 714 (6th Cir. 2002); *Pratt v. Commissioner*, T.C. Memo 2002-279; *McCrary v. Commissioner*, 92 T.C. 827 (1989); *Boucher v. Commissioner*, T.C. Memo 1979-172.

[593] *McCrary v. Commissioner*, 92 T.C. 827 (1989). *See Pritchett v. Commissioner*, 63 T.C. 149 (1974), *acq.*, 1975-2 C.B. 2. *But see Shotgun Delivery v. United States*, 269 F.3d 969 (9th Cir. 2001) (noting that accountant's version of tax-exempt accountable plan was just as flawed as implemented plan, court held that issue of negligence penalties should have been tried, as record supports conclusions that taxpayer's plan was formulated based on professional advice and deviations from advice were inadvertent).

[594] *See Chamberlain v. Commissioner*, 66 F.3d 729 (5th Cir. 1995); *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990); *Sim-Air, USA, Ltd. v. Commissioner*, 98 T.C. 187 (1992). *See also United States v. Boyle*, 469 U.S. 241 (1985); *Streber v. Commissioner*, 138 F.3d 216 (5th Cir. 1998) (Tax Court erred in upholding former §6653 penalties in light of taxpayers' relative youth and inexperience in business matters, reliance on advice of attorney, and proof of "good faith" by reporting transaction to IRS). Courts do not always require that the issue be complex. In *Shane Michael Optical, Co. v. Commissioner*, T.C. Memo 1999-267, the Tax Court declined to uphold the penalty against an elderly taxpayer or his business, noting that: the long-time accountant had never explained the distinction between business and personal expenses; the taxpayer had reasonably relied on the accountant to prepare the returns correctly; and the IRS ultimately disallowed only a small portion of the deductions as unsubstantiated.

[595] *Howard v. Commissioner*, 931 F.2d 578 (9th Cir. 1991); *Sacks v. Commissioner*, 82 F.3d 918 (9th Cir. 1996); *Conway v. United States*, 326 F.3d 1268 (Fed. Cir. 2003).

[596] *Sacks v. Commissioner*, 82 F.3d 918 (9th Cir. 1996) (prospectus warranted further investigation by prudent investor before claiming losses as tax deduction); *Collins v. Commissioner*, 857 F.2d 1383 (9th Cir. 1988) (taxpayers acted unreasonably in claiming losses where prospectus warned of tax risks). *See Addington v. Commissioner*, 205 F.3d 54 (2d Cir. 2000) (former §6653 negligence penalty upheld where taxpayer-attorneys did not investigate investments and unreasonably relied on advice of attorney who had no prior experience in investment area); *Gilmore & Wilson Constr. Co. v. Commissioner*, 166 F.3d 1221 (10th Cir. 1999) (former §6653 negligence penalty upheld where reliance by college-educated businessmen on advice of long-time CPA who had no expertise in plastics recycling and who failed to properly investigate investment was not reasonable and justifiable).

[597] 80 Fed. Cl. 568 (2008). *See Chamberlain v. Commissioner*, 66 F.3d 729 (5th Cir. 1995); *Goldman v. Commissioner*, 39 F.3d 402 (2d Cir. 1994); *Freytag v. Commissioner*, 904 F.2d 1011 (5th Cir. 1990), aff'd, 501 U.S. 868 (1991).

[598] 71 F.3d 515 (5th Cir. 1996).

[599] Reg. §1.6662-3(d)(1).

[600] Reg. §1.6662-3(c)(2), §1.6662-4(f)(4). Qualified amended returns are discussed at IV.A.3.b., above.

[601] §6662(b)(2), §6662(d); Reg. §1.6662-4(a).

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However, an understatement is reduced to the extent it is attributable to an item:[602]

- For which there is or was substantial authority for the taxpayer's treatment;[603] or
- With respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or a statement attached to the return.

Comment: The substantial understatement penalty applies only to underpayments of income tax imposed under subtitle A of the Code that is required to be shown on a return.[604] Subtitle A includes the alternative minimum tax under §55,[605] the unrelated business income tax under §511,[606] the accumulated earnings tax under §531, the personal holding company tax under §541, the tax on banks under §581, the tax on insurance companies under §801, the tax on regulated investment companies under §852, the tax on real estate investment trusts under §857, the tax on real estate mortgage investment conduits under §860A, the tax on nonresident aliens under §877, the tax on foreign corporations under §881, the branch profits tax under §884, the tax on gross transportation income under §887, the tax on domestic international sales corporations under §991, the tax on S corporations under §1374 and §1375, the self-employment tax under §1401,[607] the tax on net investment income under §1411, and withholding of tax on nonresident aliens and foreign corporations under §1441 and §1442.[608] However, it does not apply to underpayments of taxes outside subtitle A, including excise taxes,[609] gift tax, or estate tax.

Special rules apply to items that are attributable to a tax shelter. Those are discussed at IV.C.5., below.

Regardless of whether the items relate to a tax shelter, the penalty does not apply (1) with respect to any portion of the underpayment for which there is reasonable cause and the taxpayer acted in good faith,[610] or (2) if a fraud penalty under §6663 or a reportable transaction understatement penalty under §6662A is imposed.[611]

2. Substantial Understatement

a. In General

For this purpose, an "understatement" is defined as the excess of: (1) the amount of tax required to be shown on the return for a tax year, over (2) the amount of tax imposed that is shown on the return reduced by any rebate.[612] This excess is determined without regard to items to which the §6662A accuracy-related penalty for reportable transaction understatements applies.[613]

The amount of tax required to be shown on the return is the gross amount of tax imposed on the taxpayer under subtitle A for the tax year, without reductions for (a) credits for income taxes withheld on wages under §31 or income taxes withheld at the source on a nonresident alien or foreign corporation under §33, (b) payments of tax or estimated tax by the taxpayer, (c) credits for collections of amounts assessed as a result of termination assessments under §6851 or jeopardy assessments under §6861, and (d) any tax that the taxpayer is not required to assess on the return.[614]

Except in the case of items attributable to a tax shelter, the amount of tax imposed as shown on the return is computed without regard to items (a), (b) and (c) above, and is determined by treating the taxpayer as if it had properly reported any item (i) for which there is substantial authority for the treatment claimed, or (ii) with respect to which the relevant facts affecting the item's tax treatment were adequately disclosed in the return or in a statement attached to the return and there is a reasonable basis for the taxpayer's treatment of such item.[615] The reductions in clauses (i) and (ii) do not apply to any item attributable to a "tax shelter" — i.e., to a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement, in each case, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of federal income tax.[616]

Note: Generally, for returns filed after December 18, 2015, disallowed refundable credits can create a negative tax.[617]

A rebate generally is defined as the portion of an abatement credit, refund or other repayment that is made on the ground that the tax imposed was less than the excess of the sum of (1) the amount shown as the tax by the taxpayer on his return, plus (2) amounts not so shown that were previously assessed (or collected without assessment) as a deficiency, over (3) rebates previously made. The amount of the rebate is determined as if items to which the rebate is attributable as shown on the return had received the proper tax treatment.[618]

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[602] §6662(d)(2)(B); Reg. §1.6662-4(a). For a discussion of the accuracy-related penalty for reportable transaction understatements under §6662A, see 648 T.M., *Reportable Transactions.*

[603] *See CF Headquarters Corp. v. Commissioner*, 164 T.C. No. 5 (Mar. 04, 2025) (substantial authority for taxpayer's position existed when taxpayer excluded item "under its reasonable application of at least three decisions of the Supreme Court; … the statutory text of section 118 as it existed at the time; and the regulations thereunder").

[604] Reg. §1.6662-4(a).

[605] CCA 201220029.

[606] H.R. (Conf.) Rep. No. 99-841 at II-783 n. 165 (1986).

[607] *Cf. Cameron v. Commissioner*, 98 T.C. 123 (1992), aff'd, 15 F.3d 1083 (9th Cir. 1994) (interpreting a similar provision in the regulations under former §6661).

[608] GCM 39888 (Apr. 28, 1995). *See N. Ind. Pub. Serv. Co. v. Commissioner*, 101 T.C. 294 (1993).

[609] *Drummond v. Commissioner*, T.C. Memo 1997-71, aff'd in part and rev'd in part, 155 F.3d 558 (4th Cir. 1998).

[610] §6664(c); Reg. §1.6662-4(a). See discussion at IV.A.4.b., above, and XI., below. For discussion of the reasonable cause exception under §6664(d) for the penalty for reportable transaction understatements under §6662A, see 648 T.M., *Reportable Transactions.*

[611] §6662(b) (flush language). See discussion at IV.A.4.a., above.

[612] §6662(d)(2)(A).

[613] §6662(d)(2)(A). (flush language). The §6662A penalty is discussed in 648 T.M., *Reportable Transactions.*

[614] Reg. §1.6662-4(b)(3), §1.6664-2(b)).

[615] §6662(d)(2)(B). Reg. §1.6662-4(b)(4), §1.6664-2(c). Tax shelter items are discussed at IV.C.5., below. Substantial authority is discussed at IV.C.3., below. Adequate disclosure is discussed at IV.C.4., below. The more likely than not standard is discussed at IV.A.4.b.(2), above.

[616] §6662(d)(2)(C).

[617] §6664(a). See discussion of underpayment at IV.A.3.a., above.

[618] Reg. §1.6662-4(b)(5), §1.6664-2(e)).

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An understatement of income tax for a tax year is "substantial" if the understatement exceeds the greater of:[619]

- 10% of the tax required to be shown on the return for the tax year; or
- $5,000.

The 10% threshold is reduced to 5% in the case of a taxpayer who claims a deduction for the tax year under §199A (relating to qualified business income of noncorporate taxpayers).[620]

Comment: As written, the lower threshold applies to any taxpayer who claims a §199A deduction, even if the underpayment is not attributable to that deduction.

The 10% threshold is reduced to 1% in the case of a disallowance of an applicable energy credit under §45X, §45Y, or §48E, due to an overstatement of a §7701(a)(52) material assistance cost ratio with respect to a qualified facility, energy storage technology, or facility producing eligible components.[621]

For discussion of material assistance cost ratios for energy credits under §45X, §45Y, and §48E, see 512 T.M., *Tax Incentives for Production and Conservation of Energy and Natural Resources.*

In the case of a corporation other than an S corporation or a personal holding company, there is a "substantial understatement" of income tax for a tax year if the amount of the underpayment exceeds the lesser of:[622]

- 10% of the tax required to be shown on the return for the tax year or, if greater, $10,000; or
- $10 million.

For purposes of determining whether an understatement is substantial, the amount of the understatement is increased by the amount of any reportable transaction understatement under §6662A.[623] The §6662 penalty, however, applies only to the excess of the substantial understatement, if any, without regard to such increase.[624]

Example: T, an individual, files his income tax return, showing taxable income of $18,200 and a corresponding tax liability of $2,734. Subsequent IRS adjustments resulting from an audit increase T's income to $51,500 and the tax liability to $12,339. There was substantial authority for one nontax shelter adjustment item that increases T's income by $5,300. In computing the amount of the understatement, the tax liability shown on T's return is determined as if the adjustment item for which there was substantial authority had been properly reported. Thus, the amount of tax treated as shown on T's return is $4,176 (the tax on $23,500, i.e., $18,200 taxable income actually shown on T's return + $5,300 adjustment item for which there was substantial authority).

The resulting understatement is $8,163 ($12,339 tax required to be shown on the return − $4,176 tax treated as shown on T's return). Because the $8,163 understatement exceeds the greater of $1,234 (10% of $12,339 tax required to be shown on the return) or $5,000, T has a substantial understatement for the year.[625]

b. Carrybacks and Carryovers

Special rules apply in the case of underpayments attributable to carrybacks and carryovers of losses, deductions, and credits. The determination of whether an item is a "tainted item" — i.e., an item for which there is neither substantial authority nor adequate disclosure or, in the case of a tax shelter item of an individual, both substantial authority and a reasonable belief that the item is more likely than not proper — is made for the year in which the item arises.[626] However, the determination of whether an understatement is substantial is made for the carryover or carryback year, taking into account both tainted items that are carried back or carried over to such year, as well as items arising in the carryback or carryover year. The penalty is then applied in the carryback or carryover year.[627]

The amount of an understatement is not reduced as a result of a carryback of a loss, credit, or deduction to that year.[628]

Example: Individual T filed his 2016 tax return showing a tax liability of $1,504. After an audit of T's return, the IRS determined that the correct tax liability was $7,279. The resulting $5,775 ($7,279 − $1,504) understatement is a substantial understatement, as it exceeds both 10% of the $7,279 tax required to be shown and $5,000. In 2017, T incurs a net operating loss that is carried back and reduces his 2016 taxable income to $0. T is subject to the substantial understatement penalty for Year 1. The carryback does not reduce the understatement for 2016.[629]

3. Exception to Substantial Understatement Penalty for Substantial Authority

a. Effect of Substantial Authority

If there is substantial authority for the tax treatment of an item, the item is treated as if it was shown properly on the return for such year. As a result, there is no underpayment attributable to such item.[630] Substantial authority must exist either at the time the return containing the item is filed or on the last day of the tax year to which the return relates.[631]

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[619] §6662(d)(1)(A).

[620] §6662(d)(1)(C). For a discussion of §199A, see *537 T.M., Qualified Business Income Deduction: Section 199A.*

[621] §6662(m), added by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70512, effective for tax years beginning after July 4, 2025.

[622] §6662(d)(1)(B).

[623] §6662A(e)(1)(A).

[624] §6662A(e)(1)(B).

[625] Reg. §1.6662-4(b)(6) *Ex.* (1).

[626] Reg. §1.6662-4(c)(1), §1.6662-4(c)(3). In the case of a tax shelter item of a corporation, all tax shelter items are taken into account in computing the amount of any understatement. *See* §6662(d)(2)(C)(i). Accordingly, if a corporate taxpayer has a substantial underpayment attributable to a tax shelter item, the substantial understatement penalty applies unless the reasonable cause and good faith exception applies.

[627] Reg. §1.6662-4(c)(1).

[628] Reg. §1.6662-4(c)(2).

[629] Reg. §1.6662-4(c)(5) *Ex.* (3).

[630] §6662(d)(2)(B)(i); Reg. §l.6662-4(d)(1).

[631] Reg. §1.6662-4(d)(3)(iv)(C).

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b. Definition of Substantial Authority

The substantial authority standard is an objective standard, involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the "more likely than not" standard (i.e., greater than a 50% likelihood of being upheld on the merits), but stricter than the "reasonable basis" standard (i.e., a position that is more than merely arguable or more than a merely colorable claim) that generally avoids imposition of a negligence penalty.[632] The possibility that a return will not be audited or an item not raised on audit is not relevant in determining whether the substantial authority standard has been satisfied.[633] Because the substantial authority standard is an objective standard, the taxpayer's belief that substantial authority exists for a particular treatment of an item is irrelevant.[634]

To determine whether substantial authority exists, the taxpayer must evaluate the relevant authorities. The weight of authorities supporting the tax treatment must be substantial in relation to the authorities supporting contrary positions. The relative weights of the authorities is determined in light of the pertinent facts and circumstances, and there may be substantial authority for more than one position with respect to the same item.[635] The weight to be accorded an authority depends on its relevance, persuasiveness, and the type of document providing the authority.[636] For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue.[637] An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to the pertinent facts. The weight of authority from which information is deleted, such as a private letter ruling, is diminished to the extent the deleted information may have affected the authority's conclusion.[638]

The types of authority must also be considered. A revenue ruling addressing a question generally has greater weight than a private letter ruling addressing the same question. An older private letter ruling, technical advice memorandum, general counsel memorandum, or action on decision generally is accorded less weight than a more recent one and, if it is more than 10 years old, it generally is given very little weight.[639] A document's age, however, is not the only factor to consider. The persuasiveness and relevance of a document, viewed in light of subsequent developments, should also be taken into account.[640] In addition, there may be substantial authority for the tax treatment of an item despite the absence of certain types of authorities. For example, a taxpayer can have substantial authority for a position supported by no authorities other than a well-reasoned construction of the applicable statutory provision.[641]

Except in the case of a written determination described below, for purposes of determining whether there is substantial authority for the tax treatment of an item, only the following constitute authority:[642]

- The Internal Revenue Code and other statutory provisions;
- Proposed, temporary and final regulations;
- Court cases;[643]
- Revenue rulings and revenue procedures;
- Tax treaties, regulations issued under them, and official explanations of such treaties;
- Congressional intent as reflected in committee reports, joint explanatory statements of managers included in Conference Committee reports, and floor statements made before enactment by one of the bill's managers;
- The General Explanations of tax legislation prepared by the Joint Committee on Taxation (the "Blue Book");
- Private letter rulings and technical advice memorandum issued after October 31, 1976.[644]

Conclusions reached in treatises, legal periodicals, legal opinions, or opinions rendered by tax professionals are not "authority," although the authorities underlying such expressions

[632] Reg. §1.6662-4(d)(2). Reasonable basis is discussed at IV.B.3.a., above.

[633] Reg. §1.6662-4(d)(2).

[634] Reg. §1.6662-4(d)(3)(i).

[635] Reg. §1.6662-4(d)(3)(i). *See Chemtech Royalty Assocs. v. United States*, 823 F.3d 282 (5th Cir. 2016) (taxpayer failed to meet substantial authority and reasonable basis standards because supporting cases cited were materially distinguishable from taxpayer's circumstance, and thus, weight of authorities were not substantial in relation to weight of those supporting contrary treatment), *cert. denied*, 137 S. Ct. 624 (2017).

[636] Reg. §1.6662-4(d)(3)(ii).

[637] Reg. §1.6662-4(d)(3)(ii). *See Norgaard v. Commissioner*, 939 F.2d 874 (9th Cir. 1991) (an authority that is materially distinguishable on its facts carries very little weight).

[638] Reg. §1.6662-4(d)(3)(ii).

[639] Reg. §1.6662-4(d)(3)(ii). *See Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004) (regulation does not permit consideration as authority rejected evidence offered by taxpayer, even in cases in which merits of taxpayer's tax liability and threshold application of substantial understatement penalty are decided jointly merely by making fact findings), *aff'd*, 150 Fed. App'x 40 (2d Cir. 2005); *Blue Mountain Energy, Inc. v. United States*, No. 2:14-cv-418-DN, 2019 BL 366845 (D. Utah Sept. 27, 2019) (no reasonable basis for sophisticated corporate taxpayer to rely on revenue ruling that was issued outside 10 year window of persuasiveness).

[640] Reg. §1.6662-4(d)(3)(ii).

[641] Reg. §1.6662-4(d)(3)(ii). The release of IRS guidance, such as a TAM, whereby the IRS provides its interpretation, can serve to undermine the taxpayer's position. *See, e.g.*, TAM 9423003.

[642] Reg. §1.6662-4(d)(3)(iii).

[643] The applicability of a court case to a particular taxpayer by reason of the taxpayer's residence in a particular jurisdiction generally is not taken into account in determining whether there is substantial authority, but substantial authority. However, there is substantial authority the tax treatment of the item is supported by controlling precedent of the U.S. Court of Appeals to which the taxpayer has a right of appeal. Reg. §1.6662-4(d)(3)(iv)(B). *See, e.g., Chemtech Royalty Assocs. v. United States*, 823 F.3d 282 (5th Cir. 2016) (published authority from same circuit as taxpayer's case outweighed taxpayer's position, which was supported only by old and unpublished Tax Court cases), *cert. denied*, 137 S. Ct. 624 (2017); *Wise v. Commissioner*, T.C. Memo 1997-135 (Tax Court, interpreting former Reg. §1.6661-3(b)(1), held taxpayer's reliance on single Eleventh Circuit case supporting his position was substantial authority, despite that IRS's position was supported by Tax Court opinions and several other circuit court cases; court did not explain why Eleventh Circuit case (circuit to which appeal in case would lie) provided substantial authority); *Unger v. Commissioner*, T.C. Memo 1990-15 (court declined to impose former §6661 penalty where taxpayer was able to present some cases in support of novel legal argument, even though court did not provide explicit grounds for its conclusion).

[644] *See Bunney v. Commissioner*, 114 T.C. 259 (2000) (PLR may demonstrate reasonableness of return position); *Oakbrook Land Holdings, LLC v. Commissioner*, T.C. Memo 2020-54 (taxpayer's position was reasonable where it relied on PLR).

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of opinion, if applicable to the facts of a particular case, may give rise to substantial authority for the tax treatment of an item.[645] An authority ceases to be an authority to the extent it is overruled or modified, implicitly or explicitly, by a body with the power to change the earlier authority. In the case of a court decision, for example, a District Court opinion on an issue is not authority if it has been overruled or reversed by the United States Court of Appeals for such district. However, a Tax Court opinion is not considered to be overruled or modified by a decision of a Court of Appeals to which a taxpayer does not have a right of appeal, unless the Tax Court adopts the holding of that Court of Appeals. Similarly, a private letter ruling ceases to be authority if it is revoked or if it is inconsistent with a subsequent proposed regulation, revenue ruling, or other administrative pronouncement published in the Internal Revenue Bulletin.[646] Moreover, an authority that is materially distinguishable on its facts carries little weight.

Comment: Can the facts provide substantial authority? For example, can there be substantial authority to avoid a substantial understatement penalty with respect to an underpayment that arose because the court determined the taxpayer did not have the requisite profit motive? In *Osteen v. Commissioner*,[647] the Eleventh Circuit said yes. The court stated:

> The application or a substantial authority test is confusing in a case of this kind. If the horse breeding enterprise was carried on for profit, all of the deductions claimed by the Osteens would be allowed. There is no authority to the contrary. If the enterprise was not for profit, none of the deductions would be allowed. There is no authority to the contrary. Nobody argues, however, not even the Government, that because the taxpayers lose on the factual issue, they also must lose on what would seem to be a legal issue.[648]

The court then considered the penalty issue from both factual and legal standpoints, and found substantial authority on the facts as well as on the law. The Eleventh Circuit found there was some evidence to support a profit motive even though the taxpayer lost on that issue.

With the state of the record, there is substantial authority from a factual standpoint for the taxpayer's position. Only if there was a record upon which the Government could obtain a reversal under the clearly erroneous standard could it be argued that from an evidentiary standpoint, there was not substantial authority for the taxpayer's position.[649]

The Eleventh Cirsuit noted that, there are cases in which taxpayers had a profit motive for the type of activity in question.

> … we reverse because of the plethora of cases in which the Tax Court has found a profit motive in the horse breeding activities of taxpayers that were similar to those at hand. [citations omitted] Although it can properly be argued that those cases are distinguishable from the case at hand, as well they are because the ultimate facts were found for the taxpayers rather than against the taxpayer as in this case, they are not so dissimilar that they must be discarded as providing no substantial authority for the tax returns filed in this case.[650]

Despite affirming the Tax Court's conclusion that the taxpayer lacked a valid nontax business purpose for the transfer, the Sixth Circuit has found substantial authority based on "considerable factual evidence" that indicated such a purpose. Although the Circuit Court in *Estate of Kluener* recognized that, under the regulations, authority is limited to legal authority and that the facts are taken into account by applying the legal authority to the facts and by weighing the legal authority in light of the facts, it still relied on factual evidence.[651]

The District Court in Connecticut has disagreed.[652] The regulations are clear that only legal authority can be considered. Any attempt to expand the regulation's unambiguous language was "unconvincing." Moreover, the taxpayer's belief that there is substantial authority is not relevant.[653] That provision would be ineffective if the taxpayer's testimony as to a profit motive could be considered authority, especially in a case where the court found no profit motive. Under the regulations, authority that is materially distinguishable on its facts is accorded little weight.[654]

In sum, the regulation permits a taxpayer to escape penalties where the taxpayer can cite legal sources that would hold for the taxpayer on the merits of identical or closely analogous facts if the same were found by the court, even if such legal authority was rejected during the determination of the taxpayer's liability. It does not permit consideration as authority of rejected evidence offered by the taxpayer, even in cases in which the merits of the taxpayer's tax liability and the threshold application of a substantial understatement penalty are decided jointly merely by making a fact finding … .

Since the Court has found that the OTC transaction is devoid of objective economic substance and subjective business purpose, [the taxpayer] has not and cannot cite authority, much less substantial authority, for the proposition that a taxpayer may claim losses from a transaction in which the taxpayer intentionally expends far more than could reasonably be expected to be recouped through nontax economic returns in a transaction the sole motivation for which is tax avoidance.[655]

Comment: A taxpayer may have grounds for appeal where a court's substantial authority analysis is based on a "concluso-

[645] Reg. §1.6662-4(d)(3)(iii).

[646] Reg. §1.6662-4(d)(3)(iii).

[647] 62 F.3d 356 (11th Cir. 1995), aff'g in part and rev'g on this point T.C. Memo 1993-519.

[648] *Osteen v. Commissioner*, 62 F.3d 356, 359 (11th Cir. 1995).

[649] *Osteen v. Commissioner*, 62 F.3d 356, 359 (11th Cir. 1995). The Fifth Circuit followed this position in *Streber v. Commissioner*, 138 F.3d 216 (5th Cir. 1998) (2-1 decision), *rev'g* T.C. Memo 1995-601, even though it was not relevant to the ultimate outcome of the case. *See also Harston v. Commissioner*, T.C. Memo 1990-538 (without discussion, the court found substantial authority even though the taxpayer failed to show a profit motive under §183 for its horse-breeding activity), *aff'd without op.*, 936 F.2d 570 (5th Cir. 1991).

[650] *Osteen v. Commissioner*, 62 F.3d 356, 359–360 (11th Cir. 1995).

[651] *Estate of Kluener v. Commissioner*, 154 F.3d 630 (6th Cir. 1998).

[652] *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004), aff'd by unpub. op., 150 Fed. App'x 40 (2d Cir. 2005).

[653] Reg. §1.6662-4(d)(3)(i).

[654] Reg. §1.6662-4(d)(3)(ii).

[655] *Long Term Capital Holdings*, 330 F. Supp. 2d at 203–04 (D. Conn. 2004).

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ry" decision or "educated reaction" rather than an articulable, consistent, and workable test.[656]

Under a special rule, substantial authority exists if the taxpayer's position is supported by the conclusion of a "written determination" pertaining to the taxpayer — i.e., a private letter ruling or determination letter issued to the taxpayer, a technical advice memorandum in which the taxpayer is named, or an affirmative statement in a revenue agent's report with respect to a prior year of the taxpayer. Substantial authority does not exist, however, if:[657]

- There was a misstatement or omission of a material fact, or facts subsequently develop that materially differ from the facts on which the written determination was based; or
- The written determination is modified or revoked after issuance by: (1) a notice to the taxpayer; (2) the enactment of legislation or treaty ratification; (3) a Supreme Court decision; (4) the issuance of temporary or final regulation; or (5) the issuance of a revenue ruling, revenue procedure, or other statement published in the Internal Revenue Bulletin. A written determination that is modified or revoked under this provision, ceases to be authority on the date of such modification or revocation to the extent changed.

c. IRS List of Unsupported Positions

The IRS may publish a list of positions that it believes do not meet one or more of the following:[658]

- The substantial authority standard under §6662(d)(2)(B)(i) to avoid the substantial understatement portion of the accuracy-related penalty for underpayments;[659] and
- The requirements under §6664(d)(3) for the disclosure exception to apply to the accuracy-related penalty for reportable transaction understatements.[660]

4. Exception to Substantial Understatement Penalty for Adequate Disclosure

a. In General

The statute provides that the amount of an understatement is reduced by the portion of the understatement that is attributable to an item with respect to which:[661]

- The relevant facts are "adequately disclosed" in the return or in a statement attached to the return, and
- There is a reasonable basis for the tax treatment of such item by the taxpayer. Disclosure does not avoid the penalty, however, when an item that is attributable to a "tax shelter"[662] or is not properly substantiated, or when the taxpayer fails to keep adequate books and records with respect to the item.[663] In addition, the adequate disclosure rules do not apply to any item attributable to a tax shelter.[664]

b. Adequate Disclosure

A disclosure with respect to the tax treatment of an item is "adequate" only if:

- The disclosure is made on a properly completed Form 8275 (Disclosure Statement), or in the case of a position contrary to a regulation, Form 8275-R (Regulation Disclosure Statement), that is attached to the return or a qualified amended return.[665] For this purpose, a corporation's complete and accurate disclosure of a tax position on a Form 1120 Schedule UTP (Uncertain Tax Position Statement), is treated as if the corporation filed a Form 8275 or Form 8275-R with respect thereto;[666] or
- It is disclosed on a return in accordance with an annual revenue procedure addressing return disclosure.[667] If the revenue procedure does not expressly provide that disclosure of an item on the return is sufficient, disclosure with respect to that item may only be made in accordance with the prior bullet.[668]

Disclosure with respect to a recurring item must be made for each tax year in which the item is taken into account.[669] Disclosure with respect to an item included in a loss, deduction, or credit that is carried to another tax year is adequate only if it is made in connection with the return or a qualified amended return for the year in which the carryback or carryover arises.[670] The taxpayer is not required to provide additional disclosure

[656] *See Streber v. Commissioner*, 138 F.3d 216 (5th Cir. 1998) (if issue is factual and substantial authority issue turns on evidence going both ways, there is substantial factual authority for taxpayer's position); *Osteen v. Commissioner*, 62 F.3d 356 (11th Cir. 1995) (Tax Court's imposition of former §6661 penalty based on its "conclusory" decision that taxpayer's horse-breeding activity lacked profit motive reversed; court found that overabundance of cases in which Tax Court found profit motive in horse-breeding activities were not so dissimilar from taxpayer's case that they had to be discarded as providing no substantial authority for taxpayer's position).

[657] Reg. §1.6662-4(d)(3)(iv)(A). Note that a taxpayer's amended returns are not considered substantial authority. *Mancini v. Commissioner*, T.C. Memo 2019-16 (taxpayer argued that Appeal's "approval" of the position he took on amended returns was substantial authority).

[658] §6662(d)(3), as amended by the Consolidated Appropriations Act of 2018, Pub. L. No, 115-141, §401(a)(303). The list may cover positions relating to the realistic possibility of being sustained on the merits under §6694(a)(1), which is discussed at VII.C.4., below.

[659] The substantial authority standard is discussed at IV.C.3., above.

[660] The reasonable cause exception is discussed at IV.A.4.b., above, and XI., below.

[661] §6662(d)(2)(B)(ii).

[662] §6662(d)(2)(C). See discussion at IV.C.5., below.

[663] Reg. §1.6662-4(e)(2).

[664] §6662(d)(2)(C)(i). See discussion at IV.C.5., below.

[665] Reg. §1.6662-4(f)(1). Qualified amended returns are discussed at IV.A.3.b., above.

[666] Announcement 2010-75; Instructions to Form 1120 Schedule UTP. Schedule UTP is discussed in 648 T.M., *Reportable Transactions*.

[667] Reg. §1.6662-2(f)(2). *See Inter TAN, Inc. v. Commissioner*, T.C. Memo 2004-1, aff'd per curiam by unpub. op., 117 Fed. App'x 348 (5th Cir. 2004) (disclosure letter did not reasonably apprise the IRS of the nature of the controversy or potential controversy that the disputed transaction raised, as required by Rev. Proc. 94-69). The IRS issues an annual revenue procedure that provides that disclosure of certain common deductions and other items on a tax return is deemed "adequate disclosure" for purposes of reducing or eliminating the penalty. For a list of the annual revenue procedures, see Tables, Charts and Lists (Federal) > Adequate Disclosure > *Adequate Disclosure On Tax Return — Annual Revenue Procedures Under §6662 and §6694*. Still, the taxpayer must furnish all required information in a clear manner, in accordance with the instructions, and the money amounts entered on the applicable forms must be verifiable.

[668] Reg. §1.6662-4(f)(2).

[669] Reg. §1.6662-4(f)(3).

[670] Reg. §1.6662-4(f)(4).

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with the return for the year in which the carryback or carryover item is taken into account.[671]

In the case of an item attributable to a pass-through entity (i.e., a partnership, S corporation, estate, trust, RIC, REIT, or REMIC), disclosure must be made on Form 8275 or 8275-R, as appropriate, attached the entity's return or qualified amended return, or if permitted, on the entity's return in accordance with the applicable annual adequate disclosure revenue procedure. In addition, the taxpayer (i.e., the partner, shareholder, beneficiary, or holder of residual interest in a REMIC) may make a disclosure with respect to a pass-through item by filing the appropriate Form 8275 or 8275-R with its return or qualified amended return, and by filing a duplicate copy with the IRS Submission Processing Center where the entity is required to file its return.[672] A separate Form 8275 or 8275-R should be filed with respect pass-through items of each different pass-through entity.[673]

For examinations of tax year 2021 returns and later years, corporate taxpayers subject to the Large Corporate Compliance (LCC) audit program and partnerships subject to the Large Partnership Compliance (LPC) audit program are deemed to have made an adequate disclosure for penalty purposes if they submit Form 15307, *Post-Filing Disclosure for Specified Large Business Taxpayers*, and other required information to the IRS personnel conducting the examination in accordance with the procedures and timeframes set forth in Rev. Proc. 2022-39 and the form instructions.[674]

For tax year 2020 returns and earlier years, an LCC or LPC taxpayer is deemed to have made adequate disclosure on Form 8275 or Form 8275-R or a qualified amended return in accordance with the procedures and timeframes set forth in Rev. Proc. 94-69, if they provide the required information within 15 days (or such later date as may be agreed with the IRS) after the notice from the IRS agent requesting information with respect to the matter in a written statement to such agent which: (a) is captioned "furnished under Rev. Proc. 94-69;" (b) contains a description of all items that would result in adjustments if the taxpayer filed a properly completed amended return in lieu of the written statement; and (c) contains a declaration signed by the taxpayer under penalties of perjury.[675]

A reasonable basis is something more than merely being an arguable or a colorable claim, but less than substantial authority.[676] For this purpose, a corporation cannot be considered to have reasonable basis for its tax treatment of an item attributable to a multi-party financing transaction, if such treatment does not clearly reflect the corporation's income.[677]

5. Special Rules for Tax Shelter Items

Neither the substantial authority exception nor the adequate disclosure exception applies to any item that is attributable to a tax shelter.[678] Nor does disclosure made with respect to a tax shelter item affect the amount of the understatement.[679]

For this purpose, a "tax shelter" means:[680]

- Any
  - o partnership or other entity,
  - o investment plan or arrangement; or
  - o other plan or arrangement;
- If a significant purpose of such entity, plan or arrangement is the avoidance or evasion of federal income tax.

The "principal purpose" is the purpose that exceeds any other purpose.[681] The existence of economic substance does not itself establish that a transaction is not a tax shelter if the transaction includes other characteristics of a tax shelter. The principal purpose of an entity, plan or arrangement, however, is not to avoid or evade tax if it is intended only to claim tax benefits in a manner consistent with the Code and Congressional purpose.[682]

Comment: Although the substantial authority exception under pre-2004 AJCA §6662(d)(2)(C)(i)(II) required a reasonable belief that the claimed tax treatment is more likely than not the proper treatment, there is no such requirement for the reasonable cause exception under §6664(c). Section 6664(c) does not contain any special rule for tax shelters. Moreover, Reg. §1.6664-4(f) — which imposes a more likely than not standard — by its terms applies only to corporations. The regulation also makes it clear that something less than a more likely than not standard should apply for anything other than a corporate tax shelter item.[683] For tax years ending after October 22, 2004, §6664(d) contains the reasonable cause standard applicable to reportable transaction understatements. This standard is discussed in 648 T.M., *Reportable Transactions*.

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[671] Reg. §1.6662-4(f)(4).

[672] Reg. §1.6662-4(f)(5).

[673] Reg. §1.6662-4(f)(5).

[674] *See* Rev. Proc. 2022-39 (generally effective for examinations of eligible taxpayers beginning after November 16, 2022).

[675] *See* Rev. Proc. 2022-39, §2.15, §6.02. *See also* Rev. Proc. 94-69, *obsoleted by* Rev. Proc. 2022-39.

[676] Reg. §1.6662-4(e)(2)(i), §1.6662-3(b)(3). Reasonable basis is discussed at IV.B.3.a., above.

[677] §6662(d)(2)(B) (flush language).

[678] §6662(d)(2)(C)(i). A separate item deducted by the same tax shelter, which does not have a principal purpose of the avoidance or evasion of federal income tax, however, is not a tax shelter item. Reg. §1.6662-4(g)(3).

[679] *See* Reg. §1.6662-4(g)(1)(iii).

[680] §6662(d)(2)(C).

[681] Reg. §1.6662-4(g)(2)(i). Tax shelters are often transactions structured with little or no motive for the realization of economic gain, or transactions that utilize the mismatching of income and deductions, overvalued assets or assets with values subject to substantial uncertainty, certain nonrecourse financing, financing techniques that do not conform to standard commercial business practices, or the mischaracterization of the substance of the transaction. Reg. §1.6662-4(g)(2)(i).

[682] Reg. §1.6662-4(g)(2)(ii). For example, an entity plan or arrangement does not have as its principal purpose the avoidance or evasion of federal income tax solely as a result of using the following tax benefits:

- The purchase or holding of an obligation whose interest is excluded from income under §103;
- Taking accelerated depreciation allowed under §168;
- Taking percentage depletion allowed under §613 or §613A;
- Deducting intangible drilling costs under §263(c);
- Establishing a qualified retirement plan under §401–§409;
- Claiming a possession tax credit under §936; or
- Claiming tax benefits available by reason of an election to be taxed as a DISC under §992, foreign sales corporation under §927(f)(1), or S corporation under §1362. Reg. §1.6662-4(g)(2)(ii).

[683] One comment to the proposed regulations questioned the Treasury's ability to promulgate different standards for reasonable cause under §6664 corporate versus noncorporate taxpayers. The Treasury expressly rejected the comment, stating "Treasury and the IRS continue to believe that the regulations … properly implement the statute and Congressional intent." Preamble to T.D. 8617, 60 Fed. Reg. 45,661 (Sept. 1, 1995).

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D. Reportable Transaction Understatement Penalty

An accuracy-related penalty is imposed on any understatement related to any item that is attributable to:[684]

- Any listed transaction; or
- Any reportable transaction (other than a listed transaction) if a significant purpose of the transaction is federal income tax avoidance or evasion.

A reasonable cause exception may be available under §6664(d). In addition, the penalty does not apply to the extent certain other penalties apply.[685]

The penalty is generally 20% of any reportable transaction understatement.[686] A "reportable transaction understatement" is the sum of:[687]

- The product of: (1) the amount of any increase in taxable income that results from a difference between the proper tax treatment of an item to which §6662A applies and the taxpayer's treatment of the item as shown on its tax return; and (2) the highest rate of tax imposed by §1 or, in the case of a corporation, §11, and
- The amount of any decrease in the aggregate amount of income tax credits that results from a difference between the taxpayer's treatment of an item to which §6662A applies, as shown on the taxpayer's tax return, and the proper tax treatment of the item.

For a further discussion of §6662A, see 648 T.M., *Reportable Transactions.*

E. Valuation Misstatement Penalty

1. Substantial Valuation Misstatement

The Code imposes a penalty under §6662(b)(3) equal to 20% of the portion of any underpayment that is attributable to a substantial valuation misstatement.[688] A "substantial valuation misstatement" occurs if:[689]

- the value or the adjusted basis of any property claimed on a return of tax imposed under Chapter 1 is 150% or more of the correct value or adjusted basis;
- the price for any property or services (or for the use of property) claimed on a tax return under Chapter 1 in connection with a transaction between persons described in §482 is 200% or more (or 50% or less) of the correct price as determined under §482; or
- the net §482 transfer price adjustment for the tax year exceeds the lesser of $5 million or 10% of the taxpayer's gross receipts.[690]

The substantial valuation misstatement penalty, however, does not apply if the portion of the underpayment attributable to a substantial valuation misstatement does not exceed $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company).[691]

There is no disclosure exception to the substantial valuation misstatement penalty.[692]

2. Gross Valuation Misstatement

The penalty is increased to 40% in the case of a gross valuation misstatement.[693] A "gross valuation misstatement" occurs if: (1) the claimed value or adjusted basis of the property is 200% or more of the correct amount; (2) in the case of §482 valuation misstatements, the price is 400% or more or 25% or less of the correct price; or (3) the net §482 transfer price adjustment for the year exceeds $20 million or 20% of the taxpayer's gross receipts, whichever is less. A gross valuation misstatement also includes any substantial overstatement of pension liabilities,[694] any substantial estate or gift tax valuation understatement,[695] and any disallowance of a deduction for a syndicated conservation easement (discussed in IV.N., below).[696] In such cases, the substantial valuation misstatement penalty is increased from 20% to 40% of the applicable portion of the understatement.[697]

The accuracy-related penalty for reportable transaction understatements does not apply to any portion of an understatement on which the gross valuation misstatement is imposed.[698]

There is no reasonable cause exception in the case of gross valuation misstatements.[699]

A person that must pay a gross valuation misstatement penalty under §6662(h) with respect to any reportable transaction that would, but for §6662A(e)(2)(B) (relating to the coordination of such penalties), have been subject to the 30% accuracy-related penalty for reportable transaction understatements, and that must file periodic reports with the Securities and Exchange Commissioner (SEC) under §13 or §15(d) of the Securities Exchange Act of 1934 (or that must be consolidated with another person for purposes of such reports), must disclose the imposition of the penalty in the SEC reports for the periods specified by the IRS.[700] The disclosure is required once the taxpayer exhausts its administrative and judicial remedies with respect to the penalty, or upon payment of the penalty

[684] §6662A(b)(2). Reportable transactions, including listed transactions, are described at VIII.A.3.a.(2), below.

[685] §6662A(e). See LB&I Process Unit: *Accuracy-Related Penalty on Understatements With Respect to Reportable Transactions*, for IRS internal guidance on computing the reportable transaction understatement and applying the appropriate penalty rate to the understatement.

[686] §6662A(a).

[687] §6662A(b)(1).

[688] The overvaluation penalty under §6659 was renumbered and revised as part of the 1989 Omnibus Budget Reconciliation Act. Pub. L. No. 101-239, §7721(c)(2). Cases decided under §6659 generally are still relevant to analyzing the overvaluation penalty under §6662.

[689] §6662(e)(1).

[690] The §482 transfer price adjustments in the second and third bullets are discussed at IV.E.7., below.

[691] §6662(e)(2).

[692] Reg. §1.6662-5(a).

[693] §6662(h)(1).

[694] §6662(h)(2)(B).

[695] §6662(h)(2)(C).

[696] §6662(h)(2)(D), added by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T §605(a)(2)(B), applicable to contributions made after December 29, 2022.

[697] §6662(h)(1).

[698] §6662A(e)(2)(B). *See* IV.E.2., above.

[699] *See* §6664(c)(3) (as redesignated by §1409 of Pub. L. No. 111-152).

[700] §6707A(e). See Rev. Proc. 2005-51, *amp'd by* Rev. Proc. 2007-25, for guidance regarding how to make the required SEC disclosure.

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if that occurs earlier.[701] However, the penalty is only required to be reported once.[702] The SEC disclosure requirement applies even if the taxpayer determines that the amount of the penalty is not material to the SEC reports in which the penalty must appear.[703] If the person fails to make the required SEC disclosure, that failure is subject to an additional penalty amount under §6707A(b)(2) because it is treated as a failure to disclose a listed transaction.[704]

3. Penalty Thresholds

The determination whether the percentage threshold for a substantial or gross valuation misstatement has been reached is made on a property-by-property basis.[705]

> *Example:* Taxpayer claims on his tax return a value for property X of $85 and a value for property Y of $100. The correct values of X and Y are $60 and $40, respectively. Under the property-by-property determination, there is a substantial valuation misstatement for property Y (i.e., the claimed value is 250% of the correct value), but not for property X (i.e., the claimed value is 145% of the correct value). Because the claimed and correct values are compared on a property-by-property basis, there is a substantial valuation misstatement with respect to property Y, but not with respect to property X, even though the claimed values ($185) are 150% or more of the correct values ($100) when compared on an aggregate basis.[706]

Comment: It is not clear whether the IRS must appraise each asset for which it asserts a penalty or may base the value of an asset on appraisals of a random statistical sampling of the assets.[707]

The $5,000 and $10,000 thresholds are calculated by aggregating all portions of the underpayment attributable to substantial or gross valuation misstatements.[708]

> *Example:* The claimed value for Property C on individual T's return is 250% of the correct value, and the underpayment attributable to this misstatement is $2,500. On the same return, T claims a value for Property D that is 400% of the correct value, and the underpayment attributable to this misstatement is $3,500. The dollar threshold (i.e., $5,000) has been satisfied.[709]
>
> When the correct value or adjusted basis of property is zero and a higher value or adjusted basis is claimed on a return, the claimed value or adjusted basis is deemed to be 400% or more of the correct amount.[710] As a result, if the dollar threshold is satisfied, the 40% penalty rate applies.

4. Pass-Through Entities

In the case of pass-through entities, the determination of a substantial or gross valuation misstatement is made at the entity level, but the dollar limitation is applied at the taxpayer level.[711] At the taxpayer level, the portion of the underpayment attributable to the pass-through entity is aggregated with other underpayments on the taxpayer's return attributable to substantial or gross valuation misstatements to determine whether the dollar threshold has been satisfied.[712]

5. Carrybacks and Carryovers

The accuracy-related penalty applies to an underpayment for a year to which a loss, deduction, or credit is carried if the loss, deduction, or credit is attributable to a substantial or gross valuation misstatement for the year in which the loss, credit, or deduction arose. In addition, the dollar threshold must be satisfied in the carryback or carryover year.[713]

6. Attributable to a Valuation Misstatement

The accuracy-related penalty only applies to the portion of the underpayment of tax that is "attributable to" an overvaluation of property.[714] The valuation misstatement need not occur in the current tax year. For example, a valuation overstatement may cause the tax basis of property to be overstated, which affects the claimed depreciation deductions in subsequent years.[715]

In *Woods*,[716] the Supreme Court clarified that the valuation misstatement penalty applies where the transaction was disregarded as s sham because it did not have economic substance. Once the partnership was deemed not to exist, the partner's basis in his partnership interest could not be more than zero, and any claimed basis in excess of zero by definition is a gross valuation misstatement.[717] The Court also rejected the taxpayer's argument that because the partnership was a sham, the underpayment was not based on a misstatement of value, and there-

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[701] H.R. (Conf.) Rep. No. 108-755 at 599 (2004). *See* Rev. Proc. 2005-51, *amp'd by* Rev. Proc. 2007-25. The §6662A penalty is discussed in 648 T.M., *Reportable Transactions.*

[702] H.R. (Conf.) Rep. No. 108-755 at 599 (2004).

[703] H.R. (Conf.) Rep. No. 108-755 at 599 (2004). The penalty also applies even if the taxpayer treats the failure to disclose a transaction in the SEC report as a failure to disclose a listed transaction. H.R. (Conf.) Rep. No. 108-755 at 599 (2004).

[704] §6707A(e). *See* Rev. Proc. 2005-51, *amp'd by* Rev. Proc. 2007-25.

[705] Reg. §1.6662-5(f)(1). *See* CCA 201711009 (IRS did not appraise each item and instead appraised only sampling of items; Office of Chief Counsel stated it could not find court cases that addressed whether this was permissible and redacted conclusion).

[706] Reg. §1.6662-5(f)(1). The regulation on which the example is based does not reflect the legislative changes made by the 2006 PPA, Pub. L. No. 109-280.

[707] *See* CCA 201711009.

[708] Reg. §1.6662-5(f)(2).

[709] Reg. §1.6662-5(f)(2). The regulation on which the example is based does not reflect the legislative changes made by Pub. L. No. 109-280.

[710] Reg. §1.6662-5(g).

[711] Reg. §1.6662-5(h)(1).

[712] Reg. §1.6662-5(h)(2).

[713] Reg. §1.6662-5(c).

[714] §6662(b)(3).

[715] *See, e.g., Nielson v. Commissioner*, 87 T.C. 779 (1986); Rev. Rul. 85-75. The penalty may be applied even though the original valuation misstatement occurred before the effective date of the penalty. *See* Reg. §1.6662-5(k).

[716] *United States v. Woods*, 571 U.S. 31 (2013). *See Fakiris v. Commissioner*, T.C. Memo 2020-157 (applying *Woods* holding to claimed charitable deduction where donation was characterized as sham, thus no contribution occurred).

[717] *See* Reg. §1.6662-5(g). The Court noted that some commentators have suggested that the regulation is in tension with the mathematical rule forbidding division by zero, but assumes the validity of the regulation since it was not challenged by the taxpayer. *Woods*, 571 U.S. at 44 n.4 (2013).

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fore the penalty under §6662(b)(3) could not apply. The court stated that:

> the basis misstatement and the transaction's lack of economic substance were inextricably intertwined, so attributing the tax underpayment only to the artificiality of the transaction and not to the basis over-valuation is making a false distinction. [citations omitted] In short, the partners underpaid their taxes because they overstated their outside basis [in the partnerships], and they overstated their outside basis because the partnerships were shams.[718]

The Court also found that such holding would not render superfluous the §6662(b)(6) penalty for transactions lacking economic substance.[719]

Before *Woods*, there was split among the circuits. The Fifth[720] and Ninth[721] Circuits held that if the case was decided on other grounds which were not based on valuation (e.g., because the transaction was disregarded as a sham or lacked economic substance), the underpayment was not attributable to a valuation overstatement. The IRS,[722] the United States Court of Federal Claims,[723] and the First, Second, Third, Fourth, Sixth, Eighth and Eleventh Circuits[724] disagreed. Ultimately, the Tax Court decided to follow the majority view.[725]

7. Section 482 Transfer Pricing Penalty

In addition to the general rule described at IV.E.1., above, there is a "substantial valuation misstatement" if:[726]

- The price for any property or services (or the use of property) claimed on a return in connection with any transaction to which §482 applies is 200% or more (or 50% or less) of the correct transfer price; or
- The net §482 transfer price adjustment for the tax year exceeds the lesser of $5 million or 10% of the taxpayer's gross receipts.

In determining whether the §482 transfer price adjustment threshold is met, the portion of the net increase in taxable income that is attributable to a redetermination of a price may be excluded if: (1) the taxpayer determined such price in accordance with a specific pricing method under the Regulations, the taxpayer's use of such method was reasonable at the time the return was filed, the taxpayer has documentation which set forth the determination of such price in accordance with such method and which establishes that such method was reasonable, and the taxpayer provides such documentation to the IRS within 30 days after request therefor, or (2) if the taxpayer did not use a specific pricing method but establishes that none of the specific pricing methods would clearly reflect income and that the method used was likely to do so, the taxpayer has documentation which set forth the determination of the price in accordance with such method and which establishes that such method was reasonable, and the taxpayer provides such documentation to the IRS within 30 days after request therefor.[727] In addition, the portion of the net increase attributable to a transaction solely between foreign corporations is excluded, unless the treatment of such transaction affects the determination of income from sources within the U.S. or taxable income effectively connected with a trade or business in the United States.[728]

For this purpose, the "net §482 transfer price adjustment" with respect to a tax year is the net increase in taxable income for such year (determined without regard to any amount carried to such year from another tax year) resulting from §482 adjustments in the price for any property or services (or the use of property).[729]

Comment: Transfer pricing adjustments that do not meet any of the above thresholds may still be subject to a negligence or fraud penalty.

No penalty for a substantial valuation misstatement is imposed unless the portion of the underpayment of tax for the ap-

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[718] *Woods*, 571 U.S. at 47 (2013). The Court further rejected reliance on the General Explanation of the Economic Recovery Act of 1981 (Pub. L. No. 97-34) (the "1981 Blue Book") since the statutory text is unambiguous and the 1981 Blue Book constitutes "post-enactment legislative history," which is not a legitimate tool of statutory construction. *Woods*, 571 U.S. at 47–48 (2013).

[719] The §6662(b)(6) penalty is discussed at IV.H., below.

[720] *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988); *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir 1990); *Nevada Partners Fund, L.L.C. v. United States*, 720 F.3d 594 (5th Cir. 2013), vac'd and rem'd, 571 U.S. 1119 (2014), *on remand per curiam*, 556 Fed. App'x 371 (5th Cir. 2014); *Bemont Invs., LLC v. United States*, 2010-2 USTC Para. 50,551 (E.D. Tex. 2010), aff'd in part and rev'd and rem'd in part, 679 F.3d 339 (5th Cir. 2012); *NPR Invs., LLC v. United States*, 732 F. Supp. 2d 676 (E.D. Tex. 2010), aff'd in part and vac'd and rev'd in part, 740 F.3d 998 (5th Cir. 2014); *Klamath Strategic Inv. Fund, LLC v. United States*, 472 F. Supp. 2d 885 (E.D. Tex. 2007), aff'd in part and vac'd in part, 568 F.3d 537 (5th Cir. 2009); *Southgate Master Fund, L.L.C. v. United States*, 651 F. Supp. 2d 596 (N.D. Tex. 2009), aff'd, 659 F.3d 466 (5th Cir. 2011). The Fifth Circuit relied on a mistaken interpretation of the 1981 Blue Book, which provides as follows:

> The portion of a tax understatement that is attributable to a valuation overstatement will be determined after taking into account any other proper adjustments to tax liability. Thus, the underpayment resulting from a valuation overstatement will be determined by comparing the taxpayer's (1) actual tax liability (i.e., the tax liability that results from a proper valuation and which takes into account any other proper adjustments) with (2) actual tax liability as reduced to take into account the valuation overstatement. The difference between those two accounts will be the underpayment that is attributable to the valuation overstatement.

1981 Blue Book at 333.

[721] *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990). Although the Ninth Circuit followed *Gainer* in *Keller v. Commissioner*, 568 F.3d 710 (9th Cir. 2009), the court indicated that had it been writing on a clean slate, it might have reached a different conclusion.

[722] Litigation Guideline Memo TL-68 (rev.) (Aug. 12, 1992); AOD 2011-02; FSA 200051005. A Litigation Guideline Memo represents the litigation position criteria and procedures of the Office of Chief Counsel at the time issued.

[723] *Clearmeadow Inv., LLC v. United States*, 87 Fed. Cl. 509 (2009) (The 1991 Blue Book did not contemplate a situation where a deduction could be disallowed on multiple grounds. Moreover, nothing in the statute supported the notion that a taxpayer could avoid the penalty by conceding the tax on a particular ground. Such a convenient escape would defeat the very purpose of the penalty — to discourage taxpayers from overstating values or tax basis on tax returns.).

[724] *Fidelity Int'l Currency Advisor A Fund, LLC v. Commissioner*, 661 F.3d 667 (1st Cir. 2011); *Gilman v. Commissioner*, 933 F.2d 143 (2d Cir. 1991), cert. denied, 502 U.S. 1031 (1992); *Merino v. Commissioner*, 196 F.3d 147 (3d Cir. 1999); *Zfass v. Commissioner*, 118 F.3d 184 (4th Cir. 1997); *Illes v. Commissioner*, 982 F.2d 163 (6th Cir. 1992), cert. denied, 507 U.S. 984 (1993); *Massengill v. Commissioner*, 876 F.2d 616 (8th Cir. 1989); *Gustashaw v. Commissioner*, 696 F.3d 1124 (11th Cir. 2012).

[725] *AHG Invs., LLC v. Commissioner*, 140 T.C. 73 (2013).

[726] §6662(e)(1)(B).

[727] §6662(e)(3)(B)(i), §6662(e)(3)(B)(ii).

[728] §6662(e)(3)(B)(iii). *See* CCA 200729034.

[729] §6662(e)(3)(A).

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plicable year attributable to the substantial valuation misstatement exceeds $5,000 ($10,000 in the case of a C corporation other than a personal holding company).[730] The minimum penalty under §6662 is the standard 20% penalty that applies to each different type of accuracy-related penalty.

The gross valuation misstatement penalty under §6662(h) does not apply to any portion of an understatement on which the penalty for reportable transaction understatements under §6662A is imposed.[731] There is no reasonable cause exception.[732]

The §6662 substantial valuation statement penalty as it relates to issues under §482 is discussed in greater detail in 6924 T.M., *Transfer Pricing: Audits, Appeals, and Penalties* (Foreign Income Portfolios Series).

8. Valuation Misstatement Penalty Exception for Reasonable Cause

a. General

Section 6664(c)(1) generally provides an exception to an accuracy-related penalty under §6662, including a valuation overstatement penalty, to the extent the taxpayer shows that there was reasonable cause for the underpayment of tax and that the taxpayer acted in good faith with respect thereto. See discussion at IV.A.4.b., above, and XI., below.

b. Special Rule for Charitable Deduction Property

In the case of an underpayment attributable to a substantial or gross valuation overstatement of charitable deduction property — that is, property contributed by the taxpayer for which the taxpayer received a charitable deduction under §170,[733] the reasonable cause exception applies only if:[734]

- The claimed value of the property was based on a qualified appraisal made by a qualified appraiser; and
- In addition, the taxpayer made a good faith investigation of the contributed property.

This rule applies regardless of whether a charitable deduction is permitted without obtaining a qualified appraisal.[735]

For this purpose, a "qualified appraisal" is an appraisal document that meets all of the following requirements:[736]

- The appraisal is prepared, signed, and dated by a qualified appraiser;[737]
- The appraisal is prepared in accordance with generally accepted appraisal standards. However, until additional guidance is issued, an appraisal that is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice, as developed by the Appraisal Standards Board of the Appraisal Foundation, qualifies;[738]
- The appraisal is made no earlier than 60 days before the date of the contribution of the appraised property nor later than the due date of the tax return claiming the deduction, including extensions of time to file (or in the case of a deduction first claimed on an amended return, the date the return is filed);[739]
- The appraisal includes the following information:
  - o A description of the contributed property in sufficient detail to identify it as being the same property that was appraised;
  - o In the case of tangible property, its physical condition;
  - o The date (or expected date) of the contribution;
  - o The terms of any agreement or understanding by the donor or donee that relates to the use, sale or other disposition of the property;[740]
  - o The name, address and taxpayer identification number of the qualified appraiser;[741]
  - o The qualifications of the qualified appraiser who signs the appraisal, including his background, experience, education and professional appraisal association memberships;[742]
  - o A statement that the appraisal was prepared for income tax purposes;
  - o The date the property was appraised;
  - o The appraised fair market value of the property on the date (or expected date) of the contribution;[743]
  - o The method of valuation used to determine the fair market value (e.g., the income approach, the market-data approach, or the replacement-cost-less-depreciation approach); and

[730] §6662(e)(2).

[731] §6662A(e)(2)(B).

[732] §6662(e)(3)(D).

[733] §6664(c)(4)(A). For this purpose, however, money and securities for which market quotations as of the date of the contribution are readily available on an established securities market are excluded. §6664(c)(4)(A).

[734] §6664(c)(4)(A).

[735] Reg. §1.6664-4(h)(3).

[736] §6664(c)(4)(B), §170(f)(11)(E)(i); Reg. §l.6664-4(h)(2), §1.170A-13(c)(3); Prop. Reg. §1.170A-17(a).

[737] A qualified appraiser is defined below.

[738] Notice 2006-96. *See also* Prop. Reg. §1.170A-17(a)(1), §1.170A-17(a)(2). The Preamble to the proposed regulations requires compliance with such substance and principles. REG-140029-07, 73 Fed. Reg. 45,808 (Aug. 7, 2008).

[739] Prop. Reg. §1.170A-17(a)(4) would clarify that the appraisal must also be signed and dated within such period.

[740] The terms include, for example, any agreement or understanding that: (a) restricts temporarily or permanently a donee's right to use or dispose of the donated property; (b) reserves to, or confers upon, anyone (other than the donee or another organization participating with the donee in cooperative fundraising) any right to income from the contributed property or the possession of the property (including the right to vote donated securities, to acquire the property, or to designate the person having such income, possession or right to acquire); or (c) earmark donated property for a particular use. Reg. §1.170A-13(c)(3)(ii)(D); Prop. Reg. §1.170A-17(a)(3)(ii).

[741] If the qualified appraiser is acting in his capacity as a partner, employee or independent contractor engaged by a person other than the donor, the name, address and taxpayer identification number of the partnership or person engaging the qualified appraiser. Reg. §1.170A-13(c)(3)(ii)(E).

[742] The proposed regulations would also require a description of the appraiser's qualifications to value the type of property being valued. Prop. Reg. §1.170A-17(a)(3)(iv)(B).

[743] The proposed regulations would require the appraisal to include the date to which the value opinion applies and the fair market value as of such date. Prop. Reg. §1.170A-17(a)(3)(i)(C), Prop. Reg. §1.170A-17(a)(3)(i)(D), Prop. Reg. §1.170A-17(a)(5).

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- The specific basis for the valuation (e.g., specific comparable sales transactions or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed);

• The appraisal does not include an appraisal fee based in any part on a percentage (or percentages) of the appraised value of the property, unless: (a) the fee is paid to a generally recognized association that regulates appraisers; (b) the association is not organized for profit and no part of the net earnings of which inures to the benefit of any private person; (c) the appraiser does not receive any compensation from the association or any other person for making the appraisal; and (d) the fee arrangement is not based in the whole or in part on the appraised value of the property that is allowed as a charitable deduction.[744]

Comment: This is the same definition that is used for substantiation of large charitable contributions of property under the charitable contribution rules. As under such rules, substantial compliance with the requirements is generally sufficient.[745]

An appraisal that is disregarded pursuant to 31 U.S.C. §330(c) (relating to the IRS's ability to suspend or disbar a person from practicing before the IRS) can still constitute a qualified appraisal if the appraisal summary required under Reg. §1.170A-13(c)(4) includes a declaration by the appraiser stating that the appraisal is not being disregarded under 31 U.S.C. §330(c) on the date the appraisal summary is signed by the appraiser, and the taxpayer had no knowledge that the declaration was false as of the date the appraisal summary was signed by the taxpayer (or presented to him for signature if Reg.§1.170A-13(c)(4)(iv)(C) applies).[746]

A "qualified appraiser" is an individual who:[747]

• Has earned an appraisal designation from a recognized professional appraiser organization or has met minimum education and experience requirements set forth in regulations. In addition, the appraiser must demonstrate verifiable education and experience in valuing the type of property subject to the appraisal. For this purpose, an appraiser is treated as having earned the required designation if the appraiser designation is awarded on the basis of demonstrated competency in valuing the type of property for which the appraisal is being performed.[748] An appraiser is treated as having demonstrated verifiable education and experience in valuing the type of property if the appraiser makes a declaration in the appraisal that, because of the appraiser's background, experience, education and membership in professional associations, the appraiser is qualified to make appraisals of the type of property being valued.[749] An appraiser is treated as having met the minimum education and experience requirements if:

- In the case of real property, the appraiser is licensed or certified for the type of property being appraised in the state in which the real property is located;[750]

- In the case of personal property, the appraiser has (i) successfully completed college or professional level coursework that is relevant to the property being valued; (ii) obtained at least two years of experience in the trade or business of buying, selling or valuing the type of property being valued; and (iii) fully described in the appraisal the appraiser's education and experience that qualifies the appraiser to value the type of property being valued;[751]

• Regularly performs appraisals for which the appraiser receives compensation;[752]

• Prepares the required appraisal summary, including a declaration that;

• The appraiser either holds himself out to the public as an appraiser or performs appraisals on a regular basis;

• Because of the appraiser's qualifications as described in the appraisal, the appraiser is qualified to make appraisals of the type of property being valued;

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[744] Reg. §1.170A-13(c)(6).

[745] *See, e.g., Bond v. Commissioner*, 100 T.C. 32 (1993); *Hewitt v. Commissioner*, 109 T.C. 258 (1997), aff'd without op., 166 F.3d 332 (4th Cir. 1998); *Simmons v. Commissioner*, T.C. Memo 2009-208, aff'd, 646 F.3d 6 (D.C. Cir. 2011); NSAR 010323. *But cf. Bruzewicz v. United States*, 604 F. Supp. 2d 1197 (N.D. Ill. 2009) (which would limit substantial compliance to cases in which the taxpayer had a good excuse (though not a legal justification) for failing to comply with an unimportant requirement or a requirement that is unclearly or confusingly stated in the statute or regulations).

[746] Reg. §1.170A-13(c)(3)(iv)(D). The proposed regulation would require the appraiser to make the following declaration to constitute a qualified appraisal:

> I understand that my appraisal will be used in connection with a return or claim for refund. I also understand that, if a substantial or gross valuation misstatement of the value of the property claimed or the return or claim for refund results from my appraisal, I may be subject to a penalty under §6695A of the Internal Revenue Code, as well as other applicable penalties. I affirm that I have not been barred from presenting evidence or testimony before the Department of Treasury or the Internal Revenue Service pursuant to 31 U.S.C. §330(c).

Prop. Reg. §1.170A-17(a)(3)(vi). In addition, under Prop. Reg. §1.170A-17(a)(6), an appraisal is not qualified if a reasonable person would conclude that the donor failed to disclose or misrepresented facts that would cause the appraiser to overstate the value. *Compare* Reg. §1.170A-13(c)(5)(ii) with respect to qualified appraisers.

[747] §6664(c)(4)(B), §170(f)(11)(E)(ii), §170(f)(11)(E)(iii); Reg. §1.6664-4(h)(2), §1.170A-13(c)(5); Prop. Reg. §1.170A-17(b).

[748] Notice 2006-96, which provides interim guidance until regulations taking into account the amendments under the Pension Protection Act of 2006 are promulgated. The proposed regulations would continue this provision. Prop. Reg. §1.170A-17(b)(2)(iii).

[749] Notice 2006-96. The proposed regulations would eliminate this as a means of satisfying the education and experience requirement, but would continue the requirement for a declaration to ensure the appraiser's education and experience in valuing the relevant type of property are verifiable. Prop. Reg. §1.170A-17(b)(4).

[750] Applicable to tax returns filed after October 19, 2006. Notice 2006-96.

[751] Applicable to tax returns filed after February 16, 2007. Notice 2006-96. The proposed regulations would also treat an appraiser as having the requisite education and experience of the individual has successfully completed professional or college-level coursework in valuing the relevant type of property, and has two or more years of experience in valuing the relevant type of property. Prop. Reg. §1.170A-17(b)(2). The relevant type of property is determined by what is customary in the appraisal profession. Prop. Reg. §1.170A-17(b)(3).

[752] The proposed regulations would eliminate this requirement, since it is generally encompassed by the experience requirement and does not need to be met separately. Moreover, some appraisers do not receive compensation (*e.g.*, because the individual's employer is the one paid or because they do not charge for the services). Preamble to proposed regulations, REG-140029-07, 73 Fed. Reg. 45,808 (Aug. 7, 2008).

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• The appraiser is not an excluded person (generally, the donor or the taxpayer, a party to the transaction in which the donor acquired the property, the donee, an employee of any of the foregoing, a person related to any of the foregoing, or an appraiser who is regularly used by the donor, taxpayer, party to the transaction or donee, and who does not perform a majority of his appraisals during the tax year for other persons);[753]

• The appraiser understands that an intentionally false or fraudulent overstatement of the value of the property described in the appraisal or appraisal summary may subject the appraiser to a civil penalty under §6701 for aiding and abetting an understatement of tax and, moreover, the appraiser may have his appraisals disregarded pursuant to 31 U.S.C. §330(c) or Treasury Department Circular 230;

• Includes a declaration that the appraiser understands that substantial or gross valuation misstatement resulting from an appraisal of the property that the appraiser knows or reasonably should have known would be used in connection with a return may subject the appraiser to a civil penalty under §6695A;[754]

• The donor does not know of any facts that would cause a reasonably prudent person to expect the appraiser falsely to overstate the value of the donated property (e.g., the donor and the appraiser agree to a value which the donor knows exceeds the fair market value of the property); and

• The appraiser has not been prohibited from practicing before the IRS under 31 U.S.C. §330(c) at any time during the three-year period ending on the date of the appraisal.

Comment: Both education and experience are required. The preamble to the regulations refer to two types of education and experience — the minimum standard and the verifiable ability to value the relevant type of property satisfying the more stringent verifiable standard is sufficient.[755]

In addition to obtaining a qualified appraisal from a qualified appraiser, the taxpayer must make a good faith investigation of the value of the property. Merely relying on a qualified appraisal from a qualified appraiser literally is not sufficient.[756] There is, however, little guidance as to what more the taxpayer is required to do. Where the property is of a type that is commonly sold, the taxpayer may be able to rely on publicly available information relating to that type of property.[757] Similarly, if the taxpayer has a particular expertise with respect to the property contributed, he may be permitted to rely on his own expertise.[758]

Comment: It is important to remember that in the case of a conservation easement, the property being valued is the easement and not the underlying realty to which the easement applies. A good faith investigation as to the value of the underlying property before the easement, by itself, is not sufficient.[759] In such case, the taxpayer would also have to make a good faith investigation into the value of the underlying property after the easement is imposed.

Comment: In the normal situation, where the charitable donation property is not readily marketable and the taxpayer does not have any particular expertise with respect to such property, what does the taxpayer have to do to show that he made a good faith investigation of the value? Were that the only requirement, it would appear that the good faith reliance on a qualified appraisal from a qualified appraiser would be sufficient. However, that is not the case. Obtaining a second appraisal review by another appraiser as a check on the qualified appraisal should be sufficient.[760] It does not seem that the taxpayer should be required to obtain a second qualified appraisal. Absent guidance, however, a taxpayer may consider obtaining a second qualified appraisal from a second qualified appraiser and using the lower of the two values.

Comment: More recently, the Tax Court seems to have eliminated the separate good faith investigation requirement. In *Evans v. Commissioner*,[761] for example, the sole discussion of this requirement was a footnote, stating:

> As we hold below, petitioners have satisfied the general reasonable cause and good faith requirement of sec. 6664(c)(1) by showing they had reasonably and in good faith relied on [the appraisers], whom they had commissioned to conduct an appraisal of the façade easement. In doing so, petitioners had axiomatically caused to be made, on their behalf and in good faith, an investigation of the value of the contributed property. Thus, in petitioner's case, the good faith investigation requirement of sec. 6664(c)(2)(B) is subsumed under the general reasonable cause and good faith requirement of sec. 6664(c)(1).[762]

The analysis in *Evans* is clearly contrary to the express language of the statute, in effect nullifying the separate requirement of §6664(c)(2).

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[753] *See* CCA 201711009 (IRS looked at total time appraiser devoted to furnishing appraisals to taxpayer and income received from those appraisals in comparison to those variables for all other individuals and entities for which appraisal services were performed).

[754] Applicable to appraisals relating to tax returns filed after February 16, 2017. Notice 2006-96.

[755] REG-140029-07, 73 Fed. Reg. 45,808 (Aug. 7, 2008).

[756] §6664(e)(2)(B); *McMurray v. Commissioner*, 985 F.2d 36 (1st Cir. 1993), aff'g on this issue T.C. Memo 1992-27; *Sergeant v. Commissioner*, T.C. Memo 1998-265; *Whitehouse Hotel L.P. v. Commissioner*, 131 T.C. 112 (2009), vac'd and rem'd on other grounds, 615 F.3d 321 (5th Cir. 2010). The taxpayer later appealed from the Tax Court's opinion on remand. In that second appeal, the Fifth Circuit upheld the portion of the Tax Court's order disallowing a significant portion of a tax deduction claimed for the historic conservation easement, but the Fifth Circuit vacated the 40% gross overstatement penalty. In so doing, the Fifth Circuit applied a far lesser standard for the reasonable cause exception to apply to a gross valuation misstatement. 755 F.3d 236 (5th Cir. 2014). Although the decision involved the reasonable cause exception as it applies to the gross valuation misstatement — which no longer is allowed after August 17, 2006 — the reasoning employed by the Fifth Circuit in allowing the reasonable cause exception should also apply to a substantial valuation misstatement, for which a taxpayer may still use the reasonable cause exception.

[757] *See Kellahan v. Commissioner*, T.C. Memo 1999-210.

[758] *Kellahan v. Commissioner*, T.C. Memo 1999-210.

[759] *See, e.g., Whitehouse Hotel L.P. v. Commissioner*, 131 T.C. 112 (2009), vac'd and rem'd on other grounds, 615 F.3d 321 (5th Cir. 2010). Although the value of the easement may be determined by subtracting the value of the underlying real property subject to the easement from the value of the underlying real property before the easement, the value beforehand is just one part of the equation.

[760] *Whitehouse Hotel L.P. v. Commissioner*, 755 F.3d 236 (5th Cir. 2014).

[761] T.C. Memo 2010-207.

[762] *Evans v. Commissioner*, T.C. Memo 2010-207 at n. 16. *Accord Dunlop v. Commissioner*, T.C. Memo 2012-126.

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In subsequent conservation easement cases, the Tax Court appears to pay lip service to the requirement without seeming to actually require a separate good faith investigation. For example, in *Esgar Corp. v. Commissioner*,[763] the Tax Court allowed a reasonable cause exception to a taxpayer who relied on its regular accountant in connection with the grant of a conservation easement. The accountant was familiar with the tax law relating to conservation easements and believed the appraiser "took a reasonable approach to determine value." Similarly, with respect to another conservation easement, the court found reasonable cause because the taxpayer relied on the appraiser and his accountant, who was given a copy of the appraisal found no cause for concern as to its accuracy.[764]

In *Atkinson v. Commissioner*,[765] another conservation easement case, the court determined the taxpayer had reasonable cause based on its reliance on the appraiser and the donee, and the taxpayer's own commercial real estate experience, through which he found no inconsistencies in the appraiser's report. Similarly, the court found that a taxpayer made a good faith investigation of the value of conservation easement where the taxpayer was involved in the negotiations to formulate the conservation plan, relied on the appraisers and believed they used an appropriate valuation methodology, hired a civil engineer to sketch a conservation plan, and was aware of the high demand for land in the area.[766]

The taxpayer in *Schmidt* was found to have established reasonable cause based on an appraisal even though the appraiser relied on dissimilar comparable and ambiguous facts. The court found that it was possible that the appraiser and the taxpayer reasonably believed the analysis, and that the facts could be consistent with a good faith attempt by the taxpayer to determine the proper value.[767]

Comment: In none of the cases, however, was there any evidence that anyone other than the appraiser had any knowledge of the value of the conservation easement that was donated or any independent basis to feel comfortable with the appraisal.

F. Substantial Overstatement of Pension Liability Penalty

The penalty for a substantial overstatement of pension liabilities under §6662(b)(4) is 20% of the portion of the underpayment that is attributable to an overstatement of pension liabilities. Such an overstatement occurs only if the actuarial determination of the liabilities taken into account for purposes of computing the employer contribution deduction under §404(a)(1) or (2) is 200% or more of the correct amount of such liabilities (a "substantial overstatement").[768] In addition, the penalty applies only if the underpayment attributable to the overstatement of pension liabilities exceeds $1,000.[769] The penalty is increased from 20% to 40% if the overstatement of pension liabilities is 400% or more of the correct amount of such liabilities.[770]

There is no disclosure exception to this penalty. The reasonable cause exception applies and is discussed at IV.A.4.b., above and XI., below.

The IRS issued guidance on the application of the penalty for the substantial overstatement of pension liabilities under former §6659A, and this guidance is generally applicable to the §6662(b)(4) penalty. In Notice 89-47, the IRS clarified that pension liabilities are overstated when the valuation of such liabilities is based on unreasonable actuarial assumptions or methods that accelerate deductions: (1) in a manner inconsistent with the funding regulations under §412; (2) by taking into account benefits that exceed the §415 limitations; or (3) for other reasons based on the facts and circumstances. Reliance on an enrolled actuary or other professional with respect to the proper amount of the deduction does not, by itself, constitute reasonable basis or good faith for purposes of avoiding the application of the penalty. In addition, the 10% excise tax under §4972 (for excess contributions) cannot be offset against the substantial overvaluation penalty.[771]

Example: X corporation filed its income tax return showing taxable income of $300,000 after deducting $80,000 for contributions to a defined benefit pension plan, and an income tax liability of $63,000 based on a 21% income tax rate. Upon audit, the IRS adjusted the interest assumption in connection with valuing the required pension plan contributions, and disallowed $45,000 of the contribution deduction. The §6662(b)(3) penalty is $1,890, determined as follows:

(1) Pension liability taken into account	$80,000
(2) Correct amount of pension liability	35,000
(3) Percentage (1) divided by (2)	229%
Since the percentage in (3) is at least 200% but less than 400%, the penalty rate is 20%	
(4) Taxable income reported	$300,000
(5) Plus: Disallowed deduction	45,000
(6) Corrected taxable income (4) plus (5)	345,000
(7) Corrected tax (6) multiplied by × 21%	72,450
(8) Less: Tax as reported	(63,000)
(9) Underpayment attributable to overstated pension liability	9,450
(10) Penalty (9) multiplied by 20%	1,890

G. Substantial Estate or Gift Tax Valuation Understatement Penalty

A penalty equal to 20% of the understatement of tax is imposed if the value of any property claimed on a return is 65%

[763] T.C. Memo 2012-35, aff'd on other issues, 744 F.3d 648 (10th Cir. 2014).
[764] *Zarlengo v. Commissioner*, T.C. Memo 2014-161.
[765] T.C. Memo 2015-236.
[766] *McGrady v. Commissioner*, T.C. Memo 2016-233.
[767] *Schmidt v. Commissioner*, T.C. Memo 2014-159.
[768] §6662(f)(1).
[769] §6662(f)(2).
[770] §6662(h)(1), §6662(h)(2)(B).
[771] Notice 89-47.

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or less of the amount determined to be the correct value.[772] The penalty is determined separately for each property.[773] The penalty does not apply unless the portion of the underpayment attributable to the understatement for the taxable period (or, for purposes of the estate tax, the estate) exceeds $5,000.[774] The amount of the penalty is increased to 40% when the value of any property claimed on a return is 40% or less of the correct amount.[775] There is no disclosure exception to this penalty. The reasonable cause exception is discussed at IV.A.4.b., above, and XI., below.

Example: Decedent's estate tax return included the stock of three closely-held corporations, X, Y and Z. On the return, the decedent's stock of X was valued at $200,000, and his stock in Y and Z were each valued at $80,000. On audit, the IRS determined the correct values were $270,000, $190,000 and $330,000, respectively.

X Corporation:	
(1) Reported value of Decedent's X stock	$200,000
(2) Correct value of Decedent's X stock	270,000
(3) Percentage (1) divided by (2)	74%

Since the percentage exceeds 65%, there is not a substantial estate tax valuation understatement penalty with respect to Decedent's X stock.

Y Corporation:	
(1) Reported value of Decedent's stock	$80,000
(2) Correct value of Decedent's Y stock	190,000
(3) Percentage (1) divided by (2)	42%

Since the percentage is 65% or less but more than 40%, the penalty is 20% of the underpayment of the estate tax attributable to the undervaluation of Decedent's Y stock.

Z Corporation:	
(1) Reported value of Decedent's Z stock	$80,000
(2) Correct value of Decedent's Z stock	330,000
(3) Percentage (1) divided by (2)	24%

Since the percentage is 40% or less, the penalty is 40% of the underpayment of the estate tax attributable to the undervaluation of Decedent's Z stock.

H. Lack of Economic Substance Understatement Penalty

1. Economic Substance Doctrine

Taxpayers generally are free to structure their business transactions as they wish, even if motivated in part by a desire to reduce taxes.[776] The economic substance doctrine, however, permits the IRS to disregard a transaction for federal income tax purposes — even one that formally complies with the Code — if it has no effect other than generating an income tax loss.[777] The economic substance doctrine allows courts to enforce the legislative purpose of the Code by preventing taxpayers from reaping tax benefits from transactions lacking economic reality.[778] The court will respect a transaction when it constitutes a genuine, multiparty transaction compelled by business or regulatory realities, with tax-independent considerations that are not shaped solely by tax-avoidance features.[779] Whether a transaction has economic substance is a question of fact[780] on which the taxpayer bears the burden of proof.[781]

The 2010 Health Care and Education Reconciliation Act codified the judicially-created economic substance doctrine by adding §7701(o), which provides that, in a transaction to which the economic substance doctrine is relevant, the transaction will be treated as having "economic substance" only if:[782]

- The transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position (the "objective test"); and
- The transaction has a substantial purpose (apart from federal income tax effects) for entering into the transaction (the "subjective test").

For a further discussion of §7701(o) and the economic substance doctrine in general, see 508 T.M., *The Economic Substance Doctrine.*

[772] §6662(b)(5), §6662(g)(1).
[773] §6662(b)(5), §6662(g)(1); IRM 20.1.5.12.2(1) (01-24-12).
[774] §6662(g)(2).
[775] §6662(h), §6662(h)(2)(C).
[776] *Gregory v. Helvering*, 293 U.S. 465 (1935).
[777] *See, e.g., Knetsch v. United States*, 364 U.S. 361 (1960); *Daichman v. Commissioner*, T.C. Memo 2020-126.
[778] *Klamath Strategic Inv. Fund, LLC v. United States*, 568 F.3d 537, 543 (5th Cir. 2009); *Daichman v. Commissioner*, T.C. Memo 2020-126
[779] *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).
[780] *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950).
[781] *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), cert. denied, 549 U.S. 1206 (2007).
[782] §7701(o).

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2. Section 6662(b)(6) Strict Liability Penalty

Section 6662(b)(6) imposes a strict liability penalty attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance within the meaning of §7701(o) or failing to meet the requirements of any similar rule of law. For purposes of §6662(b)(6), a "similar rule of law" means a rule or doctrine that disallows the income tax benefit for the same reason as the economic substance doctrine — because the transaction does not change the taxpayer's economic position in a meaningful way apart from federal income tax effects, or the taxpayer did not have a substantial business purpose apart from federal income tax effects for entering into the transaction — even if a different term (e.g., sham transaction, substance over form or step transaction) is used to describe the rule.[783] In other words, "similar rule of law" means a rule or doctrine that applies the same factors and analysis that is required under §7701(o) for an economic substance analysis. Notwithstanding the foregoing, pending further guidance, the IRS announced that it will not apply the §6662(b)(6) penalty or otherwise argue that a transaction is described in §6662(b)(6) unless it also raises §7701(o) to support the underlying adjustment.[784] In addition, Code sections and Treasury regulations (other than §7701(o) and the regulations thereunder) that disallow tax benefits are not considered similar rules of law for this purpose.[785]

The penalty is increased to 40% for any portion of the understatement that is attributable to such a transaction if the relevant facts affecting the tax treatment are not adequately disclosed in the return or in a statement attached to the return.[786] Disclosure will be considered adequate for purposes of §6662(i)(2) if the taxpayer adequately discloses the relevant facts on a Form 8275 (Disclosure Statement), Form 8275-R (Regulation Disclosure Statement), or as otherwise prescribed on a timely filed original return (including extensions of time to file) or a qualified amended return.[787]

Note: In CCA 202244010, the IRS Chief Counsel addressed whether a taxpayer has adequately disclosed a noneconomic substance transaction for purposes of §6662(i) where the material facts are disclosed as reportable transactions on Form 8886 but are not separately disclosed on Form 8875 as required by Notice 2010-62. The IRS Chief Counsel concluded that disclosure on Form 8886 only is sufficient to avoid the 40% penalty. The IRS Chief Counsel explained that while Notice 2010-62 imposes an obligation to file Form 8275, such directive did not have the force and effect of law in the absence of regulations requiring Form 8275 to disclose a noneconomic substance transaction, and, under relevant case law addressing adequate disclosure,[788] a taxpayer would have a strong argument that filing Form 8886 with a timely filed return or qualified amended return would adequately inform the IRS of the transaction consistent with the requirements of §6662(i).

The IRS will treat a complete and accurate disclosure on a Form 1120 Schedule UTP (Uncertain Tax Position Statement), as if it is disclosed on a Form 8275 or Form 8275-R.[789] Disclosure that would be adequate under §6662(d)(2)(B) (without regard to §6662(d)(2)(C)) before the enactment of §6662(i) is deemed adequate for purposes of §6662(i)(2).[790] In addition, for tax year 2021 and later years, disclosure under Rev. Proc. 2022-39 made on a properly completed Form 15307, *Post-Filing Disclosure for Specified Large Business Taxpayers*, is taken in account for purposes of §6662(i).[791]

In the case of a transaction lacking economic substance that is a reportable transaction, the adequate disclosure requirement of §6662(i)(2) will be satisfied only if the taxpayer also meets the disclosure requirements under Reg. §1.6011-4(d).[792] Disclosure in an amended returns and supplemental information filed after the taxpayer is first contacted by the IRS regarding an examination of the return, or such other date as is specified by the IRS, is not taken into account in determining whether adequate disclosure has been made.[793]

On April 22, 2022, the IRS issued updated guidance for the economic substance doctrine and related penalties.[794] The guidance removed the requirement to seek executive approval before asserting the §6662(b)(6) and §6662(i) penalties in order to align the economic substance penalty process with the process for similar assessable penalties. Supervisor approval under §6751(b) is still required.[795] Additionally, review by Area Counsel is mandatory for any notice of deficiency asserting the economic substance doctrine under §7701(o), and the related penalties under §6662(b)(6) and §6662(i).[796]

According to LB&I-04-0422-0014, before applying the economic substance doctrine, Exam should consider all substantive arguments and technical analysis that are reasonably relevant to the proper tax treatment of the transaction. Generally application of the economic substance doctrine may be appropriate where the:

- Transaction is highly structured.
- Transaction includes unnecessary steps.
- Transaction is not at arm's length with unrelated third parties.
- Transaction creates no meaningful economic change on a present value basis (pre-tax).

[783] H.R. Rep. No. 111-443 at 304 (2010).

[784] Notice 2014-58, *amplifying* Notice 2010-62.

[785] Notice 2014-58, *amplifying* Notice 2010-62.

[786] §6662(i)(1), §6662(i)(2).

[787] Notice 2010-62, *amplified by* Notice 2014-58. Qualified amended returns are discussed at IV.A.3.b., above.

[788] *See, e.g., Elliott v. Commissioner*, T.C. Memo 1997-294; *Estate of Reinke v. Commissioner*, T.C. Memo 1993-197, *aff'd*, 46 F.3d 760 (8th Cir. 1995).

[789] Instructions to Form 1120 Schedule UTP; IRM 20.1.5.8.2.1(1) (01-24-12).

[790] Notice 2010-62, *amplified by* Notice 2014-58. See discussion at IV.C.4., above.

[791] Notice 2010-62, *amplified by* Notice 2014-58. *See* Rev. Proc. 2022-39, §4, §5, *obsoleting* Rev. Proc. 94-69. Rev. Proc. 2022-39 is generally effective for examinations of eligible taxpayers that began after November 16, 2022. Rev. Proc. 94-69 continues to apply to eligible taxpayers in LCC and CIC cases for tax years before 2021.

[792] Notice 2010-62, *amplified by* Notice 2014-58.

[793] §6662(i)(3).

[794] LB&I-04-0422-0014 (April 22, 2022) (interim guidance for IRM 4.46.4, IRM 4.10.13, and IRM 20.1.5).

[795] *See* XII.A., below.

[796] *See* IRM 4.8.9.10.2.1 (01-10-23).

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• Taxpayer's potential for gain or loss is artificially limited.

• Transaction accelerates a loss or duplicates a deduction.

• Transaction generates a deduction that is not matched by an equivalent economic loss or expense, including artificial creation or increase in basis of an asset.

• Taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of the transaction.

• Transaction involves a tax-indifferent counterparty that recognizes substantial income.

• Transaction results in separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years.

• Transaction has no credible business purpose apart from federal tax benefits.

• Transaction has no meaningful potential for profit apart from tax benefits.

• Transaction has no significant risk of loss.

• Tax benefit is artificially generated by the transaction.

• Transaction is pre-packaged.

• Transaction is outside the taxpayer's ordinary business operation.

However, even if those facts and circumstances exist, the economic substance doctrine may not be appropriate if the transaction that generates targeted tax incentives is, in form and substance, consistent with Congressional intent in providing the incentives.

If after consideration Exam believes it is appropriate to apply the economic substance doctrine, Exam must consult with local field Counsel if the issue/case is novel and/or significant or the issue has required or will require significant resources to address.[797] Field Counsel will then coordinate with Division Counsel and the appropriate Associate Chief Counsel Office to determine if applying the economic substance doctrine is appropriate, then will provide advice to Exam.[798]

3. *Exceptions to Lack of Economic Substance Understatement Penalty*

There is no reasonable cause exception to the §6662(b)(6) penalty.[799] Similarly, the reasonable cause exception for the reportable transaction understatement penalty under §6662A does not apply to the portion of the reportable transaction understatement that is attributable to a transaction that lacks economic substance under §7701(o) or fails to meet the requirements of any similar rule of law.[800] As a result, there is "strict liability" for the penalty.

Comment: By limiting the application of the §6662(b)(6) penalty to instances in which §7701(o) is expressly invoked pending further guidance,[801] strict liability does not apply to any transaction that is deemed to lack economic substance based on a "similar rule of law." As a result, the IRS currently allows reasonable cause and good faith reliance defenses against a §6662(b)(6) penalty in cases which are based solely on judicial doctrines other than a lack of economic substance under §7701(o) (e.g., transactions that are disallowed under the substance over form or step transaction doctrine). The §6662(b)(6) penalty does not apply to any portion of the underpayment on which a fraud penalty under §6663 is imposed.[802] In addition, if the 40% penalty for nondisclosed noneconomic substance transactions under §6662(i) applies, the §6662A penalty will not also apply.[803]

The valuation understatement penalty does not make the §6662(b)(6) penalty superfluous.[804] The latter covers all sham transactions, including those that do not cause a taxpayer to misrepresent value or basis, and thus can apply in situations where the valuation misstatement penalty cannot. While both penalties could apply to a sham transaction, Congress addressed such possibility by providing that only one accuracy-related penalty may apply to the same underpayment.

I. Undisclosed Foreign Financial Assets Understatement Penalty

A 40% accuracy-related penalty applies to underpayments attributable to undisclosed foreign financial assets.[805] The term "undisclosed foreign financial asset" means, with respect to any tax year, any asset that is subject to information reporting requirements under §6038, §6038B,[806] §6038D, §6046A and §6048 for such tax year for which the required information was not provided by the taxpayer.[807] An understatement is considered attributable to an undisclosed foreign financial asset if it is attributable to any transaction involving such asset.[808] For example, if a taxpayer fails to disclose amounts held in a foreign financial account under §6038D, any underpayment of tax related to the transaction that gave rise to the income would be subject to the penalty provision, as would any underpayment related to interest, dividends or other returns accrued on such undisclosed amounts.[809] The undisclosed foreign financial asset

[797] Novel or significant issues include, but are not limited to, issues of importance to tax administration (*ex*., care of first impression), one affecting large numbers of taxpayers or an industry, or one falling within an operating division's major strategic goal. LB&I-04-0422-0014.

[798] LB&I-04-0422-0014.

[799] §6664(c)(2).

[800] §6664(d)(2). The penalty for reportable transaction understatements is discussed in 648 T.M., *Reportable Transactions.*

[801] See discussion at IV.H.2., above.

[802] §6662(b) (flush language).

[803] §6662A(e)(2)(B).

[804] *United States v. Woods*, 134 S. Ct. 557 (2013).

[805] §6662(b)(7), §6662(j).

[806] Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act," Under Consideration by the Senate (JCX-4-10), Feb. 23, 2010 ("2010 HIRE Act Blue Book") n.251, lists §6038A (relating to information reporting by certain 25% foreign-owned corporations), rather than §6038B (relating to reporting certain information upon the transfer of property to a foreign corporation), in the list of provisions covered by the new rule. However, the statutory provision, which includes §6038B rather than §6038A, should control. If §6038A is intended to be covered, then a technical correction seems necessary.

[807] §6662(j)(2). These reporting requirements are discussed at X., below.

[808] §6662(j)(1).

[809] 2010 HIRE Act Blue Book.

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penalty is subject to the same exceptions as are otherwise available under §6662.[810]

Comment: Unlike other accuracy-related penalties, this penalty is imposed at the higher 40% rate, even where there has not been a substantial underpayment or omission.

Penalties for failing to file the informational reports under §6038, §6038B, §6038D, §6046A and §6048 are discussed further at X., below.

J. Inconsistent Estate Basis Penalty

1. Penalty

Section 6662(b)(8) imposes an accuracy-related penalty equal to 20% of any underpayment that is attributable to inconsistent estate basis. For this purpose, there is an "inconsistent estate basis" to the extent a portion of the underpayment is attributable to the failure to comply with §1041(f).[811] The proposed regulations conform the penalty to the consistency rules described above.[812] The reasonable cause exception is discussed at IV.A.4.b., above, and XI., below.

2. Consistency Rules

Under §1014(f),[813] the tax basis of any property acquired from a decedent whose inclusion in the decedent's gross estate increases his estate tax, cannot exceed:

- The value of the property shown on the decedent's estate tax return, if such value is not contested by the IRS before the expiration of the statute of limitations for assessment;
- The value of the property as determined by the IRS if such determination is not timely contested by the executor of the estate; and
- The value as determined by a court or pursuant to a settlement agreement with the IRS.

Comment: Because the consistency rule only applies if inclusion of the property in the gross estate would increase the federal estate tax, it does not apply if an estate tax return is not required to be filed.[814]

The proposed regulations clarify that the limitation applies only to the initial tax basis of the property; it does not limit adjustments to the basis of the property permitted by other sections of the Code as a result of post-death events.[815] In addition, the proposed regulations clarify that before the final determination of value, the taxpayer may not claim an initial basis greater than the value reported on the estate tax return.[816] Property that is not included on a required estate tax return, or an amended estate tax return filed before the expiration of the statute of limitations on assessment, is deemed to have a zero value, and therefore no basis, unless the value is otherwise determined by the IRS within the assessment period.[817]

Property is covered by §1014(f) only if including the value of the property in the decedent's gross estate increases the estate tax after reduction of allowable credits (other than the credit for prepayment of the estate tax).[818] Accordingly, the provision does not apply to property that qualifies for an estate charitable deduction under §2055 or a marital deduction under §2056 or §2056A, subject to the consistency rule.[819] Section 1014(f)(4) allows the IRS to prescribe regulatory exceptions to the consistency rule. The proposed regulations would do that by treating tangible personal property for which an appraisal is not required under Reg. §20.2031-6(b) (generally household and personal effects having artistic or intrinsic value of $3,000 or less) as not increasing the estate tax, and therefore is excluded from the consistency rules.[820]

The consistency rules also apply to property the basis of which is determined in whole or in part by reference to the basis of property subject to the rules.[821]

The executor must report the estate tax value of any property to both the IRS and each person acquiring a beneficial interest in the property.[822] The statement must be furnished at the time prescribed by the IRS, but not later than 30 days after the due date of the estate tax return, including extensions, or 30 days after the estate tax return is filed, whichever occurs first.[823] Section 6035(b) authorizes the IRS to prescribe regulations to carry out its purpose.

K. Erroneous Claim for Refund or Credit Penalty

1. In General

A person that makes a claim for credit or refund of income or employment tax higher than the allowable amount is subject to a penalty under §6676 equal to 20% of the excessive amount, unless an exception applies.[824] The §6676 penalty may apply to any form or document that presents an erroneous claim for refund or credit.[825] The claim may be made formally (e.g., on a tax return) or informally. It may be made on an original return or an amended return.[826] The §6676 penalty may be imposed on multiple claims with respect to the same tax period and the same

[810] See discussion at IV.A.4., above.

[811] §6662(k). See discussion at IV.J.1., above.

[812] Prop. Reg. §1.6662-8, REG-127923-15 (Mar. 4, 2016), generally effective after publication of final regulations, although taxpayers are permitted to rely on the proposed regulations.

[813] See discussion of the consistency rules at 560 T.M., *Income Tax Basis: Overview and Conceptual Aspects.*

[814] §6018(a).

[815] Prop. Reg. §1.1014-10(a)(2), REG-127923-15 (Mar. 4, 2016). The proposed regulations generally are effective after publication as final regulations, but taxpayers are permitted to rely on the proposed regulations before such time.

[816] Prop. Reg. §1.1014-10(c)(2).

[817] Prop. Reg. §1.1014-10(c)(3). In such case, the final value is the value determined by the IRS or by a court or settlement agreement, as applicable. Prop. Reg. §1.1014-10(c).

[818] Prop. Reg. §1.1014-10(b)(3).

[819] Prop. Reg. §1.1014-10(b)(2).

[820] Prop. Reg. §1.1014-10(b)(2).

[821] Prop. Reg. §1.1014-10(b)(1).

[822] §6035(a). The reporting rules are discussed at 822 T.M., *Estate, Gift, and Generation-Skipping Tax Returns and Audits* (Estate, Gifts and Trust Series).

[823] §6035(a)(3). The due date for any statement was extended until June 30, 2016. Notice 2016-27. *See* T.D. 9797, 81 Fed. Reg. 86,953 (Dec. 2, 2016).

[824] §6676(a), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70605(f), applicable to claims for credit or refund after July 4, 2025.

[825] IRM 20.1.5.18.3.

[826] PMTA 2014-15.

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taxpayer.[827] The IRS will also consider the penalty when all or part of a research and development tax credit is disallowed.[828]

In addition to a §6676 penalty, any promoter of the employee retention tax credit for employers due to COVID under §3134 (COVID-ERTC) is subject to a $1,000 penalty for each failure to comply with due diligence requirements for determining eligibility or the amount of any credit or advance payment of the credit.[829]

2. Exceptions to Erroneous Claim Penalty

a. Reasonable Cause or Reasonable Basis

The penalty does not apply if it can be shown that the claim for the excessive amount was due to reasonable cause.[830] For claims filed on or before December 16, 2015, the exception requires a showing that there was a reasonable basis for the excessive amount.[831] To the extent the excessive amount is attributable to the disallowance of claimed tax benefits by reason of a transaction lacking economic substance within the meaning of §7701(o) or failing to meet the requirements of any similar rule of law, it is deemed not due to reasonable cause or a reasonable basis.[832]

For this purpose, reasonable cause considers whether the taxpayer exercised ordinary business care and prudence.[833]

Comment: The change from the objective reasonable basis exception to a subjective reasonable cause exception had been recommended by, among others, the National Taxpayer Advocate for years.[834] Imposing a penalty without taking into account the taxpayer's particular facts and circumstances was considered to impair their right to a fair and just tax system.

For pre-2015 penalty purposes, although reasonable basis is not defined, the IRS has stated that, because the §6676 penalty is intended to supplement the §6662 accuracy-based penalties, it generally has the same meaning.[835] Accordingly, reasonable basis generally is a relatively high standard that is significantly higher than not frivolous or not patently improper, but does not have to be supported by substantial authority. A return position that is merely arguable or that is merely a colorable claim does not qualify. Generally, there is a reasonable basis for a return position that is reasonably based on one or more of the authorities set forth in Reg. §1.6662-4(d)(3)(iii), taking into account the relevance and persuasiveness of the authorities and subsequent developments.[836]

In *Exxon Mobil Corp. v. United States*,[837] a case involving the pre-2015 version of the §6676 penalty, the IRS, citing *Wells Fargo & Co. v. United States*,[838] argued that the court should overlay a subjective element on the reasonable basis defense, essentially meaning that the taxpayer had to show that it actually relied on relevant authorities in forming its position for the refund claim. The district rejected this approach. The court found that importing the *Wells Fargo* holding from §6662 into pre-2015 §6676 would have required the court to inherently focus on the taxpayer's subjective conduct, whereas it interpreted pre-2015 §6676 to be focused on whether the *claim* had a reasonable basis, not whether the *taxpayer* had a reasonable basis. The court also found that the legislative history underlying §6676 also counseled against extending the *Wells Fargo* holding to pre-2015 §6676 because there would have been no reason to have amended §6676 in 2015 to provide for a subjective standard if the provision already embodied such a standard.

In the case of a married couple filing a joint claim, the reasonable basis exception must be applied jointly. Since the penalty is assessed and collected in the same manner as the tax, the parties are jointly and severally liable. As a result, one spouse cannot qualify for the exception if the other does not.[839]

Comment: Presumably, the same rationale applies to the new reasonable cause exception.

b. Coordination with Other Penalties

The §6676 penalty does not apply to any portion of the excessive amount which is subject to an accuracy-related penalty under §6662 or §6662A or a fraud penalty under §6663.[840]

Comment: For returns filed before December 18, 2015, a disallowed claim of a refundable credit in excess of the tax paid created a deficiency, but not an underpayment of tax.[841] As a result, no accuracy-related penalty or fraud penalty could be imposed. The 2015 PATH Act amendment conforms the definition of an underpayment to the definition of a deficiency, so that in such situation, there will be a deficiency as well as an underpayment of tax. According to IRS Chief Counsel's Office, as a result of such change, "disallowed refundable credits … will no longer be subject to penalty under section 6676, but will instead be subject to penalty under section 6662, 6662A and 6663."[842] But the mere fact of an underpayment is not sufficient to impose a penalty under §6662, §6662A or §6663. For example, what if the underpayment is not attributable to negligence or disregard of the rules and regulations, does not amount to a substantial understatement of income tax, is not attributable to a transaction that lacks economic substance or a similar rule of law, is not attributable to a reportable transac-

[827] IRM 20.1.5.18.3.1.

[828] LMSB-4-0608-035.

[829] *See* the OBBBA, §70605(a), applicable to COVID-ERTC promoter aid, assistance, and advice provided after July 4, 2025. For further discussion of the COVID-ERTC promoter penalty, see VIII.E., below.

[830] §6676(a).

[831] Former §6676(a).

[832] Former §6676(a). The economic substance requirement and §6662(b)(6) penalty is discussed at IV.H., above.

[833] IRM 20.1.5.18. See discussion at IV.A.4.b., above, and XI., below.

[834] National Taxpayer Advocate, Annual Report to Congress (Legislative Recommendation: Amend the Erroneous Refund Penalty to Permit Relief in Case of Reasonable Cause for Claim to Refundable Credits) at 544 (Dec. 31, 2011), National Taxpayer Advocate, *Annual Report to Congress (Legislative Recommendation: Amend Section 6676 to Permit Reasonable Cause Relief)* at 351 (Dec. 31, 2014); AICPA Legislative Proposals, Tax Penalty Legislative Proposals (Apr. 11, 2013); 2015 IRSAC Large Business and International Report.

[835] PMTA 2014-15; IRM 20.1.5.18(10).

[836] *See* Reg. §1.6662-3(b)(3). See discussion at IV.B.3.a., above.

[837] 513 F. Supp. 3d 734 (N.D. Tex. 2021), *aff'd*, 43 F.4th 424 (5th Cir. 2022). The district court in *Exxon Mobil Corp.* noted that Exxon's sale versus lease position in its refund claim was reasonably based on one or more of the authorities set forth in Reg. §1.6662-4(d)(3)(iii).

[838] 957 F.3d 840 (8th Cir. 2020).

[839] PMTA 2010-03.

[840] §6676(d). The accuracy-related penalties and the fraud penalty are discussed at IV., above, and V., below, respectively.

[841] Former §6664(a); *Rand v. Commissioner*, 141 T.C. 376 (2013).

[842] CCA 201607027.

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tion, and does not rise to the level of fraud? In that case, the §6676 penalty should still be able to be imposed on the erroneous claim for refund.

Other than the accuracy-related penalties under §6662 or §6662A and the fraud penalty under §6663, the §6676 penalty is in addition to other penalties.

c. Earned Income Credit

For claims filed on or before December 18, 2015, the §6676 penalty does not apply to claims for refund or credit relating to the earned income credit.[843]

3. Assessment of Erroneous Claim Penalty

The §6676 penalty generally may be assessed within three years after the date of the erroneous claim for refund or credit.[844] The procedural requirements of §6751(a) apply, including obtaining supervisor approval, and the notice to the taxpayer include the excessive amount giving rise to the penalty, the formula for the penalty and the amount of the penalty.[845]

Comment: The deficiency procedures apply to a penalty for an erroneous claim for a refund or credit under §6676 only if the penalty is dependent on the determination of an underlying deficiency.[846] For example, if a claim for refund of a refundable credit in excess of the tax paid is disallowed, the imposition of a §6676 penalty is subject to the deficiency procedures. IRS Chief Counsel ruled that the 2015 PATH Act, which conformed the definition of an underpayment of tax under §6664(a) to the definition of a deficiency under §6211(b)(4) with respect to the treatment of refundable penalties, eliminates situations where the determination of the §6676 penalty is dependent on the determination of a deficiency, because such situations would be subject to a penalty under §6662, §6662A or §6663, and therefore the penalty under §6676 may not be imposed.[847] However, it seems there are still situations where an accuracy-related penalty or fraud penalty would not apply, and a §6676 penalty could be imposed.

In other cases, the penalty may be assessed immediately, without regard to the deficiency procedures.[848] Pre-assessment appeal procedures generally apply.[849] Otherwise, the taxpayer must pay the penalty, and file a claim for refund with the IRS. If the claim is denied, the taxpayer may seek a review in a U.S. district court or in the federal court of claims.[850]

L. Appraiser Penalties

A person who prepares an appraisal of property and who knows or reasonably should know that the appraisal will be used in connection with filing a return or refund claim may be subject to an accuracy-related penalty under §6695A, in addition to penalties imposed on the taxpayer.[851] If the claimed value of the property on a taxpayer's return or claim for refund based on the appraisal results in a substantial valuation misstatement under §6662(e), a substantial estate or gift valuation overstatement under §6662(g), or a gross valuation misstatement under §6662(h), to the taxpayer with respect to the property, the appraiser is subject to a penalty equal to the lesser of:[852]

- $1,000 or 10% of the amount of the taxpayer's underpayment of tax attributable to the misstatement, whichever is greater, or
- 125% of the gross income derived by the appraiser from the preparation of the appraisal.

The penalty, however, does not apply if the appraiser can establish to the satisfaction of the IRS that the appraised value was more likely than not the proper value.[853]

Comment: There is no requirement that the appraiser know that the taxpayer's use of the appraisal will result in an understatement of tax, as there is in the §6701 penalty for aiding and abetting.[854] Of course, the appraiser should know that would be the result if he did not at least believe that his appraisal more likely than not set forth the proper value.

The penalty is in addition to any other penalty that may be imposed.[855] Although an appraiser may be a tax return preparer,[856] the IRS has announced, that it will not impose both a preparer penalty under §6694 and an appraiser penalty under §6695A on an appraiser with respect to the same conduct.[857] Moreover, the penalty can be assessed and collected immediately; the deficiency procedures do not apply.[858]

The appraiser penalty may be assessed at any time within three years after the date the return or claim refund with respect to which the penalty is assessed was filed (or the due date of the return if it was filed early).[859] The appraiser may claim a refund

[843] Former §6676(a).

[844] IRM 20.1.5.18.2 (04-22-19). *See* CCA 202044007 (where taxpayer fraudulently claimed substantial amount of false withholdings, assessment may occur more than three years after claim).

[845] PMTA 2014-20. The requirements of §6751(a) are discussed at XII.A.1., below.

[846] PMTA 2014-20; CCA 201520005; IRM 20.1.5.18(7) (08-31-21), IRM 20.1.5.18.4(1) (04-22-19). With the 2015 amendment to the definition of an underpayment, however, it is more likely that an accuracy-related penalty or fraud penalty will apply. In such case, the §6676 penalty cannot be imposed. See discussion at IV.K.2.b., above.

[847] CCA 201607027. See discussion at IV.K.2.b., above.

[848] PMTA 2014-20; CCA 201538019; IRM 20.1.5.18.4(2) (04-22-19), IRM 20.1.5.18.5 (08-31-21).

[849] IRM 20.1.5.18.7 (12-13-16).

[850] IRM 20.1.5.18.7 (12-13-16).

[851] §6695A. Conclusory allegations that a person assisted in appraisals are insufficient to support a claim that the person is liable as an appraiser under §6695A. *United States v. Zak*, 1:18-cv-05774-AT, 2019 BL 501507 (N.D. Ga. Dec. 10, 2019).

[852] §6695A(a), §6695A(b). Substantial valuation misstatements, substantial estate or gift tax valuation misstatements, and gross valuation misstatements are described at IV.E. and IV.G., above.

[853] §6695A(c). *See* CCA 202129009 (Chief Counsel advised §6695A(c) is exception to §6695A, not rule requiring IRS to send Letter 4477, send an IDR, or to conduct interview with appraiser before assessment).

[854] The appraiser's declaration required by Reg. §1.170A-13(c)(5)(i) must include a statement that the appraiser understands that a substantial or gross valuation misstatement resulting from the appraisal that the appraiser knows or should reasonably have known would be used in connection with a return or claim for refund may subject the appraiser to a penalty under §6695A. Section 6701 is described at VIII.B., below.

[855] §6696(a). The IRS may also discipline an appraiser under 31 U.S.C. §330.

[856] See discussion at VII.B.1., below.

[857] Preamble to T.D. 9436, 73 Fed. Reg. 78,429 (Dec. 22, 2008). The §6694 preparer penalty is described at VII.C., below.

[858] §6696(b).

[859] §6696(d)(1).

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of any overpayment of the appraiser penalty within three years after the penalty was paid.[860] The claim may only be filed by the appraiser against whom the penalty was assessed.[861] The claim is made on Form 843 (Claim for Refund and Request for Abatement)[862] with the IRS office that issued the notice and demand for the appraiser penalty.[863] The claim must include a statement under penalties of perjury, setting forth: the appraiser's name, address on the notice and demand (and if different, the appraiser's address on the appraisal) and TIN; the address of the IRS office that issued the notice and demand, and the date and identifying number on such notice and demand; the identification (by amount, type and related document) of each penalty included in the claim; and a detailed statement of each ground upon which the claim is based and facts related thereto. A separate claim must be filed for each appraiser penalty.[864] A timely claim for refund is a prerequisite for a refund suit.[865] Interest is payable on such refund.[866]

The IRS may, within the applicable limitations period, credit any overpayment of appraiser penalty against any outstanding tax, interest, additional amounts, addition to tax or assessable penalty owed by the appraiser. In such case, only the remaining balance of the overpayment will be refunded.[867]

M. Overstatement of Qualified Charitable Contribution Penalty

A 50% accuracy-related penalty applies to underpayments attributable to one or more overstatements of the §170(p) deduction for qualified charitable contributions.[868] Under §170(p), for tax years beginning after 2025 and in 2021, individuals who do not elect to itemize deductions are permitted a charitable contribution deduction for qualified contributions up to a maximum of $1,000 ($2,000 joint return filers) in tax years beginning after 2025 ($300 ($600 joint return filers) in tax years beginning in 2021).[869]

For further discussion of §170(p) and charitable contributions, see 521 T.M., *Charitable Deductions and Contributions.*

Comment: Unlike other accuracy-related penalties, this penalty is imposed at the higher 50% rate, even where there has not been a substantial underpayment or omission.

N. Syndicated Conservation Easement Penalty

A 40% accuracy-related penalty for gross valuation misstatement applies to any disallowance of a deduction for a syndicated conservation easement (SCE).[870] A syndicated conservation easement is a qualified conservation contribution made by, or allocated to, a partnership or S corporation (whether directly or as a distributive share of a contribution of another partnership or S corporation) that exceeds 2.5 times the sum of each partner's or shareholder's "relevant basis" in the partnership or S corporation.[871] There is no reasonable cause exception to the penalty for disallowed SCE deductions; thus, it is a strict liability penalty.[872] The accuracy-related penalty for SCEs is also exempt from the supervisory approval requirement.[873] The limitation on deduction for qualified conservation contributions made by partnerships and other pass-through entities is discussed in 521 T.M., *Charitable Contributions: Income Tax Aspects.*

O. Penalty for Substantial Misstatements on Supplier Certifications

A penalty equal to the greater of 10% of the underpayment of tax or $5,000 is imposed if a person provides an inaccurate or false supplier certification with respect to:

1. a manufactured product, eligible component, or constituent element, material; or

2. a subcomponent of an eligible component

if the inaccuracy results in the disallowance of an applicable energy credit and an understatement of tax exceeding the lesser of 5% of the tax required to be shown on the return or $100,000.[874]

Certifications covered by the penalty are those speaking to:

- total direct costs or total direct material costs of a product or component that was not produced or manufactured by a prohibited foreign entity; or

- whether a product or component was not produced or manufactured by a prohibited foreign entity.[875]

For discussion of supplier certifications for applicable energy credits, see 512 T.M., *Tax Incentives for Production and Conservation of Energy and Natural Resources.*

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[860] §6696(d)(2).

[861] Reg. §1.6696-1(b).

[862] Reg. §1.6696-1(e).

[863] Reg. §1.6696-1(f).

[864] Reg. §1.6696-1(c).

[865] Reg. §1.6696-1(j).

[866] Reg. §1.6696-1(i).

[867] Reg. §1.6696-1(h).

[868] §6662(b)(9), §6662(l).

[869] §170(p), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70424, applicable to tax years beginning after Dec. 31, 2025.

[870] §6662(b)(10) (reference to §170(h)(7)), added by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T §605(a)(2)(A), applicable to contributions made after December 29, 2022; §6662(h)(2)(D), added by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T §605(a)(2)(B), applicable to contributions made after December 29, 2022.

[871] §170(h)(7), added by SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T §605(a)(1), applicable to contributions made after December 29, 2022; Reg. §1.170A-14(j), applicable to contributions made after December 29, 2022. See Reg. §1.170A-14(j)(6) for examples. See Reg. §1.170A-14(k) for the determination of "relevant basis." See Reg. §1.170A-14(n) for exceptions.

[872] §6664(b)(2), as amended by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T §605(a)(2)(C), applicable to contributions made after December 29, 2022.

[873] §6751(b)(2)(A), as amended by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T §605(a)(2)(D), applicable to contributions made after December 29, 2022.

[874] §6695B, added by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70512(k)(1), applicable to certifications provided after December 31, 2025.

[875] §7701(a)(52)(D)(iii)(II)(bb), added by the OBBBA, §70512(c), effective for tax years beginning after July 4, 2025.

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V. Fraud Penalty

A. Statutory Provisions

Section 6663(a) provides that if any part of any underpayment of tax required to be shown on a return is due to fraud, a penalty is imposed equal to 75% of the portion of the underpayment attributable to fraud.[876] The civil fraud penalty applies to any tax for which a return is required to be filed, which includes income, estate and gift taxes.[877] When a joint return is filed, the penalty does not apply to a spouse unless some part of the underpayment is due to the fraud of that spouse.[878]

As discussed earlier, the accuracy-related penalties do not apply to any portion of an underpayment on which the fraud penalty is imposed.[879] In addition, the fraud penalty — like the accuracy-related penalty — applies only when a return has been filed,[880] and is subject to the standardized definition of an underpayment[881] and the standardized reasonable cause exception.[882]

In addition, a taxpayer cannot receive a credit against civil fraud additions to tax for criminal fines imposed on that taxpayer. In *Schachter v. Commissioner*,[883] the IRS imposed additions to tax under former §6653(b) on a taxpayer who had been convicted of tax evasion and conspiracy and against whom was imposed a criminal fine. After losing his double jeopardy arguments, the taxpayer argued that the criminal fine should be regarded as remedial and as restitution for civil fraud additions to tax. The Tax Court rejected the argument, explaining that criminal fines and civil fraud additions to tax serve different congressional purposes. The Tax Court also noted that it would substantially frustrate the intent of Congress to make taxpayers responsible for a portion of the government's cost in detecting, investigating, and prosecuting a taxpayer's fraud by allowing the credit. The Ninth Circuit agreed, noting that to allow the taxpayer a credit for the criminal penalty already paid would not be consistent with the idea that tax fraud is subject to both criminal and civil sanctions.

Note: The 1989 Act did not alter the definition of fraud, which is found mostly in case law. There are numerous cases, each decided on its own facts. Accordingly, no attempt is made in the discussion below to cite all of the decided cases.

If a taxpayer files a fraudulent return, the fraud is not cured by subsequent filing of an amended return. The penalty amount will be based on the original fraudulent return.[884]

B. Burden of Proof

If the IRS establishes that any portion of an underpayment is attributable to fraud, the entire underpayment is considered attributable to fraud, except for any portion that the taxpayer establishes (by a preponderance of the evidence) is not attributable to fraud.[885] The IRS must establish by clear and convincing evidence both: (1) that there is an underpayment; and (2) that the underpayment is attributable to fraud.[886]

Thus, the presumption of correctness that attaches to a deficiency determination does not extend to the determination of fraud.[887] Yet, once the IRS has satisfied its burden as to any portion of a deficiency determination, the burden shifts to the taxpayer to establish that some portion of the deficiency was not attributable to fraud.

Note: The IRS's burden to prove fraud by clear and convincing evidence is a lesser standard than the burden to establish willful tax evasion in a criminal proceeding, which must be established beyond a reasonable doubt. Accordingly, the fact that a taxpayer is acquitted in a criminal proceeding does not stop the IRS from successfully asserting the civil fraud penalty.[888] A conviction or guilty plea in the criminal case, however, estops the taxpayer from contesting the civil penalty.[889]

The Tax Court considers the IRS's burden of proof to be satisfied even though the taxpayer fails to appear at trial.[890]

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[876] The 1989 Act redesignated the fraud penalty as §6663, coordinated the fraud penalty with the accuracy-related penalty, and made other modifications. These changes generally apply to returns due (without regard to extensions) after December 31, 1989.

[877] §6663(c). *See, e.g.*, *Estate of Rau v. Commissioner*, 301 F.2d 51 (9th Cir. 1962), cert denied, 371 U.S. 823 (1962); *Estate of Trompeter v. Commissioner*, 111 T.C. 57 (1998), vac'd and rem'd, 279 F.3d 767 (9th Cir. 2002); *Estate of Frost v. Commissioner*, T.C. Memo 1993-94.

[878] §6663(c). *See, e.g.*, *Zwick v. Commissioner*, T.C. Memo 1990-389 (nonfraudulent spouse satisfied "innocent spouse" requirements).

[879] §6662(b) (flush language), §6662A(e)(2)(A). Before the 1989 Act, the fraud penalty was coordinated only with the negligence penalty.

[880] §6664(b). For a discussion of what constitutes a return, see discussion at II.B.3., above. *See Mohamed v. Commissioner*, T.C. Memo 2013-255 (return that was signed only by the taxpayer's business partner, who was not an authorized agent, was not a valid return on which fraud penalty could be based for that year); CCA 201640016 (if there has been no return found to have been filed, the civil fraud penalty cannot be imposed).

[881] *See* §6664; Reg. §1.6664-2. *See also Bachner v. Commissioner*, No. 24-1420, 2025 BL 3565 (7th Cir. 2024) (taxpayer fraudulently overstated withholdings and underreported tax owed, which triggered fake refunds; §6663 penalty applied).

[882] §6664(a) (reference to §6211(b)(4)), §6664(c). Reasonable cause is discussed at XI., below.

[883] 113 T.C. 192 (1999), aff'd, 255 F.3d 1031 (9th Cir. 2001).

[884] *Badaracco v. Commissioner*, 464 U.S. 386 (1984); *Gaskin v. Commissioner*, T.C. Memo 2018-89.

[885] §6663(b). *See, e.g.*, *Sadler v. Commissioner*, 113 T.C. 99 (1999) (full underpayment was subject to fraud penalty where taxpayer, a tax attorney, did not prove any part was not attributable to fraud).

[886] §7454(a); Tax Court Rule 142(b). *See Maciel v. Commissioner*, 489 F.3d 1018 (9th Cir. 2007); *Estate of Lisle v. Commissioner*, 341 F.3d 364 (5th Cir. 2003) (Tax Court erred in determining that government proved deficiency due to fraud by clear and convincing evidence), *per curiam* granting the motion, modifying the order, and remanding the case to strike collaborative report and reinstate special trial judge's report, 431 F.3d 439 (5th Cir. 2006); *Isaacson v. Commissioner*, T.C. Memo 2020-17, *aff'd in unpub. op.*, No. 20-71121, 2022 BL 60073 (9th Cir. Feb. 23, 2022); *In re Wyly*, 552 B.R. 338 (Bankr. N.D. Tex. 2016); *Carreon v. Commissioner*, T.C. Memo 2014-6; *Garavaglia v. Commissioner*, T.C. Memo 2011-228, aff'd, 521 Fed. App'x 476 (6th Cir. 2013); *Prowse v. Commissioner*, T.C. Memo 2006-120. The IRS's burden of proving fraud is not affected by §7491(a), under which the burden of proof may shift to the IRS only if the taxpayer meets certain conditions. Section 7491(a) applies only to the burden to prove factual issues affecting a tax liability imposed by Subtitle A or B of the Code.

[887] *See Anastasato v. Commissioner*, 794 F.2d 884 (3d Cir. 1986); *Zack v. Commissioner*, 692 F.2d 28 (6th Cir. 1982).

[888] *Helvering v. Mitchell*, 303 U.S. 391 (1938).

[889] *See Amos v. Commissioner*, 360 F.2d 358 (4th Cir. 1965). See discussion at V.D.5., below.

[890] *See Smith v. Commissioner*, 91 T.C. 1049 (1988), aff'd, 926 F.2d 1470 (6th Cir. 1991) (IRS satisfied its burden of proof even though no trial was held and no evidence of fraud was formally entered into record); *Grice v. Commissioner*, T.C. Memo 1989-33. *But see Douge v. Commissioner*, 899 F.2d 164 (2d Cir. 1990) (even though Tax Court dismissed proceedings for taxpayer's failure to prepare for trial, fraud not sufficiently established).

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Thus, the fraud penalty may be imposed based solely on the record before the Tax Court where the penalty is properly asserted and approved by a supervisor following an audit and the taxpayer petitions but then fails to further prosecute the case, resulting in an order of default and entry of a decision sustaining the deficiencies and penalties.[891]

Note: IRS procedures require that Area Counsel review cases with fraud penalties before the IRS issues the notice of deficiency.[892] Congress has codified the review requirement by requiring that an IRS supervisor approve the initial determination of an assessment of non-computer-generated penalties.[893]

C. Underpayment Plus Intent

Civil tax fraud is often defined as an intentional wrongdoing on the part of the taxpayer, with the specific purpose of evading a tax known or believed to be owing.[894] There must be both an underpayment and fraudulent intent.[895] In computing the amount of the underpayment, withholding and estimated tax payments are not subtracted from the amount required to be shown on the return.[896]

In a case of first impression, *Estate of Trompeter v. Commissioner*,[897] the Tax Court held that in computing the fraud penalty, an estate's underpayment is determined based on all deductible expenses, including expenses that arise after the filing of the estate tax return. After the court held that the estate was subject to the penalty, the estate calculated its penalty amount based on an underpayment that took into account deficiency interest, trustee's fees, and attorney's fees incurred after the date it filed the estate tax return. The IRS challenged the computation based on the deduction of expenses not reported in the return. In allowing the deduction of those expenses, the court reasoned that the phrase "tax required to be shown on a return" was a rule of classification, not a mandate that all deductible expenses be shown on the filed return.

The amount required to be shown on the return also is determined without regard to subsequent events such as net operating loss carrybacks.[898] A taxpayer who commits fraud by understating his tax liability for a given year, therefore, cannot avoid the penalty on the grounds that a subsequent carryback eliminates the fraud (by eliminating the tax liability) for the prior year.[899] The carryback or carryforward of a fraudulent loss also constitutes fraud in the year the loss is used. For example, a taxpayer is liable for the civil fraud penalty for his 2014 return if he carries back a fraudulent loss on his 2016 return to 2014.[900] Similarly, if the carryback of a legitimate credit is based on a fraudulent overstatement of expenses, the fraud penalty applies in the year the credit carryback is claimed.[901]

In *Elmbrook Home, Inc. v. United States*,[902] the court held that a claim of right adjustment that requires a recomputation of the prior years' taxes under §1341 does not eliminate the underpayments in the prior years for purposes of the fraud penalty. In *Elmbrook Home*, the taxpayer, on timely filed tax returns, claimed deductions to which it knew it was not entitled. After an audit, deficiencies were determined, and fraud penalties were asserted. The taxpayer agreed to these determinations, and paid both the deficiencies and penalties. Subsequently, local authorities determined that certain payments made to the taxpayer in those same years, and included by the taxpayer in gross income, were too large. The taxpayer repaid the excess amounts to the authorities. After eliminating the fraudulent deductions and deducting the amounts required to be repaid, the taxpayer's recomputed tax liability was zero. The taxpayer filed a refund suit, seeking a refund not only of the overpaid tax but also of the fraud penalties. The taxpayer argued that after applying §1341 (which permits the taxpayer in such a situation to recompute income for the year in which amounts received under a claim of right are required to be repaid), there were no "underpayments" for the years in question and therefore no basis for asserting a fraud penalty. The court rejected this argument, stating that it "fails to recognize the basics of fraudulent conduct; the act, per se, when committed, like history, is frozen in time."[903] The fraud was committed when the return was filed, and the later events were of no consequence.

D. Relevant Factors

1. In General

For the fraud penalty to apply, there must be an intentional wrongdoing; the intent required is the specific purpose to evade a tax believed to be owing.[904] The taxpayer must have intended to mislead, conceal, or otherwise prevent collection of such tax-

[891] *See, e.g.*, *Kramer v. Commissioner*, T.C. Memo 2021-16 (fraud penalty properly imposed where taxpayer filed petition but failed to further prosecute his case or respond; court found that taxpayer was deemed to have admitted allegation in his answer that at least parts of his "underpayments of tax for the taxable years 2004 and 2005 are due to fraud with the intent to evade tax" and the additional allegation in the answer that at least parts of his "underpayments of tax for the taxable years 2006, 2007, and 2008 are due to fraud with the intent to evade tax.").

[892] IRM 20.1.5.16.1(5) (04-22-19).

[893] §6751. For a discussion of the §6751(b) requirements, see XII.A., below.

[894] *See Stoltzfus v. United States*, 398 F.2d 1002 (3d Cir. 1968); *Webb v. Commissioner*, 394 F.2d 366 (5th Cir. 1968) (citing *Carter v. Campbell*, 264 F.2d 930 (5th Cir. 1959)); *Avenell v. Commissioner*, T.C. Memo 2012-32 (although taxpayer's diversion of funds resulted in unreported income, there was no fraud because diversion was meant to evade judgment collection rather than taxes).

[895] *Jenkins v. United States*, 313 F.2d 624 (5th Cir. 1963). The way the penalty is calculated, even if the requisite intent can be established without an underpayment, the penalty is $0, since there is no "underpayment attributable to fraud." *See* SCA 1998-032 (Aug. 10, 1998) (civil fraud penalty applies to fraudulent EIC claim under §32 if claim causes an underpayment; underpayment requires that negligently or fraudulently claimed EIC be refunded).

[896] See *Doraman v. Commissioner*, T.C. Memo 1986-203.

[897] 111 T.C. 57 (1998), vacated and remanded, 279 F.3d 767 (9th Cir. 2002) (directing Tax Court to determine whether it needs to revisit conclusions regarding fraud which were based in part on vacated findings), *supplemented by*, T.C. Memo 2004-27 aff'd in part, rev'd in part and remanding the case 170 Fed. App'x 484 (9th Cir. 2006) (fraud conclusions unchanged).

[898] See *Simon v. Commissioner*, 248 F.2d 869 (8th Cir. 1957).

[899] *Simon v. Commissioner*, 248 F.2d at 877 (8th Cir. 1957).

[900] See *Toussaint v. Commissioner*, 743 F.2d 309 (5th Cir. 1984); Rev. Rul. 60-215, *amp'd by* Rev. Rul. 84-106.

[901] *See Arc Elec. Constr. Co. v. Commissioner*, 923 F.2d 1005 (2d Cir. 1991).

[902] 559 F. Supp. 787 (D.R.I. 1983).

[903] *Elmbrook Home, Inc. v. United States*, 559 F. Supp. at 790 (D.R.I. 1983).

[904] *See* V.C., above.

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es.[905] Mere carelessness is not sufficient.[906] The application of "willful blindness" in the civil tax penalty arena is not well developed, but where a taxpayer takes deliberate actions to avoid confirming a high probability of wrongdoing, the government may attempt to charge the taxpayer with knowledge of the critical facts.[907]

Since intent is difficult to establish directly, courts have inferred fraudulent intent from various kinds of circumstantial evidence. Among the factors that courts have cited as indications of fraud are:

- understatement of income;[908]
- inadequate records;
- failure to file tax returns (at all or in a timely manner);[909]
- implausible or inconsistent explanations of behavior;[910]
- concealment of assets or income;[911]
- failure to cooperate with tax authorities;[912]
- engaging in illegal activities;[913]
- attempting to conceal illegal activities;[914]
- dealing in cash;
- pattern of conduct that indicates an intent to mislead;[915]
- lack of credibility in taxpayer's testimony;[916] and
- failure to make estimated tax payments.[917]

In determining fraudulent intent with respect to a corporate taxpayer, the court looks at the fraudulent intent of the corporation's officers.[918]

In evaluating the evidence, courts also consider the education level and sophistication of the taxpayer,[919] and the credi-

[905] *Stoltzfus v. United States*, 398 F.2d 1002 (3d Cir. 1968); *Petzoldt v. Commissioner*, 92 T.C. 661 (1989).

[906] *See Stonecipher v. Commissioner*, T.C. Memo 1988-41; *Palumbo v. Commissioner*, T.C. Memo 1985-566. Underreporting and inadequate records, without more, also does not constitute fraud. *See, e.g., Douge v. Commissioner*, 899 F.2d 164 (2d Cir. 1990); *Bohannon v. Commissioner*, T.C. Memo 2013-122 (although husband's reliance on wife to properly classify expenses that formed basis of return may have been imprudent, it was not "willful blindness"; underpayment was directly attributable to misclassified expenses, not couple's intent to evade tax).

[907] *See, e.g., In re Wyly*, 552 B.R. 338 (Bankr. N.D. Tex. 2016) (taxpayer's spouse not willfully blind when she was unlikely to understand the complex offshore trust system set up by her husband and had no reason to suspect the system was being used to avoid taxation).

[908] *Hutcheson v. Commissioner*, T.C. Memo 2025-1, 2025 BL 89.

[909] *Hutcheson v. Commissioner*, T.C. Memo 2025-1, 2025 BL 89.

[910] *Hutcheson v. Commissioner*, T.C. Memo 2025-1, 2025 BL 89.

[911] *Hutcheson v. Commissioner*, T.C. Memo 2025-1, 2025 BL 89; *Harrington v. Commissioner*, T.C. Memo 2021-95 (taxpayer held accounts in names of shell companies and fictitious entities).

[912] *Hutcheson v. Commissioner*, T.C. Memo 2025-1, 2025 BL 89.

[913] *Hutcheson v. Commissioner*, T.C. Memo 2025-1, 2025 BL 89 (taxpayer engaged in massive embezzlement that resulted in his conviction and imprisonment).

[914] *Hutcheson v. Commissioner*, T.C. Memo 2025-1, 2025 BL 89 ("Mr. Hutcheson took detailed, deliberate steps to conceal his embezzlement.").

[915] *Hutcheson v. Commissioner*, T.C. Memo 2025-1, 2025 BL 89 ("Mr. Hutcheson … repeatedly misrepresented how the plan assets were invested and why the funds were not available to pay distributions… [He] also repeatedly made false statements to plan participants who wanted to know what had happened to their retirements savings."); *Flynn v. Commissioner*, T.C. Memo 2021-43 (taxpayer liable for additions to tax for fraudulent failure to file when taxpayer played active role in convincing victims to invest savings in fraudulent investment scheme, stole their money, repeatedly used false employment and federal tax documents with financial institutions, admitted he failed to report significant amounts of income, included such income on loan applications, used bank accounts, loans, and assets to conceal amounts received from his participation in scheme to defraud investors, gave inconsistent and misleading testimony during federal criminal trial, and asserted and maintained frivolous arguments); *Langer v. Commissioner*, T.C. Memo 2017-92, aff'd by unpub. op., 737 Fed. App'x. 804 (8th Cir. 2018), cert. denied, 139 S. Ct. 1571 (2019) (taxpayers repeatedly concealed income by overstating deductions; explanations were implausible); *O'Neal v. Commissioner*, T.C. Memo 2016-49 (taxpayers disguised personal expenses as business expenses; titled assets in children's names to avoid creditors with judgments against taxpayers; hid promissory notes for misappropriated funds from corporate officers).

[916] *Hutcheson v. Commissioner*, T.C. Memo 2025-1, 2025 BL 89 ("We do not find Mr. Hutcheson credible. Often, his testimony was contradicted by documents in the record and the testimony of credible witnesses."); *Harrington v. Commissioner*, T.C. Memo 2021-95 (inconsistent explanations regarding whereabouts of purported loans and connections with various bank accounts); *O'Neal v. Commissioner*, T.C. Memo 2016-49 (taxpayers provided inconsistent and implausible explanations of behavior; testimonies were not credible in light of lavish lifestyle despite business fallout).

[917] *See, e.g., Toushin v. Commissioner*, 223 F.3d 642 (7th Cir. 2000) (upholding Tax Court's calculation of unreported income of theater operator who skimmed from business and determination that the IRS clearly and convincingly proved that underpayments were due to fraud under former §6653), *aff'g* T.C. Memo 1999-171; *Bradford v. Commissioner*, 796 F.2d 303 (9th Cir. 1986) (listing badges of fraud); *Schwartz v. Commissioner*, T.C. Memo 2016-144 (same); *O'Neal v. Commissioner*, T.C. Memo 2016-49 (same); *Meier v. Commissioner*, 91 T.C. 273 (1988); *The Hicks Co. v. Commissioner*, 56 T.C. 982 (1971), aff'd, 470 F.2d 87 (1st Cir. 1972) (listing the intentional overstatement of expenses and wrongful deductions as a badge of fraud); *Spies v. United States*, 317 U.S. 492 (1943) (setting forth a similar list in the context of a criminal fraud case).

[918] *See Blossom Day Care Ctrs., Inc. v. Commissioner*, T.C. Memo 2021-87 ("A corporation acts only through its officers and cannot escape responsibility for their acts in that capacity."); *Bell Cap. Mgmt., Inc. v. Commissioner*, T.C. Memo 2021-74 ("Where fraud is alleged against a corporate taxpayer, the requisite proof of fraudulent intent is to be found in the acts of its officers, inasmuch as the corporation, being an artificial person created by law, can have no separate intent of its own apart from those who direct its affairs.") (quoting *Benes v. Commissioner*, 42 T.C. 358, 382 (1964), aff'd, 355 F.2d 929 (6th Cir. 1966), *overruled on another issue* by *Truesdell v. Commissioner*, 89 T.C. 1280 (1987)).

[919] *See In re Wyly*, 552 B.R. 338 (Bankr. N.D. Tex. 2016) (taxpayer's wife, though intelligent, was not financially sophisticated; even if she had asked for details about offshore trusts, it is unlikely she would have understood the implications); *Sadler v. Commissioner*, 113 T.C. 99 (1999) (fraud penalty upheld for tax attorney who engaged in fraudulent refund scheme, filing false Forms W-2 to generate money for financially strapped businesses); *Grosshandler v. Commissioner*, 75 T.C. 1 (1980); *Marinzulich v. Commissioner*, 31 T.C. 487 (1958), acq., 1959-1 C.B. 4; *Hutcheson v. Commissioner*, T.C. Memo 2025-1, 2025 BL 89 ("Mr. Hutcheson was a sophisticated, educated taxpayer with nearly 20 years of experience as a fiduciary and held himself out as an expert in independent fiduciary services. He sponsored training programs, wrote articles, and spoke frequently about the importance of fiduciary responsibilities including testimony before the U.S. Congress."); *Blossom Day Care Ctrs., Inc. v. Commissioner*, T.C. Memo 2021-87 (no fraudulent intent where inadequate recordkeeping was due to "sloppiness and a lack of sophistication," taxpayer both understated and overstated gross receipts in different years, and taxpayer cooperated during IRS exam); *Jacoby v. Commissioner*, T.C. Memo 2015-67 (taxpayer worked at an accounting firm and a law firm where he handled some tax matters, but the court found that his involvement in tax was very limited and that he had relied on tax advisors); *Sanchez v. Commissioner*, T.C. Memo 2014-174, aff'd, 671 Fed. App'x 571 (9th Cir. 2016) (court rejected taxpayer's assertions of low proficiency in English and rudimentary education when evidence was clear that he knowingly and intentionally reported only a tiny fraction of his true income).

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bility of the taxpayer's testimony.[920] Each case is decided on its own particular facts, and often no single factor is decisive.

Comment: The so-called "badges of fraud" often cited by the IRS[921] and the courts should not be viewed as an exclusive list for determining whether fraud occurred, a point underscored by the IRS's nonacquiesence in *Norris v. Commissioner*.[922] In *Norris*, the Tax Court, analyzing the 11 badges of fraud outlined in *Niedringhaus v. Commissioner*,[923] and giving each equal weight, tallied its finding, counting four badges in support of fraud, five against, and two "neutral," and concluded that the IRS failed to prove fraud under §6663 despite the fact that the taxpayer earlier had pled guilty to tax evasion under §7201. According to the Chief Counsel's Office, the Tax Court's approach in Norris, when evaluating the evidence, employed an "artificial and rigid system of scoring in place of a consideration of the taxpayer's entire course of conduct as reflected in the entire record." The Chief Counsel's Office noted that the 11 factors identified in *Niedringhaus* are appropriate indicators of fraud, but that the list was not comprehensive. The Chief Counsel's Office opined that fraud may be inferred from any conduct, the likely effect of which would be to mislead or conceal, and that the Tax Court itself recognized other indicators of fraud, including signing false bank loan applications, the use of nominee accounts and filing frivolous proceedings to quash IRS summonses, etc.[924]

The Chief Counsel's Office also considered the Tax Court's decision to "weigh all of the factors equally" erroneous, noting that strong evidence of only a few factors may be enough to prove fraudulent intent.[925]

The Chief Counsel's Office reiterated that the IRS would: (1) continue to evaluate the evidence of fraud by examining all relevant conduct of the taxpayer; (2) follow the guidelines set forth in IRM 25.1.2.3; and (3) continue to argue in Tax Court cases that a fraud determination is based on the taxpayer's entire course of conduct, giving each badge of fraud the weight appropriate to the particular case.

The discussion below addresses some of the more common badges of fraud.

2. *Failure to Report Income*

The failure to report income generally is not, by itself, adequate evidence of fraudulent intent,[926] but the consistent failure to report substantial amounts of income over a number of years may be a controlling factor in establishing fraud.[927] A fraud penalty based on the failure to report income is generally combined with a deficiency determination. The IRS must not only establish fraud but, as an initial matter, must establish that the unreported income was in fact realized.

The IRS uses several circumstantial methods of proof to establish that income has been understated and concealed. However, §7602(e) limits the IRS's use of financial status or economic reality examination techniques to instances in which the IRS has a "reasonable indication that there is a likelihood of such unreported income." Although these methods are more often used when a criminal investigation is underway (because of the effort and cost that must be expended), these methods are equally applicable to the civil fraud penalty. Some courts have required evidence of fraud in addition to the deficiency determined by a circumstantial method of proof.[928]

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[920] *See, e.g.*, *Toussaint v. Commissioner*, 743 F.2d 309 (5th Cir. 1984) (explaining that in an action for fraud, the honesty of the accused is not only important, it is controlling); *In re Wyly*, 552 B.R. 338 (Bankr. N.D. Tex. 2016) (taxpayer's obvious reluctance to answer questions asked of him directly reflected poorly on him; court did not have confidence that it could rely on his testimony to accurately reflect what really transpired); *Hutcheson v. Commissioner*, T.C. Memo 2025-1, 2025 BL 89 ("We do not find Mr. Hutcheson credible. Often, his testimony was contradicted by documents in the record and the testimony of credible witnesses."); *see also Mathews v. Commissioner*, T.C. Memo 2018-212 (given taxpayer dropped out of high school, had no accounting experience, and credibly testified he did not know how to report his company's income, court found he was genuinely confused about his tax liability; no fraudulent intent to evade taxes when he filed his returns, despite that taxpayer repeatedly lied to IRS agents during criminal investigation and was previously convicted for willfully submitting a false return); *DelVecchio v. Commissioner*, T.C. Memo 2001-130 (taxpayer's "lack of credibility is evidence of his fraudulent intent"); *Tandon v. Commissioner*, T.C. Memo 1998-66 ("Petitioner's lack of credibility is a factor in considering the fraud issue").

[921] *See* IRM 25.1.6.4. These are also known as "first indicators of fraud." *See also* IRM 5.1.33 (procedural guidance discussing first indicators of fraud to be used in concurrence with IRM 25.1, *Fraud Handbook*, by Field Collection employees when working potential and identified fraud development cases, including actions required prior to, during and following a referral to Criminal Investigation). For further discussion of criminal tax investigations, see 636 T.M., *Tax Crimes*.

[922] T.C. Memo 2011-161; AOD 2011-05.

[923] 99 T.C. 202 (1992).

[924] *See, e.g.*, *Temple v. Commissioner*, 67 T.C. 143 (1976); *Fuller v. Commissioner*, T.C. Memo 2007-62; *Cole v. Commissioner*, T.C. Memo 1998-457. *See also In re Wyly*, 552 B.R. 338 (Bankr. N.D. Tex. 2016) ("while certain of the 'usual' or 'typical' badges of fraud are applicable here, they do not fully address what this Court must grapple with. Thus, the Court will analyze those of the 'usual' badges of fraud that could support a finding of fraudulent intent here, along with other badges of fraud that are more tailored to our unique facts and circumstances" (examining six additional badges of fraud)).

[925] *See, e.g.*, *Cooley v. Commissioner*, T.C. Memo 2004-49 (finding sufficient evidence of fraudulent intent due to pattern of substantial understatement of income and failure to keep adequate records, particularly given the taxpayer's education and experience).

[926] *See Loftin & Woodard, Inc. v. United States*, 577 F.2d 1206 (5th Cir. 1978); *Webb v. Commissioner*, 394 F.2d 366 (5th Cir. 1968) (holding that a consistent and substantial understatement of income is insufficient, by itself, to support a finding of fraud); *Terrell Equip. Co. v. Commissioner*, T.C. Memo 2002-58; *Pappas v. Commissioner*, T.C. Memo 1981-639 (court upheld IRS's determinations of unreported taxable income not because the record proved the unreported amounts but because the taxpayer did not carry his burden of persuading the court that the excess amounts determined by the IRS were nontaxable; court refused to impose the fraud penalty because the IRS cannot meet its burden of proof on the basis of the taxpayer's failure to discharge his burden of proof with respect to the deficiencies). *See also Gagliardi v. United States*, 81 Fed. Cl. 772 (2008) (court was convinced that, at worst, taxpayers exhibited benign ineptitude in arranging their financial and tax affairs; government failed to prove by clear and convincing evidence that the underreporting was caused by intentional wrongdoing on part of a taxpayer motivated by specific purpose to evade tax known or believed to be owing); *In re Wyly*, 552 B.R. 338 (Bankr. N.D. Tex. 2016) (in a case where fraud penalties are applicable, there will almost always be an understatement of income; mere fact that understatement exists should not be badge of fraud, and some kind of intent should be required).

[927] *See, e.g.*, *Gromacki v. Commissioner*, 361 F.2d 727 (7th Cir. 1966), aff'g T.C. Memo 1964-292; *Merritt v. Commissioner*, 301 F.2d 484 (5th Cir. 1962) (consistent and substantial understatement in addition to proof that records were incomplete and inaccurate and bookkeeper was not supplied with necessary data was enough to warrant a finding of fraud); *Parks v. Commissioner*, 94 T.C. 654 (1990) (pattern of consistent underreporting of income, with other circumstances indicating intent to conceal, justified inference of fraud); *Shahadi v. Commissioner*, 29 T.C. 1157 (1958), aff'd, 266 F.2d 495 (3d Cir. 1959); *O'Neal v. Commissioner*, T.C. Memo 2016-49 (taxpayers consistently understated income by large amounts for years at issue).

[928] *See Hawkins v. Commissioner*, 234 F.2d 359 (6th Cir. 1956).

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One circumstantial method of proof is the "net worth method," in which the IRS establishes the taxpayer's assets and liabilities at the beginning and end of the year, adds in nondeductible expenses such as living expenses and subtracts any known nontaxable receipts. The IRS also must prove a likely source of the income or negate all possible nontaxable sources.[929]

A second method is the "expenditures method." It is similar to the net worth method, but instead of focusing on the difference between opening and closing net worth, it focuses on the taxpayer's expenditures, because a taxpayer who consumes all of his unreported income would have no increase in net worth. Under the expenditures method, the IRS establishes that the taxpayer's expenditures exceed his reported income and establishes a likely taxable source for that income.[930]

A third method is the "bank deposits method." Under this method, the IRS analyzes deposits into and payments made from all of the taxpayer's accounts. Deposits and cash expenditures are added; known non-income items and transfers among accounts are eliminated. What remains is the total receipts, from which deductions are subtracted to arrive at net income.[931]

A fourth method is the "percentage method," in which the taxpayer's tax return is compared to others in the same industry, with the IRS looking for variations in the percentage of gross and net profit margins, percentage of travel and entertainment as a factor of profit margin, and other percentages that may indicate income has been unreported.[932]

3. Lack of Cooperation with IRS

Failure to cooperate with the IRS can be an indication of fraud.[933] Thus, lying or giving evasive answers to IRS investigators, delaying tactics, and other actions designed to mislead IRS agents are all indicia of fraud. These and other indicia or badges of fraud (including acts of concealment, the use of dummy business entities and bank accounts opened under assumed names or in the names of relatives or nominees) can be found in numerous criminal and civil tax fraud cases.

On the other hand, even when substantial amounts of income are not reported, the taxpayer's maintenance of full and complete records, made available to IRS investigators, serves to negate any inference of intentional wrongdoing.[934]

4. Awareness of Tax Laws

The taxpayer's knowledge of the tax law is an important factor in determining whether fraud has been committed. Not surprisingly, when the taxpayer is an experienced tax attorney and/or law professor, a court is more likely to believe that omissions of income or excessive deductions are due to fraudulent intent rather than negligence or mistake.[935] The fact that the taxpayer is intelligent and sophisticated in tax matters will be taken into account even if the taxpayer is not a tax specialist. For example, in *Fried v. Commissioner*,[936] the Tax Court noted that the taxpayer was "an experienced attorney, albeit not a tax lawyer, with more than a passing familiarity with the Internal Revenue Code."[937] On the other hand, an advisor who holds himself out to the public as a tax expert, but whose knowledge and experience are in fact minimal, may not be subject to the fraud penalty.[938]

5. Criminal Prosecution

Comparisons are sometimes made between the elements necessary to convict an individual indicted for criminal tax evasion under §7201 and those required to be established by the government in a civil fraud suit.

Collateral estoppel is established when:[939]

- the party to be estopped was a party to or assumed control of the prior litigation;
- the issues presented are in substance the same as those resolved in the earlier litigation;
- the controlling facts or legal principles have not changed significantly since the earlier litigation; and
- other special circumstances warrant an exception to the normal rules of preclusion.

A conviction or guilty plea in a criminal prosecution brought under §7201 collaterally estops a taxpayer from asserting a defense to the fraud penalty for the same tax year.[940] Yet,

[929] *See United States v. Massei*, 355 U.S. 595 (1958); *Holland v. United States*, 348 U.S. 121 (1954). *See also Yoon v. Commissioner*, 135 F.3d 1007 (5th Cir. 1998) (Tax Court erroneously placed burden of establishing opening net worth on taxpayers by refusing to adjust for credit card debt without evidence from taxpayers); *Manzoli v. Commissioner*, 904 F.2d 101 (1st Cir. 1990); *Worth v. Commissioner*, T.C. Memo 2014-232, aff'd, 666 Fed App'x 692 (9th Cir. 2016) (taxpayers disputed income determination stating that IRS did not take into account undeposited cash gift in beginning net worth, but evidence established that alleged donor was not in financial position to make gift; because revenue agent deemed cash on hand to be zero for all three years, change in net worth was not affected year-to-year for any cash on hand).

[930] *See Erickson v. Commissioner*, 937 F.2d 1548 (10th Cir. 1991); *Lopez v. Commissioner*, T.C. Memo 1990-450. *See also Choi v. Commissioner*, 379 F.3d 638 (9th Cir. 2004) (§6663 penalty upheld where IRS reconstructed income using bank deposits plus cash expenditures method).

[931] *See Parks v. Commissioner*, 94 T.C. 654 (1990); *Panzitta v. Commissioner*, T.C. Memo 1986-279. *See also Choi v. Commissioner*, 379 F.3d 638 (9th Cir. 2004) (§6663 penalty upheld where IRS reconstructed income using bank deposits plus cash expenditures method); *Anyanwu v. Commissioner*, T.C. Memo 2014-123 (taxpayer entitled to reduce income calculated by IRS using bank deposits method by nontaxable sources of income and substantiated deductions).

[932] *See Way v. Commissioner*, T.C. Memo 1990-590 (tip income determined; negligence and substantial understatement penalties imposed); *Augustine's Inc. v. Commissioner*, T.C. Memo 1988-11, appeal dismissed (7th Cir. 1989) (percentage markup method; negligence penalty imposed).

[933] See *Zell v. Commissioner*, 763 F.2d 1139 (10th Cir. 1985); *Knowles v. Commissioner*, T.C. Memo 2017-152 (taxpayer subject to fraud penalty because she consistently overstated and claimed false deductions, provided false dissolution of marriage document to IRS during audit to falsely substantiate single filing status, and provided inconsistent and false testimony during IRS audit).

[934] *Ferry v. Commissioner*, T.C. Memo 1984-229; *Dagon v. Commissioner*, T.C. Memo 1984-138.

[935] See *Scallen v. Commissioner*, 877 F.2d 1364 (8th Cir. 1989).

[936] T.C. Memo 1989-430, aff'd by unpub. ord., 954 F.2d 730 (11th Cir. 1992).

[937] *Fried v. Commissioner*, T.C. Memo 1989-430, aff'd by unpub. order, 954 F.2d 730 (11th Cir. 1992). The taxpayer also had considerable experience with tax shelters such as those with respect to which the allegedly fraudulent deductions were taken.

[938] *See Capp v. Commissioner*, T.C. Memo 1968-53.

[939] *Klein v. Commissioner*, 880 F.2d 260 (10th Cir. 1989), aff'g T.C. Memo 1984-392 (citing *Montana v. United States*, 440 U.S. 147 (1979)).

[940] See *DiLeo v. Commissioner*, 96 T.C. 858 (1991); *Rodney v. Commissioner*, 53 T.C. 287 (1969). The elements of criminal tax evasion and civil tax fraud are identical. *Brooks v. Commissioner*, 82 T.C. 413 (1984), aff'd, 772

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when a guilty plea is prompted by unusual factors, such as the poor health of the taxpayer[941] or lack of understanding due to little education,[942] the guilty plea may not be controlling in a subsequent civil case. These circumstances are the exceptions to the rule; a guilty plea usually is sufficient to sustain a finding of civil fraud.[943] A plea of *nolo contendere*, however, is considered to be a mere statement of the taxpayer's unwillingness to contest the charges made against him and is not admissible evidence with respect to the issue of civil fraud.[944]

A conviction or guilty plea in a criminal prosecution brought under §7206(1) — making false statements on a return — does not collaterally estop the taxpayer from asserting a defense to the fraud penalty for the same tax year, although the conviction may be considered as evidence of the taxpayer's intent to evade payment of a tax known to be due and owing.[945] A similar rule applies to convictions or guilty pleas under 18 U.S.C. §287.[946]

Collateral estoppel applies only to the years for which the taxpayer is convicted. A conviction for a later year does not raise a presumption of civil fraud for an earlier year.[947]

The civil fraud penalty can be imposed upon a taxpayer even though he is acquitted in a criminal fraud prosecution. Because the civil penalty carries a lesser burden of proof, collateral estoppel does not apply.[948] There is also no double jeopardy, even when the civil fraud penalty is imposed on a taxpayer who is ordered to pay a criminal fine after a criminal conviction.[949]

E. Possible Defenses to the Fraud Penalty

1. Reasonable Cause

a. In General

As with other penalties, the reasonable cause defense may be raised against the fraud penalty. The defense is provided for in §6664(c), rather than in §6663, which imposes the penalty. The reasonable cause defense is discussed in XI., below.

b. Reliance on Third Parties

Reliance on third parties is one aspect of the reasonable cause defense. If a taxpayer relied on a third party to keep his books and records, to prepare and file his returns, or for tax advice generally, such reliance may indicate the absence of fraudulent intent, even if an understatement of income occurs. When the taxpayer in good faith turns over all of his books and records or otherwise makes a full and complete disclosure of all of the facts to a third party to whom he has given the task of preparing his returns, the courts generally do not find fraudulent intent.[950] If, however, the taxpayer did not supply his bookkeeper or tax return preparer with all of the relevant and necessary information, courts have found fraud. Thus, for example, in *Korecky v. Commissioner*,[951] the fraud penalty was imposed and the taxpayer was unable to use reliance on a bookkeeper as a defense due to the taxpayer's failure to provide the bookkeeper with sales receipts.

If the taxpayer did supply all necessary information to his return preparer but there was a substantial gap between what he knew to be his actual income and the amount reported on his return, courts generally have found that it should have been obvious to the taxpayer that income had been omitted. The presumed awareness of the understatement combined with the taxpayer's silence generally establishes the requisite intention to defraud. Nevertheless, the intention to defraud is not found where a taxpayer justifiably relies on an accountant's erroneous advice as to the proper tax treatment of certain items.[952]

The taxpayers in *In re Wyly*[953] presented the bankruptcy court with a nuanced argument that their reliance on the advice of their various professionals in preparing and filing their tax returns negates any possible fraudulent intent. The court, according to the taxpayers, did not need to get to the reasonable cause and good faith defense because the IRS failed to prove fraudulent intent by clear and convincing evidence. The Court did not accept the argument that reliance on the advice of counsel can negate fraudulent intent as a matter of law, where there is clear and convincing circumstantial evidence of sufficient badges of fraud to prove fraudulent intent indirectly. If the taxpayers' argument was accepted, the court reasoned, there would be no need for the reliance on advice of counsel defense set forth in the statute. That reliance would simply be used to negate fraudulent intent as a matter of law, preventing the IRS from carrying its burden of proof in every case.

Wyly demonstrates a second nuance of the defense of reliance on third parties, which is the possibility of the defense being negated by the court's finding those third parties acted as the taxpayer's agents. Mr. Wyly exerted such a high degree of control over the third parties upon whom he relied that their knowledge and actions were imputed to the taxpayer. Mr. Wyly was charged with knowing the advice obtained by his attorney from other, unrelated attorneys and with performing the actions of his attorney and other professionals.

When a partner relies on the partnership for tax information relating to his partnership income, and that income is underreported, the partner is not subject to the fraud penalty.[954] A partner who is not aware that the partnership return is fraudulent is not guilty of fraud; however, a partner who reports his

F.2d 910 (9th Cir. 1985); *Amos v. Commissioner*, 43 T.C. 50 (1964), aff'd, 360 F.2d 358 (4th Cir. 1965); *Garza v. Commissioner*, T.C. Memo 2017-7.

[941] *Powers v. Commissioner*, T.C. Memo 1962-5.

[942] *See Hendrick v. Commissioner*, T.C. Memo 1961-308.

[943] *See Arctic Ice Cream Co. v. Commissioner*, 43 T.C. 68 (1964).

[944] See *Mickler v. Fahs*, 243 F.2d 515 (5th Cir. 1957).

[945] See *Wright v. Commissioner*, 84 T.C. 636 (1985), acq. on this issue, 1988-2 C.B. 1; *United States v. Shearer*, No. 2:12-cv-02334-TLN-DB, 2018 BL 281922 (E.D. Cal. Aug. 6, 2018); *Mathews v. Commissioner*, T.C. Memo 2018-212; *Schwartz v. Commissioner*, T.C. Memo 2016-144; *Valbrun v. Commissioner*, T.C. Memo 2004-242; *Cooper v. Commissioner*, T.C. Memo 1987-303.

[946] CCA 201545016.

[947] See *Corson v. Commissioner*, T.C. Memo 1965-214, aff'd on other issues, 369 F.2d 367 (3d Cir. 1966).

[948] See *Helvering v. Mitchell*, 303 U.S. 391 (1938); *Neaderland v. Commissioner*, 424 F.2d 639 (2d Cir. 1970), aff'g 52 T.C. 532 (1969).

[949] See *Schachter v. Commissioner*, 113 T.C. 192 (1999) (also declining to give taxpayer a credit against civil fraud additions to tax for criminal fines imposed), *aff'd*, 255 F.3d 1031 (9th Cir. 2001); *Barnette v. Commissioner*, 95 T.C. 341 (1990).

[950] See *Eagle v. Commissioner*, 242 F.2d 635 (5th Cir. 1957).

[951] 781 F.2d 1566 (11th Cir. 1986).

[952] *See Palmer v. Commissioner*, T.C. Memo 1987-204.

[953] 552 B.R. 338 (Bankr. N.D. Tex. 2016).

[954] See *Estate of Roe v. Commissioner*, 36 T.C. 939 (1961), acq., 1962-1 C.B. 4.

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distributive share of partnership income with knowledge of the understatement of income at the partnership level is guilty of fraud, even if he had no part in the actual preparation or filing of the partnership return.

2. Innocent Spouse Relief

When a joint return has been signed by a husband and wife, both spouses are jointly and severally liable for the tax due, including interest and/or penalties determined after an audit of the return.[955] Under §6015, however, a spouse may be relieved of liability for tax, penalties, and interest if the spouse can establish that they are an "innocent spouse."

Penalties are not erroneous items for which a requesting spouse can seek relief separate from the tax. Relief from penalties generally is determined based on the proportion of the total erroneous items from which the requesting spouse is relieved. Similarly, penalties and interest on an underpayment are also not separate items for which a requesting spouse may seek relief under §6015(f). Relief will be determined based on the amount of relief from the underpayment to which the requesting spouse is entitled.[956]

For a further discussion of innocent spouse relief under §6015, see 645 T.M., *Innocent Spouse Relief*.

[955] §6013(d)(3).

[956] Reg. §1.6015-1(h)(4).

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VI. Certain Information Returns and Payee Statements

A. *In General*

Certain information returns and payee statements must be filed with the IRS. Payee statements are statements that must be given to the taxpayer to enable the taxpayer to file their income tax return accurately and timely.[957] Most information returns have a corresponding payee statement, and the data required to be provided on each generally is identical.

In certain instances, more than one taxpayer may be required to file information returns. For example, following a merger or an acquisition in which the successor business entity acquires substantially all of the property used in the trade or business of its predecessor, or used in a separate unit of the predecessor's trade or business, both the successor and the predecessor generally must file any required Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, information reporting forms in the Form 1098 series and Form 1099, Form 5498, *IRA Contribution Information*, or Form W-2G, *Certain Gambling Winnings*, for reportable transactions occurring in the acquisition year. However, the IRS allows for combined information reporting where, in general, the successor entity agrees to assume the predecessor's entire information reporting obligations.[958] Taxpayers are subject to information reporting penalties for a failure to properly comply.

The most common information reporting penalties are assessed for failing to file correct information returns under §6721, failing to furnish correct payee statements under §6722, and failing to comply with other information reporting requirements under §6723.

B. *Information Returns Subject to Penalty*

1. *Reporting Requirements*

A detailed description and analysis of each of the required information returns and their due dates is beyond the scope of this Portfolio. Additional analysis of information reporting requirements is discussed in 643 T.M., *Information Reporting to U.S. Persons — Payments Subject to Back-up Withholding*, and 644 T.M., *Reportable Payments and Transactions Not Subject to Backup Withholding*.

Regardless of the specific information return, the taxpayer may request an extension of time to file an information return using Form 8809, Application for Extension of Time to File Information Returns, or Form 15397, *Application for Extension of Time to Furnish Recipient Statements*, if an extension of time is needed to file payee statements.[959]

If the due date for filing the information return (including the extension due date) falls on a Saturday, Sunday, or legal holiday, the return is considered timely if it is filed by the next business day.[960] Moreover, a return that is timely mailed is considered timely filed.[961]

2. *Penalty for Failure to Timely File or Include Information on Information Return*

A penalty of $250 (adjusted annually for inflation) per information return, up to a maximum of $3 million (adjusted annually for inflation) per calendar year, may be imposed if any required information return is not filed on or before its due date (including any extension) or if the return does not properly include all of the required information.[962] A failure to include correct information encompasses a failure to include the information required by applicable reporting statutes or by any administrative pronouncements (e.g., regulations, revenue rulings, revenue procedures, announcements or information reporting forms and instructions).[963] For purposes of this penalty, an information return is any statement, return, or other item listed in §6724(d)(1), Reg. §301.6721-1(h)(2), §301.6721-1(h)(3), or §301.6721-1(h)(4).[964]

Note: For tax year 2025, Notice 2025-62, §3.01–§3.02, §5, provided transitional §6721 penalty relief in certain scenarios for qualified tips (§224) and qualified overtime compensation (§225). Reporting requirements are discussed in 643 T.M., *Information Reporting to U.S. Persons — Payments Subject to Backup Withholding*.

Note: For tax years beginning in 2022, the IRS provided a domestic filing exception for filing and furnishing Schedule K-2, *Partners' Distributive Items — International*, and Schedule K-3, *Partners' Share of Income, Deductions, Credits, etc.*

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[957] Any person required to furnish a statement under §6041–§6050T may electronically furnish that statement to any recipient who has consented to electronic delivery. The statement may be furnished in a manner similar to the one permitted for Form W-2 or in any other manner provided by the IRS. §6041–§6050T. *See* Notice 2004-10 (applicable to Forms 1099-R, Forms 1099-MSA, Forms 1099-Q, Forms 5498, Forms 5498-ESA, and Forms 5498-MSA payee statements required to be furnished to recipients for 2003 and later years). Taxpayers use Forms 1099-SA and Forms 5498-SA instead of Forms 1099-MSA and Forms 5498-MSA in 2004 and later years. Forms W-2 are discussed in IX.A.1., below.

[958] *See* Rev. Proc. 99-50.

[959] *See* Reg. §1.6081-8(a)(1). One additional nonautomatic 30-day extension is permitted. *See* Reg. §1.6081-8(a)(2). For returns in the Form W-2 series (except for Form W-2G) or a Form 1099 reporting nonemployee compensation, only one nonautomatic 30-day extension is available. *See* Reg. §1.6081-8(b). The expedited Form W-2 series procedures, including automatic extensions in Rev. Proc. 96-57 may still be followed. Reg. §1.6081-8(f). Note that a taxpayer's deadline for performing certain acts is postponed under §7508 and Reg. §301.7508-1 by reason of service in a combat zone or qualifying deployment in a contingency operation and may be postponed under §7508A and Reg. §301.7508A-1 by reason of a federally declared disaster, significant fire, or terroristic or military action. Tables, Charts & Lists > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions* provides a supplemental list of acts, including the filing of information returns under §6050I and §6050L, the filing deadlines for which may be postponed under §7508 and §7508A.

[960] §7503.

[961] §7502. See the discussion at II.B.2., above.

[962] §6721(a)(1); Reg. §301.6721-1(a)(1), T.D. 9984, 88 Fed. Reg. 87,696 (Dec. 19, 2023), effective for information returns required to be filed after December 31, 2023. The penalty amounts in §6721(a) are adjusted for inflation. §6721(f). *See also RSBCO v. United States*, No. 3:21-CV-01192, 2022 BL 99518 (W.D. La. Mar. 23, 2022) (motion for judgment on pleadings denied, with respect to determining whether §6721(a) penalty applies to late filed *resubmitted* information returns as opposed to applying only to *original* information returns, because court required evidence beyond pleadings of why IRS FIRE system rejected taxpayer's timely filed original returns).

[963] §6721(a)(2); Reg. §301.6721-1(a)(2)(ii). For inflation adjusted amounts, see Tables, Charts & Lists > Penalties > *Failure to File Correct Information Returns.*

[964] Reg. §301.6721-1(h)(1).

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— *International*, for Form 1065, if certain requirements are met.

Note: For tax years beginning in 2021, Notice 2021-39 provided transition relief from §6698, §6721, and §6722 penalties with respect to Form 1065, Schedules K-2 and K-3.[965]

The IRS cannot impose a §6721 penalty solely for an educational institution's failure to include an individual's TIN on a return or statement required under §6050S(a)(1), as long as the institution makes a contemporaneous certification (under penalty of perjury) that it has complied with promulgated standards for obtaining the individual's TIN.[966] Also, in CCA 201615012, the Chief Counsel's Office advised that a §6721 penalty will not be assessed against a withholding agent for filing a Form 1042-S with an incorrect TIN, unless that agent knew or should have known that the TIN was inaccurate.

A failure to timely file includes a failure to file in the required manner.[967] Only one penalty, however, can be imposed under §6721 with respect to any single information return.[968] If more than one penalty applies, the highest penalty amount is imposed.[969]

The long-standing 250-return threshold under §6721, §6011, and the regulations issued thereunder, has been significantly reduced. Effective for information returns required to be filed during calendar years beginning after December 31, 2023, the electronic filing requirement threshold is now 10 returns of any type, aggregated for purposes of calculation.[970]

Example: In calendar year 2024, Corporation U timely files on paper 12 Forms 1099-MISC for the 2023 calendar year with correct information. Under Reg. §301.6011-2, a person required to file at least 10 returns during calendar year 2024 must file those returns electronically. U does not correct its failures to file these returns electronically by August 1, 2024. *See* §6721(b)(2). U is therefore subject to a penalty for a failure to file timely under Reg. §301.6721-1(a)(2). However, under §6724(c) and Reg. §301.6721-1(a)(2), the penalty for a failure to file timely electronically applies only to the extent the number of returns exceeds 10. As U was required to file 12 returns electronically, it is subject to a penalty of $500 for two returns ($250 x 2 = $500).[971]

Example: In calendar year 2024, Corporation W timely electronically files 25 Forms 1099-B with incorrect information. On August 1, 2024, W discovers the errors and files 25 corrected Forms 1099-B but does so on paper. Under Reg. §301.6011-2(c)(4)(ii)(A), a person required to file an original information return covered by Reg. §301.6011-2(b) electronically must file any corrected information return corresponding to that original return electronically. Under the regulations, a failure to file a corrected information return electronically when required to do so is a failure to correct the corresponding original information return. As W was required to file its 25 corrected information returns electronically, it has failed to correct the original information returns and is subject to a penalty of $6,250 for failure to include correct information on its 25 original Forms 1099-B ($250 x 25 = $6,250), without any reductions for correcting the information on or before August 1.[972]

Additional examples are provided in the regulation.

The penalty is payable on notice and demand from the IRS in the same manner as a tax.[973] The IRS considers the penalty to be a divisible penalty for purposes of establishing refund suit jurisdiction, meaning that a taxpayer need pay only the divisible amount of the penalty attributable to a single failure (e.g., the full $250 penalty for a single incorrect information return), before filing a refund claim and instituting a refund suit.[974]

Section 6726 imposes a penalty for failures to file a complete and accurate annual information return for qualified opportunity (QOF) and qualified rural opportunity (QROF) funds as required by §6039K.[975] The penalty is $500 a day, up to a maximum of $10,000, increased to a maximum of $50,000 for large funds with gross assets exceeding $10,000,000.[976] The penalty is further increased from $500 to $2,500 a day, if the failure was due to intentional disregard, with the maximum penalty correspondingly increased from $10,000 to $50,000, and for large funds from $50,000 to $250,000.[977] Penalties under §6726 are adjusted for inflation.[978]

[965] The IRS released redesigned Schedules K-2 and K-3 for Forms 1065, Forms 1120-S, and Forms 8865 for tax year 2021 (filing season 2022). The redesigned forms and instructions give useful guidance on how to provide international tax information. Recognizing the transitional challenges with the adoption of Schedules K-2 and K-3 by affected pass-through entities and their partners and shareholders, the IRS issued Notice 2021-39 providing certain penalty relief for the 2021 tax year. IRS News Release IR-2021-140 (June 30, 2021). This penalty relief is in addition to the reasonable cause exception to the relevant penalty. Notice 2021-39.

[966] §6724(f). *See* Prop. Reg. §1.6050S-1(f)(4), REG-131418-14, 81 Fed. Reg. 50,657 (Aug. 2, 2016).

[967] Reg. §301.6721-1(a)(2)(ii). *See* PMTA 2022-05 (Chief Counsel's Office advised that upon finalization of proposed regulations, failure to file certain specified information returns electronically may result in additions to tax under §6651 and §6652). Under §6724(c), waiver provisions for failing to file electronically do not apply in the case of a return relating to withholding on foreign transfers that must be filed by a financial institution liable for tax imposed by §1461 or §1474(a) under §6011(e)(4). *See* §6724(c).

[968] Reg. §301.6721-1(a)(1). If a lesser penalty is imposed initially, and the IRS determines that a more stringent penalty applies, it may, within the assessment limitations period, supplement the assessment under §6204(a) or abate the penalty and make a new assessment based on the higher penalty. CCA 200127043.

[969] Reg. §301.6721-1(b)(4).

[970] §6011(e)(5)(A)(iii); Reg. §301.6721-1(a)(2)(ii), §301.6721-1(j). *See also* Reg. §301.6011-2(c)(4). Although electronic filing is required if 10 or more returns are required to be filed, no penalty applies to the failure to file electronically except to the extent that the failure occurs with respect to more than 10 returns. §6724(c)(2); Reg. §301.6721-1(a)(2)(ii).

[971] *See* Reg. §301.6721-1(b)(5)(iii) *Ex.* 3.

[972] *See* Reg. §301.6721-1(b)(5)(iv) *Ex.* 4.

[973] §6724(b).

[974] CCA 201315017.

[975] §6726(a), added by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70421(d)(2)(A), effective for tax years beginning after July 4, 2025; §6039K, added by the OBBBA, §70421(d)(1), effective for tax years beginning after July 4, 2025.

[976] §6726(a), §6726(b).

[977] §6726(c).

[978] §6726(d).

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For a discussion of the §6039K information reporting requirements for QOFs and QROFs, see 598 T.M., *Investments in Qualified Opportunity Zones*, at III.

a. Reduced Penalties for Prompt Correction

As an incentive to encourage timely filing and the prompt correction of any error, such failures are subject to a tiered penalty structure under which the amount of the penalty varies with the length of time within which it is corrected.[979]

If the failure to file is corrected within 30 days after the due date (i.e., by March 30 in most cases), the amount of the penalty is $50 per return, up to a maximum of $500,000 in a calendar year.[980] If the failure is corrected after 30 days, but before August 2 of the calendar year that contains the due date of the return, the penalty increases to $100 per return, up to a maximum of $1,500,000.[981]

Example 1: Corporation R fails to file timely 23,000 Forms 1099-MISC, *Miscellaneous Information*, for the Year 8 calendar year. Five thousand of these returns are filed with correct information within 30 days, and 18,000 after 30 days but on or before August 1, Year 9. For the same year R fails to file timely 400 Forms 1099-INT (relating to payments of interest) which R eventually files on September 28, Year 9, after the period for reduction of the penalty has elapsed. R is subject to a penalty of $100,000 for the 400 forms which were not filed by August 1 ($250 × 400 = $100,000), $1,500,000 for the 18,000 forms filed after 30 days ($100 × 18,000 = $1,800,000, limited to $1,500,000), and $250,000 for the 5,000 forms filed within 30 days ($50 × 5,000 = $250,000), for a total penalty of $1,850,000.[982]

Example 2: Corporation T fails to file timely 14,000 Forms 1099-MISC for the 2023 calendar year. T files the 14,000 Forms 1099-MISC on September 3, 2024. Because T does not correct the failure by August 1, 2024, T is subject to a penalty of $3,000,000, the maximum penalty under Reg. §301.6721-1(a). Without the Reg. §301.6721-1(a) limitation, T would be subject to a $3,500,000 penalty ($250 × 14,000 = $3,500,000).[983]

For returns that are not due on January 31, February 28, or March 15 (e.g., Forms 8300 reporting certain cash payments of $10,000 or more), the penalty is $15 if the failure is corrected within 30 days. If the failure is corrected after 30 days, the penalty is $50 rather than $30. There is no period during which the penalty is reduced to $30.[984]

Lower annual limitations are available for small taxpayers. If the taxpayer's average annual gross receipts for the three prior taxable years does not exceed $5 million, then the limitations described above with respect to failures during such calendar year are reduced to $175,000, $500,000, and $1,000,000.[985]

b. Exception for Inconsequential Errors or Omissions

An "inconsequential error or omission" is not considered a failure to include correct information.[986] For this purpose, an error or omission is considered "inconsequential" if it does not prevent or hinder the IRS from processing the return, correlating the information required to be shown on the return with the information shown on the payee's tax return, or otherwise putting the return to its intended use. Accordingly, a taxpayer identification number, the payee's last name, and any monetary amount (unless the de minimis requirement is met) are never considered inconsequential.[987]

c. Exception for De Minimis Failures

An omission or error on an information return can be ignored with respect to a de minimis number of returns if the failure is corrected on or before August 1 of the year in which the required filing date occurs.[988] This exception does not apply to failures with respect to returns that are not due on January 31, February 28, or March 15 (e.g., Form 8300 reporting certain cash payments of $10,000 or more). Nevertheless, the returns that are not due on January 31, February 28, or March 15 are included in the total number of all information returns that the filer is required to file during a year for purposes of calculating the number of the returns subject to the de minimis exception.[989] This de minimis rule applies only to the greater of 10 returns or 0.5% of the total number of information returns required to be filed during the calendar year.[990] If the number of returns that otherwise qualify for the de minimis exception exceeds the amount allowable, the exception applies to those returns that result in the greatest reduction in penalty.[991]

The de minimis exception applies to failures to include correct information that exist after the application (if any) of the de minimis error safe harbor discussed below, and after the application (if any) of any reasonable cause waiver under §6724(a). Returns to which the de minimis exception applies are treated as having been originally filed with correct information.[992]

Example 1: Corporation T timely files 10,000 Forms 1099-INT for Year 1 by February 28, Year 2. The 10,000

[979] 1989 Act House Report at 1382.

[980] §6721(b)(1); Reg. §301.6721-1(b)(1), T.D. 9984, 88 Fed. Reg. 87,696 (Dec. 19, 2023), effective for information returns required to be filed after December 31, 2023. The penalty amounts in §6721(b) are adjusted for inflation. §6721(f). For inflation adjusted amounts, see Tables, Charts & Lists, *Failure to File Correct Information Returns.*

[981] §6721(b)(2); Reg. §301.6721-1(b)(2). These amounts are adjusted for inflation. §6721(f). *See* Tables, Charts & Lists, *Failure to File Correct Information Returns.*

[982] Reg. §301.6721-1(b)(5)(i) *Ex.* 1.

[983] Reg. §301.6721-1(b)(5)(ii) *Ex.* 2.

[984] *See* Reg. §301.6721-1(b)(6).

[985] §6721(d); Reg. §301.6721-1(f)(1), §301.6721-1(f)(2). These amounts are adjusted for inflation. §6721(f). *See* Tables, Charts & Lists, *Failure to File Correct Information Returns.*

[986] Reg. §301.6721-1(c)(1), T.D. 9984, 88 Fed. Reg. 87,696 (Dec. 19, 2023), effective for information returns required to be filed after December 31, 2023.

[987] Reg. §301.6721-1(c)(1), §301.6721-1(c)(2).

[988] §6721(c); Reg. §301.6721-1(d)(1), T.D. 9984, 88 Fed. Reg. 87,696 (Dec. 19, 2023), effective for information returns required to be filed after December 31, 2023.

[989] Reg. §301.6721-1(d)(4).

[990] §6721(c)(2).

[991] Reg. §301.6721-1(d)(2).

[992] *See* Reg. §301.6721-1(d)(2).

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returns are all the information returns that T is required to file during the Year 2 calendar year. Of the returns filed, 70 contained incorrect information. T corrects the failures on July 12, Year 2. No penalty is imposed for 50 of the failures (i.e., the greater of 10 or .005 × 10,000 = 50) even though the total failures — 70 — exceed the number to which the de minimis exception may apply. The $100 penalty under Reg. §301.6721-1(b)(2) is imposed, in lieu of $250, for the remaining 20 failures, which were corrected after 30 days but before August 1, resulting in a total penalty of $2,000 ($100 × 20 = $2,000).[993]

Example 2: Corporation U files timely 9,500 Forms 1099-INT for 2023 by February 28, 2024. Fifty of these returns contain incorrect information with respect to which U files correct information on August 1, 2024. U also files 500 Forms 1099-INT for 2023 on August 30, 2024, after the required filing date. The 10,000 returns are all the information returns that U is required to file during the 2024 calendar year. The calculation of the de minimis exception is based on the 10,000 returns required to be filed during the 2024 calendar year even though 500 of the returns filed during the year were not filed timely. Therefore, the number of failures for which the de minimis exception applies is 50, and accordingly no penalty is imposed for the 50 Forms 1099-INT that were corrected on August 1. However, the $250 penalty under paragraph (a)(1) of this section is imposed for each failure to file timely (that is, the de minimis exception does not apply to this penalty for failure to file timely), resulting in a total penalty of $125,000 ($250 × 500 = $125,000).[994]

Example 3: Corporation V files timely 9,950 Forms 1099-INT for 2023 by February 28, 2024. However, V fails to file timely 50 of its Forms 1099-INT. The 10,000 returns are all the information returns that V is required to file during the 2024 calendar year. Upon discovering the error, V files the 50 returns within 30 days of February 28, 2024. The 50 returns are complete and correct except that V fails to include the taxpayer identification numbers of the payees on the returns. V files corrected returns on August 1, 2024. Absent application of the de minimis exception, the penalty imposed for the failure to include correct information would be $5,000 ($100 × 50 = $5,000). Because the incorrect returns are corrected on August 1, the 50 forms are treated under the de minimis exception as originally filed with correct information, and therefore no penalty is imposed under Reg. §301.6721-1(a) for the failure to include correct information. Nevertheless, the penalty under Reg. §301.6721-1(a)(1) is imposed for the failure to file timely the 50 returns because the de minimis exception does not apply to the penalty for the failure to file timely. Hence, a penalty of $2,500 ($50 × 50 = $2,500) is imposed.[995]

Example 4: Corporation W files timely 100 Forms 1099-DIV and files an additional 50 Forms 1099-DIV late, but within 30 days of February 28, 2024. These are all the information returns that W was required to file during the 2024 calendar year. W discovers errors on 10 of the returns that were filed timely, and on 5 of the returns that were filed late. W corrects all the errors on August 1, 2024. The de minimis exception applies to 10 of the corrected returns. The exception will be allocated to the 10 returns that were filed timely with incorrect information, because that allocation is most favorable to W (that is, applying the exception to a return filed late with incorrect information would save W $50, by reducing the penalty on that return from $100 to $50, but applying the exception to a return filed timely would save W $100, by reducing the penalty on that return from $100 to $0). (See Reg. §301.6721-1(b)(4)).[996]

Under a safe harbor exception for certain de minimis errors (de minimis error safe harbor), no correction is required, and no §6721(a) penalty is imposed for a failure to include correct information when the failure relates to an incorrect dollar amount and is a de minimis error. When this safe harbor applies to an information return and the information return is otherwise correct and timely filed, no correction is required and, for penalty purposes, the information return is treated as having been filed with all of the correct required information.[997] An incorrect dollar amount is a "de minimis error" if none of the erroneous amounts differs from the correct amount by more than $100 ($25 for amounts of tax withheld).[998]

The de minimis error safe harbor applies to reporting amounts on information returns, including reporting withholding of tax on information returns, but it doesn't apply to any underlying requirements to withhold or pay tax. Interest, penalties, and other additions to tax may be imposed under other Code sections for underwithholding or underpaying tax in any amount.[999]

A taxpayer may elect to override the de minimis error safe harbor no later than the later of 30 days after the date on which the payee statement is required to be furnished to the payee, or October 15 of the calendar year.[1000]

Regardless of whether the de minimis error safe harbor provides an exception for not filing a particular corrected information return, the corrected information return may be filed voluntarily if a corresponding payee statement reflecting the in-

[993] *See* Reg. §301.6721-1(d)(3)(i) *Ex.* 1.
[994] Reg. §301.6721-1(d)(3)(ii) *Ex.* 2.
[995] Reg. §301.6721-1(d)(3)(iii) *Ex.* 3.
[996] Reg. §301.6721-1(d)(3)(iv) *Ex.* 4.
[997] *See* Reg. §301.6721-1(e)(1).
[998] §6721(c)(3) (reference to §6722(c)(3)(B)); Reg. §301.6721-1(e)(2) (reference to Reg. §301.6722-1(d)(1)). "Tax withheld" includes any amount required to be shown on an information return or payee statement (as defined in §6724(d)(1) and §6724(d)(2)), respectively) withheld under §3102 or §3402, as well as any such amount required to be shown on such an information return or payee statement that is creditable under §27, §31, §33, or §1474. Reg. §301.6722-1(d)(1). The de minimis error safe harbor applies only to inadvertent errors and not to intentional misreporting, intentional disregard of the filing requirements or information reporting requirements, a failure to file a return, or a failure to furnish a payee statement.
[999] Reg. §301.6721-1(e)(5).
[1000] See Reg. §301.6721-1(e)(3) for applicability and manner of making the election.

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formation shown on the corrected information return is concurrently furnished to the payee.[1001]

d. Increased Penalties for Intentional Disregard

If any of the §6721(a)(2) failures are due to intentional disregard of the filing required or the correct information reporting requirement, an increased penalty for intentional disregard may be imposed under §6721(e). Under §6721(e), the $3,000,000 limitation does not apply,[1002] and the penalty is increased to the greater of $500 or:

- 10% of the aggregate amount of items required to be correctly reported (other than under §6045(a), §6041A(b), §6050H, §6050I, §6050J, §6050K, §6050L, or §6050V);
- 5% the aggregate amount of items required to be correctly reported under §6045(a), §6050K, or §6050L;
- For returns required to be filed under §6050I(a), for any transaction (or related transactions), the greater of $25,000 or the amount of cash (within the meaning of §6050I(d)) received in the transaction up to $100,000; or
- 10% of the value of the benefit contact required to be reported under §6050V.[1003]

A failure to timely file or a failure to include correct information is due to intentional disregard if it is omitted knowingly or willfully.[1004]

The determination is based on all the facts and circumstances, including but not limited to:

- whether the failure to timely file or include correct information is part of a pattern of conduct by the filer;
- whether correction was promptly made upon discovery of the failure;
- whether the filer corrects the failure within 30 days after written request from the IRS; and
- whether the amount of the information return penalty is less than the cost of complying.[1005]

If the intentional disregard relates to a dollar amount, the applicable percentage applies to the difference between the dollar amount reported and the amount required to be reported. In other cases, the percentage is applied to the aggregate amount of items required to be reported correctly.[1006] In determining the aggregate amount of items required to be reported correctly, no item is taken into account more than once. For example, if a filer willfully fails to file a Form 1099-INT, *Interest Income*, on which $800 of interest and $160 backup withholding is required to be reported, only the $800 amount is taken into account in computing the penalty.[1007]

There are instances where the IRC, Treasury Regulations, and the Internal Revenue Manual are silent with regard to the procedure to be used for computing the applicable percentage aggregate amount of the penalty. In such instances, the computation is a policy decision best left to the discretion of the IRS Office of Servicewide Penalties (OSP).[1008] In addition, the maximum limits, small business rules, and de minimis rules do not apply.[1009] Finally, a penalty imposed for intentional disregard is not taken into account in determining the maximum limit on penalties for failures that are not due to intentional disregard.[1010]

If the failure relates to a dividend or patronage dividend of less than $10, the penalty is $1 for each failure, up to a maximum of $1,000 during the calendar year.[1011]

Example 1: On December 1, 2023, Automobile dealer P receives $55,000 from an individual for the purchase of an automobile in a transaction subject to reporting under §6050I. The individual presents documents to P that identify him as John Doe. However, P completes the Form 8300 (relating to cash payments over $10,000 received in a trade or business) and reflects the name of a cartoon character as the filer. Because P knew at the time of filing the Form 8300 that the filer's name was not the name of the cartoon character, he willfully failed to include correct information as described in Reg. §301.6721-1(g)(2). Therefore, the penalty under Reg. §301.6721-1(g)(4) is imposed for the intentional disregard of the requirement to include correct information. The amount used in computing the penalty under Reg. §301.6721-1(g)(5) is $55,000 (that is, the amount required to be reported on the return with respect to which the payee is not correctly identified). The amount of the penalty determined under Reg. §301.6721-1(g)(4)(iv)(C) is $55,000 (that is, the greater of $25,000 or the amount of cash received in the transaction up to $100,000).[1012]

Example 2: On December 1, 2023, Individual B contacts his agent, F, to act as his intermediary in the purchase of an automobile. B gives F $20,000 and requests F to

[1001] Reg. §301.6721-1(e)(4).

[1002] Reg. §301.6721-1(g)(4)(ii), T.D. 9984, 88 Fed. Reg. 87,696 (Dec. 19, 2023), effective for information returns required to be filed after December 31, 2023.

[1003] §6721(e); Reg. §301.6721-1(g)(1), §301.6721-1(g)(4)(iii), and §301.6721-1(g)(4)(iv), T.D. 9984, 88 Fed. Reg. 87,696 (Dec. 19, 2023), effective for information returns required to be filed after December 31, 2023. The amounts are adjusted for inflation. §6721(f). For inflation-adjusted amounts for recent years, see Tables, Charts & Lists > Penalties > *Failure to File Correct Information Returns.*

[1004] Reg. §301.6721-1(g)(2). *See DeGuerin v. United States*, 214 F. Supp. 2d 726 (S.D. Tex. 2002) (attorneys may be subject to penalties for intentional disregard of the informational return filing requirements where the withheld information is not privileged); *Tysinger Motor Co. v. United States*, 428 F. Supp. 2d 480 (E.D. Va. 2006) (intentional disregard lacking where taxpayer's compliance system had internal flaw that resulted in omission of several reports; district court found that implementation of compliance system following earlier audit in addition to reporting of some transactions was evidence of lack of willfulness).

[1005] Reg. §301.6721-1(g)(3). *See, e.g., In re Flanary & Sons Trucking, Inc.*, 2004-1 USTC ¶50,181 (Bankr. E.D. Tenn. 2004) (increased penalty not applied).

[1006] Reg. §301.6721-1(g)(5).

[1007] Reg. §301.6721-1(g)(5).

[1008] CCA 201603031 (no guidance on computing applicable percentage aggregate amount where taxpayer intentionally disregards §6011(e) electronic media filing requirements; IRS provides several computation options, but advises that OSP needs to determine method that can be consistently applied in all cases). After CCA 201603031, the IRS released guidance on computing the penalty where the taxpayer files on the incorrect media. IRM 20.1.7.8.2 (12-16-22).

[1009] §6721(e)(1), §6721(e)(3).

[1010] §6721(e)(3).

[1011] §6652(a).

[1012] Reg. §301.6721-1(g)(6)(i) *Ex.* 1.

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purchase the automobile in F's name, which F does. F prepares Form 8300 as required under §6050I, but in the area designated for the name of the filer, F writes confidential. Because F knew at the time the return was filed that it contained incomplete information, the penalty under Reg. §301.6721-1(g)(4) is imposed for the intentional disregard of the requirement to include correct information. The amount used in computing the penalty under Reg. §301.6721-1(g)(5) is $20,000 (that is, the amount required to be reported on the return with respect to which the payee is not correctly identified). The amount of the penalty determined under Reg. §301.6721-1(g)(4)(iv)(C) is $25,000 (that is, the greater of $25,000 or the amount of cash received in the transaction up to $100,000).[1013]

Additional examples are provided in the regulation.

e. Special Rule for Reporting Certain Additional Taxes

For transfers, rollovers, and exchanges occurring after December 31, 2023, the IRS cannot impose a penalty for failure to timely file an information return (or a failure to include required information on an information return) if:[1014]

- a person makes a return or report under §6047(d) or §408(i) with respect to any distribution,[1015]
- such distribution is made following a rollover, transfer, or exchange described in §72(t)(4)(C) or §72(q)(3)(C),[1016]
- in making such return or report the person relies upon a certification provided by the taxpayer that the distributions satisfy the requirements of §72(t)(4)(C)(iii) or §72(q)(3)(B)(iii), as applicable,[1017] and
- such person does not have actual knowledge that the distributions do not satisfy such requirements.[1018]

3. Penalty for Failure to Furnish Correct Payee Statements

a. Reporting Requirements

Payors generally are required to furnish payee statements to taxpayers to enable them to file timely and proper returns. Otherwise, payors are subject to a penalty under §6722. Payee statements generally subject to the §6722 penalty are those described in §6724(d)(2).[1019]

Payors generally are required to furnish a copy of the information return to the recipient on or before January 31 following the end of the calendar year to which it relates.[1020]

One notable exception to this deadline applies for partnerships' payee statements. Partnerships are required to furnish Schedules K-1 to their partners on or before the day on which the partnership return for that taxable year must be filed, as determined with regard to extensions.[1021] Information that must be furnished by the partnership under §6031(b) may not be amended after the due date of the return to which the information relates except under limited circumstances and in the manner specified by the IRS.[1022]

b. Penalty for Failure to Timely Furnish or Include Information on Payee Statements

Any person who fails to timely furnish a required payee statement (described above) or who fails to include correct information generally is subject to a penalty of $250 per statement, up to a maximum of $3 million in any calendar year.[1023]

A failure to furnish includes a failure to furnish a payee statement in the proper manner or on the proper form, as well as an omission of any information required by the Code, regulations, revenue rulings, revenue procedures, or the information reporting form itself.[1024]

Note: For tax year 2025, Notice 2025-62, §3.01–§3.02, §5, provided transitional §6722 penalty relief in certain scenarios for qualified tips (§224) and qualified overtime compensation (§225). Reporting requirements are discussed in 643 T.M., *Information Reporting to U.S. Persons — Payments Subject to Backup Withholding.*

Note: The penalty amounts generally apply equally to all the information returns described in §6724(d), with a few exceptions. The IRS cannot impose a §6722 penalty solely for an educational institution's failure to include an individual's TIN on a return or statement required under §6050S(a)(1), as long as the institution makes a contemporaneous certification (under penalty of perjury) that it has complied with promulgated standards for obtaining the individual's TIN.[1025]

The IRS can impose only one penalty under §6722 with respect to a single payee statement, even though there may be more than one failure with respect to the statement. However, a separate penalty will apply to each type of payment and other required information included on a composite substitute payee statement.[1026]

Lower annual limitations also are available for small taxpayers. If the taxpayer's average annual gross receipts for the three prior taxable years does not exceed $5 million, the limita-

[1013] Reg. §301.6721-1(g)(6)(ii) *Ex.* 2.

[1014] §6724(g), added by SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §323(c).

[1015] §6724(g)(1).

[1016] §6724(g)(2).

[1017] §6724(g)(3).

[1018] §6724(g)(4).

[1019] "Payee statement" is defined in Reg. §301.6722-1(e)(2). "Payee" is defined in Reg. §301.6721-1(h)(5).

[1020] *See generally* §6031–§6053.

[1021] Reg. §1.6031(b)-1T.

[1022] *See* §6031(b)(1)–§6031(b)(4).

[1023] §6722(a)(1); Reg. §301.6722-1(a)(1), T.D. 9984, 88 Fed. Reg. 87,696 (Dec. 19, 2023), effective for payee statements required to be furnished after December 31, 2023. The penalty amounts are adjusted for inflation. §6722(f). These amounts are available in Tables, Charts & Lists > Penalties > *Failure to Furnish Correct Payee Statements.* Limited penalty relief was provided in Notice 2017-71, *amplifying, clarifying, and superseding* Notice 2017-47. Limited penalty relief was also provided in Notice 2019-66, as discussed in II.D., above. *See* Prop. Reg. §1.951A-1(e)(2)(ii) (penalty relief for §6722(a) failures related to §951A if notification and reporting requirements met), as discussed at II.D., above, and in 6200 T.M., *CFCs — General Overview* (Foreign Income Series).

[1024] Reg. §301.6722-1(a)(2).

[1025] §6724(f). *See* Prop. Reg. §1.6050S-1(f)(4), REG-131418-14, 81 Fed. Reg. 50,657 (Aug. 2, 2016).

[1026] §6722(a); Reg. §301.6722-1(a)(1) (a composite substitute payee statement is a single document created by a filer to reflect several types of payments made to the same payee; the total amount imposed on any person for all failures during any calendar year for all payee statements will not exceed $3 million).

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tions described above with respect to failures during such calendar year are reduced to $175,000, $500,000, and $1,000,000, respectively.[1027]

The penalty is payable on notice and demand from the IRS in the same manner as a tax.[1028] The IRS considers the penalty to be a divisible penalty for purposes of establishing refund suit jurisdiction, meaning that a taxpayer need only pay the divisible amount of the penalty attributable to a single failure (e.g., the full $250 penalty for a single late information return), before filing a refund claim and instituting a refund suit.[1029]

c. Reduced Penalties for Prompt Correction

The §6722 penalty is subject to a tiered penalty structure under which the amount of the penalty varies depending on how quickly the error is corrected. If the failure is corrected within 30 days after the required filing date, the penalty is $50 per statement (with a maximum imposed penalty of $500,000 per calendar year). For corrections made after 30 days but before August 2, the penalty is $100 per statement (with a maximum penalty imposed of $1,500,000 per calendar year).[1030]

d. Exception for De Minimis Failures

An omission or error on a return can be ignored with respect to a de minimis number of returns if the failure is corrected before August 2 of the calendar year in which the return is required to be filed.[1031] This de minimis rule applies only to the greater of 10 returns or 0.5% of the total number of information returns required to be filed during the calendar year.[1032]

Under a safe harbor exception for certain de minimis errors (de minimis error safe harbor), no correction is required, and no §6722 penalty imposed, if there is an incorrect dollar amount and none of the erroneous amounts differ from the correct amount by more than $100 ($25 for amounts withheld).[1033] The safe harbor does not apply to any underlying requirements to withhold or pay tax. Interest, penalties, and other additions to tax may be imposed under other sections of the Code for underwithholding or underpaying tax in any amount.[1034]

However, the person to whom the statement is required to be furnished (payee) may make an election to override the safe harbor.[1035] The election applies to all types of payee statements the filer is required to furnish to the payee, unless the payee specifies otherwise on the election,[1036] but the election is not available for certain information that cannot be altered under specific reporting rules.[1037]

A payee may revoke an election by providing the revocation to the filer. The effect of a revocation of a prior election is that the de minimis error safe harbor will apply to the payee statements that the payee (recipient) identifies and that are furnished (or due to be furnished) after the revocation is received. Provided the revocation includes all required information, the revocation is effective on the date it is received by the filer.[1038]

Example 1: Filer W must file with the IRS by February 28, 2024, and furnish to Payee E by February 15, 2024, Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*, because W is a broker who sold stocks on behalf of E resulting in proceeds of $5,000 during calendar year 2023. W properly withheld an amount of $1,736 under applicable backup withholding rules because E failed to furnish E's TIN to W. On the Form 1099-B, W reports as follows: Box 1d, Proceeds, $4,900; and Box 4, Federal income tax withheld, $1,761. W otherwise correctly and timely files and furnishes the Form 1099-B. E does not make an election under Reg. §301.6722-1(d)(3)(i). The safe harbor exception for de minimis errors applies, because the differences between each of the amounts reported in error and the correct amounts are not more than the applicable limits. The error in the dollar amount reported in Box 1d, Proceeds, is de minimis because the difference between the amount in error ($4,900) and the correct amount ($5,000) is not more than $100; it is exactly $100. The error in the dollar amount reported in Box 4, Federal income tax withheld, is de minimis because the $25 difference between the amount in error ($1,761) and the correct amount ($1,736) is not more than $25, the limit for an error with respect to an amount reported for tax withheld.[1039]

Example 2: Filer W must file with the IRS by February 28, 2024, and furnish to Payee E by February 15, 2024, Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*, because W is a broker who sold stocks on behalf of E resulting in proceeds of $5,000 during calendar year 2023. W properly withheld an amount of $1,736 under applicable backup withholding rules because E failed to furnish E's TIN to W. On the Form 1099-B, W reports as follows: Box 1d, Proceeds, $4,900; and Box 4, Federal income tax withheld, $1,710. W otherwise correctly and timely files and furnishes the Form 1099-B. E does not make an election under Reg. §301.6722-1(d)(3)(i). The safe harbor exception for de minimis errors provided for by paragraph Reg. §301.6722-1(d)(1) of this section does not apply because the Form 1099-B contains a failure that is not a de minimis error. The difference between the amount in error ($1,710) and the correct amount ($1,736) is $26, which is more than the $25 limit for de minimis errors with respect to an amount reported for tax withheld.[1040]

[1027] §6722(d). The penalty amounts under §6722(d)(1) are adjusted for inflation. §6722(f). These amounts are available in Tables, Charts & Lists > Penalties > *Failure to Furnish Correct Payee Statements.*

[1028] §6724(b).

[1029] CCA 201315017.

[1030] §6722(b)(1) and §6722(b)(2). The dollar amounts described in §6722(b) are adjusted for inflation beginning in 2015. §6722(f). See Tables, Charts & Lists > Penalties > *Failure to Furnish Correct Payee Statements.*

[1031] §6722(c).

[1032] §6722(c).

[1033] §6722(c)(3)(A); Reg. §301.6722-1(d)(2), T.D. 9984, 88 Fed. Reg. 87,696 (Dec. 19, 2023), effective for payee statements required to be furnished after December 31, 2023.

[1034] Reg. §301.6722-1(d)(7).

[1035] §6722(c)(3)(B); Reg. §301.6722-1(d)(3)(i). See Reg. §301.6722-1(d)(3)(ii), Reg. §301.6722-1(d)(3)(iii), and Reg. §301.6722-1(d)(3)(iv) for the time and manner of making the election.

[1036] Reg. §301.6722-1(d)(3)(iv).

[1037] Reg. §301.6722-1(d)(3)(iv).

[1038] Reg. §301.6722-1(d)(3)(vii).

[1039] Reg. §301.6722-1(d)(5)(i) *Ex.* 1.

[1040] Reg. §301.6722-1(d)(5)(ii) *Ex.* 2.

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Additional examples are provided in the regulation.

Regardless of whether the de minimis error safe harbor provides an exception for not filing a particular corrected information return, the corrected information return may be filed voluntarily if a corresponding payee statement reflecting the information shown on the corrected information return is concurrently furnished to the payee.[1041] Filers must retain records of any election, revocation, and notification for as long as the contents of the election, revocation, or notification may be material in the administration of any internal revenue law. For rules regarding record retention, see §6001 and Reg. §1.6001-1. For additional procedures applicable to record retention in the context of electronic storage, see Rev. Proc. 97-22, Rev. Proc. 98-25, and any subsequently published guidance.[1042]

e. Exception for Inconsequential Errors or Omissions

An inconsequential error or omission is not considered a failure to include correct information on a payee statement. An inconsequential error or omission means any failure that cannot reasonably be expected to prevent or hinder the payee from timely receiving correct information, reporting it on a tax return, or otherwise putting the statement to its intended use.[1043] Because of the fundamental nature of the information, errors or omissions that are never inconsequential include any dollar amount, a significant item in the payee's address, the appropriate form, and the manner of furnishing the statements required to be delivered in person or by first class mail.[1044]

f. Increased Penalties for Intentional Disregard

If the failure is due to an intentional disregard of the requirements to timely furnish correct payee statements, the de minimis error safe harbor does not apply, the $3 million limitation does not apply, and the penalty increases to $500 per statement, or if greater:

- 10% of the aggregate dollar amount required to be reported correctly (other than under §6045(b), §6041A(e), §6050H(d), §6050J(e), §6050K(b), or §6050L(c)); or
- 5% of the aggregate dollar amount required to be reported correctly under §6045(b), §6050K(b), or §6050L(c).[1045]

In determining the aggregate amount of items required to be reported correctly, the same item is counted only once. For example, if a filer willfully fails to furnish a Form 1099-INT on which $800 of interest and $160 of federal income tax withheld (i.e., backup withholding) is required to be shown, only the $800 amount is taken into account in computing the penalty.[1046] However, if the intentional disregard relates to a dollar amount, then the penalty applies only to the difference between the amount required to be shown on the return and the amount actually reported.[1047]

g. Special Rule for Reporting Certain Additional Taxes

For transfers, rollovers, and exchanges occurring after December 31, 2023, the IRS cannot impose a penalty for failure to furnish correct payee statements if:[1048]

- a person makes a return or report under §6047(d) or §408(i) with respect to any distribution,[1049]
- such distribution is made following a rollover, transfer, or exchange described in §72(t)(4)(C) or §72(q)(3)(C),[1050]
- in making such return or report the person relies upon a certification provided by the taxpayer that the distributions satisfy the requirements of §72(t)(4)(C)(iii) or §72(q)(3)(B)(iii), as applicable,[1051] and
- such person does not have actual knowledge that the distributions do not satisfy such requirements.[1052]

4. Penalty for Failure to Comply with Other Reporting Requirements

A penalty of $50 is imposed for each failure to comply with a "specified information reporting requirement" (other than with respect to an information return or payee statement, the penalty for which is governed by §6721 or §6722 as discussed above), up to a maximum of $100,000 during any calendar year.[1053] A separate penalty can be imposed for each failure to satisfy the information reporting and payee statement requirements described above.[1054] Only one penalty is imposed, however, if there is both a failure to comply and a failure to include correct information on a single document.[1055]

The specified reporting requirements to which the §6723 penalty applies relate to:

- the notice required when a transferor of a partnership interest does not promptly notify the partnership of the transfer;[1056]
- the requirement to include a TIN on any return statement or document (other than an information return or payee statement), furnish a TIN to any person, or include a TIN on any return statement or document (other than an information return or payee statement) made with respect to the TIN of such person;[1057]
- the requirements that any person that claims a deduction for qualified residence interest paid on any seller-provided financing must include the TIN of the recipient on a return claiming the deduction, that any person that receives or ac-

[1041] Reg. §301.6722-1(d)(6).
[1042] Reg. §301.6722-1(d)(4).
[1043] Reg. §301.6722-1(b)(1).
[1044] Reg. §301.6722-1(b)(2).
[1045] §6722(e); Reg. §301.6722-1(c)(2). Whether there is intentional disregard is based on the facts and circumstances surrounding the failure, including those in Reg. §301.6721-1(g)(3), discussed above. Reg. §301.6722-1(c)(1). *Note:* The dollar amounts described in §6722(e) are adjusted for inflation. §6722(f) Tables, Charts & Lists > Penalties > *Failure to Furnish Correct Payee Statements.*
[1046] Reg. §301.6722-1(c)(3).
[1047] Reg. §301.6722-1(c)(3).
[1048] §6724(g), added by SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §323(c).
[1049] §6724(g)(1).
[1050] §6724(g)(2).
[1051] §6724(g)(3).
[1052] §6724(g)(4).
[1053] §6723.
[1054] §6723; Reg. §301.6723-1(a)(1).
[1055] Reg. §301.6723-1(a)(1).
[1056] *See* §6724(d)(3)(A), §6050K(c).
[1057] *See* §6724(d)(3)(B), §6109 and the regulations thereunder.

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crues such interest must include the TIN of the payor on the return for the taxable year of receipt or accrual, and that the payor and recipient must furnish their TINs to each other.[1058]

No penalty is imposed if the error or omission does not frustrate the purpose or use for which the information is intended.[1059] In addition, the penalty does not apply if the failure is due to reasonable cause and not willful neglect.[1060]

C. *Reasonable Cause Exception for Penalties Relating to Information Returns and Payee Statements*

1. In General

Each of the penalties for failure to file a correct information return (as defined in §6724(d)(1)), furnish a correct payee statement (as defined in §6724(d)(2)), or comply with other information reporting requirements is waived if the failure is due to reasonable cause and not willful neglect.[1061]

Reasonable cause exists only if:

- There are significant mitigating factors with respect to the failure (discussed in VI.C.2., below); or
- The failure arose from events beyond the filer's control (discussed in VI.C.3., below).[1062]

In addition, the filer must establish that he acted in a "responsible manner" both before and after the failure occurred.[1063]

Filers may seek a reasonable cause waiver by submitting a written statement detailing:

- Provision under which the waiver is being requested (i.e., Reg. §301.6724-1(b), Reg. §301.6724-1(c)(2) through §301.6724-1(c)(6), or Reg. §301.6724-1(h));
- All the facts alleged as the basis for reasonable cause;
- The signature of the person required to file the return; and
- Declaration under penalties of perjury.[1064]

A filer may also establish reasonable cause for failure to timely file correct information returns, payee statements, and other specified information failures, if the filer exercised due diligence.[1065]

Special rules apply to the exercise of due diligence for failures to provide a correct TIN on:

- Information returns (Reg. §301.6721-1(h));
- Payee statements (Reg. §301.6722-1(e));
- Other specified documents (Reg. §301.6723-1(a)(4)).[1066]

Specific due diligence safe harbor guidance related to TIN failures applies to:

- Payee certifications that the TIN was correct (Reg. §301.6724-1(g)(2));
- Accounts opened and instruments acquired after December 31, 1983 (Reg. §301.6724-1(g)(3));
- Instruments not transferred with assistance of broker (Reg. §301.6724-1(g)(4));
- Filer undue hardship (Reg. §301.6724-1(g)(5));
- Acquisitions of pre-1984 accounts or instruments (Reg. §301.6724-1(g)(6));
- Limited reliance on certain pre-2001 rules (Reg. §301.6724-1(g)(7)).

2. Significant Mitigating Factors

To establish reasonable cause, the filer must both establish that the filer acted in a responsible manner (discussed in VI.C.4., below) and show that there are significant mitigating factors for the failure.[1067]

Mitigating factors include, but are not limited to:

- Before the failure, the filer was never required to file the particular type of return or furnish the particular type of statement with respect to which the failure occurred; and[1068]
- Whether the filer has an established history of complying with information reporting requirements.[1069]

In determining whether the filer has such an established history, significant consideration is given to (i) whether the filer has previously incurred any penalty under Reg. §301.6721-1, §301.6722-1, or §301.6723-1; and (ii) if the filer has previously incurred any such penalty, the extent of the filer's success in lessening its error rate from year to year.[1070]

Comment: Although the exception requires significant mitigating factors, the examples provided in the regulations are only of mitigating factors. No guidance, however, is provided as to when a mitigating factor is significant. The absence of clear guidance as to when a mitigating factor is significant may present an opportunity for a filer who has been denied administrative relief to seek a more favorable result by means of a district court refund suit. For example, in *Payless Drugstores Nw., Inc. v. Commissioner*,[1071] the taxpayer failed to file on magnetic media approximately 10,000 otherwise correct and timely filed Forms 1099 for 1986. At the time of filing, the taxpayer was unaware of the then-newly enacted magnetic media filing requirements under the 1986 TRA and accompany-

[1058] *See* §6724(d)(3)(C) (former §6724(d)(3)(D)), §6109(h).

[1059] Reg. §301.6723-1(a)(3).

[1060] §6724(a). See the discussion of reasonable cause at XI., below.

[1061] §6724(a); Reg. §301.6724-1(a)(1), T.D. 9984, 88 Fed. Reg. 87,696 (Dec. 19, 2023), effective for information returns required to be filed and payee statements required to be furnished after December 31, 2023. Reg. §301.6724-1(j).

[1062] Reg. §301.6724-1(a)(2)(ii).

[1063] Reg. §301.6724-1(a)(2)(iii). Note also a reasonable cause safe harbor for persons who exercise due diligence under Reg. §301.6724-1(g), and the reasonable cause safe harbor after an election under §6722(c)(3)(B) and Reg. §301.6724-1(h).

[1064] Reg. §301.6724-1(m).

[1065] Reg. §301.6724-1(g)(1). *See also* Reg. §301.6723-1(a)(2), §301.6724-1(j).

[1066] Reg. §301.6724-1(g)(1)(i).

[1067] Reg. §301.6724-1(b), T.D. 9984, 88 Fed. Reg. 87,696 (Dec. 19, 2023), effective for information returns required to be filed and payee statements required to be furnished after December 31, 2023.

[1068] Reg. §301.6724-1(b)(1).

[1069] Reg. §301.6724-1(b)(2).

[1070] Reg. §301.6724-1(b)(2)(i), §301.6724-1(b)(2)(ii).

[1071] 94-1 USTC ¶50,108 (D. Or. 1993).

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ing regulations. In addition, the taxpayer's outside accounting firm failed to notify it regarding the filing requirements. The taxpayer first became aware of the filing requirement in September 1987 when it received an IRS notice regarding a local filing seminar in late 1987 to help educate practitioners. After the seminar, the taxpayer determined that it could not develop an in-house computer system in time to meet the filing deadline and attempted unsuccessfully to secure processing services from outside contractors. The IRS ultimately granted a waiver of the filing requirements for 1987 on the grounds that the taxpayer had reasonable cause and that enforced compliance would impose a significant hardship. The IRS, however, assessed a $100,000 penalty relating to the 1986 returns under §6721. The taxpayer paid a portion of the penalty and filed a district court refund suit. The district court determined that the taxpayer's 1986 failure was due to reasonable cause and not due to willful neglect. Among the factors the court considered were: 1986 was the first year the filing requirements were imposed; the IRS provided minimal notice to taxpayers generally of the changes to the laws relating to information return filing effected by the adoption of the regulations, considering the magnitude and significance of the changes; and the IRS's local education efforts came after the deadline for filing the 1986 returns. The court also found credible the taxpayer's testimony that even had it known of the 1986 law and regulatory changes before the filing deadline, it still would have lacked sufficient time to comply with the practical requirements of formatting, testing, and using the required software. The court also noted that the IRS's grant of a waiver for 1987 was "strong evidence" that such waiver would have been granted for 1986 had the taxpayer known to make such a request.

Reg. §301.6011-3(b) provides procedures for obtaining waivers from the electronic filing requirement for partnership returns for one or more years in cases of undue hardship, as determined based upon all of the facts and circumstances.[1072] Some factors include the reasonableness of the incremental cost to the partnership of complying with the electronic filing requirements as well as temporary equipment breakdowns and destruction of electronic filing equipment. Reg. §301.6011-3 is discussed further at II.D.1., above.

A filer may establish reasonable cause with respect to a failure relating to an information reporting requirement as described in Reg. §301.6724-1(j) under Reg. §301.6724-1(h) if the failure is a result of an election under Reg. §301.6722-1(d)(3)(i) and the presence of a de minimis error or errors as described in §6721(c)(3) and Reg. §301.6721-1(e) and §301.6722-1(d) on a filed information return or furnished payee statement. Reg. §301.6724-1(h) applies only if the safe harbor exceptions provided for by Reg. §301.6721-1(e) and §301.6722-1(d)(1) would have applied, but for an election under Reg. §301.6722-1(d)(3)(i). To establish reasonable cause and not willful neglect under Reg. §301.6724-1(h), the filer must file a corrected information return or furnish a corrected payee statement, or both, as applicable, within 30 days of the date of the election under Reg. §301.6722-1(d)(3)(i). When specific rules provide for additional time in which to furnish a corrected payee statement and file a corrected information return, the 30-day rule does not apply, and the specific rules will apply. See for example Reg. §31.6051-1(c), §31.6051-1(d), and §31.6051-2(b). If the filer rectifies the failure outside of this 30-day period, the determination of reasonable cause will be on a case-by-case basis.[1073]

3. Events Beyond Filer's Control

Alternatively, the filer may be able to avoid a penalty under §6721–§6723 relating to information returns and payee statements by showing that the failure was due to events beyond the filer's control.[1074] Events beyond the filers control include, but are not limited to:

- The unavailability of relevant business records. The records must be unavailable under such conditions, in such manner, and for such period as to prevent timely compliance. This generally requires that the records be unavailable for at least two weeks before the due date (with extensions) of the required return or payee statement. In addition, the unavailability must be caused by an event that is beyond the filer's control, including but not limited to: (1) a casualty that damages or impairs the filer's relevant business records or system for processing and filing such records; (2) a statutory or regulatory change that has a direct impact on data processing that is made so close to the due date that, for all practical purposes, the change cannot be complied with; or (3) the unavoidable absence (e.g., due to death or serious illness) of the person with the sole responsibility for filing the return or furnishing the payee statement.[1075]

- A failure to file electronically because the filer lacked the necessary hardware, provided: (1) the filer attempted to contract out the filing on a timely basis; (2) the cost of filing on electronically was prohibitive, as determined at least 45 days before the returns' due date (without extension); (3) the cost is supported by at least two estimates from unrelated parties; and (4) the filer filed the returns on paper. This exception can generally be used only once.[1076]

- A failure to file electronically due to a software malfunction can qualify as a failure beyond the filer's control when it is shown the filer used the software correctly.[1077]

- Good-faith reliance on erroneous written information from the IRS, if the IRS was aware of all the relevant facts. To substantiate an exception under this rule, the filer must provide a copy of the written information furnished by the

[1072] See Reg. §301.6011-3(b)(1), T.D. 9972, 88 Fed. Reg. 11,754 (Feb. 23, 2023), for parameters on obtaining waivers of the electronic filing requirements for partnerships.

[1073] Reg. §301.6724-1(h), T.D. 9984, 88 Fed. Reg. 87,696 (Dec. 19, 2023), effective for information returns required to be filed and payee statements required to be furnished after January 4, 2017.

[1074] Reg. §301.6724-1(a)(2)(ii).

[1075] Reg. §301.6724-1(c)(1)(i), §301.6724-1(c)(2). At least one appellate court has vacated a district court ruling and remanded the case for a new trial based on an overly broad jury instruction under Reg. §301.6724-1(c)(2). See *RSBCO v. United States*, 2024 BL 203721 (5th Cir. 2024) ((jury instruction that would excuse taxpayer's untimely filing inconsistent with regulation).

[1076] Reg. §301.6724-1(c)(1)(ii), §301.6724-1(c)(3).

[1077] *Dealers Auto Auction of Sw. LLC v. Commissioner*, T.C. Memo 2025-38 (taxpayer failed to establish that software did not perform as intended and that it acted reasonably before or after software malfunction).

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IRS and, if available, a copy of the filer's request for the information.[1078]

• Actions of the filer's agent if: (1) the filer exercised reasonable business judgment in contracting with the agent sufficiently in advance of the due date to timely file correct returns or timely furnish correct payee statements; and (2) there were significant mitigating factors or events beyond the agent's control that constitute reasonable cause for his failure.[1079]

• Failure of a payee to furnish correct information. The filer must show that the failure resulted from incorrect information provided by the payee (or any other person — e.g., a broker — required to provide information necessary for the filer to comply with the information reporting requirements) that the filer relied upon in good faith. If requested, the filer must provide documentary evidence to show that the failure was attributable to the payee (or other person).[1080]

Example 1: On August 1, 2023, Individual A, an independent contractor, establishes a relationship (account) with Institution L, which pays A amounts reportable under §6041. When A opens the account L requests that A supply his TIN on the account creation document. A fails to provide his TIN. On October 2, 2023, L mails a solicitation for A's TIN that satisfies Reg. §301.6721-1(e)(1)(ii). A does not provide a TIN to L during 2023. L timely files an information return subject to §6721, that does not contain A's TIN, for payments made during the 2023 calendar year with respect to A's account. A penalty is imposed on L, pursuant to Reg. §301.6721-1(a)(2), for L's failure to file a correct information return because A's TIN was not shown on the return. The penalty will be waived, however, if L establishes that the failure was due to reasonable cause.

To establish reasonable cause, L must show it acted in a responsible manner in attempting to satisfy the information reporting requirement and demonstrates that the failure arose from events beyond its control. L may demonstrate that it acted in a responsible manner only by showing it requested a TIN at the time the account was opened (the initial solicitation) and, if the filer does not receive the TIN at that time, to solicit the TIN on or before December 31 of the year the account is opened (for accounts opened before December) or January 31 of the following year (for accounts in the preceding December) (the annual solicitation). Because L has performed these solicitations within the time and in the manner prescribed, L has acted in a responsible manner. Under the facts, L can show that the failure was caused by A's failure to provide a TIN, an event beyond L's control. As a result, L has established reasonable cause. Therefore, the penalty imposed under Reg. §301.6721-1(a)(2) for the failure on the 2023 information return is waived. See §3406(a)(1)(A), which requires L to impose backup withholding on reportable payments to A if L has not received A's TIN.[1081]

Example 2: On August 1, 2023, Individual B opens an account with Bank M, which pays B interest reportable under §6049. When B opens the account, M requests that B supply his TIN on the account creation document. B provides his TIN to M. On February 28, 2024, M includes the TIN that B provided on the Form 1099-INT, *Interest Income*, for calendar-year 2023. In October 2024 the IRS, pursuant to §3406(a)(1)(B), notifies M that the 2023 return filed for B contains an incorrect TIN. In April 2025 a penalty is imposed on M, pursuant to Reg. §301.6721-1(a)(2), for M's failure to file a correct information return for the 2023 calendar year, that is, the return did not contain B's correct TIN. The penalty will be waived if M establishes that the failure was due to reasonable cause as defined in Reg. §301.6724-1.

To establish reasonable cause under Reg. §301.6724-1, M must show it acted in a responsible manner in attempting to satisfy the information reporting requirement and demonstrates that the failure arose from events beyond its control. M can demonstrate that it acted in a responsible manner only if M requested a TIN at the time the account is opened, an initial solicitation. The initial solicitation relates to failures on returns filed for the year an account is opened. Because M performed the initial solicitation in 2023 in the time and manner prescribed and reflected the TIN received from B on the 2023 return as required, M has acted in a responsible manner. M can also show that the failure was caused by B's failure to provide a correct TIN, an event beyond M's control. As a result, M has established reasonable cause and the penalty imposed under Reg. §301.6721-1(a)(2) for the failure on the 2023 information return is waived. See §3406(a)(1)(B), which requires M to impose backup withholding on reportable payments to B if M has not received B's correct TIN.[1082]

Additional examples are provided in the regulation.

4. Acted in a Responsible Manner

Under any scenario, the filer must prove that he acted in a responsible manner. Acting responsibly means that the filer:

• Exercised the care that a reasonably prudent person would use under the circumstances, in the course of its business, in determining its filing obligations and in handling account information;[1083] and

• Undertook significant steps to avoid or mitigate the failure.[1084]

Accordingly, if appropriate, the filer must:

• Request appropriate extensions of time to file, when practicable, in order to avoid the failure;[1085]

[1078] Reg. §301.6724-1(c)(1)(iii), §301.6724-1(c)(4).
[1079] Reg. §301.6724-1(c)(1)(iv), §301.6724-1(c)(5).
[1080] Reg. §301.6724-1(c)(1)(v), §301.6724-1(c)(6).
[1081] Reg. §301.6724-1(k)(1) *Ex.* 1.
[1082] Reg. §301.6724-1(k)(2) *Ex.* 2.
[1083] Reg. §301.6724-1(d)(1)(i).
[1084] Reg. §301.6724-1(d)(1)(ii).
[1085] Reg. §301.6724-1(d)(1)(ii)(A).

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• Attempt to prevent any foreseeable impediment or failure;[1086]

• Act to remove an impediment or the cause of a failure once it occurs;[1087] and

• Rectify the failure as promptly as possible (generally within 30 days) after the impediment is removed or the failure is discovered.[1088]

A filer seeking a waiver for reasonable cause under Reg. §301.6724-1(c)(6) with respect to a failure resulting from a missing or an incorrect TIN will be deemed to have acted in a responsible manner in compliance with Reg. §301.6724-1(d)(1)(i) only if the filer satisfies the requirements of Reg. §301.6724-1(e) (relating to missing TINs) or Reg. §301.6724-1(f) (relating to incorrect TINs), whichever is applicable.[1089]

Special rules apply if the failure relates to a missing or incorrect TIN of a third party. Generally, a filer seeking a reasonable cause waiver must establish that the failure to include the TIN or provide the correct TIN resulted from the payee's failure to provide information to the filer in response to an initial solicitation, and, if required, after annual solicitations for the TIN by the filer. A missing TIN is a number that does not contain nine digits or includes one or more alpha characters as one of the nine digits.[1090] An initial solicitation for a payee's correct TIN must generally be made at the time an account is opened.[1091] A filer must undertake an annual solicitation if a TIN is not received as a result of an initial solicitation, or if the filer was not required to make an initial solicitation, and the filer has not received a payee's TIN.[1092] If the TIN is not received as a result of the first annual solicitation, the filer must undertake a second annual solicitation.[1093] After receiving a TIN, a filer must provide that TIN on the information return's by the first due date occurring after the date that the filer receives the TIN.[1094] The initial and first annual solicitations relate to failures on returns filed for the year in which an account is opened. The second annual solicitation relates to failures on returns filed for the year immediately following the year in which an account is opened and for succeeding calendar years.[1095] See Reg. §301.6724-1(e)(1)(vi) for more about the following solicitation requirement exceptions and limitations:

• An information reporting provision provides specific requirements for TIN solicitation time and manner;[1096]

• No payments are made to the account or no return is required to be filed for the account for the year;[1097]

• If after failing to make one or more required solicitations, the filer made two consecutive annual solicitations in subsequent years;[1098]

• Solicitation by mail for financial institutions that have accounts with stop-mail or hold-mail instructions;[1099]

• Solicitation by mail for any filer on accounts with an undeliverable address.[1100]

In general, a filer that is seeking a waiver for reasonable cause under Reg. §301.6724-1(c)(6) satisfies Reg. §301.6724-1(d)(2) with respect to establishing that a failure resulted from incorrect information provided by the payee or any other person (that is, inclusion of an incorrect TIN) on an information return only if the filer makes the initial and annual solicitations described in Reg. §301.6724-1(f). See Reg. §301.6724-1(e)(1) for the definition of the term solicitation. See Reg. §301.6724-1(f)(5)(i) for alternative solicitation requirements. See Reg. §301.6724-1(g) for the safe harbor due diligence rules.[1101]

An initial solicitation for a payee's correct TIN must be made at the time the account is opened. The term account includes accounts, relationships, and other transactions. However, a filer is not required to make an initial solicitation under Reg. §301.6724-1(f)(1)(i) with respect to a new account if the filer has the payee's TIN and uses that TIN for all accounts of the payee. No additional solicitation is required after the filer receives the TIN unless the IRS or a broker notifies the filer that the TIN is incorrect. Following such notification the filer may be required to make an annual solicitation to obtain the correct TIN as provided in paragraphs Reg. §301.6724-1(f)(1)(ii) and §301.6724-1(f)(1)(iii) of this section.[1102]

Except as provided in Reg. §301.6724-1(f)(5), a filer must undertake an annual solicitation only if the payor has been notified of an incorrect TIN and such account contains the incorrect TIN at the time of the notification. The first annual solicitation must be made as required by Reg. §301.6724-1(f)(2) or §301.6724-1(f)(3), whichever applies. An account contains an incorrect TIN at the time of notification if the name and number combination on the account matches the name and number combination set forth on the notice from the IRS or a broker. A filer may be notified of an incorrect TIN by the IRS or by a broker pursuant to §3406(a)(1)(B) or by a penalty notice issued by the IRS pursuant to §6721. Except as otherwise provided in Reg. §301.6724-1, the annual solicitation required by Reg. §301.6724-1(f) must be made on or before December 31 of the year in which the filer is notified of the incorrect TIN or

[1086] Reg. §301.6724-1(d)(1)(ii)(B).
[1087] Reg. §301.6724-1(d)(1)(ii)(C).
[1088] Reg. §301.6724-1(d)(1)(ii)(D).
[1089] Reg. §301.6724-1(d)(2).
[1090] Reg. §301.6724-1(e)(1). See Reg. §301.6724-1(e)(2) for the time and manner of making annual solicitations. *See also* CCA 201234025 (when gaming establishment followed established requirements to solicit winning patron's TIN at time of slot machine winnings, gaming establishment qualifies under Reg. §301.6724-1(f)(5)(i), for exception to annual solicitation requirement; further, when each reportable slot machine jackpot is separate and discreet transaction and there is no ongoing account or relationship between establishment and patron, establishment qualifies under Reg. §301.6724-1(f)(5)(ii) for exception to annual solicitation requirement). Reg. §301.6724-1(f)(2) and §301.6724-1(f)(3) clarify how annual solicitations must be made following notification of an incorrect TIN using a §3406(a)(1)(B) penalty notice (B notice).
[1091] Reg. §301.6724-1(e)(1)(i).
[1092] Reg. §301.6724-1(e)(1)(ii).
[1093] Reg. §301.6724-1(e)(1)(iii).
[1094] Reg. §301.6724-1(e)(1)(iv).
[1095] Reg. §301.6724-1(e)(1)(v).
[1096] Reg. §301.6724-1(e)(1)(vi)(A).
[1097] Reg. §301.6724-1(e)(1)(vi)(B).
[1098] Reg. §301.6724-1(e)(1)(vi)(C)(1).
[1099] Reg. §301.6724-1(e)(1)(vi)(D).
[1100] Reg. §301.6724-1(e)(1)(vi)(E).
[1101] Reg. §301.6724-1(f)(1).
[1102] Reg. §301.6724-1(f)(1)(i).

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by January 31 of the following year if the filer is notified of an incorrect TIN in the preceding December.[1103]

A filer must undertake a second annual solicitation as required by Reg. §301.6724-1(f)(2) or §301.6724-1(f)(3), whichever applies, if the filer is notified in any year following the year of the notification described in Reg. §301.6724-1(f)(1)(ii) that the account of a payee contains an incorrect TIN, as described in Reg. §301.6724-1(f)(1)(ii).[1104]

Upon receipt of a TIN, a filer must include that TIN on any information returns due after the date that the filer receives the TIN.[1105]

A filer that has been notified of an incorrect TIN by a penalty notice or other notification pursuant to §6721 may satisfy the Reg. §301.6724-1(f) solicitation requirement either by mail, in the manner set forth in Reg. §301.6724-1(e)(2)(i); by telephone, in the manner set forth in Reg. §301.6724-1(e)(2)(ii); or by requesting the TIN in person.[1106]

A filer that has been notified of an incorrect TIN pursuant to §3406(a)(1)(B) (except filers to which Reg. §31.3406(d)-5(b)(4)(i)(A) applies) will satisfy the solicitation requirement of Reg. §301.6724-1(f) only if it makes a solicitation in the manner and within the time period required under Reg. §31.3406(d)-5(d)(2)(i) or §31.3406(d)-5(g)(1)(ii), whichever applies.[1107]

A filer that has been notified of an incorrect TIN by a notice pursuant to §6721 (except filers to which Reg. §31.3406(d)-5(b)(4)(i)(A) of this chapter applies) is not required to make the annual solicitation of Reg. §301.6724-1(f) if:

- The filer has received an effective notice pursuant to §3406(a)(1)(B) with respect to the same payee, either during the same calendar year or for information returns filed for the same year; and
- The filer makes a solicitation in the manner and within the time period required under Reg. §31.3406(d)-5(d)(2)(i) or §31.3406(d)-5(g)(1)(ii), whichever applies, before the filer is required to make the Reg. §301.6724-1(f) annual solicitation.[1108]

A filer that has been notified of an incorrect TIN by a notice pursuant to §6721 with respect to a fiduciary or nominee account to which Reg. §31.3406(d)-5(b)(4)(i)(A) applies is required to make the Reg. §301.6724-1(f) annual solicitation.[1109]

The initial solicitation relates to failures on returns filed for the year an account is opened and for any succeeding year that precedes the year in which the filer receives a notification of an incorrect TIN. The first and second annual solicitations relate to failures on returns filed for the year in which a notification of an incorrect TIN is received. The second solicitation also relates to failures on returns filed for succeeding calendar years.[1110]

The Reg. §301.6724-1(f) solicitation requirements do not apply to the extent that an information reporting provision under which a return, as defined in Reg. §301.6721-1(h), is filed provides specific requirements relating to the manner or the time period in which a TIN must be solicited. In that event, the requirements of §301.6724-1(f) will be satisfied only if the filer complies with the manner and time period requirement under the specific information reporting provisions and §301.6724-1(f), to the extent applicable.[1111]

An annual solicitation is not required to be made for a year under Reg. §301.6724-1(f) with respect to an account if no payments are made to the account for such year or if no return, as defined in Reg. §301.6721-1(h), is required to be filed for the account for such year.[1112]

If a filer fails to make one (or more) of the required solicitations under Reg. §301.6724-1(f)(1)(i) (solicitation when account is opened), §301.6724-1(f)(1)(ii) (first annual solicitation), and §301.6724-1(f)(1)(iii) (second annual solicitation), the filer may satisfy the requirement of acting in a responsible manner by:

- Making two consecutive annual solicitations in subsequent years ("make-up solicitations"), and
- Satisfying Reg. §301.6724-1(f)(1)(iv) (i.e., upon receipt of a TIN, include that TIN on any information returns the original due date of which — with regard to extensions — is after the date that the filer receives the TIN).[1113]

A filer who has made none of the required solicitations may satisfy the requirements by making two consecutive solicitations. In determining whether a filer has made two consecutive solicitations, years to which Reg. §301.6724-1(f)(5)(ii) (an annual solicitation need not be made for a year if no payments are made to the account for that year or if no return is required to be filed for the account for that year) applies are disregarded. If a filer fails to make the initial solicitation at the time the account is opened, the make-up solicitations described in Reg. §301.6724-1(f)(5)(iii) may be made in the years in which the first and second annual solicitations are required to be made. However, the penalty will apply with respect to the year in which the filer failed to make the initial solicitation. The penalty will apply to failures in years in which a required solicitation is not made and to failures for subsequent years until the filer conducts its make-up solicitations. The penalty will not apply to the year in which the first make-up solicitation is made (unless it is also the year in which the filer fails to make the initial solicitation) if the second make-up solicitation is made in the following year.[1114]

A financial institution need not make an annual solicitation by mail on accounts with "stop-mail" or "hold-mail" instructions, provided the filer furnishes the solicitation material to the payee in the same manner as it furnishes other mail.[1115]

A filer need not make annual solicitations by mail on accounts with respect to which the filer has an undeliverable address, i.e., when other mailings to that address have been re-

[1103] Reg. §301.6724-1(f)(1)(ii).
[1104] Reg. §301.6724-1(f)(1)(iii).
[1105] Reg. §301.6724-1(f)(1)(iv).
[1106] Reg. §301.6724-1(f)(2).
[1107] Reg. §301.6724-1(f)(3)(i).
[1108] Reg. §301.6724-1(f)(3)(ii).
[1109] Reg. §301.6724-1(f)(3)(iii).
[1110] Reg. §301.6724-1(f)(4).
[1111] Reg. §301.6724-1(f)(5)(i).
[1112] Reg. §301.6724-1(f)(5)(ii).
[1113] Reg. §301.6724-1(f)(5)(iii).
[1114] Reg. §301.6724-1(f)(5)(iii).
[1115] Reg. §301.6724-1(f)(5)(iv).

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turned to the filer because the address was incorrect and no new address has been provided to the filer.[1116]

In general, except as provided in Reg. §301.6724-1(f)(1)(i) and §301.6724-1(f)(5)(iii), no more than two annual solicitations are required for a filer to establish reasonable cause. However, a filer who complies with Reg. §301.6724-1(f) during a calendar year after receiving a notice under §6721 and who later during the same calendar year receives a notice pursuant to §3406 may have to undertake additional annual mailings in such calendar year pursuant to §3406(a)(1)(B) in order to satisfy the annual solicitation requirement in Reg. §301.6724-1(f)(3) (coordination with solicitations under §3406(a)(1)(B)).[1117]

The TIN solicitation requirements and back-up withholding programs are discussed further in 643 T.M., *Information Reporting to U.S. Persons — Payments Subject to Back-up Withholding.*

D. Broker Notification Requirements

Every person doing business as a broker must make a return when required by the IRS, in accordance with applicable regulations, showing the name and address of each customer, with details regarding gross proceeds and any other information as the IRS may require by forms or regulations.[1118] A broker includes a dealer, a barter exchange,[1119] and any person who, for consideration, regularly acts as a middleman with respect to property or services.[1120] For returns required to be filed, and statements required to be furnished after December 31, 2023, a broker also includes any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.[1121] Under §6045(b), every broker who must make a return also must furnish to each customer whose name is required to appear on the return a written statement on or before February 15 following the end of the calendar year to which the return relates.

Note: The Form 1099-B furnished by brokers also must include the adjusted basis of the security sold and whether any gain or loss with respect to the security sold is long-term or short-term.[1122] If the adjusted basis is reported incorrectly, but the broker is not required to correct the amount under §6721(c)(3) or §6722(c)(3), the incorrect amount is treated as the correct adjusted basis.[1123] However, if a broker, on identifying a dollar amount as incorrect, voluntarily both files a corrected information return and issues a corrected payee statement showing the correct dollar amount, the adjusted basis will be the correct dollar amount as reported on the corrected statements regardless of any requirement under §6721 or §6722.[1124]

The backup withholding provisions impose special reporting requirements on brokers. A broker through whom "readily tradable instruments" are acquired for a customer must also notify the payor of the instrument in certain situations when the payee is subject to backup withholding.[1125]

A broker who willfully fails to provide the required notice to a payor is subject to a penalty of $500 for each failure.[1126] This penalty is imposed in addition to any other penalty required by law.[1127]

The broker reporting requirements are discussed further in 643 T.M., *Information Reporting to U.S. Persons — Payments Subject to Back-up Withholding.* Broker reporting requirements for digital assets are discussed in detail in 190 T.M., *Taxation of Cryptocurrency and Other Digital Assets.*

E. OID Information Requirements

The issuer of a debt instrument having original issue discount ("OID")[1128] is required, to the extent provided by the regulations, to set forth on the instrument the amount of OID and the issue date.[1129] If the debt issue is not publicly offered, the information is not required before a disposition of the instrument by the first buyer.[1130] In addition, the issuer of a publicly traded debt instrument having OID is required to furnish the IRS with the amount of the OID, the issue date, and such other information as may be required by the regulations.[1131] This reporting requirement also applies to the public offerings of stripped bonds or stripped coupons, but does not apply to certain instruments described in §1272(a)(2) with respect to which the holder is not required to include OID in income.[1132]

A $50 penalty is imposed for each failure to set forth the required information on an OID instrument.[1133] The penalty for failing to provide the IRS with the required information on the date prescribed is 1% of the aggregate issue price of the issue, with a $50,000 maximum penalty for a single issue.[1134] Neither penalty is imposed if the taxpayer establishes that the failure to include the required information on the instrument or the failure to furnish the required information to the IRS is due to reasonable cause, and not willful neglect.[1135]

The deficiency procedures are expressly made inapplicable to the assessment or collection of these penalties.[1136]

See 181 T.M., *Time Value of Money — Holders of Debt Instruments*, 182 T.M., *Time Value of Money — Issuers of Debt Instruments*, and 643 T.M., *Information Reporting to U.S.*

[1116] Reg. §301.6724-1(f)(5)(v).
[1117] Reg. §301.6724-1(f)(5)(vi).
[1118] §6045(a), §6045(g); Reg. §1.6045-1, Reg. §1.6045-2, Reg. §1.6045-1(d)(2).
[1119] Barter exchanges are not required to report exchanges involving property or services with a fair market value of less than $1.00. Notice 2000-6.
[1120] §6045(c)(1). Farm managers are exempt from the requirement of filing a Form 1099, because this information must be filed on a Schedule F. §6045(c)(1) (flush language).
[1121] §6045(c)(1)(D).
[1122] §6045(g); Reg. §1.6045-1(d)(2), Under a pilot program payers may truncate (mask) the payee's identifying number, and thus show only the last four digits. *See* Notice 2009-93.
[1123] §6045(g)(2)(B)(iii).
[1124] Reg. §1.6045-1(d)(6)(vii), T.D. 9984, 88 Fed. Reg. 87,696 (Dec. 19, 2023), effective for information returns required to be filed and payee statements required to be furnished after December 31, 2023. Reg. §1.6045-1(d)(6)(ix).
[1125] §3406(d)(2)(B).
[1126] §6705(a).
[1127] §6705(b).
[1128] Original issue discount is defined at §1273(a).
[1129] §1275(c)(1)(A).
[1130] §1275(c)(1)(B).
[1131] §1275(c)(2).
[1132] §1275(c)(2), §1275(c)(3).
[1133] §6706(a).
[1134] §6706(b).
[1135] §6706(a), §6706(b).
[1136] §6706(c). *See also* §6665 and §6671(a), discussed at XII., below.

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Persons — Payments Subject to Back-up Withholding, for a further discussion of OID and reporting requirements.

F. Attorney Fee Reporting

Section 6045(f) requires a payor engaged in a trade or business to report the annual gross proceeds paid to an attorney (including legal services corporations) in connection with legal services (whether or not the services were performed for the payor), except for payments required to be reported under §6041 or §6051. Under §6045(b) and §6045(f), every payor who must report such proceeds also must furnish to each attorney whose name is required to appear on the return a written statement on or before February 15 following the end of the calendar year to which the return relates.

Generally, a payor must report payments to an attorney in connection with legal services (regardless of whether the legal services are performed for the payor) aggregating $600 or more during a calendar year.[1137] A payor — a person who makes a payment and is an obligor on the payment or the obligor's insurer or guarantor — must include the payor's taxpayer identification number ("TIN") as well as the TIN for the attorney to whom a payment was made.[1138] A payment is subject to backup withholding in the event that an attorney fails or refuses to provide the TIN.[1139]

Reg. §1.6045-5(g) cross-references the following penalty provisions for failure to comply with §6045(f) or with the proposed regulations:

- §6721 for failure to file a correct information return;
- §6722 for failure to furnish a correct payee statement;
- §6723 for failure to comply with other reporting requirements; and
- §7203 for willful failure to supply information (including a TIN).

For a full discussion of attorney fee reporting requirements, see 523 T.M., *Deductibility of Legal and Other Professional Fees*.

[1137] Reg. §1.6045-5(a)(1).

[1138] Reg. §1.6045-5(a)(2), §1.6045-5(d)(3), §1.6045-5(e).

[1139] Reg. §1.6045-5(e).

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VII. Tax Return Preparer Penalties

A. Background

There are standards of performance and disclosure requirements for persons who prepare tax returns and refund claims for compensation. If a tax return preparer violates these standards or requirements, the IRS can impose a variety of civil penalties[1140] and may seek an injunction to prevent the preparer from preparing additional returns and/or bar the preparer from practice before the IRS. Tax return preparer penalties include the penalties under §6694 for the preparer's understating a taxpayer's liability due to a position that the preparer knew (or reasonably should have known) was unreasonable or due to the preparer's willful attempt to understate such liability or his reckless or intentional disregard of rules and regulations,[1141] and the penalties under §6695 for the preparer's failing to furnish a copy of the prepared return to the taxpayer, failing to sign a prepared return, failing to include his identification number on a prepared return, failing to retain a copy of a prepared return, failing to file a correct information return, negotiating a taxpayer's refund check, or failing to diligently determine head of household filing status and certain credits.[1142]

Comment: If a tax return preparer or other advisor is potentially subject to a penalty, the preparer's interests may differ from those of the taxpayer. At that time, it may be appropriate for the taxpayer to seek separate counsel.

B. Tax Return Preparer

1. Tax Return Preparer

a. In General

A "tax return preparer" is:[1143]

- Any person;
- Who prepares (or who employs one or more persons who prepare);
- All or a substantial portion of;
- A tax return or a claim for refund under the Code;
- For compensation.

Comment: The preparer penalties apply to paid preparers of any tax return required to be filed under the Code. As a result, preparers of income tax returns, estate tax returns, gift tax returns, generation-skipping transfer tax returns, excise tax returns and tax returns of exempt organizations are covered.[1144] However, the preparer penalties do not apply to returns required to be filed under another statute. For example, the penalties do not apply to preparing FinCEN Form 114, *Report of Foreign Bank and Financial Accounts,* which is required by the Bank Secrecy Act.[1145]

b. Person

A preparer can be any person; it does not have to be an individual. In addition to an individual, a preparer may be a corporation, a partnership, a trust, an estate, a company, or an association.[1146]

c. Prepares or Employs Another to Prepare

Preparing a return or claim for refund for purposes of being considered a tax return preparer is much broader than merely filing out a return or claim for refund based on information provided by the taxpayer. For example, a person who furnishes to a taxpayer or another tax return preparer sufficient information and advice so that completion of the return or claim for return is largely a mechanical or clerical matter is considered a tax return preparer, even though that person does not actually place or review placement of information on the return or claim for refund.[1147] In one ruling, for example, a corporation was considered to be a preparer even though, under its franchise agreement, it was prohibited from physically preparing any returns.[1148] Similarly, where appraisals represent a substantial portion of a tax return, an appraiser may be liable as a tax return preparer under §6694.[1149]

A person who renders tax advice on a position that is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund is regarded as having prepared that entry.[1150] As a result, a person who reviews a return for substantive correctness is considered a preparer, whether or not the review results in any changes to the return.[1151] Similarly, an advisor who conducted a study of the taxpayer's allowable research credits for prior years is a preparer where the results of the study, including the improper election and computation, formed the basis of the taxpayer's reporting on his tax return.[1152] In addition, a company that furnishes computerized tax return preparation services (and the computer programmer) is treated as preparing the tax returns that utilized the program where the program goes beyond mere mechanical and clerical assistance and makes substantive determinations concerning the application of the tax law to the in-

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[1140] §6696(a).

[1141] See the discussion at VII.C., below.

[1142] See the discussion at VII.D., below.

[1143] §7701(a)(36)(A). For purposes of the preparer penalties under §6694, a return or claim for refund is considered prepared on the date it is signed by the tax return preparer. If a signing tax return preparer (defined in VII.B.2., below) fails to sign, the return or claim for refund is considered prepared on the date it is filed. In the case of a nonsigning tax return preparer (defined in VII.B.3., below), the relevant date is the date the nonsigning preparer provides the tax advice for the position giving rise to the understatement of tax. Such date is determined based on all the facts and circumstances. Reg. §1.6694-1(a)(2). The preparer penalties under §6694 are discussed at VII.C., below.

[1144] 2007 Blue Book at 34; Preamble to Proposed Regulations, REG-129243-07, 73 Fed. Reg. 34,560 (June 17, 2008).

[1145] See the discussion at X.B., above.

[1146] §7701(a)(1).

[1147] Reg. §301.7701-15(c).

[1148] TAM 8731004 (company is preparer because it made certain determinations for the proper characterization of payments).

[1149] *United States v. Zak*, 1:18-cv-05774-AT, 2019 BL 501507 (N.D. Ga. Dec. 10, 2019).

[1150] Reg. §301.7701-15(b)(3)(i).

[1151] Rev. Rul. 84-3; PLR 7902033.

[1152] FAA 20032601F.

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formation provided.[1153] It is not relevant that the person (or his employees) did not personally review the return.[1154]

Example: Attorney A provides legal advice to a taxpayer regarding a completed transaction. The advice is directly relevant to the determination of an entry on the taxpayer's return and leads to a position or entry that constitutes a substantial portion of the return. A is a tax return preparer for that return.[1155]

Example: Attorney B provides legal advice to a taxpayer regarding the tax consequences of a proposed transaction. Based on this advice, the taxpayer enters into the transaction. B does not provide any advice after the transaction was completed. Accordingly, B is not a tax return preparer.[1156]

Example: P developed a computer program to prepare tax returns for customers who purchase the program. A customer enters his information pursuant to the prescribed forms. Based on the information fed into it, the program calculates return items, including the amount of depreciation allowed, whether the particular taxpayer is eligible for certain deductions, and limitations on various deductions. Because the program makes substantive determinations in applying the tax law to the information provided, P is a preparer of the tax return, even though P never saw the return.[1157]

Comment: The IRS recognized the need to treat as preparers people who render advice related to a position on the return, but who do not sign the return. Otherwise, the preparer penalties could be avoided by the signing preparer by relying on an opinion from another tax professional who is not subject to the penalty.

A person's educational qualifications and professional status (or lack thereof) are not relevant in determining whether the person is a tax return preparer.[1158] Similarly the location where a return or claim for refund is prepared, and the nationality and residence of the person preparing the return or claim for refund, are irrelevant.[1159]

A tax return preparer for one return is not considered a tax return preparer of another return merely because one or more entries reported on the first return may affect an entry reported on the other return. If, however, the entries reported on the first return are directly reflected on the other return and constitute a substantial portion of the other return, the preparer is also considered a preparer of the other return.[1160] For example, the sole preparer of a partnership or S corporation income tax return is considered a preparer of the returns of a partner or shareholder, if the entries on the partnership or S corporation return that are reportable on the partner's or shareholder's return constitute a substantial portion of such returns.[1161] Similarly, the tax return preparer of a return showing a net operating loss is also a preparer of each return that reflects a carryback or carryover of that loss as a substantial portion of such return.[1162]

Comment: Although the regulation refers only to a return, presumably the same rule applies to a claim for refund.

A person who employs another person to prepare all or a substantial portion of a return or claim for refund for compensation is also a preparer.[1163] The legislative history clarifies that for this purpose, the other person may be either an employee or an independent contractor.[1164] To be considered an employee for this purpose, the purported employer must control or have the right to control at least some aspect of the policies, procedures and standards relating to the operation of the income tax return preparation business.[1165] The fact that an employee prepared a substantial portion of the return does not prevent the employer from being a preparer. It is irrelevant whether or not the employer assisted in the preparation of a substantial portion of the return.[1166]

Comment: As a result of these provisions, a return can have more than one preparer.

Example: S, the owner and operator of a large department store, grants P corporation the privilege of operating a tax return preparation business as a licensed department in S's store. P is required to operate within certain general rules established by S for advertising, hours of operation, etc. Generally, S does not attempt to establish policies, procedures, or standards relating to the daily operation of P's tax return preparation business. Moreover, S does not control, or have any right to control, the actual preparation of tax returns prepared by P or by P's sublicensees.

P sublicenses Y, another corporation, to operate the tax return preparation business in S's store. Under the terms of the sublicense, Y operates its business in strict compliance with the policies, procedures and standards established by P. Y is responsible for staffing the facility with qualified tax return preparers who actually prepare the returns. P, however, provides assistance to Y by making a consultant

[1153] Rev. Rul. 85-187, Rev. Rul. 85-188, Rev. Rul. 85-189. However, if the services are limited to typing, reproduction or other mechanical assistance, the person is not a tax return preparer. Reg. §301.7701-15(f)(1)(viii). See the discussion at VII.B.4., below.

[1154] Rev. Rul. 85-189.

[1155] Reg. §301.7701-15(b)(2)(ii) *Ex.* 1.

[1156] Reg. §301.7701-15(b)(2)(ii) *Ex.* 2.

[1157] Rev. Rul. 85-189.

[1158] Reg. §301.7701-15(d). *Cf. Powell v. Kopman*, 511 F. Supp. 700 (S.D.N.Y. 1981) (status as an attorney did not prevent individual from being a preparer).

[1159] Reg. §301.7701-15(e). The person preparing the return, however, must obtain a TIN if such person is (a) an employer of another tax return preparer, (b) a partnership in which one or more of the general partners is a tax return preparer, (c) a firm in which one or more of the equity holders is a tax return preparer, or (d) an individual who is not employed by another tax return preparer. Reg. §301.7701-15(e).

[1160] Reg. §301.7701-15(b)(3)(iii). Substantial portion is described at VII.B.1.d., below.

[1161] Reg. §301.7701-15(b)(3)(iii); *Goulding v. United States*, 957 F.2d 1420 (7th Cir. 1992). *See also Adler & Drobny, Ltd. v. United States*, 9 F.3d 627 (7th Cir. 1993), rev'g and rem'g 792 F. Supp. 579 (N.D. Ill. 1992).

[1162] Rev. Rul. 81-171.

[1163] §7701(a)(36); Reg. §301.7701-15(a).

[1164] 1976 Act House Report at 276, n. 1; 1976 Act Senate Report at 352. In this part VII., except as otherwise indicated, "employee" includes both a common law employee and an independent contractor, and the person engaging such employee is referred to as the "employer.".

[1165] Rev. Rul. 81-246.

[1166] *Schneider v. United States*, 257 F. Supp. 2d 1154 (S.D. Ind. 2003).

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available to help resolve any tax or administrative problem that may arise. Under the terms of the arrangement, S receives all monies from the operation of the license department and pays over to P an established percentage of the receipts. P then pays Y its share.

Accordingly, the individuals engaged by Y are tax return preparers. Y, having retained these individuals as employees, is also considered a preparer. P is a preparer, because it asserts control over the policies, procedures and standards relating to the operation of the tax return preparation business and because it provides assistance in resolving problems concerning return preparation. S, on the other hand, is not a preparer. S does not control, or have any right to control the actual preparation of the tax returns. The license agreement between S and P merely gives S the right to control matters that relate only incidentally to the preparation of tax returns.[1167]

d. All or a Substantial Portion

Only a person who prepares all or a substantial portion of a return or claim for refund is considered a tax return preparer of that return or claim for refund. Whether a schedule, entry or other portion of a return or claim for refund is a "substantial portion" is determined based upon whether the person knows or reasonably should know that the tax attributable to such schedule, entry or other portion is a substantial portion of the tax required to be shown on the return or claim for refund.[1168] A single tax entry may constitute a substantial portion of the tax required to be shown on the return.[1169] Factors to consider in determining whether a schedule, entry or other portion of a return or claim for refund constitutes a substantial portion of such return or claim for refund include (but are not limited to):

(1) the size and complexity of the item relative to the taxpayer's gross income, and

(2) the size of the understatement attributable to the items compared to the taxpayer's reported tax liability.[1170]

Special rules apply in determining what is a substantial portion in the case of a nonsigning preparer. See the discussion at VII.B.3., below.

e. Return or Claim for Refund

A person can only be a tax return preparer of a return or claim for refund of a tax under the Code.[1171] For this purpose, a "return" is either:[1172]

• A return (including an amended or adjusted return) filed by (or on behalf of) a taxpayer[1173] reporting the taxpayer's liability for tax under the Code, if the type of return is identified in published guidance in the Internal Revenue Bulletin; or

• An information return or other document identified in published guidance in the Internal Revenue Bulletin that reports information that is or may be reported on another taxpayer's return under the Code if the information reported on the information return or other document constitutes a substantial portion of the taxpayer's return.

The definition of "return" is broader for purposes of §6694 (understatement of taxpayer's liability by tax return preparer), §6695 (other assessable penalties for the preparation of tax returns for other persons), and §6695A (substantial and gross valuation misstatements attributable to incorrect appraisals). For purposes of those Code sections, a return is any return of any tax imposed by title 26, any partnership administrative adjustment request under §6227, and any partnership adjustment tracking report under §6226(b)(4)(A).[1174]

A "claim for refund" is a claim for refund of, or credit against, any tax that is included in published guidance in the Internal Revenue Bulletin,[1175] and for purposes of §6694, §6695, and §6695A, means a claim for refund of, or credit against, any tax imposed by Title 26.[1176] It also includes a request for abatement.[1177]

In Rev. Proc. 2009-11, the IRS set forth the list of tax returns and claims for refund to which the preparer penalties may apply. Since the designation is penalty specific, the list is included in the discussion of the particular penalty. Generally, returns include: (1) income tax returns, (2) estate and gift tax returns, (3) employment tax returns, (4) excise tax returns, (5) withholding tax returns, and (6) information returns that affect other returns.

f. For Compensation

Only a person who prepares a return for compensation can be a preparer. Compensation can be payment either in cash or other property. For example, purchasing property at a discount from a taxpayer for whom a return is prepared is compensation.[1178]

In the absence of an explicit or implicit agreement for compensation, a person who renders advice or fills out a return is not a preparer. It is immaterial that the person may receive a gift, a service, or a favor for his efforts.[1179]

Example: P prepares an income tax return gratuitously for his friend F. To show his appreciation, F invites P to dinner. P is not a tax return preparer.

[1167] Rev. Rul. 81-246.

[1168] Reg. §301.7701-15(b)(3)(i).

[1169] Reg. §301.7701-15(b)(3)(i). *See also Adler and Drobny, Ltd. v. United States*, 9 F.3d 627 (7th Cir. 1993) (under pre-2007 Act regulations, a single entry on a Schedule K-1 constituted a substantial portion of an individual partner's personal return).

[1170] Reg. §301.7701-15(b)(3)(i).

[1171] §7701(a)(36).

[1172] Reg. §301.7701-15(b)(4)(i). *See* §6696(e)(1).

[1173] As used in VII., below, "taxpayer" also includes a nontaxable entity that is required to file a return of tax.

[1174] §6696(e)(1).

[1175] Reg. §301.7701-15(b)(4)(ii).

[1176] §6696(e)(2).

[1177] Rev. Proc. 2009-11.

[1178] Rev. Rul. 86-55. *See Tiddy v. United States*, 762 F. Supp. 122 (W.D.N.C. 1991) (landlord who prepared tenants' tax returns and purchased refunds at a discount in lieu of back rent deemed a preparer, provided that refund payments were compensation as opposed to a return on investment), *vac'd by unpub. op.*, 956 F.2d 1163 (4th Cir. 1992).

[1179] Reg. §301.7701-15(f)(1)(xii).

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The compensation need not be a separately stated fee for preparation of the taxpayer's return. For example, the amount a corporation pays for the preparation of its return is also compensation for the preparation of the returns of its shareholders if they are prepared by the same person without charge to the shareholders in a package deal.[1180] In the case of a partnership, a partnership has been treated as an aggregate of the partners. Accordingly, the partnership's payment for the preparation of its return (including the Schedule K-1s) is treated as coming from the partners. As a result, the preparer of the partnership's return is also the preparer of the partner's returns.[1181]

2. Signing Tax Return Preparer

The regulations distinguished between signing and nonsigning tax return preparers. A "signing tax return preparer" is the individual tax return preparer who has the primary responsibility for the overall substantive accuracy of the preparation of the tax return or claim for refund.[1182]

Example: Partnership is an accounting firm that prepares returns and claims for refunds for clients, including Taxpayer. A and B, employees of Partnership prepare a return for Taxpayer, including gathering the necessary information, analyzing the proper application of the tax law to the information, and performing the necessary computations. Following the preparation of the return, C, a supervising employee of Partnership reviews the information that was provided and the application of the tax laws to Taxpayer's particular facts. D, another employee of Partnership, reviews the mathematical computations and carryforward amounts. Partnership's policies and practices then require E, a partner, to finally review all aspects of the return preparation. On these facts, E may exercise these responsibilities to a greater or lesser degree, depending on the complexity of the return, his confidence in the individuals preparing and reviewing the return, and other factors. E is the individual tax return preparer who is primarily responsible for the overall accuracy of Taxpayer's return, and accordingly, E is the signing preparer.[1183]

Example: Corporation is engaged in preparing returns. Corporation engages individual A to collect information relating to Taxpayer. A completes the worksheet kit provided by Corporation, which he mails to Corporation. In the process, A classifies the information into appropriate categories for the preparation of the return. B, an employee of Corporation, reviews the worksheet kit to make sure it was properly completed, but does not review any of the information for its validity or accuracy. B may, but did not, make the final decision regarding the proper application of the tax laws to the information provided. The data from the worksheet is entered into the computer and the return form is completed. In this case, A is the signing preparer.[1184]

Comment: The signing tax return preparer is not defined as the individual who signs the tax return. However, the signing tax return preparer is required to sign the tax return.[1185]

3. Nonsigning Tax Return Preparer

A "nonsigning tax return preparer" is any tax return preparer who is not a signing tax return preparer, but who prepares all or a substantial portion of a return or claim for refund for events that have occurred at the time the advice is rendered.[1186] In determining whether a person is a nonsigning tax return preparer, any time spent on advice that is given for events that have occurred that represents less than 5% of the total time spent by the individual for the positions giving rise to the understatement is not taken into account.[1187]

Comment: The less-than-5% test is intended to encourage tax professionals who principally rendered advice regarding events that have not yet occurred to provide follow-up advice requested by the taxpayer without the concern that, by providing such advice, the professional would become a tax return preparer.[1188]

Notwithstanding the foregoing, time spent on advice before the events have occurred will be taken into account in determining whether the person is a nonsigning tax return preparer if all facts and circumstances show that the positions giving rise to the understatement of tax:[1189]

- is primarily attributable to the advice,
- the advice was substantially given before events occurred primarily to avoid treating the person as a tax return preparer, and
- the advice given before events occurred was confirmed after the events occurred for purposes of preparing a tax return.

Comment: Like many other anti-abuse rules, the application of this provision is based on many vague, undefined terms. The parameters of this rule are left to the courts to determine.

Example: Attorney B provides legal advice to a taxpayer regarding the tax consequences of a proposed transaction. Based on that advice, the taxpayer enters into the transaction. After the transaction is completed, B does not provide any additional advice to the taxpayer and is not the signing preparer. B is not considered a nonsigning tax return preparer.[1190] The result would not change if B supplemented the advice on a telephone call after the transaction occurred, where B's time for the supplemental advice was

[1180] *Papermaster v. United States*, 81-1 USTC ¶9217 (E.D. Wis. 1980), aff'd by *unpub. op.,* 685 F.2d 435 (7th Cir. 1982). *Accord* Rev. Rul. 86-55 (used car dealership that prepared tax returns free of charge for customers who applied the refund toward the downpayment on the purchase of a car is compensated for its return preparation services).

[1181] *Goulding v. United States*, 957 F.2d 1420 (7th Cir. 1992).

[1182] Reg. §301.7701-15(b)(1).

[1183] Reg. §1.6695-1(b)(4) *Ex.* 2.

[1184] Reg. §1.6695-1(b)(4) *Ex.* 3.

[1185] Reg. §1.6695-1(b)(1). See the discussion at VII.D.1., below.

[1186] Reg. §301.7701-15(b)(2)(i).

[1187] Reg. §301.7701-15(b)(2)(i).

[1188] Preamble to Proposed Regulations, REG-129243-07, 73 Fed. Reg. 34,559 (June 17, 2008).

[1189] Reg. §301.7701-15(b)(2)(i).

[1190] Reg. §301.7701-15(b)(2)(ii) *Ex.* 2.

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less than 5% of B's total time in providing tax advice on the position.[1191]

As discussed above, a person is a preparer only if he prepares all or a substantial portion of a return or claim for refund.[1192]

A special de minimis exception applies to nonsigning preparers. If a preparer is a nonsigning preparer, a schedule, entry or other portion of a return or claim for refund is not considered to be a substantial portion if such schedule, entry or other portion involves amounts of gross income, amounts of deduction or amounts on the basis of which tax credits are determined which are: (1) less than $10,000, or (2) less than $400,000 and which are also less than 20% of the gross income (adjusted gross income in the case of an individual taxpayer) shown on the return or claim for refund.[1193] If more than one schedule, entry or other portion is involved, they are aggregated for purposes of applying the de minimis test.[1194]

Example: Accountant C prepares a schedule for an individual taxpayer's Form 1040, reporting $4,000 in dividend income and gives oral advice that results in a claim of a $5,000 medical expense deduction. C is not the signing tax return preparer. Since the aggregate income and deductions relating to C's advice is less than $10,000, C is not a nonsigning tax return preparer with respect to the tax return.[1195]

4. Exceptions

Notwithstanding the foregoing, the following persons are not tax return preparers:[1196]

• An official or employee of the IRS performing official duties;

• An individual who provides tax assistance under a Volunteer Income Tax Assistance ("VITA") program established by the IRS, but only with respect to those returns prepared as part of the VITA program;

• An organization sponsoring or administering a VITA program established by the IRS, but only for that sponsorship or administration;

• An individual who provides tax counseling for the elderly under a program established pursuant to Revenue Act of 1978 §163, but only for those returns prepared as part of that program;

• An organization sponsoring or administering a program to provide tax counseling for the elderly established pursuant to Revenue Act of 1978 §163, but only for that sponsorship or administration;

• An individual who provides tax assistance as part of a qualified Low-Income Taxpayer Clinic as defined by §7526 ("LITC"), but only (a) for those returns and claims for refund prepared as part of the LITC program, (b) where some of the assistance with respect to the return or claim for refund is directly related to a controversy with the IRS for which the LITC is providing assistance or is an ancillary part of a LITC program to inform individuals for whom English is a second language about their rights and responsibilities under the Code, and (c) the LITC does not charge a separate fee, a fee that varies based on whether the LITC provides assistance with a return or refund claim under the Code or more than a nominal fee for its services;[1197]

• An organization that is a qualified LITC, but only if clauses (b) and (c) of the immediately preceding bullet are met;

• An individual who provides only typing, reproduction or other mechanical assistance in the preparation of a return or claim for refund;

Example: A reporting agent who does not provide tax advice or exercise any discretion or independent judgment, but merely processes a client's information and signs the return as authorized by the client pursuant to Form 8655, *Reporting Agent Authorization,* is merely furnishing mechanical assistance. Accordingly, the reporting agent is not a tax return preparer.[1198]

• An individual preparing a return or claim for refund of a taxpayer, or an officer, a general partner, member, shareholder or employee of a taxpayer, by whom the individual is regularly and continuously employed or compensated or in which the individual is a general partner. For this purpose, an employee of a corporation owning more than 50% of the voting power of another corporation, or the employee of a corporation more than 50% of the voting power of which is owned by another corporation, is considered the employee of the other corporation;[1199]

Example: F, a full-time employee of X corporation, prepares a return for his coworker. F is not a preparer of the coworker's return, even if the coworker pays for such service. F could also fill out returns for employees of Y corporation, X's wholly-owned subsidiary, without being considered a tax return preparer. However, if X hires CPA, an accountant, to prepare its return or the individual returns of its employees, CPA is a tax return preparer.[1200]

• An individual preparing a return or claim for refund for a trust, estate or other entity of which the individual either is a fiduciary or is an officer, general partner or employee of the fiduciary. For this purpose, an estate, guardianship, conservatorship, committee or any similar arrangement for a taxpayer under a legal disability (e.g., as a minor, an in-

[1191] Reg. §301.7701-15(b)(2)(ii) *Ex.* 3.
[1192] See the discussion at VII.B.1.d., above.
[1193] Reg. §301.7701-15(b)(3)(ii)(A). The de minimis rule does not apply to a signing tax return preparer. Reg. §301.7701-15(b)(3)(ii)(C).
[1194] Reg. §301.7701-15(b)(3)(ii)(B).
[1195] Reg. §301.7701-15(b)(3)(iv) *Ex.* 2.
[1196] §7701(a)(36)(B); Reg. §301.7701-15(f)(1).
[1197] Reg. §301.7701-15(f)(2), §301.7701-15(f)(3).
[1198] Reg. §301.7701-15(f)(6) *Ex.* 1.
[1199] Reg. §301.7701-15(f)(4).
[1200] 1976 Act House Report at 276; 1976 Act Senate Report at 352.

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competent or an infirm individual) is considered a trust or estate;[1201]

• An individual preparing a claim for refund for a taxpayer in response to (a) a notice of deficiency issued to the taxpayer, or (b) a waiver of restriction on assessment after limitation of an audit of the taxpayer (or another person if a determination in the audit of the other person directly or indirectly affects the tax liability of the taxpayer); or

Example: The IRS audits T's income tax return and proposes a deficiency. T consents to the adjustments by signing a Form 870, *Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment.* T pays the tax and retains P to prepare a claim for refund for that amount. P is not a tax return preparer with respect to such claim for refund.

• A person who prepares a return or claim for refund for a taxpayer with no explicit or implicit agreement for compensation, even if the person receives an insubstantial gift, return service or favor.

C. Tax Return Preparer's Understatement of Taxpayer Liability Penalty

1. Tax Return Preparers Subject to the Penalty

Section 6694(a), discussed in VII.C.3., below, and §6694(b), discussed in VII.C.4., below, impose penalties on tax return preparers for conduct giving rise to certain understatements of liability on a return (including an amended or adjusted return) or claim for refund. A return or claim for refund is deemed prepared on the date it is signed by the tax return preparer.[1202]

a. Individual Within a Firm

For purposes of the preparer penalties under §6694 relating to understatements of tax, the "tax return preparer" is the individual tax return preparer who is primarily responsible for the position or positions on the return or claim for refund which caused an understatement.[1203] There is only one individual tax return preparer within a firm for any position on a return or claim for refund. If different tax return preparers from different firms are involved, there can be multiple individual tax return preparers who are subject to the §6694 penalty.[1204]

If the signing preparer is from the firm, the signing preparer is generally considered to be the individual responsible for all of the positions on the return or claim for refund giving rise to the understatement of tax.[1205] However, it may be shown, based upon credible information from any source, that the signing preparer was not primarily responsible within the firm for one or more positions on the return or claim for refund.[1206]

If there is no signing preparer within the firm or if it is shown that the signing preparer was not primarily responsible for a position giving rise to an understatement of tax, then the preparer with respect to that position for purposes of §6694 is the nonsigning preparer with the firm with overall supervisory responsibility for the position, or another nonsigning preparer within the firm who is shown, based upon credible information from any source, to be primarily responsible for the position.[1207]

In the course of identifying the individual within a firm who is primarily responsible for a position on the return or claim for refund which resulted in an understatement of tax, the IRS may notify multiple individuals in the firm that they may be considered to be primarily responsible for the position.[1208] The individuals can then provide information as to who actually had primary responsibility. If the information would support a finding that either a signing preparer or a nonsigning preparer within a firm is primarily responsible for a position giving rise to an understatement, the IRS may assess the penalty against either individual, but not both, as the primarily responsible tax return preparer.[1209] The determination is based on all the evidence presented. It is expected that the IRS will assess the penalty against the tax return preparer who has the greatest responsibility for the position based on the information available to the IRS at the time.[1210]

Example: Accountant A prepares and signs Taxpayer's return. In the course of such preparation, A consults with Accountant B, at the same firm, with respect to the proper treatment of an item after all the events have occurred with respect to such item. B's advice is reflected on the return and the item constitutes a substantial portion of the return. The IRS later challenges the position, giving rise to an understatement of tax on the return. For purposes of §6694, A, as the signing preparer, is initially considered to be the individual at the firm who is primarily responsible for the position. If, based on information provided by A or another person, it is shown that B was primarily responsible for the position, then B, not A, would be considered the preparer of that position for purposes of §6694. If the information is inconclusive as to whether A or B was primarily responsible for the position, the IRS may assess the §6694 penalty against either A or B, but not both.[1211]

Comment: If the IRS assesses a §6694 penalty against one preparer in a situation where the information would support multiple responsible preparers at the firm having primary responsibility for a position, it does not appear that the preparer who is assessed has any rights of contribution against the other primarily responsible preparers. The Preamble to T.D. 9436 makes it clear that the preparers are not jointly and severally liable for the penalty.

[1201] Reg. §301.7701-15(f)(5).
[1202] Reg. §1.6694-1(a)(2).
[1203] Reg. §1.6694-1(b)(1). Who is a tax return preparer, including the definitions of a signing preparer and a nonsigning preparer, are discussed at VII.B., above.
[1204] Reg. §1.6694-1(b)(1).
[1205] Reg. §1.6694-1(b)(2).
[1206] Reg. §1.6694-1(b)(2).
[1207] Reg. §1.6694-1(b)(2), §1.6694-1(b)(3).
[1208] Reg. §1.6694-1(b)(1).
[1209] Reg. §1.6694-1(b)(4).
[1210] Preamble to T.D. 9436, 73 Fed. Reg. 78,429, 78,433 (Dec. 22, 2008).
[1211] Reg. §1.6694-1(b)(6) *Exs.* 1, 2, 4.

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b. Firm

The firm that employs an individual tax return preparer or in which an individual tax return preparer is a partner, member, shareholder or other equity holder is also considered to be a tax return preparer for purposes of the preparer penalty under §6694 if and only if:[1212]

- One or more principal managers or principal officers of the firm (or a branch office) participated in or knew of the conduct proscribed by §6694;
- The firm failed to provide reasonable and appropriate procedures to review the positions which gave rise to the penalty; or
- The firm disregarded its reasonable and appropriate review procedures through willfulness, recklessness or gross indifference (including ignoring facts that would lead a reasonably prudent and competent person to investigate or ascertain) in the formulation of the advice or the preparation of the return or claim for refund that included the position for which the penalty is imposed.

The determination is based on all facts and circumstances.[1213]

Note: The IRS's interpretation of the regulation is that generally, the entity that employs a tax return preparer will simultaneously be subject to the penalty under §6694(b) only if the specific conditions set forth in the regulation are met.[1214] Otherwise, only the individual that is primarily responsible for the position(s) on the return or claim for refund that gives rise to the understatement should be assessed. For this reason, the IRS Chief Counsel recommends that unless one or more individuals within a firm other than the preparer "are the moving force behind the decisions and calculations regarding the return" the penalty should be assessed against only the preparer and not the firm due to legal hazard.[1215]

c. Date Return or Claim for Refund is Deemed Prepared

For purposes of §6694, a return or claim for refund is deemed prepared on the date it is signed by the tax return preparer. If a signing tax return preparer (defined in VII.B.2., above) fails to sign the return or claim for refund, it is deemed prepared on the date it is filed. In the case of a nonsigning tax return preparer (defined in VII.B.3., above), the relevant date is the date the nonsigning tax return preparer provides the tax advice with respect to the position giving rise to the understatement. This date is determined based on all the facts and circumstances.[1216]

2. Returns and Claims for Refund

A "return" means any return of a tax imposed by the Code, any administrative adjustment request under §6227, and any partnership adjustment tracking report order under §6226(b)(4)(A).[1217] a claim for refund means a claim for refund or credit of any tax imposed by the Code.[1218] Subject to the foregoing, solely for purposes of §6694, a return or claim for refund includes:[1219]

Income Tax Returns

- Form 990T (Exempt Organization Business Income Tax Return);
- Form 1040 series (including 1040-PR before tax year 2023);
- Form 1040-C (U.S. Departing Alien Income Tax Return);
- Form 1040EZ-T (Claim for Refund of Federal Telephone Excise Tax);
- Form 1040-NR (U.S. Nonresident Alien Income Tax Return);[1220]
- Form 1040-SS (U.S. Self-Employment Tax Return (Including the Additional Child Tax Credit for Bona Fide Residents of Puerto Rico));
- Form 1040X (Amended U.S. Individual Income Tax Return);
- Form 1041 (U.S. Income Tax Return for Estates and Trusts);
- Form 1041-N (U.S. Income Tax Return for Electing Alaska Native Settlement Trusts);
- Form 1041-QFT (U.S. Income Tax Return for Qualified Funeral Trusts);
- Form 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons);
- Form 1066 (U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return);
- Form 1120 (U.S. Corporation Income Tax Return);
- Form 1120-C (U.S. Income Tax Return for Cooperative Associations);

[1212] Reg. §1.6694-2(a)(2), §1.6694-3(a)(2).

[1213] *See* Preamble to T.D. 9436, 73 Fed. Reg. 78,429 (Dec. 22, 2008).

[1214] *See, e.g.*, FAA 20223301F (advising that penalty under §6694(b) be assessed against firm where multiple partners or principals participated in recommendation to take return position contrary to established law).

[1215] *See* CCA 201825028. The Chief Counsel observed that in the case, the owner was the sole owner of the S-corporation and personally signed or prepared over twenty-eight of the tax returns at issue, and that the owner and the entity "were the moving force behind the decisions and calculations regarding the returns." *Cf. United States v. Elsass*, 978 F. Supp. 2d 901 (S.D. Ohio 2013), aff'd, 769 F.3d 390 (6th Cir. 2014), in which the court found that the owner of the entity against whom the penalty was assessed was the tax return preparer for purposes of §6694 and §6695. *But see, e.g., Lowery v. United States*, No. 3:16-CV-701-DCK (W.D.N.C. Sept. 26, 2018) (owner of firm that employed individuals who prepared returns at issue not liable for preparer penalties where he did not sign returns, take position with respect to returns or have knowledge of what positions preparers took on the returns, or otherwise engage in willful or reckless conduct with respect to the returns).

[1216] Reg. §1.6694-1(a)(2).

[1217] §6696(e)(1).

[1218] §6696(e)(2).

[1219] Rev. Proc. 2009-11.

[1220] For tax years before 2020, certain nonresident aliens could file Form 1040NR-EZ (U.S. Income Tax Return for Certain Nonresident Aliens With No Dependents). Beginning for tax year 2020, Form 1040NR-EZ is no longer available. Instead, taxpayers who used that form in the past can file the redesigned Form 1040-NR. *See* Instructions for Form 1040-NR.

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• Form 1120-F (U.S. Income Tax Return of a Foreign Corporation);

• Form 1120-FSC (U.S. Income Tax Return of a Foreign Sales Corporation);

• Form 1120-H (U.S. Income Tax Return for Homeowners Associations);

• Form 1120-IC DISC (Interest Charge Domestic International Sales — Corporation Return);

• Form 1120-L (U.S. Life Insurance Company Income Tax Return);

• Form 1120-ND (Return for Nuclear Decommissioning Funds and Certain Related Persons);

• Form 1120-PC (U.S. Property and Casualty Insurance Company Income Tax Return);

• Form 1120-POL (U.S. Income Tax Return for Certain Political Organizations);

• Form 1120-REIT (U.S. Income Tax Return for Real Estate Investment Trusts);

• Form 1120-RIC (U.S. Income Tax Return for Regulated Investment Companies);

• Form 1120S (U.S. Income Tax Return for an S Corporation);

• Form 1120-SF (U.S. Income Tax Return for Settlement Funds (Under Section 468B));

• Form 1120X (Amended U.S. Corporation Income Tax Return);

• Form 2438 (Undistributed Capital Gains Tax Return);

• Forms 8038-T (Arbitrage Rebate and Penalty in Lieu of Arbitrage Rebate);

• Form 8038-R (Request for Recovery of Overpayment Under Arbitrage Rebate Provisions);

• Form 8288 (U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests); and

• Form 8804 (Annual Return for Partnership Withholding Tax (Section 1446)).

Estate and Gift Tax Returns

• Form 706 (U.S. Estate Tax Return);

• Form 706-A (United States Additional Estate Tax Return);

• Form 706-D (United States Additional Estate Tax Return Under Code Section 2057);

• Form 706-GS(D) (Generation-Skipping Transfer Tax Return for Distributions);

• Form 706-GS(T) (Generation-Skipping Transfer Tax Return for Terminations);

• Form 706-NA (United States Estate (and Generation-Skipping Transfer) Tax Return — Estate of Nonresident not a Citizen of the United States);

• Form 706-QDT (United States Estate Tax Return for Qualified Domestic Trusts);

• Form 709 (United States Gift (and Generation-Skipping Transfer) Tax Return); and

• Form 843 (Claim for Refund and Request for Abatement).

Employment Tax Returns

• Form CT-1 (Employer's Annual Railroad Retirement Tax Return);

• Form CT-1 X (Adjusted Employer's Annual Railroad Retirement Tax Return or Claim for Refund);

• Form CT-2 (Employee Representative's Quarterly Railroad Tax Return);

• Form 843 (Claim for Refund and Request for Abatement);

• Form 940, including 940-PR (Employer's Annual Federal Unemployment Tax Return);

• Form 941 (Employer's Quarterly Federal Tax Return);

• Form 941-X, including 941-X (PR) (Adjusted Employer's Quarterly Federal Tax Return of Claim for Refund);

• Form 941-M (Employer's Monthly Federal Tax Return);

• Form 943, including 943-PR (Employer's Annual Federal Tax Return for Agricultural Employees);

• Form 943-X, including 943-X (PR) (Adjusted Employer's Annual Federal Tax Return for Agricultural Employees or Claim for Refund);

• Form 944 (Employer's Annual Federal Tax Return);

• Form 944-X, including 944-X (PR) and 944-(SP) (Adjusted Employer's Annual Federal Tax Return or Claim for Refund);

• Form 945 (Annual Return of Withheld Federal Income Tax);

• Form 945-X (Adjusted Annual Return of Withheld Federal Income Tax or Claim for Refund); and

• Schedule H, Form 1040, including Anexo H-PR to 1040-PR (Household Employment Tax).

Excise Tax Returns

• Form 11-C (Occupational Tax and Registration Return for Wagering);

• Form 720 (Quarterly Federal Excise Tax Return);

• Form 720X (Amended Quarterly Federal Excise Tax Return);

• Form 7208 (Excise Tax on Repurchase of Corporate Stock);

• Form 730 (Monthly Tax Return for Wagers);

• Form 843 (Claim for Refund and Request for Abatement);

• Form 990-PF (Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Pri-

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vate Foundation (with respect to the excise tax based on investment income));

• Form 2290, including 2290(SP) (Heavy Highway Vehicle Use Tax Return);

• Form 4720 (Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code);

• Form 5330 (Return of Excise Taxes Related to Employee Benefit Plans);

• Form 8612 (Return of Excise Tax on Undistributed Income of Real Estate Investment Trusts);

• Form 8613 (Return of Excise Tax on Undistributed Income of Regulated Investment Companies);

• Form 8849 (Claim for Refund of Excise Taxes);

• Form 8831 (Excise Taxes on Excess Inclusions of REMIC Residual Interests (I.R.C. §860E));

• Form 8924 (Excise Tax on Certain Transfers of Qualifying Geothermal or Mineral Interests (New Form, Exclusion from Capital Gains));

• Form 8725 (Excise Tax on Greenmail); and

• Form 8876 (Excise Tax on Structured Settlement Factoring Transactions).

Procedure and Administration

• Form 8752 (Required Payment or Refund Under Section 7519).

Section 6694 also may apply to an information return listed below that includes information that is or may be reported on a taxpayer's return or claim for refund if such information constitutes a substantial portion of the taxpayer's return or claim for refund:[1221]

• Form 706-GS (D-1) (Notification of Distribution From a Generation-Skipping Trust);

• Form 926 (Return by a U.S. Transferor of Property to a Foreign Corporation);

• Form 1042-S (Foreign Person's U.S. Source Income Subject to Withholding);

• Form 1065 (U.S. Return of Partnership Income (including Schedules K-1));

• Form 1065-B (U.S. Return of Income for Electing Large Partnerships);[1222]

• Form 1120S (U.S. Income Tax Return for an S Corporation (including Schedules K-1));

• Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts);

• Form 3520-A (Annual Information Return of Foreign Trust With a U.S. Owner (Under Section 6048(b));

• Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations);

• Form 5472 (Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code));

• Form 5500 (Annual Return/Report of Employee Benefit Plan);

• Form 5500-EZ (Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan or A Foreign Plan);

• Form 5500-SF (Form Annual Return/Report of Small Employee Benefit Plan);

• Form 8805 (Foreign Partner's Information Statement of Section1446 Withholding Tax);

• Form 8858 (Information Return of U.S. Persons With Respect To Foreign Disregarded Entities); and

• Form 8865 (Return of U.S. Persons With Respect to Certain Foreign Partnerships).

In addition, solely for purposes of §6694, a document that includes information that is or may be reported on a taxpayer's return or claim for refund is treated as a return if the information reported constitutes a substantial portion of such return or claim for refund.[1223]

3. Unreasonable Position Understatement Penalty

a. Penalty

(1) In General

A tax return preparer is subject to a penalty equal to the greater of $1,000 or 50% of the income derived (or to be derived) by the preparer with respect to a return or claim for refund that it prepares that results in an understatement of the taxpayer's liability due to a position if:[1224]

• The preparer knew (or reasonably should have known) of the position; and

• Either:

o the position is with respect to a tax shelter (as defined in §6662(d)(2)(C)(ii))[1225] or a reportable transaction to which §6662A applies,[1226] and it was not reasonable to believe that the position would more likely than not be sustained on the merits;

o the position is not with respect to a tax shelter or a reportable transaction to which §6662A applies, the

[1221] Rev. Proc. 2009-11.

[1222] For tax years beginning after December 31, 2017, Form 1065-B is obsolete. *See* Instructions for Form 1065-B.

[1223] Rev. Proc. 2009-11.

[1224] §6694(a)(1), §6694(a)(2); Reg. §1.6694-2, §58.6694-1(b) (preparer of any return of, or claim for refund of, stock repurchase excise tax may be subject to penalties under §6694(a) in the manner stated in Reg. §1.6694-2), T.D. 10002, 89 Fed. Reg. 55,045 (July 3, 2024), applicable to returns and refund claims filed, and advice provided, after June 28, 2024, and during taxable years ending after June 28, 2024 (Reg. §58.6694-1(e)).

[1225] Tax shelters are described at IV.C.5., above.

[1226] Reportable transactions and the §6662A penalty are described at IV.D., above.

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position was not disclosed in the manner provided in §6662(d)(2)(C)(ii), and there was no substantial authority for the position; or

o the position is not with respect to a tax shelter or a reportable transaction to which §6662A applies, the position was disclosed in the manner described below, but there was no reasonable basis for the position.

The penalty, however, does not apply if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith.[1227]

(2) Understatement of Tax Liability

For purposes of the §6694 preparer penalties, an understatement of the taxpayer's tax liability exists if, viewing the return or claim for refund as a whole, there is an understatement of the net amount payable by the taxpayer or an overstatement of the net amount refundable or creditable to the taxpayer, with respect to any tax under the Code.[1228] Taxes under the Code do not include interest, additions to tax, penalties or additional amounts. The net amount payable is not reduced by any carryback amount.[1229]

Comment: The preparer penalty may be imposed if there is any underpayment of tax. Unlike the taxpayer penalty under §6662(d), the underpayment does not have to be substantial.[1230]

Except as provided with respect to an abatement of the §6694 penalty, the determination of whether there is an understatement of liability may be made in a proceeding involving the tax return preparer that is separate and apart from any proceeding involving the taxpayer.[1231] Generally, a preparer penalty will not be proposed until an underlying examination of the taxpayer's return or claim for refund has been completed.[1232] However, if a penalty under §6694 has been assessed, and it is subsequently established by a final administrative determination or a final judicial decision that there was no understatement of liability relating to the positions on the return or claim for refund underlying the penalty, then the penalty must be abated, and the amount of the penalty that was previously paid must be refunded to the person who paid the penalty. The payment is made in the same manner as a tax refund, but without regard to any statute of limitations.[1233]

Comment: Although it is not entirely clear, the rule should also apply to any reduction in the understatement, even if it is not entirely eliminated.

(3) Income Derived or To Be Derived

Income derived (or to be derived) means all compensation the tax return preparer subject to the penalty receives or expects to receive with respect to its engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position(s) taken on the return or claim for refund that give rise to the understatement of liability.[1234] If the tax return preparer is not compensated directly by the taxpayer, but is paid by a firm that employs him or with which he is associated, the income taken into account is the compensation the tax return preparer receives (or expects to receive) from the firm that is reasonably allocable to such engagement or tax advice. If the firm that employs the individual tax return preparer or of which such individual is an equity owner is subject to the penalty, the income derived (or to be derived) is the compensation the firm receives (or expects to receive) from the engagement or tax advice.[1235] If both the individual tax return preparer and the firm are subject to the §6694 penalty, the amount of the penalty assessed against both the individual and the firm cannot exceed 50% (75% for §6694(b)) of such income derived (or to be derived) by the firm, and the portion of the penalty assessed against the individual cannot exceed 50% of such income derived (or to be derived) by the individual.[1236]

Example: Attorney A is employed by Firm L with a salary of $75,000 per year. A performs tax preparation work for Client X, including 100 hours (out of 2,000 hours billed during the year) relating to a position that results in an understatement liability that is subject to a §6694 penalty. L earned $50,000 with respect to the position reflected on C's return. If A is subject to the penalty, the penalty is $1,875 (the greater of $1,000, or 50% × 100 hours/2,000 hours × $75,000). If L is subject to the penalty, the penalty is $50,000 (the greater of $1,000, or 50% × $50,000), less any penalty imposed against A. Assuming a $1,875 penalty is assessed against A, L's penalty would be $23,125 ($25,000−$1,875).[1237]

Only compensation related to the position(s) on the return or claim for refund that gave rise to the understatement of liability is taken into account.[1238] In the case of a lump sum fee that includes amounts not related to such position(s), the amount of income derived (or to be derived) for purposes of computing the §6694 penalty is based on a reasonable allocation of the lump sum amount to the tax advice giving rise to the penalty.[1239] If there are multiple engagements relating to the same return or claim for refund, only those relating to the position(s) that gave rise to the underpayment of tax are taken into account.[1240] If it is concluded that the tax return preparer's or firm's compensation attributable to such position(s) is less than the total compensation associated with the engagement and tax advice, the lower amount is used to compute the penalty.[1241]

A refund to the taxpayer of all or part of the compensation paid to the tax return preparer or firm does not reduce the §6694 penalty. A discounted fee or an alternative fee arrangement, however, is taken into account.[1242]

[1227] §6694(a)(3).
[1228] Reg. §1.6694-1(c).
[1229] Reg. §1.6694-1(c).
[1230] The §6662(d) penalty is discussed at IV.C., above.
[1231] Reg. §1.6694-1(c).
[1232] IRM 20.1.6.4 (03-30-23). *Cf.* CCA 201519029 (no requirement that IRS allow amounts claimed on amended return before §6694(b) penalty assessed).
[1233] Reg. §1.6694-1(d).
[1234] Reg. §1.6694-1(f)(1).
[1235] Reg. §1.6694-1(f)(1).
[1236] Reg. §1.6694-1(f)(3).
[1237] Reg. §1.6694-1(f)(4) *Ex.* 4.
[1238] Reg. §1.6694-1(f)(2)(ii).
[1239] Reg. §1.6694-1(f)(2)(ii).
[1240] Reg. §1.6694-1(f)(2)(i).
[1241] Reg. §1.6694-1(f)(2)(iv).
[1242] Reg. §1.6694-1(f)(2)(iii).

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(4) Knew or Reasonably Should Have Known

For the §6694(a) penalty to apply, the preparer must know or reasonably should know of the position on the return or claim for refund that give rise to the understatement of tax.[1243] Whether the preparer knew or reasonably should have known of the position is a question of fact based on all the facts and circumstances. The standard contains both a subjective test and an objective test; meeting either is sufficient.

b. Exception for Reasonable Belief It Is More Likely Than Not That Position Will Be Sustained on the Merits

In the case of a tax shelter (within the meaning of §6662(d)(2)(C)(ii)) or a reportable transaction subject to §6662A, the §6694(a) penalty does not apply if it is reasonable to believe that the position that gave rise to the understatement of the taxpayer's tax more likely than not would have been sustained on its merits.[1244] For this purpose, it is reasonable to believe that the position more likely than not would be sustained on its merits if the tax return preparer analyzes the pertinent facts and authorities in the manner described in Reg. §1.6662-4(d)(3)(ii) (relating to the substantial authority exception to the substantial understatement of tax penalty for a taxpayer), and reasonably concludes in good faith that as of the date the return or claim for refund is deemed prepared, the position has a greater than 50% likelihood of being sustained on its merits.[1245] Because the test is based on the merits, the possibility that the position will not be challenged by the IRS (e.g., because the taxpayer's return is not audited or because the issue is not raised in the audit) is not taken into account.[1246]

Whether the preparer meets this standard is determined based on all the facts and circumstances.[1247] The level of diligence required with respect to a particular position on the return or claim for refund depends on the preparer's experience in the area and familiarity with the taxpayer's affairs, as well as the complexity of the issues and facts.[1248]

The special exception for tax shelters is discussed at VII.C.3.f., below.

c. Exception to Unreasonable Position Understatement Penalty for Substantial Authority

Where the position giving rise to understatement of tax does not relate to a tax shelter or a reportable transaction to which §6662A applies, the §6694(a) preparer penalty is not imposed if there is substantial authority for the position.[1249] The test for substantial authority is the same as under §6662(d)(2)(B)(i) (relating to the substantial authority exception to the substantial understatement of tax penalty on the taxpayer) and is determined on the date the return or claim for refund is deemed prepared or on the last day of the taxable year to which the return or claim for refund relates.[1250] Notwithstanding the rules under §6662(d), a written determination under Reg. §1.6662-4(d)(3)(iv)(A) continues to constitute substantial authority with respect to a preparer despite a misstatement or omission of a material fact, unless the preparer knew (or should have known) of the misstatement or omission when the return or claim for refund was filed.[1251] Moreover, although the applicability of court cases to the taxpayer's situation by reason of the taxpayer's residence is not taken into account in determining whether there is substantial authority for a position, there is substantial authority for this purpose if the position is supported by controlling precedent in the Court of Appeals to which the taxpayer has a right of appeal with respect to the position. In addition, for purposes of §6694(a), there is considered to be substantial authority if the tax return preparer relies in good faith and without verification on another advisor, another tax return preparer, or another party.[1252]

d. Exception to Unreasonable Position Understatement Penalty for Reasonable Basis and Adequate Disclosure

Even if there is no substantial authority for a position (other than a tax shelter or reportable transaction subject to §6662A), the preparer penalty under §6694(a) does not apply if the position has a reasonable basis and was adequately disclosed on the return or claim for refund.[1253] For this purpose, reasonable basis has the same meaning as under the rules relating to the exception to the substantial understatement of tax penalty for the taxpayer,[1254] which is described at IV.C.3. and IV.B.3.a., above.

"Adequate disclosure" with respect to a position is made by a signing preparer if:[1255]

- The position was disclosed on the return or claim for refund in the manner required to avoid the substantial understatement of tax penalty under §6662(d) on the taxpayer (i.e., disclosure on Form 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement), as applicable, or on the return or claim for refund in accordance with the applicable annual revenue procedure), which are described at IV.C.4.b., above;

[1243] §6694(a)(1)(B).

[1244] §6694(a)(2)(C).

[1245] Reg. §1.6694-2(b)(1), §1.6694-2(b)(2), §1.6694-2(b)(5). In making the determination, the preparer must consider the authorities described in Reg. §1.6662-4(d)(3)(iii), and may rely on a written determination from the IRS with respect to the taxpayer as provided in Reg. §1.6662-4(d)(3)(iv)(A). Reg. §1.6694-2(b)(2), §1.6694-2(b)(3). The rules under Reg. §1.6662-4(d)(3)(iv)(B) relating to the impact of the taxpayer jurisdiction on the applicability of a court case also applies. Reg. §1.6694-2(b)(4). These rules under §6662(d) are described in detail at IV.C.4., above. The date a return or claim for refund is deemed prepared is described at VII.C.1.c., above.

[1246] Reg. §1.6694-2(b)(1).

[1247] Reg. §1.6694-2(b)(1).

[1248] Reg. §1.6694-2(b)(1). The preparer may rely in good faith on information furnished by the taxpayer or others as described in VII.C.5., below.

[1249] §6694(a)(2)(A).

[1250] Notice 2009-5. Substantial authority is discussed at IV.C.3., above. The date the return or claim for refund is deemed prepared is discussed at VII.C.1.c., above.

[1251] Notice 2009-5.

[1252] Notice 2009-5. Relying on information from another advisor, another tax return preparer, or another party is discussed at VII.C.5., below. Factors used in evaluating a preparer's good faith reliance are discussed at VII.C.3.e., below.

[1253] §6694(a)(2)(B). For the preparer's ability to rely on certain information or advice furnished to him, See the discussion at VII.C.5., below.

[1254] Reg. §1.6694-2(d)(2).

[1255] Reg. §1.6694-2(d)(3)(i).

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• The preparer provided the taxpayer with a return or claim for refund that included the adequate disclosure described above; or

• If the taxpayer is subject to an accuracy-related penalty with respect to the return or claim for refund other than the substantial understatement of tax penalty under §6662(d) the preparer advised the taxpayer of the penalty standards applicable to the taxpayer and the preparer contemporaneously documented such advice in his files.

In the case of a nonsigning preparer, disclosure is "adequate" if the position is disclosed on the return or claim for refund in the manner required to avoid a §6662(d) substantial understatement of tax penalty on the taxpayer, which are described at IV.C.4.b., above.[1256] A nonsigning preparer who provides advice to the taxpayer with respect to a position for which there is a reasonable basis but no substantial authority (other than a position relating to a tax shelter or a reportable transaction to which §6662A applies) satisfies the disclosure requirement if the preparer advises the taxpayer of any opportunity to disclose the position and avoid the §6662 accuracy-related penalties that could be imposed on the taxpayer as a result of the position, and of the standards for disclosure, to the extent applicable.[1257] In addition, the preparer must contemporaneously document the advice in his files.[1258]

If the nonsigning preparer gave advice to another tax return preparer with respect to a position for which there is a reasonable basis but no substantial authority (other than a position relating to a tax shelter or a reportable transaction subject to §6662A), disclosure is considered "adequate" if the nonsigning preparer advises the other preparer that disclosure under §6694(a) may be required, and the nonsigning preparer contemporaneously documents such advice in his files.[1259]

For purposes of satisfying the third disclosure methodology for a signing preparer or the disclosure requirements of a nonsigning preparer with respect to giving advice to the taxpayer or another tax return preparer, each position that the preparer is considered to have prepared must be addressed.[1260] A single document may cover one or more positions. The preparer's advice must relate to the particular taxpayer and must be tailored to his particular facts and circumstances. A general disclaimer is not sufficient. There is no special language or format required to comply with the rules, although preparers and their firms may rely on established forms or templates.[1261]

In the case of items attributable to a pass-through entity, the disclosure may be made at the entity level in accordance with the rules relating to the substantial understatement of tax penalty for the taxpayer.[1262]

[1256] Reg. §1.6694-2(d)(3)(ii).
[1257] Reg. §1.6694-2(d)(3)(ii)(A).
[1258] Reg. §1.6694-2(d)(3)(ii)(A).
[1259] Reg. §1.6694-2(d)(3)(ii)(B).
[1260] Reg. §1.6694-2(d)(3)(iii).
[1261] Reg. §1.6694-2(d)(3)(iii).
[1262] Reg. §1.6694-2(d)(3)(iv). The disclosure rules are described at IV.C.4., above.

e. Exception to Unreasonable Position Understatement Penalty for Reasonable Cause and Good Faith

The penalty under §6694(a) is not imposed if, considering all the facts and circumstances, it is determined that the understatement was due to reasonable cause and the tax return preparer acted in good faith.[1263] Factors to consider include:[1264]

• *The nature of the errors causing the understatement.* The more complex, uncommon or technical the issue, the more likely it is that a competent tax return preparer could have made the error. The reasonable cause and good faith exception, however, does not apply to an error that would have been apparent from a general review of the return or claim for refund.

• *The frequency of errors.* Although the reasonable cause exception generally applies to isolated errors (e.g., an inadvertent mathematical or clerical error), it does not apply if the isolated error is so obvious, flagrant or material that it should have been discovered during a review of the return or claim for refund. Moreover, the exception does not apply if there is a pattern of errors on the return or claim for refund, even though any one error, in isolation, would have qualified.

• *The materiality of the errors.* The reasonable cause and good faith exception generally applies if the understatement is of a relatively immaterial amount. Nevertheless, even an immaterial understatement may not qualify for the exception if the errors creating the understatement are sufficiently obvious or numerous.

• *The preparer's normal office practice.* The reasonable cause and good faith exception may apply if the preparer's normal office practice, when considered together with other facts and circumstances (e.g., the preparer's knowledge), indicates that the error would rarely occur and such normal office practice was followed in preparing the return or claim for refund. For this purpose, a "normal office practice" is a system for promoting accuracy and consistency in the preparation of returns and claims for refund, and in the case of a signing preparer, generally includes checklists, methods for obtaining necessary information from the taxpayer, a review of the prior year's return, and review procedures. Notwithstanding these rules, the exception does not apply if there is a flagrant error or a return or claim for refund, a pattern of errors on a return or claim for refund, or a repetition of the same or similar errors on numerous returns or claims for refund.

• *Reliance on advice of others.* The preparer may rely on information furnished by the taxpayer and information and advice furnished by another advisor, as described at VII.C.5., below. The information or advice may be written or oral. The preparer has the burden of proving that the information or advice was received and relied on in good faith. Good faith reliance does not exist if: (1) the information or advice is unreasonable on its face, (2) the preparer

[1263] §6694(a)(3).
[1264] Reg. §1.6694-2(e).

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knew (or should have known) that the person providing the information or advice was not aware of all relevant facts, or (3) the preparer knew (or should have known), based on the nature of the preparer's practice, that the information or advice was no longer reliable due to developments in the law since the information or advice was received.

• *Reliance on generally accepted administrative or industry practices.* A tax return preparer may reasonably rely in good faith on generally accepted administrative or industry practice in taking a position on a return or claim for refund. Such reliance is not considered to be in good faith if the preparer knew (or should have known) based on the nature of the preparer's practice that the administrative or industry practice was no longer reliable due to developments in the law or IRS administrative practice since the time the practice was developed.

For purposes of demonstrating that the tax return preparer had reasonable cause and acted in good faith, the preparer may rely in good faith and without verification on information furnished by the taxpayer, on information and advice furnished by another advisor, another tax return preparer or another party, and on information on previously filed returns.[1265]

f. Special Exception for Tax Shelter Transactions

Until further guidance is issued, for purposes of §6694(a), a position with respect to a tax shelter under §6662(d)(2)(C)(ii) is not considered "unreasonable" if there is substantial authority for the position, and the preparer advises the taxpayer of the §6662(d) penalty standards that apply to the taxpayer in the event the transaction is deemed to have a significant purpose of avoiding or evading a federal tax.[1266] Such advice must include an explanation stating that if the position has a significant tax avoidance or evasion purpose, there must be at least substantial authority for the position, the taxpayer must reasonably believe the tax treatment was more likely than not the proper treatment, and disclosure will not protect the taxpayer from the penalty. The preparer must contemporaneously document such advice in his files.[1267]

If a nonsigning preparer advises another tax return preparer regarding a position relating to a tax shelter, the position is not considered unreasonable for purposes of §6694(a) if there is substantial authority for the position, the nonsigning preparer provides a statement to the other preparer about the penalty standards applicable to the other preparer under §6694(a), and the nonsigning preparer contemporaneously documents that such statement was given. If both preparers are in the same firm, contemporaneous documentation of advice provided by any preparer in that firm to the taxpayer regarding applicable penalty standards also covers the advice by a nonsigning preparer to the other preparer in the firm.[1268]

Comment: This special rule does not apply to positions relating to §6662A reportable transactions.[1269]

4. Willful or Reckless Conduct Understatement Penalty

a. In General

A tax return preparer who prepares a return or claim for refund is subject to a penalty under §6694(b) equal to the greater of $5,000 or 75% of the income derived (or to be derived) by the preparer with respect to the return or claim if any part of the understatement of tax is due to:[1270]

• A willful attempt in any manner to understate the taxpayer's liability for tax on the return or claim for refund; or

• A reckless or intentional disregard of rules or regulations by the preparer.

The penalty is reduced by any penalty imposed under §6694(a)[1271] for understatement due to unreasonable positions.

The same analyses discussed with respect to the preparer subject to the penalty (see VII.C.1., above),[1272] the understatement of liability (VII.C.3.a.(2)), returns and claims for refund (VII.B.1.e.), and income derived (or to be derived) (VII.C.3.a.(3)) apply for purposes of the §6694(b) penalty. The preparer's ability to rely on information and advice furnished by others is discussed at VII.C.5., below.

b. Willful Attempt to Understate Liability

A tax return preparer is considered to willfully attempt to understate a taxpayer's liability on a return or claim for refund if the preparer disregards information furnished to him in an attempt to wrongfully reduce the tax liability on the return or claim for refund. It is irrelevant whether the information was furnished by the taxpayer or another person. For example, a preparer is guilty of willfully attempting to understate the tax if he reports six dependents on a return for individual who advised the preparer that he had only two dependents.[1273]

[1265] Reg. §1.6694-1(e). See the discussion at VII.C.5., below.

[1266] Notice 2009-5. Substantial authority is described at VII.C.3.c. and IV.C.3., above. Tax shelters and the §6662(d) penalty are described at IV.C.5., above.

[1267] Notice 2009-5.

[1268] Notice 2009-5.

[1269] Notice 2009-5.

[1270] §6694(b)(1), §6694(b)(2); Reg. §1.6694-3, §58.6694-1(c) (preparer of any return of, or claim for refund of, stock repurchase excise tax may be subject to penalties under §6694(b) in the manner stated in Reg. §1.6694-3), T.D. 10002, 89 Fed. Reg. 55,045 (July 3, 2024), applicable to returns and refund claims filed, and advice provided, after June 28, 2024, and during taxable years ending after June 28, 2024 (Reg. §58.6694-1(e)).

[1271] §6694(b)(3).

[1272] Reg. §1.6694-3(a)(2). The §6694(b) penalty may be assessed against a preparer who signed a return even if the return was never filed. CCA 201519029.

[1273] Reg. §1.6694-3(b). *See Richey v. IRS*, 9 F.3d 1407 (9th Cir. 1993) (quoting *Pickering v. United States*, 691 F.2d 853 (8th Cir. 1982), willfulness under §6694(b)(2)(A) requires "a conscious act or omission made in the knowledge that a duty is therefore not being met"; like §7206, willfulness does not include recklessness); *Rodgers v. United States*, 772 Fed. App'x. 555, 2019 BL 231026 (9th Cir. June 21, 2019) (following *Richey*), *on remand,* No. CV 15-9441 PA, 2019 BL 480819 (C.D. Cal. Dec. 12, 2019) (behavior was willful where preparer failed to report large amounts of income received, overstated deductions, and included expenses that were not actually incurred; for returns at issue, long-time preparer also skipped his customary review by second preparer).

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c. Reckless or Intentional Disregard of Rules or Regulations

For purposes of the §6694(b) penalty, a "rule or regulation" includes the provisions of the Code, final or temporary Treasury regulations, and revenue rulings and notices issued by the IRS and published in the Federal Register.[1274]

A tax return preparer generally is considered to recklessly or intentionally disregard a rule or regulation if the preparer takes a position on a return or claim for refund that is contrary to a rule or regulation, and the preparer knows (or is reckless in not knowing) of the rule or regulation. A preparer is reckless in not knowing of a rule or regulation if the preparer makes little or no effort to determine the existence of the rule or regulation, under circumstances that demonstrate a substantial deviation from the standard of conduct that a reasonable preparer would observe in the situation.[1275]

A tax return preparer is not considered to have recklessly or intentionally disregarded a rule or regulation if the position contrary to the rule or regulation has a reasonable basis and is adequately disclosed, in each case as described above with respect to the preparer penalty under §6694(a) (with respect to an unreasonable position).[1276] For this purpose, however, it is not sufficient for a signing preparer to provide the disclosure on the return or claim for refund if that disclosure is not actually filed or to disclose in accordance with the annual revenue procedure under §6662(d) (relating to the substantial understatement of tax penalty on the taxpayer).[1277] Moreover, in the case of a position contrary to a regulation, the position must represent a good faith challenge to the regulation.[1278]

In the case of a provision contrary to a revenue ruling or notice (other than a notice of proposed rulemaking) published by the IRS in the Internal Revenue Bulletin, a tax return preparer is also not considered to have acted recklessly or with intentional disregard of the ruling or notice if the position is not with respect to a reportable transaction to which §6662A applies and the position has substantial authority under §6662(d).[1279]

Example: Taxpayer provides Preparer with detailed check registers reflecting personal and business expenses. One of the checks was for domestic help, which was identified as a personal expense. Preparer knowingly deducted the expense as a business expense. Accordingly, Preparer is subject to the penalty under §6694(b).

Comment: A signing preparer may need to include a provision in the engagement letter to ensure that the return or claim for refund that is prepared with a disclosure statement is actually filed with the statement.

The IRS's disallowance of the position does not prevent the penalty from being applied. It is the improper preparation of the return or claim for refund showing an understatement of tax that gives rise to the imposition of the penalty.[1280]

5. Verification of Information

For purposes of the penalty under §6694, a tax return preparer generally may rely in good faith without verification upon:[1281]

- Information furnished by the taxpayer;
- Information and advice furnished by another advisor, another tax return preparer or other party (including another advisor or preparer at the same firm); and
- A tax return that has been previously prepared by the taxpayer or another tax return preparer and filed with the IRS.

The tax return preparer is not required to audit, examine or review the books and records, business operations, documents or other evidence to independently verify the information received. However, the preparer may not ignore the implications of information furnished to him or actually known by him. If the information furnished appears to be incorrect or incomplete, the preparer must make reasonable inquiries.[1282] In addition, the preparer must make appropriate inquiries to determine if the specific requirements for a deduction or credit are met.[1283] Where the preparer relies on a prior return, he is required to confirm that the position being relied on has not been adjusted upon audit or otherwise.[1284]

Example: Taxpayer tells Preparer that he made a charitable contribution of real property worth $50,000. Preparer reported the deduction on Taxpayer's return without inquiring about the existence of a qualified appraisal or Form 8283 (Noncash Charitable Contributions) as required by the reporting and substantiation rules of §170(f)(11). In fact, the contribution had not been made. Preparer is subject to a penalty under §6694 since he failed to properly verify the information received.[1285]

Example: While preparing Individual's income tax return, Preparer realizes that Individual did not provide a Form 1099-INT (Interest Income) for a bank account that produced significant income the prior year. Preparer asked about the account, and Individual furnished the form. Individual, however, did not furnish information about another bank account of which Preparer was unaware, despite Preparer's general inquiry about whether Individual had any

[1274] Reg. §1.6694-3(e). Revenue procedures are not included in the definition, nor are court decisions. *Schneider & Co. v. United States*, 99-2 USTC ¶50,663 (S.D. Ind. 1999).

[1275] Reg. §1.6694-3(c).

[1276] Reg. §1.6694-3(c)(2). See the discussion at VII.C.3.d., above.

[1277] Reg. §1.6694-3(c)(2).

[1278] Reg. §1.6694-3(c)(2).

[1279] Reg. §1.6694-3(c)(3). Reportable transactions and the §6662A penalty are discussed in 648 T.M., *Reportable Transactions.* Substantial authority is discussed at VII.C.3.c. and 648 T.M., *Reportable Transactions.*

[1280] *See Schneider, CPA v. United States*, 257 F. Supp. 2d 1154 (S.D. Ind. 2003); *Swart v. United States*, 568 F. Supp. 763 (C.D. Cal. 1982), aff'd by unpub. op., 714 F.2d 154 (9th Cir. 1983); *Pickering v. United States*, 82-1 USTC ¶9375 (E.D. Ark. 1982), aff'd per curiam, 691 F.2d 853 (8th Cir. 1982); CCA 201519029.

[1281] Reg. §1.6694-1(e)(1), §1.6694-1(e)(2).

[1282] Reg. §1.6694-1(e)(1), §1.6694-1(e)(2).

[1283] Reg. §1.6694-1(e)(1).

[1284] Reg. §1.6694-1(e)(2).

[1285] Reg. §1.6694-1(e)(3) *Ex.* 1.

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other income. Preparer acted properly in verifying Individual's income, and is not subject to a §6694 penalty.[1286]

Comment: The rule is intended to allow a preparer to rely in good faith without verification on facts furnished by the taxpayer or others. The preparer, however, should not be able to rely on legal conclusions on tax issues given by the taxpayer, since the preparer and not the taxpayer is supposed to be the expert in this area. Because of concerns about how to handle mixed questions of fact and law furnished by the taxpayer, the regulations do not contain an absolute prohibition on reliance on legal conclusions from taxpayers. The preparer, however, must still meet the diligence standards described above.[1287]

6. Coordination with Other Penalties

Section 6696(a) provides that the §6694 penalty for the understatement of a taxpayer's liability by tax return preparer applies in addition to any other penalty. On the other hand, §6701(f)(2) provides that a §6694 penalty may not be imposed with respect to any document for which a penalty is assessed on the tax return preparer is subject to a penalty for aiding and abetting an understatement of tax under §6701. The IRS follows §6701(f)(2).[1288]

Comment: The IRS can select which penalty it wants to assess.[1289] The limitation only applies if the preparer penalty is actually assessed. The §6694 penalty will be equal to or greater than the §6701 penalty.

In addition, the IRS will not stack the penalties under §6694 and §6695A (with respect to an appraiser) with respect to the same conduct.[1290]

An appraiser may be a signing or nonsigning tax return preparer. If the requirement of each penalty is met, the IRS may choose which one to impose.

D. Other Duties of a Tax Return Preparer and Related Penalties

1. Signing Return or Claim for Refund

A person (individual or otherwise) that is a signing tax return preparer (defined in VII.B.2., above) must sign the return or claim for refund after it is completed and before it is presented to the taxpayer for signature.[1291] If the signing preparer is not available, another tax return preparer must review the entire preparation of the return or claim for refund and then sign it.[1292] Although no definition of "unavailable" is provided, an example in the regulations indicates that a preparer is unavailable if he is out of town for one week, but not if he is away in the same city for only a day.[1293] The preparer must sign in the manner prescribed by the IRS in the appropriate form, instructions or other guidance.[1294]

Comment: Only the return that is filed and the copy required to be retained by the signing preparer must be signed. The preparer is not required to sign the taxpayer's copy.[1295]

The foregoing does not apply to an electronically signed return, but the signing tax return preparer must electronically sign the return in the manner prescribed by the IRS.[1296] In addition, the signing tax return preparer, however, must give all of the information that will be transmitted as the electronically signed tax return to the taxpayer contemporaneously with furnishing the Form 8879, *IRS e-file Signature Authorization*, or other similar IRS e-file signature form. The information can be furnished on a replica of an official form.[1297]

A person required to sign a return or claim for refund is subject to a $50 (adjusted annually for inflation) penalty for each failure, unless the failure is due to reasonable cause and not willful neglect. The maximum penalty that may be imposed on any individual with respect to documents filed during any calendar year is $25,000 (adjusted annually for inflation).[1298]

For this purpose, reasonable cause is a cause that arises despite ordinary care and prudence exercised by the signing preparer. To assert reasonable cause for failure to sign a return or claim for refund, the preparer must submit a written statement to the IRS setting forth the facts constituting such reasonable cause.[1299]

2. Furnishing Preparer's Tax Identification Number

A signing tax return preparer (defined in VII.B.2., above) must include on the return or claim for refund his Preparer Tax Identification Number (PTIN), which is the exclusive identifying number.[1300] A failure to provide a PTIN may subject a signing tax return preparer to a penalty of $50 (adjusted annually for inflation) for each such failure, up to a maximum of $25,000 (adjusted annually for inflation) per calendar year, unless the failure is due to reasonable cause and not willful ne-

[1286] Reg. §1.6694-1(e)(3) *Ex.* 2.

[1287] Preamble to T.D. 9436, 73 Fed. Reg. 78,430, 78,433 (Dec. 22, 2008).

[1288] IRM 20.1.6.6(3) (05-22-24), IRM 20.1.6.14.4(1) (07-26-17). The §6694 penalty may be imposed with respect to a different document even if it relates to the same taxpayer and same tax year.

[1289] H.R. (Conf.) Rep. No. 97-248 at 577 (1982).

[1290] Preamble to T.D. 9436, 73 Fed. Reg. 78,430, 78,436 (Dec. 22, 2008). The appraiser penalty under §6695A is described in IV.L., above.

[1291] Reg. §1.6695-1(b)(1), §58.6695-1(a) (same for preparers of stock repurchase excise tax returns and refund claims), T.D. 10002, 89 Fed. Reg. 55,045 (July 3, 2024), applicable to returns and refund claims filed after June 28, 2024, and during taxable years ending after June 28, 2024 (Reg. §58.6695-1(b)). For purposes of this chapter VII., a "taxpayer" includes a nontaxable entity that files a tax return.

[1292] Reg. §1.6695-1(b)(1).

[1293] Reg. §1.6695-1(b)(4) *Ex.* 4.

[1294] Reg. §1.6695-1(b)(1). The IRS has authorized alternative methods of signing returns, including by rubber stamp, mechanical device or computer software program that includes either a facsimile of the individual preparer's signature or the individual preparer's printed name. Notice 2004-54.

[1295] *See* Rev. Rul. 78-317. *See also* CCA 201519029 (§6694(b) preparer penalty can be assessed if filed amended return contained understatement of liability due to preparer's willful or reckless conduct; preparer's signature not required).

[1296] Reg. §1.6695-1(b)(2).

[1297] Reg. §1.6695-1(b)(2). *See, e.g.*, Form 8879-F, *IRS e-file Signature Authorization for Form 1041.*

[1298] §6695(b), §6695(h); Reg. §1.6695-1(b), §58.6695-1(a) (penalty also applies to preparers of stock repurchase excise tax returns and refund claims). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Other Assessable Penalties With Respect to the Preparation of Tax Returns for Other Persons*, at **Annually adjusted penalty amounts under §6695**.

[1299] Reg. §1.6695-1(b)(3).

[1300] §6109(a)(4); Reg. §1.6109-2(a), §58.6109-1(a) (same for signing preparers of stock repurchase excise tax returns and refund claims), T.D. 10002, 89 Fed. Reg. 55,045 (July 3, 2024), applicable to stock repurchase excise tax returns and refund claims required to be filed after June 28, 2024, and during taxable years ending after June 28, 2024 (Reg. §58.6109-1(b)).

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glect.[1301] Only one penalty may be imposed under this provision with respect to a single return or claim for refund.[1302]

The PTIN rules are discussed further in 620 T.M., *Practice Before the IRS; Attorney's Fees in Tax Proceedings*.

3. Providing Copy of Return to Taxpayer

A signing tax return preparer (defined in VII.B.2., above) must furnish the taxpayer with a completed copy of the return or refund claim no later than the time the original return or claim for refund is presented to the taxpayer for signature.[1303] The copy may be provided to the taxpayer in any media, including electronic media, that is acceptable to both the preparer and the taxpayer. In the case of an electronically filed return, a complete copy consists of the electronic portion of the return or claim for refund, including all schedules, forms, .pdf attachments, and jurats, that was filed with the IRS. The copy provided to the taxpayer must include all of the information submitted to the IRS to enable the taxpayer to determine what schedules, forms, electronic files, and other supporting materials have been filed with the return. Such copy, however, need not include the preparer's identification number.[1304]

Comment: A best practice may be for a preparer to obtain a separate PTIN, and include it on all returns and claims for refunds, and on all copies. That protects his social security number.

The electronic portion of the return or refund claim may be contained on a replica of an official IRS form or on an unofficial form. On an unofficial form, however, data entries must reference the line numbers or descriptions on an official form.[1305]

A signing preparer who fails to provide a copy of the return or claim for refund to the taxpayer at the appropriate time is subject to a penalty of $50 (adjusted annually for inflation) for each such failure, up to a maximum of $25,000 (adjusted annually for inflation) per calendar year, unless the failure is due to reasonable cause and not willful neglect.[1306] In addition, the penalty does not apply to a tax return preparer who furnishes a copy of the return or claim for refund:[1307]

- To a taxpayer who holds an elected or politically appointed position with the government of the United States, or a state or political subdivision thereof;
- Who, in order to faithfully carry out his official duties, has arranged his affairs so they have less than full knowledge of the property he holds or the debts for which he is responsible; and
- Information is deleted from such copy in order to preserve or maintain this arrangement.

4. Retaining Copy or List

A signing tax return preparer (defined in VII.B.2., above) must:[1308]

- Retain a completed copy of each return or refund claim, or retain a record or list of the name, TIN number, and taxable year of each taxpayer for whom a return or claim for refund was prepared;
- Retain a record, for each return or claim for refund presented to the taxpayer, of the name of the individual tax return preparer required to sign the return or refund claim; and
- Make the copy or record of returns and claims for refund and record of the individuals required to sign available for inspection upon request by the IRS. Such copies and records must be retained and kept available for inspection for at least three years after the close of the "return period," i.e. the 12-month period ending on June 30.[1309]

A penalty of $50 (adjusted annually for inflation) is imposed for each failure, up to $25,000 (adjusted annually for inflation) for any return period, unless the failure is due to reasonable cause and not willful neglect.[1310]

5. Record of Tax Return Preparers Employed

Any person who employs a tax return preparer to prepare a return or claim for refund (other than for such person) must retain a record of the name, taxpayer identification number, and

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[1301] §6695(c); Reg. §1.6695-1(c), §58.6695-1(a) (penalty also applies to signing preparers of stock repurchase excise tax returns and refund claims). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Other Assessable Penalties With Respect to the Preparation of Tax Returns for Other Persons*, at **Annually adjusted penalty amounts under §6695**. Although the regulations require a preparer to furnish an address, there is no separate penalty for failing to comply.

[1302] Reg. §1.6695-1(c)(2).

[1303] §6107(a); Reg. §1.6107-1(a)(1), §58.6107-1(a) (same for signing preparers of stock repurchase excise tax returns), T.D. 10002, 89 Fed. Reg. 55,045 (July 3, 2024), applicable to stock repurchase excise tax returns and refund claims required to be filed after June 28, 2024, and during taxable years ending after June 28, 2024 (Reg. §58.6107-1(b)). For this purpose, a "taxpayer" includes a nontaxable entity that files a tax return. The preparer may obtain a receipt from the taxpayer to show compliance with this requirement. Reg. §1.6107-1(a).

[1304] Reg. §1.6107-1(a)(2).

[1305] Reg. §1.6107-1(a)(2). The information may be provided on a replica of an official form that provides all of the information. Reg. §1.6107-1(a)(3).

[1306] §6695(a); Reg. §1.6695-1(a), §58.6695-1(a) (penalty also applies to preparers of stock repurchase excise tax returns and refund claims), T.D. 10002, 89 Fed. Reg. 55,045 (July 3, 2024), applicable to returns and refund claims filed after June 28, 2024, and during taxable years ending after June 28, 2024. The penalty amounts in §6695(a) are adjusted annually for inflation. §6695(h). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Other Assessable Penalties With Respect to the Preparation of Tax Returns for Other Persons*, at **Annually adjusted penalty amounts under §6695**.

For purposes of this chapter VII, a "taxpayer" includes a nontaxable entity that files a tax return.

[1307] Reg. §1.6695-1(a)(2).

[1308] §6107(b); Reg. §1.6107-1(b)(1), §58.6107-1(a) (same for signing preparers of stock repurchase excise tax returns). Copies and records may be retained in any form. Reg. §1.6107-1(b)(1). Rev. Proc. 97-22 permits electronic copies. For purposes of this part VII., a taxpayer includes a nontaxable entity that files a tax return.

[1309] Reg. §1.6107-1(b)(2). Special rules apply if the return becomes due during a return period following the return period in which it was presented for signature or if the corporation or partnership preparer dissolved during the three-year period. Reg. §1.6107-1(b)(2). A "return period" is defined in §6060(c).

[1310] §6695(d); Reg. §1.6695-1(d), §58.6695-1(a) (penalty also applies to preparers of stock repurchase excise tax returns and refund claims). The penalty amounts in §6695(d) are adjusted annually for inflation. §6695(h). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Other Assessable Penalties With Respect to the Preparation of Tax Returns for Other Persons*, at **Annually adjusted penalty amounts under §6695**.

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principal place of work of each such preparer.[1311] The records may be retained in any form, but must disclose on its face, the names of the individuals employed during the "return period", i.e. the 12-month period ending on June 30.[1312] These records must be retained for three years after the close of the return period to which the record relates, and must be made available to the IRS upon request.[1313]

For this purpose, a partnership is treated as the employer of its partners, and an individual signing tax return preparer (defined in VII.B.2., above) is treated as his/her own employer.[1314] Accordingly, a sole proprietor must retain and make available records with respect to returns that he himself prepared.

A person who fails to retain or make such records available to the IRS is subject to a penalty of $50 (adjusted annually for inflation) for each failure, unless the failure is due to reasonable cause and not willful neglect. The maximum penalty imposed on a person under this subsection cannot exceed $25,000 (adjusted annually for inflation) with respect to any return period.[1315]

6. *Due Diligence in Determining Eligibility for the Certain Refundable Credits*

A tax return preparer who fails to comply with the due diligence requirements for determining a taxpayer's eligibility for, or amount of, the §32 earned income credit, §24 child tax credit (including the additional child tax credit), §25A(i) American opportunity tax credit, or head of household filing status (as defined in §2(b)), is subject to a penalty of $500 under §6695(g) (adjusted annually for inflation) for each such failure.[1316] The penalty is $500.[1317]

Note: The penalty applies to head of household filing status determination and to each credit claimed, meaning more than one penalty could apply to a single return or claim for refund.[1318] For example, if a preparer prepares a federal income tax return for a taxpayer claiming the child tax credit and the American Opportunity Tax Credit and fails to meet the due diligence requirement with respect to both, the preparer is subject to two penalties under §6695(g).[1319]

Generally, in order to comply with the due diligence requirements, tax return preparers must complete a Form 8867, *Paid Preparer's Due Diligence Checklist*, properly document credit computations, and satisfy the knowledge requirement, which requires the preparer to make certain inquiries and contemporaneously document responses. Each of these requirements is discussed in further detail below.

The first requirement is that the tax return preparer must complete Form 8867, or complete such other form and provide such other information as may be prescribed by the IRS.[1320]

A tax return preparer must either: (1) complete the applicable credit worksheet in the Form 1040 or Form 8863 instructions; or (2) otherwise record in one or more documents in the preparer's paper or electronic files the preparer's credit computation, including the method and information used to make the computation.[1321]

The tax return preparer's completion of the Form 8867 and applicable worksheet (or other record of the preparer's computation of a credit) must be based on information provided by the taxpayer to the tax return preparer or otherwise reasonably obtained or known by the tax return preparer.[1322] However, the tax return preparer must not know, or have reason to know, that any information used by him in determining the taxpayer's eligibility to file as head of household or in determining the taxpayer's eligibility for, or, amount of any credit described above, and claimed on the return or claim for refund is incorrect. The preparer cannot rely on prior knowledge. In this regard, the tax return preparer may not ignore the implications of information furnished to, or known by, him and must make reasonable inquiries if a reasonable and well-informed tax return preparer knowledgeable in the law would conclude that the information furnished appears to be incorrect, inconsistent, or incomplete. The tax return preparer must also contemporaneously document in his files any inquiries made and the responses to those inquiries.[1323]

> *Example:* S engages Preparer E to prepare S's income tax return. During E's standard intake interview, S states that S has never been married and that S's niece and nephew lived with S for part of the year. Based on the information, E believes that S may be eligible to file as head of household, and may claim the niece and nephew as qualifying children for purposes of the earned income credit and child credit. To meet the knowledge requirement, however, E must make reasonable inquiries to determine whether S is eligible to file as head of household and whether each child is a qualifying child of S for purposes of the credits, including verifying the children's residency, S's relationship to the children, the children's income, the sources of

[1311] §6060(a); Reg. §1.6060-1(a)(1), §58.6060-1(a) (same for preparers of stock repurchase excise tax returns and refund claims). An alternative method may be used if the IRS approves it. §6060(b).

[1312] Reg. §1.6060-1(a)(3), §58.6060-1(a) (same for preparers of stock repurchase excise tax returns and refund claims). "Return period" is defined in §6060(c).

[1313] Reg. §1.6060-1(a)(1), Reg. §1.6060-1(a)(2), §58.6060-1(a) (same for preparers of stock repurchase excise tax returns and refund claims).

[1314] Reg. §1.6060-1(a)(5), §58.6060-1(a) (same for signing preparers of stock repurchase excise tax returns and refund claims).

[1315] §6695(e); Reg. §1.6060-1(c); Reg. §1.6695-1(e), §58.6695-1(a). The penalty amounts in §6695(e) are adjusted annually for inflation. §6695(h). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Other Assessable Penalties With Respect to the Preparation of Tax Returns for Other Persons*, at **Annually adjusted penalty amounts under §6695**.

[1316] §6695(g).

[1317] The penalty amounts in §6695(g) are adjusted annually for inflation. §6695(h). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Other Assessable Penalties With Respect to the Preparation of Tax Returns for Other Persons*, at **Annually adjusted penalty amounts under §6695**.

[1318] Reg. §1.6695-2(a)(1).

[1319] *See* Reg. §1.6695-2(a)(1).

[1320] Reg. §1.6695-2(b)(1)(i). The preparer's completion of Form 8867 must be based on information provided by the taxpayer to the preparer or otherwise reasonably obtained or known by the preparer. Reg. §1.6695-2(b)(2)(ii). *See* IRS Pub. 4687, *Paid Preparer Due Diligence*.

[1321] Reg. §1.6695-2(b)(2)(i).

[1322] Reg. §1.6695-2(b)(1)(ii), §1.6695-2(b)(2)(ii).

[1323] Reg. §1.6695-2(b)(3)(i). The Treasury rejected a request to permit other forms of evidence to prove that the tax return preparer made the required inquires on the grounds that contemporary documentation is important for improving compliance and reducing errors. Preamble to T.D. 9842, 83 Fed. Reg. 55,632, 55,634 (Nov. 7, 2018).

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support for the children and S's contribution to the payment of costs related to operating the household, and E must contemporaneously document the inquiries and S's response.[1324]

Example: Preparer E's prior knowledge from social interactions with S that the niece and nephew lived with S for more than half the year and did not provide more than half their own support does not change E's obligation. E must make the same reasonable inquires to determine whether S is eligible to file as head of household and whether each child is a qualifying child for purposes of the credits as above, and E must contemporaneously document the inquires and responses.[1325]

Due diligence for this purpose also requires that the tax return preparer retain: (1) a paper or electronic copy of the completed Form 8867, (2) a copy of the applicable credit worksheet (or the preparer's computation), and (3) a record of how and when the information used to complete Form 8867 and the applicable worksheet (or other record) was obtained by the tax return preparer (including the identity of any person providing the information, as well as a copy of any document that was provided by the taxpayer and on which the tax return preparer relied to complete the form, worksheet, or other record).[1326] The tax return preparer must keep the records for three years from the latest of the following dates, as applicable: (1) the due date of the tax return (disregarding filing extensions), (2) in the case of a signing tax return preparer (defined in VII.B.2., above) electronically filing the tax return or claim for refund, the date the tax return or claim for refund was filed, (3) in the case of a signing tax return preparer not electronically filing the tax return or claim for refund, the date the tax return or claim for refund was presented to the taxpayer for signature, or (4) in the case of a nonsigning tax return preparer (defined in VII.B.3., above), the date the nonsigning tax return preparer submitted to the signing tax return preparer that portion of the tax return or refund claim for which the nonsigning tax return preparer was responsible.[1327] Analogous record-keeping and records retention apply for all completed worksheets or other record of the tax return preparer's computations, including the method and information used to make the computations, for all the applicable credits.

A firm that employs a tax return preparer subject to a penalty under §6695(g) also is subject to penalty if, and only if: (1) one or more members of the principal management (or principal officers) of the firm or a branch office participated in or, before the time the return was filed, knew of the failure to comply with the due diligence requirements; (2) the firm failed to establish reasonable and appropriate procedures to ensure compliance with the due diligence requirements; or (3) the firm disregarded its reasonable and appropriate compliance procedures through willfulness, recklessness, or gross indifference (including ignoring facts that would lead a person of reasonable prudence and competence to investigate) in the preparation of the tax return or claim for refund for which the penalty is imposed.[1328]

The §6695(g) penalty will not be applied with respect to a particular tax return or refund claim if the tax return preparer can demonstrate to the IRS's satisfaction that, considering all the facts and circumstances, the tax return preparer's normal office procedures were reasonably designed and routinely followed to ensure compliance with the due diligence requirements, and the failure to meet such requirements with respect to the particular tax return or claim for refund was isolated and inadvertent. This rule does not apply to a firm.[1329]

7. *No Negotiating Refund Check*

A tax return preparer who endorses or otherwise negotiates a tax refund check issued to a taxpayer (other than the preparer) with respect to a return or refund claim prepared by the preparer, is subject to a $500 (adjusted annually for inflation) penalty under §6695(f) for each such check.[1330] The penalty applies to both direct negotiation and indirect negotiation through an agent.[1331] However, the penalty does not apply solely as a result of the preparer having affixed the taxpayer's name to a refund check for the purpose of depositing the check into an account in the taxpayer's name or in the joint names of the taxpayer and one or more other persons (other than the preparer) pursuant to an authorization from the taxpayer or the taxpayer's representative.[1332]

In addition, the penalty does not apply to a tax return preparer-bank that:[1333]

- Cashes a refund check and remits all of the cash to the taxpayer or accepts a refund check for deposit in full to a taxpayer's account, so long as the bank does not initially endorse or negotiate the check (unless the bank has made a refund anticipation loan to the taxpayer); or
- Endorses a refund check for deposit in full to a taxpayer's account pursuant to a taxpayer's written authorization (unless the bank has made a refund anticipation loan to the taxpayer).

Comment: The penalty may apply even if a preparer endorses or negotiates a check issued to the taxpayer by reason of a power of attorney from the taxpayer.[1334]

[1324] Reg. §1.6695-2(b)(3)(ii)(E).
[1325] Reg. §1.6695-2(b)(3)(ii)(F).
[1326] Reg. §1.6695-2(b)(4)(i).
[1327] Reg. §1.6695-2(b)(4)(ii).
[1328] Reg. §1.6695-2(c). *See* CCA 201846005 (if firm preparer requirement is met, IRS can assert penalty against S corporation; Office of Chief Counsel advised there are legal hazards with assessing directly on co-owner of S corporation because S corporation employs preparers, not co-owner).
[1329] Reg. §1.6695-2(d).
[1330] §6695(f); Reg. §1.6695-1(f), §58.6695-1(a) (penalty also applies to preparers of stock repurchase excise tax returns and refund claims). The penalty amounts in §6695(f) are adjusted annually for inflation. §6695(h). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Other Assessable Penalties With Respect to the Preparation of Tax Returns for Other Persons*, at **Annually adjusted penalty amounts under §6695**.
[1331] §6695(f).
[1332] §6695(f); Reg. §1.6695-1(f)(1).
[1333] Reg. §1.6695-1(f)(2). A tax return preparer-bank may also subsequently endorse or negotiate a refund check as part of the check clearing process through the financial system after the initial endorsement or negotiation. Reg. §1.6695-1(f)(3).
[1334] PLR 7824017.

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8. Fiduciary Duty

Generally, a tax return preparer does not owe a fiduciary duty to the taxpayer as a matter of law.[1335] The preparer is not the taxpayer's agent.[1336] The preparer has no authority to bind the taxpayer, and the taxpayer does not control the preparer.

Notwithstanding the foregoing, a fiduciary duty may arise in particular factual situations.[1337] Factors may include the size of the preparer, the sophistication of the taxpayer, and the period of the relationship.

Even if there is a fiduciary duty, the taxpayer has no claim against the preparer unless the preparer abused the relationship to gain an improper personal benefit. Moreover, §6694 does not provide grounds for collateral attack on a preparer by a taxpayer who is subject to a civil or criminal penalty for understatement of his taxes.[1338]

E. Assessment of Tax Return Preparer Penalties

1. Assessment Procedure

The deficiency procedures do not apply to the assessment or collection of the preparer penalties imposed by §6694 and §6695.[1339] Instead, the IRS can merely assess the applicable preparer penalty and issue a notice and demand for payment.[1340] Generally, the preparer must pay the penalty before he can contest its validity. However, §6694(c) provides a minimum partial payment option (15% or more) for §6694 penalties for a time-limited exception giving a United States district court jurisdiction over a refund claim on a partial payment of the penalty. Preparer penalties may be subject of the Fast Track Settlement procedures and may be considered by Appeals during the course of a collection due process hearing.[1341] In addition, there are special procedures for the §6694 understatement penalties.[1342]

The amount of any penalty under §6694(a) or §6695 must be assessed within three years after the filing of the return or claim for refund for which the penalty is assessed.[1343] Unless the penalty is timely assessed, the IRS cannot bring an action to collect the penalty after the end of such three-year period. No statute of limitations, however, applies in the case of a §6694(b) penalty for a preparer's willful attempt to understate tax or his reckless or intentional disregard of the rules or regulations. In such case, the penalty can be assessed, or a collection proceeding brought without assessment, at any time.[1344]

2. Claim for Refund of a Preparer Penalty

A claim for refund of a penalty assessed against a tax return preparer is made by filing a Form 6118, *Claim for Refund of Tax Return Preparer and Promoter Penalties,* with the IRS campus or office that issued the notice and demand for payment.[1345] The claim may only be filed by the tax return preparer (or the estate of the preparer) against whom the penalty is assessed.[1346] There is no restriction, however, on who may prepare the claim.[1347]

The claim must identify (by type, amount and document) the preparer penalties to which the claim relates, the amount and date of each payment of the penalty and include a detailed statement setting forth each ground for asserting that the preparer penalty has been overpaid and facts sufficient to apprise the IRS of the exact basis of the claim.[1348] The claim must be signed by the preparer (or his estate) under penalties of perjury.[1349]

Generally, a separate claim for refund must be filed for each preparer penalty asserted.[1350] A tax return preparer, however, may file a consolidated claim for any or all preparer penal-

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[1335] *See, e.g., Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014); *Sorenson v. H&R Block, Inc.*, No. 99-10268-DPW (D. Mass. 2002), reh'g denied, (D. Mass. 2003), aff'd, 107 Fed. App'x 227 (1st Cir. 2004); *Peterson v. H&R Block Tax Servs., Inc.*, 971 F. Supp. 1204 (N.D. Ill. 1997); *Basile v. H&R Block, Inc.*, 563 Pa. 359 (2000), *on remand*, 2001 PA Super. 136 (2001), appeal denied, 569 Pa. 714 (2002); *Estate of Smith v. Marcet*, 352 B.R. 462 (Bankr. N.D. Ill. 2006). *But see Green v. H&R Block, Inc.*, 355 Md. 488 (1999).

[1336] *See* Restatement (Second) of Agency §§1, 2, 14, 32.

[1337] *See, e.g., Geo. Knight & Co. v. Watson Wyatt & Co.*, 170 F.3d 210 (1st Cir. 1999).

[1338] *Sorenson v. H&R Block, Inc.*, No. 99-10268-DPW (D. Mass. 2002), reh'g denied, (D. Mass. 2003) (taxpayer has no claim against preparer who reported taxpayer's improper return to the IRS), *aff'd*, 107 Fed. App'x 227 (1st Cir. 2004).

[1339] §6696(b). *See also* §6665 and §6671(a), discussed at XII., below. These procedural rules also apply to the appraiser penalty under §6695A.

[1340] Reg. §1.6696-1(a)(1), §58.6696-1(a) (same for preparers of stock repurchase excise tax returns and refund claims), T.D. 10002, 89 Fed. Reg. 55,045 (July 3, 2024), applicable to stock repurchase excise tax returns and claims for refund required to be filed, and advice provided, after June 28, 2024, and during taxable years ending after June 28, 2024 (Reg. §58.6696-1(b)). The IRS cannot assert a §6694 or §6701 penalty against tax return preparer merely for filing refund claim after statute of limitations has expired; both penalties require claim due to "understatement of liability" defined under §6694(e) (see the discussion at VII.C.3.a.(2), above), which does not include time barred refund claims. *See* CCA 201519029.

[1341] Rev. Proc. 2017-25 (small business/self-employed fast track settlement procedures); Rev. Proc. 2003-40 (fast track settlement procedures); IRM 20.1.6.16 (05-22-24). The Fast Track Mediation — Collection (FTMC) program does not apply to collection due process (CDP) matters. Rev. Proc. 2016-57, *obsoleting* Rev. Proc. 2003-41. FTMC replaced the Fast Track Mediation (FTM) Program, which included CDP cases.

[1342] See the discussion at VII.E.5., below.

[1343] §6696(d)(1). The IRS is not explicitly prohibited from beginning a tax return preparer investigation before completing an audit of the underlying return. However, the matter cannot be forwarded to Appeals before the underlying audit is completed. To the extent that a return preparer exam is delayed and there is not sufficient time remaining on the statute of limitations, the IRS generally will follow the procedures for short statute preparer cases in former IRM 20.1.6.19.1, now IRM 20.1.13.3.5 (07-13-22). If the statute of limitations is about to expire and the preparer will not agree to an extension, the penalty will be assessed. If the preparer has not previously had the opportunity to request an Appeals hearing, the preparer, upon request, will be provided post-assessment appeal rights in the same way pre-assessment appeal rights would have been provided. (Examiners also will advise return preparers that the period for filing a refund claim under §6694(c) is not extended by a post-assessment appeal). Examiners will not submit preparer penalty cases to Appeals if less than 180 days remain on the statute of limitations when received by Appeals. In these instances, examiners will first solicit an extension of the statutory period for assessment. CCA 201425012.

[1344] §6696(d)(1).

[1345] §6696(c); Reg. §1.6696-1(b), §1.6696-1(e), §1.6696-1(f), §58.6696-1(a) (same for preparers of stock repurchase excise tax returns and refund claims).

[1346] Reg. §1.6696-1(b), §58.6696-1(a) (same for preparers of stock repurchase excise tax returns and refund claims).

[1347] Reg. §1.6696-1(b), §58.6696-1(a) (same for preparers of stock repurchase excise tax returns and refund claims).

[1348] Reg. §1.6696-1(d), §58.6696-1(a) (same for preparers of stock repurchase excise tax returns and refund claims).

[1349] Reg. §1.6696-1(b), §1.6696-1(d), §58.6696-1(a) (same for preparers of stock repurchase excise tax returns and refund claims).

[1350] Reg. §1.6696-1(c)(1).

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ties imposed on the preparer by a single IRS campus or office relating to:[1351]

- Failure to sign penalties under §6695(b);
- Failure to furnish the preparer's identification number penalties under §6695(c);
- Failure to furnish a copy of the return to a taxpayer penalties under §6695(a);
- Failure to file correct information returns under §6695(e);
- Negotiation of checks under §6695(f);
- Failure to be diligent in determining eligibility for certain tax benefits under §6695(g); and
- Failure to retain a copy of the return or list penalties under §6695(d).

whether the penalties are asserted on a single or on separate notices and demands. In addition, a consolidated claim may be filed for any or all failures to report penalties under §6695(e) that are asserted against the preparer on a single notice and demand.[1352]

To be valid, the claim for refund must be filed within three years after the date on which the preparer penalty was paid, or in the case of a consolidated claim, within three years of the first date of payment of any penalty included in the claim.[1353] For this purpose, a payment is considered made on the date the IRS receives it or the date on which an amount is credited in satisfaction of the penalty.[1354] If the last day on which the claim can be filed is a Saturday, Sunday, or legal holiday, the time for filing a claim is extended until the next business day.[1355] A claim is deemed timely filed if it bears a U.S. postmark date that is within the period prescribed for filing, even if it is delivered later.[1356]

3. Suit for Refund

A tax return preparer may not bring a suit to recover a preparer penalty unless: (1) he timely filed a claim for refund of the penalty, and (2) either the IRS denied the claim or six months elapses from the date the claim was filed.[1357] The tax return preparer then has two years to file suit, although the parties can agree in writing to extend this period.[1358] If the last day for filing suit falls on a Saturday, Sunday, or legal holiday, the period is extended to the next business day.[1359]

Special rules apply to suits by a preparer where the understatement on which the penalty is based is abated or where the preparer paid at least 15% of the penalty.[1360]

For a discussion of suits for refund, see 631 T.M., *Refund Litigation.*

4. Abatement of Penalty

If there is a final administrative or judicial determination that the tax shown on the return is not understated, the preparer penalty under §6694(a) or §6694(b) for that return must be abated. The amount, if any, of the penalty that has been paid must be refunded, without regard to any statute of limitations that would otherwise apply.[1361]

For this purpose, a tax is considered understated if there is an understatement of the net amount payable for that tax or an overstatement of the net amount refundable or creditable for that tax. Except as otherwise provided above, whether a tax is understated is determined without regard to any administrative or judicial action involving the taxpayer.[1362]

5. Special Procedures Regarding §6694 Understatement Penalties

A special procedure allows a §6694 tax return preparer to contest an understatement penalty without first having to pay the entire penalty.[1363] Before assessing a preparer understatement penalty under §6694(a) or §6694(b), the IRS will send a report of its examination to the tax return preparer.[1364] Unless the three-year statute of limitations on assessing the penalty is about to expire, the IRS will issue a 30-day letter before the penalty is assessed.[1365] The preparer can then request an Appeals conference within such 30-day period and receive a final administrative determination without first having to pay the penalty.[1366]

If the IRS assesses an understatement penalty, it must send a notice and demand for payment of the penalty separate from any notice of tax deficiency.[1367] The preparer then has a choice, either to follow the regular contest procedures (described above) or to follow a special procedure. Under the special procedure, the §6694 preparer must pay at least 15% of the

[1351] Reg. §1.6696-1(c)(2), §58.6696-1(a) (same for preparers of stock repurchase excise tax returns and refund claims); Form 6118, *Claim for Refund of Tax Return Preparer and Promoter Penalties.*

[1352] Reg. §1.6696-1(c)(2), §58.6696-1(a) (same for preparers of stock repurchase excise tax returns and refund claims).

[1353] §6696(d)(2); Reg. §1.6696-1(g)(1), §58.6696-1(a) (same for preparers of stock repurchase excise tax returns and refund claims).

[1354] Reg. §1.6696-1(g)(1), §58.6696-1(a) (same for preparers of stock repurchase excise tax returns and refund claims).

[1355] Reg. §1.6696-1(g)(2) (reference to §7503), §58.6696-1(a) (same for preparers of stock repurchase excise tax returns and refund claims).

[1356] Reg. §1.6696-1(g)(2) (reference to §7502), §58.6696-1(a) (same for preparers of stock repurchase excise tax returns and refund claims).

[1357] §7422(a), §6532(a)(1); Reg. §1.6696-1(j)(1), §58.6696-1(a) (same for preparers of stock repurchase excise tax returns and refund claims).

[1358] §6532(a); Reg. §1.6696-1(j)(2)(i), (same for preparers of stock repurchase excise tax returns and refund claims). If the preparer files a waiver of the notice of disallowance, the two-year period begins at that time. §6532(a)(3).

[1359] Reg. §1.6696-1(j)(2)(ii), §58.6696-1(a) (same for preparers of stock repurchase excise tax returns and refund claims); §7503.

[1360] §6696(c); §6696(d)(2); Reg. §1.6696-1(j)(2)(i), §58.6696-1(a) (same for preparers of stock repurchase excise tax returns and refund claims). See the discussion at VII.E.5., below.

[1361] §6694(d).

[1362] §6694(e).

[1363] §6694(c); Reg. §1.6694-4. The same special procedure is available to preparers of stock repurchase excise tax returns and preparers of claims for refund of stock repurchase excise tax. *See* Reg. §58.6694-1(d), T.D. 10002, 89 Fed. Reg. 55,045 (July 3, 2024), applicable to stock repurchase excise tax returns and claims for refund required to be filed, and advice provided, after June 28, 2024, and during taxable years ending after June 28, 2024 (Reg. §58.6694-1(e)).

[1364] Reg. §1.6694-4(a)(1).

[1365] Reg. §1.6694-4(a)(2). *See McNamee v. Commissioner*, T.C. Memo 2020-37 (where statute of limitations was about to expire and taxpayer refused to extend, appropriate to assess before final administrative determination).

[1366] Reg. §1.6694-4(a)(2).

[1367] Reg. §1.6694-4(a)(3).

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total amount assessed for each return or claim for refund, and file a claim for refund of this amount within 30 days after the date of the IRS notice and demand.[1368]

Filing such a claim precludes the IRS from trying to collect the balance of the assessed penalty until 30 days after the earlier of: (1) the date on which the preparer's claim for refund is denied, or (2) the expiration of six months after the date on which the claim for refund was filed.[1369] The preparer can extend the no-collection period by commencing an action in the appropriate federal district court within the 30-day period.[1370] In such a case, the IRS cannot collect the balance of the penalty until the proceeding is finally resolved.[1371] The IRS, however, can file a counterclaim in this proceeding for the unpaid balance of the penalty.[1372] Final resolution of the proceeding includes any settlement between the IRS and the preparer, a final determination by a court (for which the period for appeal, if any, has expired), and generally, the types of determinations related to taxpayer deficiencies, as provided under §1313(a).[1373]

The statute of limitations on collection of the unpaid amount of the penalty is suspended for the period during which the IRS is prohibited from collecting the penalty under the prior paragraph.[1374]

6. *Application of Overpaid Penalty*

The IRS can apply a tax return preparer's overpayment of a preparer penalty against any outstanding tax, interest, or assessable penalty (including a preparer penalty) owed by the preparer. The balance is refunded to the preparer.[1375]

7. *Interest*

A tax return preparer penalty under §6694 or §6695 is treated as a tax liability for purposes of applying the interest rules. Interest is charged on any unpaid preparer penalty that is assessed against a tax return preparer and is allowed on any overpayment of a preparer penalty.[1376]

F. Other Preparer Penalties

1. *Aiding and Abetting Penalty*

A tax return preparer may also be subject to the penalty for aiding and abetting the understatement of a tax liability under §6701.[1377] This penalty, however, does not apply in situations where the preparer is charged with an understatement penalty under §6694(a) or §6694(b).[1378]

Comment: The scienter element (discussed below) of the aiding and abetting penalty requires that the preparer must be directly involved with the preparation or presentation of a false or fraudulent return. One court has held that a return is necessarily false or fraudulent if the preparer knows that the return as prepared will result in an understatement of tax.[1379] Commentators have severely criticized that court's equating a knowing understatement with a fraudulent act, as being directly contrary to the professional standards applicable to attorneys and accountants in preparing returns.[1380] Both ABA Formal Opinion 85-352 and the AICPA Statements on Standards for Tax Services, as well as the understatement penalties of §6694, allow a preparer to recommend a position that he does not believe will prevail, provided that there is some reasonable possibility of success based on the merits.

2. *Disclosure or Use of Information Penalty*

Generally, information furnished to an income tax return preparer for or in connection with the preparation of a return is confidential. Such tax return information includes the taxpayer's name, address, identification number, and other information furnished by or on behalf of the taxpayer for or in connection with the preparation of an income tax return of the taxpayer.[1381] Any person engaged in the business of preparing or providing services in connection with the preparation of income tax returns, or who, for compensation, prepares a return for another person, and who discloses or uses any tax return information other than to prepare or assist in preparing the taxpayer's return is subject to a penalty of $250 for each disclosure or use ($1,000, in the case of a disclosure or use that is made in connection with a crime relating to the misappropriation of another person's taxpayer identity (as defined in §6103(b)(6)), whether or not such crime involves any tax filing).[1382] The maximum penalty that may be imposed generally cannot exceed $10,000 in any calendar year ($50,000 per calendar year, in the case of a disclosure or use that is made in connection with a crime relating to the misappropriation of another person's taxpayer iden-

[1368] §6694(c)(1); Reg. §1.6694-4(a)(4).

[1369] §6694(c)(2); Reg. §1.6694-4(a)(5). Notwithstanding the anti-injunction rule of §7421(a), the preparer can enforce the prohibition against collection during the applicable period by a proceeding in the proper court. §6694(c)(1); Reg. §1.6694-4(a)(5).

[1370] §6694(c)(2).

[1371] Reg. §1.6694-4(a)(5). Attempts by the IRS to collect can be enjoined, notwithstanding §7421(a). Reg. §1.6694-4(a)(5).

[1372] §6694(c)(1); Reg. §1.6694-4(a)(6).

[1373] Reg. §1.6694-4(a)(6).

[1374] §6694(c)(3).

[1375] Reg. §1.6696-1(h), §58.6696-1(a) (same for preparers of stock repurchase excise tax returns and refund claims), T.D. 10002, 89 Fed. Reg. 55,045 (July 3, 2024), applicable to returns and claims for credit or refund filed, and advice provided, after June 28, 2024, and during taxable years ending after June 28, 2024 (Reg. §58.6696-1(b)).

[1376] Reg. §1.6696-1(i), §58.6696-1(a) (same for preparers of stock repurchase excise tax returns and refund claims).

[1377] See VIII.B., below.

[1378] §6701(f)(2). Although §6696(a) provides that §6694 penalty is in addition to all other penalties, the IRS follows the §6701(f)(2) limitation. IRM 20.1.6.6(3) (05-22-24), IRM 20.1.6.14.4(1) (07-26-17).

[1379] *Warner v. United States*, 698 F. Supp. 877 (S.D. Fla. 1988), motion granted in part and denied in part, 700 F. Supp. 532 (S.D. Fla. 1988), summary judgment *granted in part and denied in part,* 726 F. Supp. 1287 (S.D. Fla. 1989), aff'd by unpub. op., 979 F.2d 212 (11th Cir. 1992).

[1380] *See, e.g.*, Jeffrey A. Ritholz and Bryan C. Skarlatos, *Is the Preparer Understatement Penalty in Conflict With Ethical Guidelines?* 77 J. Tax'n 104 (Aug. 1992).

[1381] *Cf.* Reg. §301.7216-1(b)(3).

[1382] §6713(a), §6713(b)(1). Section 6713 is the civil penalty counterpart of §7216. The IRS has not issued regulations under §6713. However, §6713(c) provides that the rules of §7216 apply for purposes of §6713. For additional guidance and the rules regarding the disclosure and use of tax return information by tax return preparers under Reg. §301.7216-1, *et seq.*, see 620 T.M., *Practice Before the IRS; Attorney's Fees in Tax Proceedings.* For guidance regarding a tax return preparer's ability to disclose a taxpayer's SSN to a tax return preparer located outside the United States, including the need for taxpayer consent and the use of adequate data protection safeguards, see Reg. §301.7216-3 and Rev. Proc. 2013-14 *modified by* Rev. Proc. 2013-19. *See also* 636 T.M., *Tax Crimes.*

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tity (as defined in §6103(b)(6)), whether or not such crime involves any tax filing).[1383]

As indicated above, an enhanced penalty applies for improper use or disclosure relating to the misappropriation of a taxpayer's identity by a return preparer. In the case of any disclosure or use made in connection with a crime relating to the misappropriation of a taxpayer's identity (as defined in §6103(b)(6)) — regardless of whether such crime involves any tax filing — the penalty is $1,000 for each such disclosure or use, with a maximum penalty per calendar year of $50,000.[1384]

Note: The calendar year limitation is applied separately for disclosures or uses made in connection with taxpayer identity theft. Thus, for example, a preparer could incur penalties of up to $10,000 in a calendar year for unauthorized disclosures of client return information and penalties of up to $50,000 in the same calendar year for misappropriation of client identities.[1385]

The penalty can be assessed without following the deficiency procedures of subchapter 63B.[1386]

Comment: By including all persons engaged in the business of preparing returns or providing auxiliary services and individuals whose duties include performing such services, the application of this provision is broader than the scope of who is a tax return preparer under §7701(a)(36).[1387]

Exceptions to the penalty are provided for:[1388]

• A disclosure pursuant to any other provision of the Code or regulations;

• A disclosure of tax return information to the IRS;

• A use of the taxpayer's tax information to update and test the taxpayer's tax return preparation software;

• A disclosure by a preparer located in the United States to an officer, employee or member of the preparer who is also in the United States to assist in the preparation of, or assist in providing ancillary services in connection with the preparation of, the taxpayer's returns;

• A disclosure by a preparer located outside the United States to an officer, employee or member to assist in the preparation of, or assist in providing auxiliary services in connection with the preparation of, the taxpayer's returns;

• A disclosure to another tax return preparer located in the United States to assist in the preparation of, or assist in obtaining or providing auxiliary services in connection with, the taxpayer's return, so long as the services provided are not substantive determinations or advice affecting the taxpayer's tax liability;

• A disclosure to an independent contractor of the preparer in connection with the programming, maintenance, repair, testing or procurement of equipment or software used to prepare returns, to the extent necessary for the independent contractor to provide the contracted services, provided the preparer ensures all individuals who receive such information receive a written notice regarding the applicability of §6713 and §7216 to them, the requirements thereof and the penalties thereunder;

• A disclosure or use of certain information in preparing a return for a party related to the first taxpayer, whose interest is not adverse, provided that such use or disclosure is not expressly prohibited by the first taxpayer. For this purpose, parties are related if they are spouses, parent and child, grandparent and grandchild, partnership and partner, trust or estate and beneficiary or fiduciary, corporation and shareholder, or members of a controlled group of corporations under §1563;

• A disclosure pursuant to the order of a court of record; a grand jury subpoena; a Congressional subpoena; an administrative order, demand, summons or subpoena of a federal agency or a state agency charged with licensing, registering or regulating preparers; a written request from a professional association, ethics committee or board investigating the ethical conduct of the preparer; or a written request from the PCAOB in connection with an inspection under §105 of the Sarbanes Oxley Act;

• A disclosure to the preparer's attorney for purposes of securing legal advice; an employee of the IRS for use in connection with an investigation of the preparer conducted by the IRS; or to an officer of the court for use in connection with a proceeding involving the preparer before the court (or a grand jury which may be convened by the court);

• A disclosure or use by a preparer who is an attorney or accountant to another officer, employee or member of the preparer's law or accounting firm to provide other legal or accounting services to the taxpayer; to third parties in the normal course of rendering the legal or accounting services to the taxpayer, unless the taxpayer directs otherwise; or consistent with ethical responsibilities, take such information into account in the course of performing legal or accounting services for another client;

• A disclosure or use by a corporate fiduciary that prepares a return for a taxpayer for whom it renders fiduciary, investment, or other custodial or management services in the ordinary course of its business of rendering such services to the taxpayer or to the taxpayer's attorney, accountant or investment advisor, unless the taxpayer otherwise directs;

• A disclosure to the taxpayer's fiduciary, estate or duly authorized agent after the taxpayer dies or becomes incompetent, insolvent or bankrupt, or after his assets are placed in a conservatorship or receivership;

• A disclosure to pay for tax preparation services to the extent necessary to process or collect the payments;

• A disclosure in connection with the preparation of other returns for the taxpayers, an audit by the IRS of a return of the taxpayer or any subsequent tax litigation with respect thereto;

• The use of certain limited taxpayer information for the purpose of contacting the taxpayer to provide tax information and general business and economic information or

[1383] §6713(a), §6713(b)(1).
[1384] §6713(b)(1).
[1385] §6713(b)(2).
[1386] §6713(d). *See also* §6665 and §6671(a), discussed below.
[1387] Tax return preparers are discussed at VII.B.1., above.
[1388] §6713(c), adopting the exceptions set forth in §7216(b); Reg. §301.7216-2, §301.7216-3.

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analysis for educational purposes, or to solicit additional return preparation services;

• A use to provide a statistical compilation of certain data, and the disclosure thereof to the extent directly related to the internal management or support of the preparer's return preparation business or to bona fide research or public policy discussions regarding federal or state taxation, provided the information is anonymous as to taxpayer identity and includes data from at least 10 returns;

• A disclosure to the extent necessary for a quality, peer or conflict review. In the case of quality or peer reviewing, the preparer must maintain a record of the review, including the identity of the reviewer and information reviewed;

• A disclosure to the extent necessary to report the commission of a crime, or activities that may constitute a crime, to the proper authorities, even if the disclosure is made in a bona fide (but mistaken) belief of a crime;

• A disclosure following the death or incapacity of the preparer to assist the preparer, his legal representative or the representative of a deceased preparer's estate in operating the business; and

• Any other disclosure with the formal consent of the taxpayer.

Any taxpayer consent must be knowing and voluntary; services may not be conditioned on receiving consent (other than a preparer conditioning its services on the taxpayer's consent to disclosing information to another preparer that is assisting in, or providing ancillary services in connection with, the preparation of his return.)[1389] The consent must: (1) include the name of the taxpayer and the name of the preparer, (2) identify the purpose of the disclosure or the particular use authorized, (3) identify the permitted recipient or recipients of the information, (4) specify the particular information to be disclosed or used, (5) if the preparer is located outside the United States, specifically consent to such disclosure, and (6) must be signed and dated by the taxpayer.[1390] The consent may also specify a duration for the consent.[1391] The consent must be provided before the disclosure or use; retroactive consents are not permitted.[1392]

3. Action to Enjoin Preparer

The IRS may seek to enjoin a tax return preparer from further engaging in specific abusive practices or from acting as a tax return preparer by bringing suit in federal district court for the district in which the preparer resides or has his principal place of business, or the district in which the taxpayer whose return is the basis for the action resides.[1393] If the court finds that:[1394]

• The tax return preparer has:

o Engaged in conduct subject to a preparer penalty under §6694 or §6695;

o Engaged in conduct subject to a criminal penalty under the Code;

o Misrepresented his eligibility to practice before the IRS;

o Misrepresented his experience or education as a preparer;

o Guaranteed the payment of any tax refund or the allowance of any tax credit; or

o Engaged in any other fraudulent or deceptive conduct that substantially interferes with the proper administration of the tax law; and

• Injunctive relief is appropriate to prevent the recurrence of such conduct, at margin the court may enjoin the preparer from further engaging in such conduct. If the court finds that the preparer has continually or repeatedly engaged in any such conduct and that an injunction prohibiting only a specific type of conduct would not be sufficient to prevent further interference by the preparer in the proper administration of the tax law, the court may enjoin the preparer from acting as a preparer.[1395] The court may consider such injunctive action separate and apart from any other action taken against the preparer.[1396] The IRS could, for example, assess a penalty against the preparer for certain acts at the same time as it seeks to enjoin the preparer from engaging in such conduct or from continuing to act as a preparer.

Both Congress and the courts have taken precautions not to permanently preclude a tax return preparer from his livelihood except in the most egregious cases. The legislative history requires the injunctive relief sought to be commensurate with

[1389] Reg. §301.7216-3(a)(1), §301.7216-3(a)(2).

[1390] Reg. §301.7216-3(a)(3).

[1391] Reg. §301.7216-3(b)(5). If no duration is specified, the consent is effective for one year from the date it is signed by the taxpayer. Reg. §301.7216-3(b)(5).

[1392] Reg. §301.7216-3(b)(1). There are additional limitations on a tax return preparer's ability to request a taxpayer's consent for the disclosure or use of tax return information. *See generally* Reg. §301.7216-3(b).

[1393] §7407(a). Such an injunction action is not subject to the bankruptcy automatic stay provision (11 U.S.C. §362). *United States v. Fisher*, 93 AFTR 2d 444 (N.D. Tex. 2004).

[1394] §7407(b)(1).

[1395] §7407(b)(2). *See, e.g.*, *United States v. Scott*, 93 AFTR 2d 970 (N.D. Tex. 2004) (promoter of purported federal grant program for minority-owned business, enjoined from, among other things, acting as a preparer of federal income tax returns); *United States v. Farnell*, 91 AFTR 2d 754 (M.D. Fla. 2003), modified in part, 91 AFTR 2d 1356 (M.D. Fla. 2003) (preliminary injunction granted under §7402, §7407 and §7408); *United States v. Ratfield*, 2002-2 USTC ¶50,765 (S.D. Fla. 2002) (preliminary injunction granted); *Abdo v. IRS*, 234 F. Supp. 2d 553 (M.D.N.C. 2002) (marketer of "Tax Return Audit Challenge" and "voluntary compliance" programs permanently enjoined from acting as tax return preparer and related activities), *aff'd*, 63 Fed. App'x 163 (4th Cir. 2003), *cert. denied*, 540 U.S. 1120 (2004); *United States v. Foster*, 2002-2 USTC ¶50,785 (E.D. Va. 2002) (preparer permanently enjoined from making returns that claim or support refund claims based on slavery reparations credit); *United States v. Olsen*, 97-2 USTC ¶50,730 (D. Colo. 1997), aff'd on other grounds by unpub. op., 81 AFTR 2d 466 (10th Cir. 1998) (preparer who regularly misapprehended, misconstrued, and misapplied tax code and regulations in information to customers and in preparation of tax returns and who advised unrealistic and frivolous positions was deemed negligent in his efforts to understand the laws and enjoined from further return preparation).

[1396] §7407(a).

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the conduct that causes the IRS to seek the injunction.[1397] For example, if a preparer who is only experienced in preparing individual returns overstates his qualifications as a preparer by claiming expertise in the preparation of corporate returns, the injunction should be directed toward the misrepresentation itself or the preparation of corporate returns, but not toward preventing the preparer from preparing any returns at all. Similarly, if only some of an employer's employee-preparers have engaged in conduct leading to a request for an injunction, the IRS should not seek an injunction against the employer or any of the other employees unless they were actively involved in the improper conduct.

The legislative history also reaffirms the inherent authority of the court to limit the scope and duration of any injunction as it may deem appropriate.[1398] The court is given wide latitude to fashion appropriate relief based on the exigencies of the particular case.[1399]

The major considerations in determining whether to grant a preliminary injunction (pending a hearing on the merits) are the likelihood that the government will suffer irreparable harm if the preliminary injunction is not granted before the hearing, and the importance of balancing the need for the injunction against the harm to the preparer. Other factors that enter into the equation include the probability that the IRS will prevail on the merits and the public interest.[1400]

In the case of a permanent injunction, the courts customarily assess the totality of the circumstances, with a particular focus on the following factors: (1) the gravity of harm caused by the offense, (2) the extent of the preparer's participation, (3) his degree of scienter, (4) the isolated or recurrent nature of the infraction and the likelihood that the preparer's customary business activities might again involve such transactions, (5) the preparer's recognition of his own culpability, and (6) the sincerity of the preparer's assurances against future violations.[1401]

Even where the specific provisions of §7407 are not satisfied, the IRS may still attempt to enjoin preparers under the more general provisions of §7402. Section 7402(a) permits the U.S. district courts to issue injunctions where necessary or appropriate for the enforcement of the tax laws.[1402] For a discussion of §7402, see 637 T.M. *Federal Tax Collection Procedure — Liens, Levies, Suits and Third Party Liability.*

The IRS may also seek a temporary restraining order against a preparer on an ex parte basis under the Federal Rules of Civil Procedure. The legislative history warns, however, that this procedure should be used only in those extreme cases where the administration of the tax laws would be irreparably harmed by the continuation of the conduct against which the restraining order is sought.[1403]

[1397] 1976 Act House Report at 281–82; 1976 Act Senate Report at 359.

[1398] 1976 Act House Report at 281–82; 1976 Act Senate Report at 359. *Cf.* S. Rep. No. 97-494, ("1982 Act Senate Report") at 268–69 (1982) for the general jurisdiction of the federal district courts under §7402.

[1399] *See, e.g.*, *United States v. Franchi*, 756 F. Supp. 889 (W.D. Pa. 1991) (notwithstanding 87 preparer penalties aggregating $16,000 over eight years, the court granted only a preliminary injunction against defendant acting as preparer, pending a hearing, following which it will determine appropriate relief).

[1400] *See, e.g.*, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bradley*, 756 F.2d 1048 (4th Cir. 1985); *United States v. Franchi*, 756 F. Supp. 889 (W.D. Pa. 1991), aff'd without op., 952 F.2d 1394 (3d Cir. 1991), cert. denied, 504 U.S. 959 (1992); *United States v. Savoie*, 594 F. Supp. 678 (W.D. La. 1984); Charles Alan Wright and Arthur R. Miller, *Federal Practice and Procedure*, §2948 (2003).

[1401] *United States v. Simon*, 824 Fed. App'x. 986, 2020 BL 349654 (11th Cir. 2020) (permanent injunction affirmed where defendant and his wife caused loss of millions in tax revenue by repeatedly filing false returns and claimed false credits and deductions for more than six years);*United States v. Bailey*, 789 F. Supp. 788 (N.D. Tex. 1992), aff'd, 996 F.2d 305 (5th Cir. 1993). *See United States v. Nordbrock*, 38 F.3d 440 (9th Cir. 1994) (preparer permanently enjoined after continually failing to provide IRS with information regarding returns he prepared even after IRS initiated court enforcement action); *United States v. Stinson*, 239 F. Supp. 3d 1299 (M.D. Fla. 2017) aff'd, 729 Fed. App'x 891 (11th Cir. 2018) (permanent injunction granted against owner-operator of tax preparation stores); *Abdo v. United States*, 234 F. Supp. 2d 533 (M.D.N.C. 2002), aff'd, 63 Fed. App'x 163 (4th Cir. 2003), cert. denied, 540 U.S. 1120 (2004); *United States v. Foster*, 2002-2 USTC ¶50,785 (E.D. Va. 2002) (preparer permanently enjoined from preparing returns claiming tax credits for slavery reparations); *United States v. Rotzinger*, 88-1 USTC ¶9303 (C.D. Ill. 1988); *United States v. Venie*, 691 F. Supp. 834 (M.D. Pa. 1988) (preparers enjoined from engaging in specific acts).

[1402] *See United States v. Ernst & Whinney*, 735 F.2d 1296 (11th Cir. 1984), cert. denied, 470 U.S. 1050 (1985). *See also United States v. Fisher*, 93 AFTR 2d 444 (N.D. Tex. 2004) (injunction action not subject to bankruptcy automatic stay).

[1403] *United States v. Ernst & Whinney*, 735 F.2d 1296 (11th Cir. 1984), cert. denied, 470 U.S. 1050 (1985).

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VIII. Promoter and Protester Penalties

A. Tax Shelters

1. Promoting Abusive Tax Shelter Penalty

a. Penalty

A civil penalty is imposed under §6700 on any person (a "promoter") who:[1404]

- Organizes or assists in the organization of, or participates (directly or indirectly) in the sale of, an interest in an entity, plan or arrangement (a "tax shelter"); and
- Makes or furnishes (or causes another person to make or furnish) in connection with such organization or sale:
  - o A statement with respect to the availability of any tax benefit by reason of participating in the tax shelter that the promoter knows or has reason to know is false or fraudulent as to any material matter; or
  - o A gross valuation overstatement as to any material matter.

In the case of a false or fraudulent statement, the amount of the penalty is equal to 50% of the gross income derived (or to be derived) by the person from the activity.[1405] The penalty is based on the gross income derived from the entire promotion, including the gross income derived from activities after the formation of the abusive tax shelter.[1406] Gross income is not reduced by expenses.[1407] For gross valuation overstatements, the amount of the penalty with respect to each such activity is $1,000 or, if the promoter can show that it is less, an amount equal to 100% of the gross income derived (or to be derived) by the promoter from the activity.[1408] In each case, where the amount to be derived by the promoter is contingent or speculative, the formula is based on the amounts that the promoter can reasonably be expected to realize.[1409]

The amount of the §6700 penalty determined by the IRS is presumed correct.[1410] Accordingly, when the IRS established that the promoter sold a certain number of materials, the burden shifts to the promoter to show that the income derived (or to be derived) was less than $1,000 a transaction.[1411]

The IRS can waive any or all of the §6700 penalty for a gross valuation overstatement if there is a reasonable basis for the valuation and if the valuation is made in good faith.[1412] The mere existence of an appraisal is not sufficient, by itself, to show either reasonable cause or good faith. Rather, the IRS can, for example, examine the basis for the appraisal, the manner in which it was obtained, and the appraiser's relationship to the investment or promoter.[1413] There is no provision for waiving the §6700 penalty for false or fraudulent statements.

The penalty applies regardless of whether a purchaser relies on the plan or arrangement or underreports his/her income tax.[1414] The penalty is based on the actions of the promoter. The actions or motivations of the purchaser are irrelevant.

In calculating the amount of the penalty, the organization of each tax shelter and the participation in each sale constitute separate activities.[1415] The courts that have considered the issue have reached different conclusions as to how the penalty is computed when a promoter participates in multiple sales of interests in a single tax shelter. The District Court in *Hargrove & Costanzo*[1416] held that the $1,000 penalty applies per entity, not with respect to each sale in which the promoter participates. The *Hargrove* court determined that the penalty applies to two activities — organizing and participating in the sale of interests — and that each of the activities had to occur with respect to an entity. As additional support for its conclusion that multiple sale penalties are not intended, the *Hargrove* court cited the statute's use of the singular "sale of any interest in an entity," rather than sales. If Congress had intended multiple penalties, the Hargrove court believes Congress would have clearly stated that intent.

The district court in *Grant, Konvalinka & Harrison*[1417] strongly disagreed, finding that §6700(a) clearly imposed a

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[1404] §6700(a).

[1405] §6700(a) (flush language). At least one court has pierced the corporate veil when calculating the penalty. *Tarpey v. United States*, No. CV-17-94-BMM, 2019 BL 428954 (D. Mont. Nov. 7, 2019) (citing *Towe Antique Ford Found. v. IRS*, 999 F.2d 1387 (9th Cir. 1993), court found nonprofit corporation was alter ego of taxpayer). The Ninth Circuit affirmed the district court's decision in *Tarpey*, including its ruling that the nonprofit corporation's gross income is included in the taxpayer's gross income for purposes of the penalty calculation because the nonprofit corporation was the taxpayer's alter ego. *Tarpey v. United States*, 78 F.4th 1119 (9th Cir. 2023). For a discussion of piercing the corporate veil, see 628 T.M., *Transferee Liability*.

[1406] *See Tarpey v. United States*, 78 F.4th 1119 (9th Cir. 2023) (entire timeshare donation business — not just appraisal portion — is part of tax-avoidance scheme and is therefore the "activity"); CCA 202125008 (regarding microcaptive insurance transactions, §6700 penalty is based on entire promotion including fees promoter received for ongoing management of tax shelter after its formation), CCA 202125009 (same).

[1407] *Tarpey v. United States*, 78 F.4th 1119 (9th Cir. 2023); *Patients Mut. Assistance Collective Corp. v. Commissioner*, 151 T.C. 176, 204 (2018), aff'd, 995 F.3d 671 (9th Cir. 2021).

[1408] §6700(a) (flush language).

[1409] 1982 Act Senate Report at 267; *In re MDL-731 — Tax Refund Litig. of Organizers & Promoters of Inv. Plans Involving Book Props. Leasing ("In re Tax Refund Litig.")*, 989 F.2d 1290 (2d Cir. 1993), aff'g in part and rev'g in part 766 F. Supp. 1248 (E.D.N.Y. 1991).

[1410] *In re Tax Refund Litig.*, 989 F.2d 1290 (2d Cir. 1993); *Schulz v. United States*, 2018 BL 247343 (N.D.N.Y. July 12, 2018).

[1411] *United States v. Alexander*, 2010 BL 89905 (D.S.C. Apr. 21, 2010), aff'd per curiam by unpub. op., 434 Fed. App'x 246 (4th Cir. 2011).

[1412] §6700(b)(2).

[1413] 1982 Act Senate Report at 267.

[1414] *See, e.g., United States v. Estate Pres. Servs.*, 202 F.3d 1093 (9th Cir. 2000); *Gardner v. Commissioner*, 145 T.C. 161 (2015), aff'd, 704 Fed. App'x 720 (9th Cir. 2017); S. Rep. No. 97-494 (Vol. 1) at 267 (1982).

[1415] §6700(a) (flush language).

[1416] *Hargrove & Costanzo v. United States*, 2008-2 USTC ¶50,545 (E.D. Cal. 2008). Hargrove & Costanzo issued 18 bond opinions (one with respect to each entity) that resulted in a total of 4,143 customers purchasing bonds, and gross federal income to the firm of $1,781,367. The IRS imposed a §6700 penalty equal to such amount, contending that it is the lesser of the gross income derived or $1,000 per sale ($1,000 × 4,143 sales = $4,143,000).

[1417] *Grant, Konvalinka & Harrison, P.C. v. United States*, 612 F. Supp. 2d 950 (E.D. Tenn. 2009). There, a firm made 107,756 sales of bonds in an entity for which it received $570,870 in fees. The IRS assessed a §6700 penalty of $570,870, since it was less than $1,000 per sale (or $107,756,000). The court granted partial summary judgment to the government, rejecting the promoter's position, based on *Hargrove & Costanzo*, that only a single §6700 penalty can apply to the promoter's participation in multiple sales in the same entity. *See Schulz v. United States*, No. 1:15-cv-01299 (BKS/CFH) 2019 BL 106454 (N.D.N.Y. Mar. 27, 2019) (penalty based upon gross income generated

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penalty any time a promoter participates in the sale of an interest in an entity. According to the court, the statutory language contained no limitation on the number of times a promoter could participate in the sale of an interest in an entity.

Comment: The *Grant* interpretation is the correct one. Literally, the penalty is imposed each time a preparer participates in the sale of an interest in an entity. Participation in each sale is a separate activity.[1418] The reference to an entity merely describes what type of interest is sold. Moreover, the use of the singular "sale" simply authorizes the imposition of the penalty with respect to each sale; multiple sales are not required.

As a result, the amount of the penalty for a single tax shelter can be staggering. Moreover, the penalty is in addition to any other penalties that may apply.[1419] On the other hand, the penalty is divisible for purposes of filing a refund suit.[1420]

The §6700 penalty may be assessed at any time.[1421] Because it does not depend on the filing of a tax return, the limitations under §6501(a) do not apply. In addition, the catch-all five-year period on actions, suits or proceedings for enforcement of any penalty does not apply; the IRS's assessment of a §6700 penalty does not arise from an action, suit or proceeding.[1422] Moreover, as a matter of law, laches cannot bar the assessment. The courts also recognized that it is not inappropriate that no statute of limitations should apply to what is, in essence, an anti-fraud provision.

Taxpayers can use Form 14242, *Report Suspected Abusive Tax Promotions or Preparers* to report a suspected abusive tax avoidance scheme and/or a tax preparer promoting such a scheme.

b. Definition of Promoter

(1) In General

Although §6700 is obviously aimed at individuals organizing and marketing interests in tax shelter partnerships, the coverage is much broader. For this purpose, a promoter is one who, directly or indirectly, organizes or assists in the organization of a tax shelter or who participates in the sale of any interest in a tax shelter.[1423] Any person — an individual, a corporation, a partnership, a trust, or an estate — can be a promoter.

There is disagreement, however, as to whether separate §6700 penalties may be imposed against a partnership and its partners from the same conduct. Although a separate §6700 penalty applies to each separate legal entity that engages in the prohibited conduct, one court considered a partnership to be merely the aggregate of its partners for this purpose.[1424] Since there was no legal or economic difference between imposing the penalty on the partnership or on its partners, the court found that an imposition on both would constitute an improper double tax. Another court and the IRS, however, rejected that analysis and concluded that separate §6700 penalties are applicable to a partnership and to each partner who engaged in the conduct that §6700 prohibits.[1425] They found nothing in the statute that prevents the imposition of multiple penalties when a partner in his individual capacity and the partnership each violate the statute. Additionally, the Chief Counsel's Office advised that the §6700 penalty can apply to members, officers or employees of a promoter, as well as the promoter.[1426]

The tax shelter may be in the form of any entity, plan, or arrangement from which a tax benefit may be derived. The tax benefit may be in the form of a deduction, credit, excludability of income, increase in basis or otherwise.[1427] For example, bonds issued with alleged tax-exempt interest may constitute a tax shelter.[1428] In such case, possible promoters include the bond counsel, investment bankers, issuers, financial advisors, feasibility consultants, engineers, and their respective counsel. Moreover, the plan or arrangement need not be an investment; it can include other activities, such as the sale of mail-order ministries or family trust arrangements.[1429]

(2) Organization of a Tax Shelter

Although there are no regulations defining what constitutes organizing a tax shelter for purposes of §6700, the IRS believes the same definition for purposes of registering a tax shelter under pre-2004 AJCA §6111 applies.[1430] In such case, the organizer of a tax shelter is any person who: (1) discovers, creates, investigates or initiates the investment; (2) devises the business or financial plans for the investment; or (3) carries out those plans through negotiations or transactions with others.[1431] In addition, a person participates in the organization of a tax shelter if he performs any act (directly or through an agent) related to the establishment of the tax shelter, including: (1) preparation of any document establishing the tax shelter; (2) preparation of any document in connection with the registration (or exemption from registration) of the tax shelter with any federal, state or local governmental agency; (3) preparation of any prospectus, offering memorandum, financial statement or other statement describing the tax shelter; (4) preparation of a tax or other legal opinion relating to the tax shelter; (5) preparation of an appraisal relating to the tax shelter; and (6) negotiation or other participation on behalf of the tax shelter in the purchase of any property relating to the tax shelter.[1432]

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by number of tax shelter promotion "packets" sold by taxpayer and not limited to income earned during discrete taxable periods), aff'd, 831 Fed. App'x. 48 (2d. Cir. 2020).

[1418] §6700(a) (flush language).

[1419] §6700(c). *See* VIII.D.1., below.

[1420] *Humphrey v. United States*, 854 F. Supp. 2d 1301 (N.D. Ga. 2011). *See* §6700(a) (flush language).

[1421] *In re Tax Refund Litig.*, 766 F. Supp. 1248 (E.D.N.Y. 1991), aff'd in part and rev'd in part, 989 F.2d 1290 (2d Cir. 1993); *Kraye v. United States*, 93-1 USTC ¶50,047 (D. N.M. 1992); *Groves v. United States*, 2017 BL 151110 (N.D. Ill. May 5, 2017).

[1422] An action, suit or proceeding implies an adversarial adjudication, whether administrative or judicial. By contrast, an assessment under §6700 is merely the determination of a penalty and the recording of the liability.

[1423] *See* §6700(a)(1); 1989 Act House Report at 1397.

[1424] *In re Tax Refund Litig.*, 989 F.2d 1290 (2d Cir. 1993), aff'g in part and rev'g in part 766 F. Supp. 1248 (E.D.N.Y. 1991).

[1425] *Bailey Vaught Robertson & Co. v. United States*, 828 F. Supp. 442 (N.D. Tex. 1993). *Cf.* CCA 200402008.

[1426] CCA 202125009.

[1427] §6700(a)(2)(A).

[1428] 1989 Act House Report at 1397.

[1429] Staff of Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* ("1982 Blue Book") at 211.

[1430] CCA 200402008.

[1431] *See* Reg. §301.6111-1T Q&A-27.

[1432] *See* Reg. §301.6111-1T Q&A-28.

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(3) Participation in the Sale

Section 6700 may apply to a person who participates in the sale of an interest in a tax shelter. Here too, the IRS applies the tax shelter registration regulations under pre-2004 AJCA §6111 by analogy.[1433] In such case, participation in the sale of a tax shelter includes any marketing activities (directly or indirectly through an agent) with respect to an investment in the tax shelter, including: (1) direct contact with a prospective purchaser of an interest (or his representative or agent) relating to the possible purchase of an interest in the tax shelter, (2) solicitation of investors, or (3) instructing or advising a salesperson regarding the tax shelter or sales presentations with respect thereto.[1434]

c. Conduct to Which the Penalty Applies

The penalty applies to two distinct types of conduct: (1) making a false statement; and (2) making a gross valuation overstatement. In this regard, the IRS has implemented its Abusive Tax Shelter Detection Program to identify and investigate potential abusive tax shelters and investor returns that are likely to meet these requirements.[1435] In April 2021, the IRS created the IRS Office of Promoter Investigations (OPI) to increase the agency's focus on promoters of abusive tax avoidance transactions. Although positioned within the Small Business/Self-Employed (SB/SE) business division, the office works on agency-wide compliance issues and coordinates promoter activities with promoter teams in other business divisions, including LB&I, TE/GE, the Office of Fraud Enforcement, and the IRS's Criminal Investigation Division. The OPI Director serves as the principal advisor and consultant to IRS division commissioners and deputy commissioners on issues involving promoters of abusive transactions. The office also develops related strategic plans, programs, and policies.[1436]

(1) False Statements with Respect to a Material Matter

The penalty applies to a promoter who, in connection with the organization or sale of an interest in the tax shelter, makes or furnishes (or causes another person to make or furnish) a statement with respect to: (1) the allowability of any deduction or credit; (2) the excludibility of any income; or (3) the securing of any other tax benefit, by reason of holding an interest in the entity or participating in the plan or arrangement that the promoter knows or has reason to know is false or fraudulent as to any material matter.[1437] A "statement" includes those "directly addressing the availability of tax benefits, and those concerning factual matters that are relevant to the availability of tax benefits."[1438] In determining whether there is reason to know, courts have looked to "what a reasonable person in the taxpayer's subjective position would have discovered."[1439] That includes examining: "(1) the extent to which the taxpayer relied on knowledgeable professionals, (2) the taxpayer's sophistication and education, and (3) the taxpayer's familiarity with tax matters."[1440] An alleged promoter has reason to know the statements could be and probably are false, where he or she knew the "statements contradicted settled law or were contrary to express IRS guidance."[1441]

Comment: Any statement by a promoter in connection with the organization or sale of the shelter is sufficient. It does not have to be an opinion, or even be in writing. Moreover, the promoter need not be familiar with the relevant tax provisions. As indicated above, it is not necessary that any investor relied on the information or that an actual underreporting of tax occurred.[1442] On the other hand, this penalty does not apply to subsequent false statements not made in connection with the organization, the tax shelter, or the sale of an interest.

The "knows or has reason to know" standard means that the IRS can rely on subjective or objective evidence of the person's knowledge.[1443] Whether a person who makes or furnishes a statement knows or has reason to know that it is false or fraudulent depends upon that person's role in the organization or sale.[1444] Each person is imputed with the knowledge required to carry out his role in the transaction, but has no duty to inquire further. For example, a salesman is ordinarily deemed to have knowledge of the facts revealed in sales materials that are furnished to him by the promoter.[1445] In addition, a promoter can rely on an expert in his area of expertise, unless the promoter knows or has reason to know why he should not. For example, counsel is entitled to rely on a feasibility study conducted by

[1433] CCA 200402008.

[1434] *See* Reg. §301.6111-1T Q&A-31.

[1435] Rev. Proc. 84-84, *modifying* Rev. Proc. 83-78. The IRS revoked Rev. Proc. 83-78 and Rev. Proc. 84-84, because the procedures contained in those guidances are no longer consistent with the IRS's practices and organizational structure. Rev. Proc. 2001-49.

[1436] IRS News Release IR-2021-88 (Apr. 19, 2021). See the IRS LB&I Process Unit: *Tax Shelter Promoter Investigations Under IRC 6700*, https://aboutbtax.com/0RN, which includes a summary of IRS process steps in determining if a promoter has engaged in conduct that violates civil penalty statutes; obtaining participant lists; determining if the promotion is reoccurring or likely to reoccur and if the promoter should be referred for an injunction; and ensuring future compliance with the requirements of reportable transactions statutes.

[1437] §6700(a)(2)(A). *See Kersting v. United States*, 206 F.3d 817 (9th Cir. 2000) (with respect to disallowed interest deductions in excess of investment). A constitutional argument that the penalty violated the promoter's First Amendment rights was rejected. *United States v. Estate Preservation Servs.*, 202 F.3d 1093 (9th Cir. 2000). *See also Nagy v. United States*, 519 Fed. App'x 137 (4th Cir. 2013) (information regarding CPA's personal tax filing failures is inadmissible character evidence in §6700 penalty matter where CPA provided advice on tax shelter where government failed to make connection between failures in CPA's personal filings and advice provided regarding tax shelter).

[1438] *United States v. Campbell*, 897 F.2d 1317, 1320 (5th Cir. 1990). *See* CCA 202125009 (for purposes of abusive micro-captive insurance transactions, statements include advice, promotional materials, or any false statements that are material relating to income exclusion under §831(b) or deductions under §162 for paid insurance premiums).

[1439] *Lemay v. Commissioner*, T.C. Memo 2020-59 (reason to know where petitioner was aware of contrary IRS guidance and received advice from independent tax practitioners), citing *United States v. Campbell*, 897 F.2d 1317 (5th Cir. 1990)).

[1440] *Lemay v. Commissioner*, T.C. Memo 2020-59, citing *United States v. Estate Pres. Servs.*, 202 F.3d 1093 (9th Cir. 2000).

[1441] *Davison v. Commissioner*, T.C. Memo 2020-58, citing *United States v. Stover*, 650 F.3d 1099 (8th Cir. 2011).

[1442] 1982 Act Senate Report at 267. *See United States v. Estate Pres. Servs.*, 202 F.3d 1093 (9th Cir. 2000) (whether customers used misinformation to violate the law is irrelevant).

[1443] 1982 Blue Book at 211.

[1444] 1989 Act House Report at 1398; 1982 Blue Book at 211; *United States v. Estate Preservation Servs.*, 202 F.3d 1093 (9th Cir. 2000); *United States v. Campbell*, 897 F.2d 1317 (5th Cir. 1990); and *Sanders v. United States*, 509 F.2d 162, 166 (5th Cir. 1975) (the standard is "what a reasonable person in the [defendant's] subjective position would have discovered").

[1445] H.R. (Conf.) Rep. No. 97-760 at 572 (1982); 1982 Blue Book at 211.

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an engineering firm reputed to be an expert in the area, unless counsel independently knows or has reason to know information that brings the results of that study into question. Absent that, counsel is not required to question the assumptions underlying the study or its results. On the other hand, counsel must draw its own legal conclusions from that information.[1446]

Comment: In requesting additional guidance from the IRS, the New York State Bar Association proposed that a §6700 penalty be imposed on a lawyer on the ground that the lawyer has reason to know that a statement is false only if a reasonable person in the lawyer's position would have discovered the problem using a minimum level of ordinary care.[1447] This minimum level of ordinary care would require the lawyer to make an effort to determine the facts on which the lawyer's statement as to the tax consequences is based. The lawyer could rely on factual representations from others, but would have a duty to question or make further inquiry when the representations are unreasonable or unbelievable or the lawyer knows that the representation may not be accurate. The determination would be made on a case-by-case analysis, taking into account the following criteria:[1448]

- The lawyer's role in the transaction;
- Whether the lawyer reasonably relied on statements of a reputed expert or another participant in the transaction;
- Whether the lawyer was on notice there might be a problem with the tax analysis;
- Whether the lawyer was deceived or misled;
- The complexity of the transaction; and
- Whether the lawyer conducted due diligence designed to elicit facts that might be material to the tax analysis.

The false or fraudulent statement must relate to a material matter. For this purpose, a matter is considered to be "material" if it would have a substantial impact on the decision-making process of a reasonably prudent investor.[1449]

(2) Gross Valuation Overstatement

The penalty provided by §6700 also applies to a promoter who makes or furnishes (or causes another person to make or furnish) a gross valuation overstatement as to any material matter in connection with the organization or sale of any interest in the shelter.[1450] A "gross valuation overstatement" is any statement as to the value of any property or services if:[1451]

- The stated value exceeds twice the amount determined to be the correct value; and
- The value of such property or service is directly related to the amount of income tax deduction or credit allowable to any participant.

Because the correct value is fair market value, the penalty does not apply to a bona fide arm's-length commercial or investment transaction.[1452]

Comment: Although the definition of a gross valuation overstatement may, at first blush, look similar to the definition of a substantial valuation misstatement under §6662(e),[1453] there are significant differences. First, §6662(e) applies only to a valuation of property and not services (except in the case of certain transfers of services between related parties under §482). Second, although a gross valuation overstatement must relate to a material item, there is no dollar threshold for the application of the penalty as there is under §6662(e).

d. Action to Enjoin Promoter

The IRS may seek to enjoin a person from further engaging in any conduct that is subject to the penalty for promoting an abusive tax shelter under §6700.[1454] If the court finds that the promoter has engaged in conduct that is subject to the §6700 penalty and that injunctive relief is appropriate to prevent the recurrence of that conduct, the court can enjoin the promoter from further engaging in such conduct or any other conduct subject to the penalty.[1455]

In other words, in order to obtain an injunction, the government must prove:[1456]

- The defendant organized an entity, plan, or arrangement;
- The defendant made (a) false or fraudulent statements concerning the tax benefits to be derived from the entity, plan or arrangement which the defendant knew or had reason to know that the statements were false or fraudulent; or (b) a gross valuation overstatement;
- The false or fraudulent statements or gross valuation overstatement pertained to a material matter; and
- An injunction was necessary to prevent recurrence of this conduct.

[1446] 1989 Act House Report at 1398.

[1447] New York State Bar Association Tax Section Report on Application of Section 6700 Penalties to Lawyers: The "Reason to Know" Standard (Jan. 10, 2005).

[1448] New York State Bar Association Tax Section Report on Application of Section 6700 Penalties to Lawyers: The "Reason to Know" Standard (Jan. 10, 2005).

[1449] 1982 Act Senate Report at 267.

[1450] §6700(a)(2)(B). A material matter is discussed at VIII.A.1.c.(1), above.

[1451] §6700(b)(1).

[1452] 1982 Act Senate Report at 267.

[1453] A substantial valuation misstatement is discussed at IV.E.1., above.

[1454] §7408(a). This type of injunction action is not subject to the bankruptcy automatic stay provision. *United States v. Fisher*, 2004 BL 16633 (N.D. Tex. Jan. 26, 2004). The authority to obtain injunctions also extends to actions or failures to act in violation of Circular No. 230. §7408.

[1455] §7408(b). *See United States v. Schiff*, 379 F.3d 621 (9th Cir. 2004) (scope of preliminary injunction does not violate constitutional rights of promoters of filing of "zero income" tax returns), cert. denied, 546 U.S. 812 (2005); *United States v. Estate Pres. Servs.*, 202 F.3d 1093 (9th Cir. 2000); *United States v. Raymond*, 228 F.3d 804 (7th Cir. 2000) (enjoining promoter's sale of "De-Taxing America Program") cert. denied, 533 U.S. 902 (201); *Abdo v. United States*, 234 F. Supp. 2d 553 (M.D.N.C. 2002) (permanently enjoining promoter of "Tax Return Audit Challenge" and "voluntary compliance" programs from acting as preparer), aff'd, 63 Fed. App'x. 163 (4th Cir. 2003), cert. denied, 540 U.S. 1120 (2004); *United States v. Farnell*, 2003 BL 16388 (M.D. Fla. Feb. 27, 2003), modified in part, 2003-1 USTC ¶50,236 (M.D. Fla. 2003) (preliminary injunction enjoining promoter from engaging in activities subject to penalty). *See also United States v. Farnell*, 2003 BL 16416 (M.D. Fla. Apr. 28, 2003) (permanent injunction).

[1456] *United States v. Hartshorn*, 751 F.3d 1194 (10th Cir. 2014) (citing *United States v. Estate Pres. Servs.*, 202 F.3d 1093, 1098 (9th Cir. 2000)).

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The action is brought in the federal district court for the district in which the promoter resides, has his principal place of business, or has engaged in the prohibited conduct.[1457] For this purpose, any citizen or resident who does not live in or have his principal place of business in the United States is treated as residing in the District of Columbia.[1458]

Although the enjoined conduct must be subject to the penalty, there is no requirement that the IRS must actually impose or even assert the penalty. The court may exercise its jurisdiction over the injunction separate and apart from any other action brought against the promoter.[1459]

Comment: The injunction is an effective weapon against tax shelter promoters. If the IRS can show the need for injunctive relief, it can be obtained at any time after the promoter's first organization or sale of an interest in an abusive tax shelter. Thereafter, the promoter must operate under the restrictions imposed by the injunction and is subject to contempt for any activity that violates its terms. This may be more effective than the §6700 penalty as a means of regulating certain promoters.

2. *Participant's Failure to Disclose Reportable Transaction Penalty*

a. *Tax Shelter Disclosure Statement by Participant*

(1) In General

Every taxpayer required to file a tax return who participates in a reportable transaction is subject to special reporting requirements with respect to the reportable transaction.[1460] The fact that a transaction is a reportable transaction does not affect the legal determination of whether the taxpayer's tax treatment of the transaction is proper.[1461]

Comment: The purpose of the reporting rules is to ensure that questionable transactions are disclosed and subject to IRS review.[1462]

For this purpose, a taxpayer means an individual, trust, partnership, association, company, or corporation or S corporation. Except as otherwise specifically provided, it also includes an affiliated group of corporations that joins in the filing of a consolidated federal income tax return.[1463]

For purposes of the reporting rules, a transaction is broadly defined to include all factual elements relevant to the expected tax treatment of any investment, entity, plan or arrangement, and includes any series of steps carried out as part of a plan.[1464] The tax shelter reporting rules generally apply only to federal income taxes.[1465] Listed transactions, however, must also be disclosed if they involve estate, gift, employment or certain excise taxes.[1466]

If a taxpayer fails to include on any return or statement for a taxable year any information with respect to a listed transaction that is required to be included under §6011 with the return or statement, the statute of limitations for assessment of tax with respect to the transaction does not expire before the date that is one year after the earlier of (1) the date on which the IRS is furnished the required information, or (2) the date that a material advisor satisfies the list maintenance requirements with respect to a request by the IRS under §6112(b).[1467]

If a taxpayer engages in a transaction that becomes a listed transaction before the assessment limitations period closes, but the taxpayer does not disclose the transaction as required by Reg. §1.6011-4, the transaction is subject to the extended statute of limitations.[1468] However, if the IRS lists a transaction after the assessment limitations period for the taxpayer's tax return for the year the transaction was entered into is closed, the statute of limitations on assessment does not reopen with respect to the transaction for the year. Nonetheless, if the purported tax benefits of the transaction are recognized over multiple tax years, the extension of the assessment limitations period applies to the tax benefits in any subsequent tax year in which the statute of limitations had not closed before the date the transaction became a listed transaction.[1469]

The IRS's Office of Tax Shelter Analysis, located in Washington, D.C., is the intended clearinghouse for all information relating to tax shelter activity that comes to the attention of the IRS.[1470]

(2) Reportable Transactions Defined

There are several categories of reportable transactions:[1471]

- Listed transactions;
- Confidential transactions;
- Transactions with contractual protection;
- Loss transactions; and
- Transactions of interest.

[1457] §7408(a).

[1458] §7408(d).

[1459] §7408(a). *See* H.R. (Conf.) Rep. No. 98-861 at 227 (1984); 1982 Senate Report at 269.

[1460] Reg. §1.6011-4(a).

[1461] Reg. §1.6011-4(a).

[1462] *See, e.g.,* The Treasury Department's Enforcement Proposals for Abusive Tax Avoidance Transactions (Mar. 20, 2002).

[1463] Reg. §1.6011-4(c)(1).

[1464] Reg. §1.6011-4(b)(1).

[1465] Reg. §1.6011-4(c)(5), §1.6011-4(c)(7).

[1466] Reg. §20.6011-4 (estate tax), §25.6011-4 (gift tax), §31.6011-4 (employment tax), §53.6011-4 (excise tax relating to private foundations and certain tax-exempt organizations), §54.6011-4 (excise tax relating to qualified pension plans), §56.6011-4 (excise tax relating to public charities).

[1467] §6501(c)(10). *See* CCA 200112003, CCA 201047022, CCA 201531019, CCA 201538018 (*Gabelli v. SEC*, 568 U.S. 442 (2013) does not stand against an unlimited statute of limitation). Equitable tolling may not be used to toll the statute of limitations. *Doe v. KPMG, LLP*, 398 F.3d 686 (5th Cir. 2005). *See United States v. Brockamp*, 519 U.S. 347 (1997).

[1468] H.R. (Conf.) Rep. No. 108-755 at 605–606 (2004).

[1469] H.R. (Conf.) Rep. No. 108-755 at 606 n.482. In Rev. Proc. 2005-26, the IRS also explained that, if the limitations period on assessment has not expired and the taxpayer fails to disclose a transaction that becomes a listed transaction after the return has been filed, the limitations period will not expire earlier than one year after the taxpayer discloses the transaction in accordance with the revenue procedure. The revenue procedure was adopted in T.D. 9718, 80 Fed. Reg. 16,973 (Mar. 31, 2015).

[1470] *See* Announcement 2000-12 for a discussion of the IRS's Office of Tax Shelter Analysis which, although part of the Large Business and International Division (LB&I), reviews information relating to tax shelters affecting all taxpayers. For an overview of the functions, procedures, and policy for the OTSA, see IRM 4.50.5 (02-20-24) et seq.

[1471] Reg. §1.6011-4(b)(1). In 2007, the IRS proposed to add patented tax transactions to the list. Prop. Reg. §1.6011-4(b)(7).

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(a) Listed Transactions

A "listed transaction" is a transaction that is the same as or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction and identified as a listed transaction by notice, regulation or other form of published guidance.[1472] The term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy.[1473] It is broadly construed in favor of requiring disclosure. An opinion regarding the tax consequences of the transaction is not relevant to the determination.[1474]

Comment: The definition of substantially similar merely requires that the transactions be similar. There is no substantiality requirement in the definition. As a result, it is much broader than many taxpayers and practitioners may realize. It is also much more difficult to determine which transactions are substantially similar to a listed transaction. The definition also relies on the similarity of the tax strategies. Tax strategy, however, is not defined.

(b) Confidential Transactions

A "confidential transaction" is a transaction that is offered to a taxpayer under conditions of confidentiality and for which the taxpayer paid an advisor a minimum fee.[1475] A transaction is considered to be offered under conditions of confidentiality if the advisor who is paid the minimum fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction, and the limitation on disclosure protects the confidentiality of that advisor's tax strategies.[1476] It does not matter if the limitation is not legally binding on the taxpayer. On the other hand, a claim that a transaction is proprietary or exclusive is not treated as a limitation on disclosure if the advisor confirms to the taxpayer that there is no limitation on disclosure of the tax treatment or tax structure of the transaction.[1477] Moreover, the confidentiality filter and reporting obligations should not apply to transactions in which confidentiality is imposed by a party to the transaction acting in that capacity.[1478]

For this purpose, the minimum fee is $250,000 for a transaction if the taxpayer is a corporation (or a partnership or trust in which all of the owners or beneficiaries are corporations, looking through any partners or beneficiaries that are themselves partnerships or trusts), and $50,000 for all other transactions.[1479] In determining whether the minimum fee threshold is met, all fees for a tax strategy, for advice (whether or not tax advice) and for the implementation of the transaction are included.[1480] Such services include services to analyze the transaction (whether or not related to the tax consequences of the transaction), to implement the transaction, to document the transaction, and to prepare tax returns to the extent that the fee exceeds the customary fee for preparing such tax returns. The fees may be paid in cash or in kind. A taxpayer is also treated as paying fees to an advisor if the taxpayer knows or should know that the amount it pays will be paid indirectly to the advisor, such as through a referral fee or fee-sharing arrangement. A fee, however, does not include amounts paid to a person, including an advisor, in that person's capacity as a party to the transaction. The IRS will carefully scrutinize all the facts and circumstances in determining whether consideration received in connection with a confidential transaction constitutes fees.[1481]

Comment: The revised confidentiality filter goes a long way toward eliminating normal business transactions from its grasp. There are, however, still some items that need greater clarification. For example, the term "tax strategy" is still undefined. In addition, it is not clear how or when the advisor must confirm that the tax treatment and tax structure of the transaction may be disclosed. Absent such guidance, taxpayers and advisors may look at the prior regulations.

The confidentiality must relate to the tax treatment or tax structure of the transaction. The "tax treatment" of a transaction is defined as the purported or claimed federal income tax treatment of the transaction.[1482] The "tax structure" of a transaction is any fact that may be relevant to the understanding of such tax treatment.[1483] A tax strategy, on the other hand, is not defined by the regulations.

Comment: Relevancy is a very broad standard. Some commentators have suggested a materiality standard, akin to the requirement for the IRS to retroactively revoke or modify a private letter ruling.[1484]

Comment: Relevant facts appear to include the taxpayer's name, address and taxpayer identification number. Reg. §601.201(e)(2) uses similar language in connection with an application for a private letter ruling, and specifically provides that such identifying information is relevant. There is no reason a taxpayer's identifying information should be disclosable to the world. Such information as well as pricing terms and other nonpublic business or financial information that is not material to understanding the tax consequences of the transaction should be allowed to be kept confidential. Disclosure could adversely

[1472] Reg. §1.6011-4(b)(2). *See* the Worksheets for 648 T.M., *Reportable Transactions*, for a list of listed transactions.

[1473] Reg. §1.6011-4(c)(4). For example, transactions using short sales, futures, derivatives or any other type of offsetting obligations to inflate basis in a partnership interest is considered substantially similar to the listed transaction in Notice 2000-44, which involved offsetting options transferred to a partnership where the taxpayer claims basis in the partnership for the cost of the purchased options but does not adjust basis under §752 as a result of the partnership's assumption of the taxpayer's obligation with respect to the options. Reg. §1.6011-4(c)(4) *Ex.* (1). Reg. §1.6011-4(c)(4) *Ex.* (2) holds that a transaction using any intermediary to prevent the recognition of gain is substantially similar to the listed transaction in Notice 2001-16, in which the taxpayer sells stock to an intermediary loss corporation, which then sells the assets of the acquired corporation to the buyer without the imposition of a corporate-level tax.

[1474] Reg. §1.6011-4(c)(4).

[1475] Reg. §1.6011-4(b)(3)(i). For purposes of the confidentiality filter, related persons under §267(b) or §707(b) are treated as the same person.

[1476] Reg. §1.6011-4(b)(3)(ii). The terms minimum fee, tax treatment and tax structure are discussed below.

[1477] Reg. §1.6011-4(b)(3)(ii).

[1478] Preamble to T.D. 9108, 68 Fed. Reg. 75,128 (Dec. 30, 2003).

[1479] Reg. §1.6011-4(b)(3)(iii).

[1480] Reg. §1.6011-4(b)(3)(iv).

[1481] Reg. §1.6011-4(b)(3)(iv).

[1482] Reg. §1.6011-4(c)(8).

[1483] Reg. §1.6011-4(c)(9).

[1484] *See, e.g.*, Letter from Terence F. Cuff to Pamela F. Olsen dated July 24, 2003, reprinted in 100 Tax Notes 1059 (Aug. 25, 2003) ("Cuff Letter"); Reg. §601.201(l)(5).

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affect the taxpayer and its business. When the IRS publishes a private letter ruling, such information is redacted.[1485] On the other hand, nothing in the tax shelter disclosure rules allows such information to be kept confidential. In fact, in finalizing the disclosure regulations, the Treasury ignored comment letters suggesting that the same type of information that is redacted from private rulings be excluded from the definition of tax structure.[1486]

(c) Transactions with Contractual Protection

A "transaction with contractual protection" is a transaction for which the taxpayer (or a related party as described in §267(b) or §707(b)) has the right to a full or partial refund of fees paid by or on behalf of the taxpayer (or related party) to any person who makes a tax statement, oral or written, to the taxpayer (or related person) as to the potential tax consequences that may result from the transaction, if all or part of the intended tax consequences are not sustained, or if such fees are contingent on the taxpayer's realization of the tax benefit from the transaction.[1487] Tax benefits include deductions, exclusions from gross income, nonrecognition of gain, tax credits, adjustments (or the absence of adjustments) to the basis of property, status as an entity exempt from federal income taxation, and any other tax consequences that may reduce a taxpayer's federal income tax liability by affecting the amount, timing, character or source of any item of income, gain, expense, loss or credit.[1488] All of the facts and circumstances relating to the transaction are considered in determining whether a fee is refundable or contingent, including the right to reimbursements of amounts that the parties have not designated as fees or any arrangement to provide services without reasonable compensation.[1489]

Notwithstanding the foregoing, a transaction is not considered to have contractual protection solely because a party to the transaction has the right to terminate the transaction upon the happening of an event affecting the taxation of one or more parties to the transaction.[1490] In addition, refundable or contingent fees are not taken into account in determining contractual protection if the person to whom the fee is payable makes the tax statement only after the taxpayer entered into the transaction and reported the consequences of the transaction on a filed tax return, and that person has not previously received any fees relating to the transaction.[1491]

Comment: Like the confidential transaction trigger, this provision will require many ordinary, nonabusive transactions to report as tax shelters.[1492] Contingent fees and success fees are common in many types of transactions outside the tax shelter arena (e.g., in connection with large acquisitions). Moreover, if a transaction does not produce the desired result, professionals will often return part of their fees.

Rev. Proc. 2007-20[1493] lists transactions that are not taken into account in making the determination.

(d) Loss Transactions

A "loss transaction" is any transaction that results in the taxpayer claiming a loss under §165 of at least:[1494]

- $10 million in any single taxable year or $20 million in any combination of taxable years in the case of a corporation or a partnership with only corporations as partners (looking through any partner that is itself a partnership);
- $2 million in any single taxable year or $4 million in any combination of years in the case of any other partnership, S corporation, individual or trust; or
- $50,000 in any single taxable year for individuals and trusts if the loss arises with respect to a §988 transaction (relating to foreign currency losses).

In determining whether the thresholds are met for a combination of years, only losses claimed in the taxable year that the transaction is entered into and the five subsequent taxable years are combined.[1495]

For this purpose, a loss is a loss under §165.[1496] To determine the threshold, the amount of the §165 loss is adjusted for any salvage value and for any insurance or other compensation received.[1497] However, a §165 loss does not take into account offsetting gains, or other income or limitations.[1498] The full amount of a §165 loss is taken into account in the year in which the loss is sustained, regardless of whether all or part is treated as a net operating loss or a capital loss that may be carried back or forward to another taxable year.[1499]

(e) Transactions of Interest

A "transaction of interest" is defined as a transaction that is the same as or substantially similar to one of the types of transactions that the IRS has identified as such in published guidance, i.e., a transaction that the IRS believes has the potential for tax avoidance or evasion, but for which the IRS lacks enough information to determine whether the transaction should be identified specifically as a tax avoidance transaction.[1500] A transaction is considered "substantially similar" to another transaction if it is expected to obtain the same or similar types of tax consequences and is either factually similar or

[1485] §6110(c).

[1486] *See, e.g.,* Letter from Kenneth Kies to the IRS dated December 6, 2002 (recommending that the then temporary and proposed regulations be clarified to provide that tax structure does not include specific transaction details, such as dates, locations, monetary amounts, specific property involved or identity of the parties). The Preamble to T.D. 9046, 68 Fed. Reg. 10,161 (Mar. 4, 2003), which promulgated the final regulations, notes that all comments were reviewed thoroughly.

[1487] Reg. §1.6011-4(b)(4)(i), §1.6011-4(b)(4)(ii).

[1488] Reg. §1.6011-4(c)(6).

[1489] Reg. §1.6011-4(b)(4)(i).

[1490] Reg. §1.6011-4(b)(4)(iii)(A).

[1491] Reg. §1.6011-4(b)(4)(iii)(B).

[1492] *See, e.g.,* Cuff Letter.

[1493] *Modifying and superseding* Rev. Proc. 2004-65.

[1494] Reg. §1.6011-4(b)(5)(i).

[1495] Reg. §1.6011-4(b)(5)(ii).

[1496] Reg. §1.6011-4(b)(5)(i).

[1497] Reg. §1.6011-4(b)(5)(iii)(A). It concludes an amount deductible pursuant to a provision that treats a transaction as a sale or other disposition, or otherwise results in a deduction under §165 (*e.g.,* a loss from the sale or exchange of a partnership interest under §741 or a loss from a §988 transaction). Reg. §1.6011-4(b)(5)(iii)(B).

[1498] Reg. §1.6011-4(b)(5)(iii)(A). For example, the §1211 and §1212 limitations relating to capital losses are not taken into account.

[1499] Reg. §1.6011-4(b)(5)(iii)(A). Loss carrybacks and carryovers are not taken into account in the year to which they are carried.

[1500] Reg. §1.6011-4(b)(6).

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based on the same or similar tax strategy.[1501] It is broadly construed in favor of disclosure.

Comment: Although the transaction must be the same or substantially similar to a designated transaction of interest, there is no actual substantiality requirement to the similarity. As a result, the inclusion is broader than many taxpayers and practitioners may realize. In addition, it may be based on having the same or a similar tax strategy, but tax strategy is not defined in the regulations.

When the IRS has gathered enough information to make an informed decision as to whether the transaction of interest is a tax avoidance type of transaction, it may take one or more actions, including removing the transaction from the transactions of interest category in published guidance, designating the transaction as a listed transaction, or providing a new category of reportable transaction.

The IRS has issued a number of notices identifying transactions of interest.[1502]

(f) Exceptions to Reportable Transactions Penalty

Notwithstanding the foregoing, a transaction will not be considered a reportable transaction (or will be excluded from a particular category of reportable transaction) if the IRS determines by published guidance that the transaction is excluded.[1503] A regulated investment company under §851 (or an investment vehicle that is at least 95% owned by one or more regulated investment companies at all times during the course of the transaction) are subject to the tax shelter reporting rules only with respect to listed transactions.[1504]

(3) Participation

Generally, a taxpayer is considered to participate in a reportable transaction if the taxpayer's tax return reflects a tax benefit from the transaction.[1505] A taxpayer is also considered to participate in a listed transaction if the taxpayer knows or has reason to know that his tax benefits are derived directly or indirectly from a listed transaction.[1506] The IRS may identify other types or classes of persons that will be treated as participants in a listed transaction.[1507]

In the case of a confidential transaction or transaction with contractual protection, if a partnership, S corporation or trust is subject to the confidentiality limitations but the partner, shareholder or beneficiary is not, then the entity is a participant, but the partner, shareholder or beneficiary is not.[1508] In the case of a loss transaction, the partner, shareholder or beneficiary is considered to participate if his tax return reflects a loss from the pass through entity that equal or exceed the applicable threshold amount. For this purpose, a tax return is deemed to reflect the full amount of a §165 loss allocable to the taxpayer, regardless of whether all or part of the loss is treated as a net operating loss or net capital loss that may be carried back or carried over to another tax year.[1509]

In the case of a transaction of interest, a taxpayer is considered to participate if the taxpayer is one of the types or classes of persons identified as participants in the transaction in the published guidance describing the transaction of interest.[1510]

Special rules apply in the case of certain foreign corporations.[1511]

(4) Disclosing Reportable Transactions

The required disclosure with respect to a reportable transaction is made on a Form 8886, *Reportable Transaction Disclosure Statement,* attached to the taxpayer's tax return (and each amended return) for each taxable year for which the taxpayer participates in a reportable transaction.[1512] In addition, a copy of the Form 8886 must be sent to the IRS's Office of Tax Shelter Analysis ("OTSA") at the same time that a disclosure statement is first filed with the taxpayer's tax return for such reportable transaction.[1513] To be considered complete, the information provided on the form must describe the expected tax treatment and all potential tax benefits expected to result from the transaction, describe any tax result protection with respect to the transaction, and identify and describe the transaction in sufficient detail for the IRS to be able to understand the tax structure of the reportable transaction and the identity of all parties involved in the transaction.[1514] The disclosure must include the reportable transaction number, if any for the reportable transaction. A taxpayer is deemed to have satisfied the reporting requirements with respect to a specific transaction if he requests a ruling on the merits with respect to the transaction on or before the date disclosure would otherwise be required, and receives a favorable ruling from the IRS.[1515]

In the case of a taxpayer that is a partnership, an S corporation or a trust, the Form 8886 must be attached to the entity's tax return for each taxable year in which the entity participates in the reportable transaction.[1516]

To address situations in which partners, shareholders and beneficiaries have filed their returns before receiving Schedules K-1 from the entity that participated in a reportable transaction, the regulations provide that, if a taxpayer who is a partner in a partnership, a shareholder in an S corporation, or a beneficiary of a trust receives a timely Schedule K-1 less than 10 calendar days before the due date of the taxpayer's return (including extensions) and, based on receipt of the timely Schedule K-1, the taxpayer determines that the taxpayer participated in a reportable transaction, the disclosure statement will not be con-

[1501] Reg. §1.6011-4(c)(4).

[1502] *See, e.g.*, Notice 2015-74, Notice 2009-7, Notice 2008-99, Notice 2007-73, Notice 2007-72.

[1503] Reg. §1.6011-4(b)(8)(i). *See* Rev. Proc. 2004-65, Rev. Proc. 2004-66, Rev. Proc. 2004-67, and Rev. Proc. 2004-68.

[1504] Reg. §1.6011-4(b)(8)(ii).

[1505] Reg. §1.6011-4(c)(3)(i).

[1506] Reg. §1.6011-4(c)(3)(i)(A).

[1507] Reg. §1.6011-4(c)(3)(i)(A).

[1508] Reg. §1.6011-4(c)(3)(i)(B), §1.6011-4(c)(3)(i)(C).

[1509] Reg. §1.6011-4(c)(3)(i)(D).

[1510] Reg. §1.6011-4(c)(3)(i)(E).

[1511] Reg. §1.6011-4(c)(3)(i)(G).

[1512] Reg. §1.6011-4(d), §1.6011-4(e)(1). For this purpose, a transaction becomes a loss transaction in the first taxable year in which the applicable threshold amount is reached. Reg. §1.6011-4(e)(2)(ii).

[1513] Reg. §1.6011-4(e)(1).

[1514] Reg. §1.6011-4(d). An incomplete Form 8886 containing a statement that information will be provided upon request is not considered a complete disclosure statement.

[1515] Reg. §1.6011-4(f)(1). The ruling request fully must disclose all relevant facts.

[1516] Reg. §1.6011-4(e)(1).

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sidered late if the taxpayer discloses the reportable transaction by filing a disclosure statement with OTSA within 60 calendar days after the due date of the taxpayer's return (including extensions). A taxpayer filing a disclosure statement need only file the statement with OTSA and does not need to file an amended return to make the disclosure.[1517]

If a reportable transaction results in a loss that is carried back to a prior year, the disclosure statement for the reportable transaction must be attached to the taxpayer's application for tentative refund or amended return for that prior year.[1518]

If a transaction becomes a listed transaction or a transaction of interest after the taxpayer files his tax return (including an amended return) reflecting the tax consequences of the transaction, but before the statute of limitations closes, then a disclosure statement must be filed with OTSA within 90 days after the date the transaction became a listed transaction or transaction of interest, even if the taxpayer did not participate in the transaction in the year it became a listed transaction or a transaction of interest.[1519] In the case of a loss transaction, a disclosure statement must be attached to the taxpayer's return for the first taxable year in which the threshold is met and to any subsequent tax return that reflects a §165 loss from the transaction.[1520]

Comment: The different sets of disclosure rules are not coordinated. Multiple disclosures may be required. The tax shelter disclosure regulations specifically require a taxpayer to file the Form 8886 with respect to a reportable transaction even if the taxpayer also plans to disclose the transaction under other rules.[1521]

If a taxpayer requests a ruling on the merits of a specific transaction on or before the date that disclosure otherwise would be required, and receives a favorable ruling as to the transaction, the disclosure rules are deemed to be satisfied with regard to the transaction so long as the request fully discloses all relevant facts relating to the transaction that would otherwise be disclosed on a Form 8886. Similarly, if a taxpayer requests a ruling as to whether a specific transaction is a reportable transaction on or before the date that disclosure otherwise would be required, the IRS has discretion to determine that the submission satisfies the §6011 disclosure rules if the request fully discloses all such relevant facts. However, the potential obligation of the taxpayer to disclose the transaction is not suspended during the period that the ruling request is pending.[1522]

If a taxpayer is uncertain whether a transaction must be disclosed, the taxpayer may file Form 8886 disclosing the transaction on a protective basis.[1523] The IRS will not treat disclosure statements filed on a protective basis any differently than other disclosure statements. For a protective disclosure to be effective, the taxpayer must comply with the disclosure regulations by providing the IRS with all information requested by the IRS under this election.[1524]

(5) Effect on Reasonable Cause

The failure to report the transaction precludes the taxpayer from making a showing of reasonable cause and good faith under §6664(d) with respect to a reportable transaction understatement.[1525]

(6) Retention of Records

The taxpayer must retain copies of all documents and other records relating to a reportable transaction that are material to understanding the tax treatment or tax structure of the transaction, until the expiration of the statute of limitations with respect to the last taxable year for which disclosure of the transaction is required under the tax shelter reporting rules.[1526] Such documents may include: (1) marketing materials with respect to the transaction; (2) written analyses used in decision-making related to the transaction; (3) correspondence and agreements between the taxpayer and any advisor, lender or other party to the reportable transaction that relate to the transaction; (4) documents discussing, referring to or demonstrating the purported or claimed tax benefits arising from the reportable transaction; and (5) documents referring to the business purposes for the reportable transaction.[1527] A taxpayer is not required to retain earlier drafts of a document if he retains a copy of the final document (or if there is no final document, the latest draft) and such final document (or latest draft) contains all of the information in the earlier drafts that is material to an understanding of the purported tax treatment or tax structure of the transaction.[1528] This retention requirement is in addition to any other document retention requirements.[1529]

Comment: It may be risky to discard earlier drafts of materials. For example, the final document (or latest draft) may not contain all of the information in the earlier drafts.

(7) Extended Statute of Limitations for Listed Transactions

If a taxpayer fails to disclose the required information with respect to a listed transaction for any taxable year, the time for assessing any tax with respect to such listed transaction for such taxable year will not expire before one year after the earlier of: (1) the date on which the required information is furnished to the IRS, or (2) the date that a material advisor meets the list maintenance requirements of §6112 with respect to a request by the IRS under §6112(b) with respect to such transaction.[1530] The assessment may include tax, interest and penalties

[1517] Reg. §1.6011-4(e)(1); Preamble to REG-103038-05, 71 Fed. Reg. 64,488 (Nov. 2, 2006).

[1518] Reg. §1.6011-4(e)(1).

[1519] Reg. §1.6011-4(e)(2)(i).

[1520] Reg. §1.6011-4(e)(2)(ii).

[1521] Reg. §1.6011-4(e)(3).

[1522] Reg. §1.6011-4(f)(1).

[1523] Reg. §1.6011-4(f)(2); Instructions to Form 8886. The form would indicate that the disclosure statement is being filed on a protective basis.

[1524] Reg. §1.6011-4(f)(2).

[1525] §6664(d)(2).

[1526] Reg. §1.6011-4(g)(1).

[1527] Reg. §1.6011-4(g)(1).

[1528] Reg. §1.6011-4(g)(2).

[1529] Reg. §1.6011-4(g)(1).

[1530] §6501(c)(10). The required information refers to the Form 8886 required to be filed with OTSA. *May v. United States*, 691 Fed. App'x 334 (9th Cir. 2017). If the IRS lists a transaction after the taxpayer filed his return for the year the transaction was entered into closed, this provision does not reopen the statute of limitations for such tax year. However, if the purported tax benefits are recognized over multiple tax years, the extended statute of limitations applies to any open year. H.R. Rep. No. 108-548 (part 1) at 267 n. 250

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that relate to the listed transaction, as well as any item that is affected thereby.[1531] Penalties may include the accuracy-related penalties under §6662 or §6662A.

The disclosure must be made on the latest version of Form 8886 (Reportable Transaction Disclosure Statement) and must indicate that it is being submitted under §6501(c)(10) and must specify the tax returns and taxable years to which it relates.[1532] The form must be filed with the Office of Tax Shelter Analysis ("OTSA") with a cover letter signed under penalties of perjury.[1533] The taxpayer may, but is not required to, file an amended return with the Form 8886 and cover letter.[1534] Separate Forms 8886 and separate cover letters must be submitted for each listed transaction the taxpayer failed to properly disclose. Multiple taxable years with respect to a listed transaction, however, may be disclosed on the same form and cover letter.[1535]

In the case of a partnership, S corporation or trust, only the failure to disclose by a partner, shareholder or beneficiary is relevant.[1536] The disclosure or failure to disclose by the entity does not affect the partner's, shareholder's or beneficiary's obligation under the provision.

If the taxpayer making the disclosure is under examination or Appeals consideration with respect to such taxable year, a copy of the submission must also be given to the IRS examiner or Appeals officer.[1537]

The IRS may prescribe alternative procedures to satisfy the disclosure requirements.[1538]

In response to a written request of the IRS under §6112, a material advisor with respect to a listed transaction must furnish the IRS the information described in §6112.[1539] If the information identifies the taxpayer as a person who entered into the listed transaction, the requirements of this provision are deemed satisfied with respect to that taxpayer.[1540]

b. Penalty

An overview of the history and statutory framework of §6707A is provided below. For a detailed discussion of the §6707A penalty and the regulations and other IRS guidance issued under §6707A, see 648 T.M., *Reportable Transactions.*

The American Jobs Creation Act of 2004 added a penalty for the failure to disclose a reportable transaction, effective for returns and statements due after October 22, 2004, and for penalties assessed before January 1, 2007.[1541] As originally enacted, the penalty for failing to disclose a reportable nonlisted transaction was $10,000 in the case of an individual and $50,000 in any other case. However, if the failure was with respect to a so-called "listed transaction", the amount increased to $100,000 and $200,000, respectively.

Responding to criticism that, although originally designed to encourage the disclosure of corporate tax shelters, the strict liability penalty had the unintended effect of subjecting individuals and small businesses that had limited assets, derived little or no tax savings, and had no knowledge that they were entering into a corporate tax shelter, to harsh penalties, Congress in September 2010 significantly modified the §6707A penalty amount to achieve greater proportionality between the penalty and the tax savings that were derived from the transaction, established statutory maximums and minimums, and made the changes retroactive. Effective for penalties assessed on or after January 1, 2007, under the general rule, the amount of the penalty for failing to disclose a reportable transaction is equal to 75% of the decrease in tax shown on the return as a result of such transaction (or which would have resulted from such transaction if it were respected for federal tax purposes).[1542] The penalty is based on the decrease shown on the return; it does not matter whether the decrease ultimately is allowed, disallowed, or settled. The "decrease in tax shown on the return as a result of such transaction (or which would have resulted from such transaction if it were respected for federal tax purposes)" also includes situations where a taxpayer's participation in a reportable transaction creates a liability for a tax that would not exist absent participation in the transaction. For returns with respect to which disclosure is required but on which no tax is required to be shown (for example, returns of pass-through entities), the minimum penalty amount will be imposed for the failure to disclose. For further discussion, see 648 T.M., *Reportable Transactions.*

The minimum penalty under §6707A may not be less than $10,000 ($5,000 in the case of an individual).[1543] The maximum penalty under §6707A with respect to a listed transaction may not exceed $200,000 ($100,000 in the case of an individual), and, in the case of any other reportable transaction, may not exceed $50,000 ($10,000 in the case of an individual.[1544] When a

(2004). Moreover, the provision never shortens the statute of limitations. Reg. §301.6501(c)-1(g)(2).

[1531] Reg. §301.6501(c)-1(g)(7).

[1532] Reg. §301.6501(c)-1(g)(5)(i)(A), effective for taxable years with respect to which the period of limitations on assessment under §6501, including §6501(c)(10), did not expire before March 31, 2015. For prior periods, see Rev. Proc. 2005-26.

[1533] Reg. §301.6501(c)-1(g)(5)(i)(B)(1). The taxpayer must state:

> Under penalties of perjury, I declare that I have examined this reportable transaction disclosure statement and, to the best of my knowledge and belief, this reportable transaction disclosure statement is true, correct and complete.

Reg. §301.6501(c)-1(g)(5)(i)(B)(2). If the Form 8886 is prepared by a paid preparer, in addition, the preparer must certify:

> Under penalties of perjury, I declare that I have examined this reportable transaction disclosure statement and, to the best of my knowledge and belief, this reportable transaction disclosure statement is true, correct and complete. This declaration is based on all information of which I, as paid preparer, have knowledge.

Reg. §301.6501(c)-1(g)(5)(i)(B).

[1534] Reg. §301.6501(c)-1(g)(5)(i)(A).

[1535] Reg. §301.6501(c)-1(g)(5)(i)(A).

[1536] Reg. §301.6501(c)-1(g)(4).

[1537] Reg. §301.6501(c)-1(g)(5)(i)(C).

[1538] Reg. §301.6501(c)-1(g)(5)(ii).

[1539] §6112 is discussed at VIII.A.3., below, and material advisor is discussed at VIII.A.3.a.(3), below.

[1540] Reg. §301.6501(c)-1(g)(6)(i).

[1541] §6707A(a).

[1542] §6707A(b)(1). *See Yari v. Commissioner*, 143 T.C. 157 (2014), aff'd, 669 Fed. App'x. 489, 2016 BL 341372 (9th Cir. 2016) (penalty calculated on amount of tax shown on return giving rise to the required disclosure and not on a later or amended return where different tax amount is shown from original return).

[1543] §6707A(b)(3). The minimum penalty would apply, for example, to an S corporation, a partnership, or a limited liability company that does not pay income tax.

[1544] §6707A(b)(2).

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taxpayer whose participation in a subsequently identified listed transaction or transaction of interest is reflected on more than one return and when that taxpayer fails to timely file a complete and proper disclosure statement, the amount of the penalty is the sum of the decreases in tax shown on each return for which the period of limitations on assessment remains open at the time the transaction becomes reportable, subject to the statutory minimum and maximum penalty amounts.

If the penalty is imposed with respect to a listed transaction, it cannot be rescinded.[1545] For other reportable transactions, the IRS may rescind all or a portion of the penalty if such rescission would promote compliance with the tax laws and effective tax administration.[1546]

A taxpayer that must pay the penalty for failing to disclose a listed transaction and that must file periodic reports under §13 or 15(d) of the Securities Exchange Act of 1934 (or that must be consolidated with another person for purposes of such reports), must disclose the imposition of the penalty in such SEC reports. The taxpayer must disclose in such report: (i) the penalty imposed by §6707A(a) for failing to disclose a listed transaction; (ii) the accuracy-related penalty imposed by §6662A(a) at the 30% rate determined under §6662A(c) for a reportable transaction understatement with respect to which the relevant facts affecting the tax treatment of the reportable transaction were not adequately disclosed under §6011; (iii) the accuracy-related penalty imposed by §6662(a) at the 40% rate determined under §6662(h) for a gross valuation misstatement, if the taxpayer (but for the exclusionary rule of §6662A(e)(2)(B)) would have been subject to the penalty under §6662A(a) at the 30% rate determined under §6662A(c); and/or (iv) the §6707(e) penalty imposed for failing to disclose in the SEC report(s) the requirement to pay any of the penalties described above.[1547]

Disclosure is required when the taxpayer exhausts its administrative and judicial remedies with respect to the penalty or pays the penalty, whichever occurs earlier. However, the penalty is required to be reported only once.[1548] The SEC disclosure requirement applies even if the taxpayer determines that the amount of the penalty is not material to the reports in which the penalty must appear.[1549] If the taxpayer fails to make the required SEC disclosure, that failure is subject to a penalty under §6707A for each failure. However, the penalty will be rescinded if the IRS rescinds the full penalty for failing to disclose under §6011 the reportable transaction underlying the penalty.

The Tax Court has held that it lacks jurisdiction to redetermine the §6707A penalty because, according to the court, the penalty is an assessable penalty collected outside the Code's deficiency procedures and, therefore, is not within the Tax Court's deficiency jurisdiction.[1550] For a discussion of the Tax Court's jurisdiction over penalties, see 630 T.M., *Tax Court Litigation.*

If a taxpayer has an underpayment attributable to a reportable transaction, the taxpayer's failure to satisfy these disclosure requirements may affect its exposure to the accuracy and fraud-related penalties under §6662 and §6663.[1551] If any portion of an underpayment is attributable to a reportable transaction, then failure by the taxpayer to disclose the transaction under the tax shelter reporting rules[1552] is a "strong indication" that the taxpayer did not act in good faith with respect to the portion of the underpayment attributable to the reportable transaction.[1553] Failure to disclose, however, does not foreclose a good faith argument. Although the regulations are intended to be construed strongly in favor of disclosure, they recognize that there may be circumstances in which a taxpayer does not lack good faith in failing to disclose a reportable transaction.[1554] Similarly, a taxpayer who takes a position contrary to a revenue ruling with respect to a reportable transaction cannot avoid a negligence or disregard penalty by showing that the taxpayer's position has a realistic possibility of being sustained on its merits.[1555]

The §6707A penalty is discussed in more detail in 648 T.M., *Reportable Transactions.*

3. Material Advisor's Failure to Disclose Reportable Transaction Penalty

a. Tax Shelter Disclosure Statement by Material Advisor

(1) In General

Each material advisor with respect to a reportable transaction must timely file an information return identifying and describing the transaction, describing any potential tax benefits expected to result from the transaction, and providing other information the IRS may prescribe.[1556]

(2) Reportable Transaction

A reportable transaction is defined in §6707A(c) and Reg. §1.6011-4(b), which is discussed at VIII.A.3.a.(2), above, and 648 T.M., *Reportable Transactions.*

(3) Material Advisor

(a) In General

Under §6111(b)(1), a "material advisor" is a person who:

• Provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, imple-

[1545] §6707A(d)(1)(A). *See Barzillai v. United States*, 137 Fed. Cl. 788 (Fed. Cl. 2018).

[1546] §6707A(d)(1)(B).

[1547] §6707A(e).

[1548] 2004 Act Conf. Report at 599.

[1549] 2004 Act Conf. Report at 599. In addition, disclosure is not satisfied by treating the failure to disclose a transaction in such reports as a failure to disclose a listed transaction. 2004 Act Conf. Report at 599.

[1550] *Smith v. Commissioner*, 133 T.C. 424 (2009). *But see Yari v. Commissioner*, 143 T.C. 157 (2014), aff'd, 669 Fed. App'x. 489, 2016 BL 341372 (9th Cir. 2016) (Tax Court can exercise jurisdiction to redetermine §6707A penalty as part of a CDP appeal).

[1551] Preamble to T.D. 8877.

[1552] *See* Reg. §1.6011-4, §1.6011-4T.

[1553] Reg. §1.6664-4(d), Reg. §1.6664-1(b)(2)(ii).

[1554] Preamble to T.D. 9109.

[1555] Reg. §1.6662-3(a). See the discussion at VII.C.4.b., above.

[1556] §6111(a).

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menting, insuring, or carrying out any reportable transaction;[1557] and

• Directly or indirectly derives gross income of more than:

o $250,000 ($50,000 if substantially all of the tax benefits from the reportable transaction are provided to individuals, looking through any partnership, S corporation or trust);[1558] or

o in the case of a listed transaction or a transaction of interest, $25,000 ($10,000 if substantially all of the tax benefits are provided to individuals, looking through partnerships, S corporations and trusts).[1559]

The gross income threshold is applied separately for each reportable transaction; there is no aggregation of fees across reportable transitions.[1560]

For this purpose, the transaction includes all of the factual elements that are relevant to the expected tax treatment of the investment, entity, plan or arrangement, and includes any series of steps carried out as part of a plan.[1561] In addition, the IRS may expand the types or classes of persons who are material advisors.[1562]

(b) Providing Material Aid, Assistance or Advice

A person provides material aid, assistance or advice with respect to organizing, managing, promoting, selling, implementing, insuring or carrying out a transaction if the person makes or provides a tax statement to or for the benefit of:[1563]

• A taxpayer who is required to disclose the transaction under §6011 because it is a listed transaction or a transaction of interest (or who would be required to disclose the transaction if it became a listed transaction or a transaction of interest);

• A taxpayer who the advisor knows is or reasonably expects to be required to disclose the transaction under §6011 because the transaction is a reasonably expected to be a reportable transaction other than a listed transaction or a transaction of interest;

• A material advisor who is required to disclose the transaction under §6111 because it is a listed transaction or a transaction of interest; or

• A material advisor who the advisor knows is or reasonably expects to be required to disclose the transaction under §6111 because the transaction is or is reasonably expected to be a reportable transaction other than a listed transaction or a transaction of interest.

A "tax statement" is any statement (including another person's statement) that relates to a tax aspect of a transaction that causes the transaction to be a reportable transaction. The statement may be oral or written.[1564] In the case of a confidential transaction, a tax statement is a statement that concerns a tax benefit related to the transaction, where either (1) the taxpayer's disclosure of the tax treatment or the tax structure of the transaction is limited in the manner described in Reg. §1.6011-4(b)(3) (i.e., the transaction is offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a minimum fee), or (2) the advisor making the statement knows that the taxpayer's ability to disclose the tax structure or tax aspects of the transaction is so limited.[1565] A statement relates to a tax aspect of a transaction that causes the transaction to be considered a transaction with contractual protection if the statement concerns a tax benefit of the transaction, and either (a) the taxpayer has the right to a full or partial refund of fees paid to the advisor or the fees are contingent fees in the manner described in Reg. §1.6011-4(b), or (b) the advisor knows or has reason to know that the taxpayer has the right to a full or partial refund of fees paid by the taxpayer which is contingent on the taxpayer's realization of tax benefits from the transaction in the manner described in Reg. §1.6011-4(b)(4).[1566] A statement with respect to a loss transaction is a tax statement if it concerns an item that gives rise to a §165 loss described in Reg. §1.6011-4(b)(5).[1567] A statement that only includes information that is publicly available from documents filed with the Securities and Exchange Commission before the close of the transaction, however, is not considered a tax statement.[1568]

Notwithstanding the foregoing, a material advisor generally does not include a person who makes a tax statement solely in his capacity as an employee, shareholder, partner or agent of another person. Any statement made by a person in such capacity is attributed to that person's employer, corporation, partnership or principal. However, a person will be treated as a material advisor if the person forms or avails of an entity for the purpose of avoiding the reporting or list maintenance rules of §6111 or §6112, or the related penalties under §6707 or §6708.[1569]

In addition, a person is not considered a material advisor with respect to a transaction if the person did not make or provide a tax statement regarding the transaction until after the first tax return reflecting a tax benefit from the transaction is filed with the IRS. This exception, however, does not apply to a person who makes a tax statement with respect to a transaction if it is expected that the taxpayer will file a supplemental or amended return reflecting additional tax benefits from the transaction.[1570]

Comment: It seems the exception to the exception should only apply if the tax statement relates to the additional tax ben-

[1557] The definition of participation in the organization, management, promotion or sale of the transaction is discussed in 648 T.M., *Reportable Transactions.*

[1558] Reg. §301.6111-3(b)(3)(i)(A). Derive means receive or expect to receive. Reg. §301.6111-3(c)(3). Proposed regulations would reduce these amounts to $500 and $250, respectively, for a new proposed reportable transaction of patented transactions. Prop. Reg. §301.6111-3(b)(3)(i)(C).

[1559] Reg. §301.6111-3(b)(3)(i)(B).

[1560] Reg. §301.6111-3(b)(3)(ii).

[1561] Reg. §301.6111-3(b)(1).

[1562] Reg. §301.6111-3(b)(5).

[1563] Reg. §301.6111-3(b)(2)(i).

[1564] Reg. §301.6111-3(b)(2)(ii)(A).

[1565] Reg. §301.6111-3(b)(2)(ii)(B). Confidential transactions are discussed at VIII.A.2.a.(2)(b), above.

[1566] Reg. §301.6111-3(b)(2)(ii)(C).

[1567] Reg. §301.6111-3(b)(2)(ii)(D). Loss transactions are discussed at VIII.A.2.a.(2)(d), above.

[1568] Reg. §301.6111-2(b)(2)(iii)(C).

[1569] Reg. §301.6111-3(b)(2)(iii)(A). Section 6112 and the §6708 penalty are discussed at VIII.A.4., below.

[1570] Reg. §301.6111-3(b)(2)(iii)(B).

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efits that are expected to be reflected on the supplemental or amended return.

(c) Gross Income Derived from Material Aid, Assistance or Advice

An advisor's gross income derived directly or indirectly from material aid, assistance or advice includes all fees for: (a) a tax strategy, (b) services for advice (whether or not tax advice), (c) services to analyze the reportable transaction (whether or not related to the tax consequences of the transaction), (d) services to implement the reportable transaction, (e) services to document the reportable transaction, and (f) services to prepare tax returns which include the reportable transaction to the extent such return preparation fees are unreasonable in light of all the facts and circumstances.[1571] The fee must be included whether it is paid in cash or in kind. A fee, however, does not include any amount paid to a person as a party to the transaction. For example, a fee does not include reasonable charges for the use of capital or the sale or use of property.[1572]

Comment: Income is considered derived if it is received or expected to be received.[1573] Accordingly future fees that are expected to be received must be taken into account in determining whether the threshold is met.

The IRS will carefully scrutinize all the facts and circumstances in determining whether consideration received in connection with a reportable transaction constitutes gross income derived directly or indirectly for material aid, assistance or advice.[1574]

(d) Substantially All of the Tax Benefit

Whether substantially all of the tax benefit from a reportable transaction is derived by individuals is determined based on all the facts and circumstances. Generally, the requirement is considered met if 70% or more of the tax benefits are provided to individuals (looking through partnerships, S corporations and trusts), unless the facts and circumstances prove otherwise.[1575]

(e) When a Person Becomes a Material Advisor

A person becomes a material advisor when all of the following events have occurred (in no particular order):[1576]

- The person provides material aid, assistance or advice as described at VIII.A.3.a.(3)(b), above;
- The person directly or indirectly derives gross income in excess of the applicable threshold, as described at VIII.A.3.a. and VIII.A.3.a.(3)(c), above; and
- The reportable transaction is entered into by a taxpayer to whom or for whose benefit the person provided the tax statement or if the tax statement is provided to another material advisor, when the transaction is entered into by a taxpayer to whom or for whose benefit that material advisor provided a tax statement, as described at VIII.A.3.a.(3)(b), above.

Material advisors (including those providing services before the transaction is entered into) are required to make reasonable, good faith efforts to determine whether the events in the last bullet have occurred.[1577]

If a transaction that was not a reportable transaction is later identified by the IRS as a listed transaction or a transaction of interest, the person is treated as becoming a material advisor on the date the transaction is so identified.[1578]

(4) Disclosure Statement

(a) In General

The disclosure must be made on a Form 8918, *Material Advisor Disclosure Statement*, filed with the IRS OTSA by the last day of the month that follows the end of the calendar quarter in which the advisor became a material advisor with respect to the reportable transaction.[1579] Form 8918 must be filed electronically if the material advisor is required to file at least 10 returns of any type during the calendar year (subject to waiver provisions in cases of undue hardship), effective for statements required to be filed after December 31, 2023.[1580]

Example: During the calendar year ending December 31, 2024, Material Advisor X was required to file one Form 1040, *U.S. Individual Income Tax Return*, and 10 Forms 1099-NEC, *Nonemployee Compensation*. Because X is required to file 11 returns during calendar year 2024, X must file Forms 8918 electronically.[1581]

To be considered complete, the Form 8918 must: (a) describe the expected tax treatment and all potential tax benefits expected to result from the reportable transaction, (b) describe any tax result protection with respect to the reportable transaction, (c) identify and describe the transaction in sufficient detail for the IRS to be able to understand the tax structure of the reportable transaction, and (d) identify each other person whom the reporting material advisor knows or has reason to know acted as a material advisor with respect to the reportable transaction.[1582] A single Form 8918 may be filed with respect to all substantially similar reportable transactions.[1583]

The material advisor must file an amended Form 8918 if the information previously provided is no longer accurate.[1584] The amended form is due by the last day of the month that fol-

[1571] Reg. §301.6111-3(b)(3)(ii).
[1572] Reg. §301.6111-3(b)(3)(ii).
[1573] Reg. §301.6111-3(c)(3).
[1574] Reg. §301.6111-3(b)(3)(ii).
[1575] Reg. §301.6111-3(b)(3)(i)(D).
[1576] Reg. §301.6111-3(b)(4)(i).
[1577] Reg. §301.6111-3(b)(4)(ii).
[1578] Reg. §301.6111-3(b)(4)(iii).
[1579] Reg. §301.6111-3(d)(1), §301.6111-3(e).
[1580] *See* Reg. §301.6011-14, as amended by T.D. 9972, 88 Fed. Reg. 11,754 (Feb. 23, 2023).
[1581] *See* Reg. §301.6011-14(e)(1).
[1582] Reg. §301.6111-3(d)(1). An incomplete Form 8918 containing a statement that information will be provided upon request is not a complete disclosure statement. Reg. §301.6111-3(d)(1).
[1583] Reg. §301.6111-3(d)(1). The meaning of substantially similar is discussed at VIII.A.2.a.(2)(a), above. An additional form is not required for each additional taxpayer that enters into the same or substantially similar reportable transaction. Reg. §301.6111-3(d)(1).
[1584] Reg. §301.6111-3(d)(1).

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lows the end of the calendar quarter in which circumstances occur to require the amendment.[1585]

If a potential material advisor is uncertain whether a transaction is required to be disclosed, the advisor may disclose the transaction on Form 8918 and indicate that it is being filed on a protective basis.[1586] The IRS will treat the protective form in the same manner as other disclosure statements. If a potential material advisor requests a private letter ruling with respect to whether a specific transaction is a reportable transaction, the IRS, in its discretion, may treat the submission as satisfying the disclosure requirement if the submission includes all the information that is required to be disclosed under §6111.[1587] However, the potential obligation of the advisor to disclose the transaction under §6111 or to maintain lists under Reg. §301.6112-1 is not suspended during the period the ruling request is pending.[1588]

The statute authorizes the IRS to issue regulations that create exemptions from the disclosure requirements.[1589]

(b) Designation Agreement

If more than one material advisor is required to disclose the reportable transaction, the material advisors, by written agreement, may designate one of them to disclose the transaction. The disclosure must be made by the earliest due date for each of the material advisors that are party to such agreement. The designation of one material advisor to disclose the transaction, however, does not relieve any other material advisor from its obligation to disclose if the designated material advisor fails to do so.[1590]

(c) Reportable Transaction Registration Number

The IRS will issue to a material advisor a reportable transaction number with respect to the disclosed reportable transaction. Receipt of a reportable transaction number does not indicate that the Form 8918 is complete, or that the transaction has been reviewed, examined or approved by the IRS. Material advisors must provide the reportable transaction number to all taxpayers and other material advisors for whom the material advisor acts as a material advisor, at the time the transaction is entered into, or if the transaction is entered into before the material advisor receiving the reportable transaction number, within 60 days after the date the reportable transaction number is mailed to the material advisor.[1591]

b. Penalty

(1) In General

Any material advisor who fails to timely file a disclosure statement with respect to a reportable transaction, as required under §6111, or who files a false or incomplete disclosure statement with respect to the reportable transaction, is subject to a penalty of $50,000 for any such failure.[1592] In the case of a listed transaction, the penalty is increased to the greater of $200,000 or 50% (75% in the case of an intentional failure or act) of the material advisor's gross income derived with respect to aid, assistance, or advice provided with respect to the transaction before the date the information return that includes the transaction is filed.[1593]

"False information" is information provided on a Form 8918, *Material Advisor Disclosure Statement,*) that is untrue or incorrect when the form was filed. Information filed with the IRS will not be considered false when the return contains untrue or incorrect information by mistake or accident after the exercise of reasonable care or when the untrue or incorrect information is immaterial.[1594] "Incomplete information" means a Form 8918 filed with the IRS that does not provide the information required under Reg. §301.6111-3(d).[1595] A Form 8918 will not be considered incomplete when the information not provided on the form is immaterial or was not provided due to mistake or accident after the exercise of reasonable care. Whether information is immaterial is determined based on the facts and circumstances surrounding each failure to file or filing of an incomplete return. A Form 8918 will be considered incomplete if it omits required information and contains a statement that the omitted information will be provided upon request. However, a material advisor who completes the form to the best of his ability and knowledge after the exercise of reasonable efforts to obtain the information will not be considered to have filed an incomplete form.[1596] The determination of whether a failure is intentional is made separately for each material advisor.[1597]

A failure to timely file or the submission of false or incomplete information is considered "intentional" if the material advisor knew of the obligation to file under §6111 and knowingly failed to do so, or filed a Form 8918 knowing it was false or incomplete.[1598] Whether a failure was intentional is determined based on all of the facts and circumstances. The failure to file will not be considered intentional if the material advisor remedies the failure by filing a true and complete return with the IRS before the earlier of: (1) the date that any taxpayer files a Form 8886, *Reportable Transaction Disclosure Statement,* identifying the material advisor with respect to the reportable transaction in question, or (2) the date the IRS contacts the material advisor concerning the reportable transaction.[1599]

[1585] Reg. §301.6111-3(e).

[1586] Reg. §301.6111-3(g). For the protective disclosure to be effective, the advisor must also comply with the list maintenance requirements of Reg. §301.6112-1. Reg. §301.6111-3(g). See discussion at VIII.A.4., below.

[1587] Reg. §301.6111-3(h).

[1588] Reg. §301.6111-3(h).

[1589] §6111(c)(2).

[1590] Reg. §301.6111-3(f).

[1591] Reg. §301.6111-3(d)(2).

[1592] §6707(a), §6707(b)(1). Material advisor is defined in §6111(b)(1). Reg. §301.6707-1(b)(6). See discussion at VIII.A.3.a.(3), above. Reportable transaction is defined in §6707A(c)(1) and Reg. §1.6011-4(b)(1). Reg. §301.6707-1(b)(7). See discussion at VIII.A.2.a.(2), above.

[1593] §6707(b)(2). If the transaction is both a listed transaction and another reportable transaction, only the higher penalty applies. Reg. §301.6707-1(a)(1)(C). Listed transaction is defined in §6707A(c)(2) and Reg. §1.6011-4(b)(2). Reg. §301.6707-1(b)(5). See discussion at VIII.A.2.a.(2)(a), above. Gross income derived with respect to a listed transaction is determined in accordance with Reg. §301.6111-3(b)(3)(ii). Reg. §301.6707-1(a)(2). See discussion at VIII.A.3.a.(3)(c), above. Derive is defined in Reg. §301.6111-3(c)(3). Reg. §301.6707-1(b)(1). See discussion at VIII.A.3.a.(3)(c), above.

[1594] Reg. §301.6707-1(b)(2).

[1595] Reg. §301.6707-1(b)(3).

[1596] Reg. §301.6707-1(b)(3).

[1597] Reg. §301.6707-1(c)(2).

[1598] Reg. §301.6707-1(b)(4).

[1599] Reg. §301.6707-1(c)(1).

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A separate penalty may be assessed against each material advisor for its own failure to timely file the required Form 8918.[1600] If multiple material advisors who have filing obligations under §6111 enter into a designation agreement under Reg. §301.6111-3(f) designating one material advisor to file the required return on behalf of all parties to the agreement, the §6707 penalty may be imposed upon each party to the agreement if the designated material advisor either fails to timely file or files a return with false or incomplete information.[1601] In the case of a listed transaction, if the designated material advisor fails to timely file or files a false or incomplete return, a nondesignated material advisor who is a party to the designation agreement will not be considered to have intentionally violated its obligations under §6111 unless the nondesignated material advisor knew or should have known that the designated material advisor would fail to timely file a true and complete return.[1602]

Example: Advisor A becomes a material advisor to Client X on January 5 with respect to a listed transaction. A expects to earn $400,000 in gross income from his advice to X, even though A has not yet received any fee. On October 10, A becomes a material advisor to Client Y with respect to the same transaction, and expects to receive $100,000 in gross income from services to Y. A fails to file Form 8918 with respect to the listed transaction, and the failure is unintentional. A is subject to a §6707 penalty of $250,000 (the greater of $200,000 or 50% of $500,000 gross income derived from X and Y).[1603]

For refund claims, the §6707 penalty is not divisible.[1604]

(2) Rescission

No reasonable cause defense is available. However, the IRS may rescind the penalty for a reportable transaction, other than a listed transaction, if rescission would promote compliance with the requirements of the Code and effective tax administration.[1605]

The regulations set forth the factors that the IRS will take into account in determining whether to rescind all or a portion of any penalty imposed under §6707, adopting the list of factors set forth in Rev. Proc. 2007-21. The IRS cautioned that this list is not an exclusive list, and that no single factor will be determinative of whether to grant rescission, *i.e.,* the IRS will consider and weigh all relevant factors, regardless of whether the factor is included in the list.[1606] According to the IRS, the fact that a material advisor voluntarily files the form required under §6111 before the earlier of: (i) the date that any taxpayer files a Form 8886 identifying the material advisor with respect to the reportable transaction in question or (ii) the date the IRS contacts the material advisor concerning the reportable transaction, will weigh strongly in favor of rescission.[1607] Additional factors that weigh in favor of rescission are: (1) failure to disclose the reportable transaction properly was due to an unintentional mistake of fact that existed despite trying to determine the correct facts; (2) the material advisor has an established history of properly disclosing and complying with other tax laws; (3) failure resulted from events beyond the material advisor's control; (4) material advisor cooperates with IRS by timely providing information; and (5) assessment of the penalty weighs against equity and good conscience, including whether there was reasonable cause and good faith.[1608] The IRS will not consider doubt as to collectability or liability for the penalties when determining whether to grant rescission, however, the IRS may consider doubt as to liability as a factor in reasonable cause and good faith.[1609]

(3) No Tax Court Jurisdiction

The Tax Court has held that it lacks jurisdiction to redetermine the §6707 penalty because the penalty is an assessable penalty collected outside the Code's deficiency procedures and, therefore, is not within the Tax Court's deficiency jurisdiction.[1610] For a discussion of the Tax Court's jurisdiction over penalties, see 630 T.M., *Tax Court Litigation.*

c. Action to Enjoin Material Advisor

The IRS can seek to enjoin a material advisor from further engaging in conduct that is subject to penalty for failure to furnish information regarding reportable transactions under §6707.[1611]

4. Material Advisor's Failure to Furnish List of Advisees

a. In General

Each material advisor with respect to a reportable transaction must maintain a list that identifies each person with respect to whom the advisor acted as a material advisor regarding the reportable transaction ("advisees") and that contains other information the IRS may require.[1612] For this purpose, the terms "material advisor" and "reportable transaction" have the same meaning as under §6111.[1613] The list maintenance requirement

[1600] Reg. §301.6707-1(c)(2). The taxpayer disclosure on Form 8886 is discussed at VIII.A.2.a.(4), above.

[1601] Reg. §301.6707-1(c)(3). The designation agreement is described at VIII.A.3.a.(4)(b), above.

[1602] Reg. §301.6707-1(c)(3).

[1603] Reg. §301.6707-1(d) *Ex.* 3.

[1604] *See Diversified Grp., Inc. v. United States*, 123 Fed. Cl. 442 (2015), aff'd, 841 F.3d 975 (Fed. Cir. 2016) (court distinguished pre-2004 §6707 (before amendment by Pub. L. No. 108-357, §816) from §6700, holding that pre-2004 §6707 penalties are not divisible and thus require full payment). *See Pfaff v. United States*, 2016 BL 73898 (D. Colo. Mar. 10, 2016), and *Larson v. United States*, 2016 BL 432464 (S.D.N.Y. Dec. 28, 2016), aff'd, 888 F.3d 578 (2d Cir. 2018) (both following *Diversified Grp.* decision holding pre-2004 §6707 penalties are not divisible).

[1605] §6707(c) (referencing §6707A(d)); Reg. §301.6707-1(e)(1).

[1606] Reg. §301.6707-1(e)(3).

[1607] Reg. §301.6707-1(e)(3)(i).

[1608] Reg. §301.6707-1(e)(3). According to the regulations, the absence of the factors weighs against rescission, but the presence of one or more will not necessarily be determinative of whether rescission is granted. Instead, the IRS will consider all facts and circumstances. Reg. §301.6707-1(e)(4).

[1609] Reg. §301.6707-1(e)(5).

[1610] *Endeavor Partners Fund, LLC v. Commissioner*, T.C. Memo 2016-12. *But see Yari v. Commissioner*, 143 T.C. 157 (2014), aff'd, 669 Fed. App'x 489 (9th Cir. 2016) (Tax Court can exercise jurisdiction to redetermine §6707A penalty as part of a CDP appeal).

[1611] §7408. The authority to obtain injunctions also extends to actions or failures to act in violation of Circ. No. 230. §7408. The procedure for an injunction is discussed at VIII.A.2., above.

[1612] §6112(a).

[1613] §6112(a). Material advisor is discussed at VIII.A.3.a.(3), above. Reportable transactions are discussed at VIII.A.2.a.(2), above.

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applies whether or not the material advisor is required to file a disclosure statement under §6111 with respect to the reportable transaction.[1614] In addition, any person who is required to maintain such a list must make the list available to the IRS for inspection upon the written request of the IRS, as discussed below.[1615]

b. Preparation, Maintenance and Furnishing of Lists

(1) Preparation of List

The requirement to maintain a list arises when a person becomes a material advisor with respect to a reportable transaction.[1616] The material advisor then has 30 days to prepare the list.[1617] A separate list must be maintained for each reportable transaction; provided, however, that a single list must be maintained for substantially similar transaction.[1618]

The list must identify each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction.[1619] Each list must include:[1620]

- A statement of:
  - The name of the reportable transaction and any substantially similar reportable transactions covered by the list, the citation to the published guidance identifying the transaction if the transaction is a listed transaction or a transaction of interest, and the reportable transaction number obtained under §6111;[1621]
  - The name, address or TIN of each advisee required to be included on the list;
  - The date on which each such advisee entered into the reportable transaction, if known by the material advisor;
  - A summary or schedule of the tax treatment that each person is intended or expects to derive from participation in the reportable transaction or substantially similar transaction; and
  - The name of each other material advisor to the reportable transaction or substantially similar transaction, if known by the material advisor;
- A detailed description of the reportable transaction and each included substantially similar transaction that describes both the tax structure of the transaction and its purported tax treatment; and
- A copy of the following documents:
  - Any designation agreement (as described below) with respect to the reportable transaction or substantially similar transaction to which the material advisor is a party; and
  - Any additional written materials with respect to the reportable transaction or substantially similar transaction that are material to an understanding of the purported tax treatment or tax structure of the transaction that have been shown or provided to any participant or potential participant or their representatives, tax advisors or agents by the material advisor or any related party to the material advisor,[1622] including any tax analyses or opinions. However, a material advisor is not required to retain earlier drafts of a document that if he retains a copy of the final document (or the most recent draft if there is no final document), and the final document (or most recent draft) contains all of the information in the earlier draft that is material to an understanding of the tax structure of the transaction and its purported tax treatment.

(2) Maintenance of List

Each material advisor must maintain each component of the list in a form that is readily accessible, for seven years after the earlier of:[1623] (1) the date on which the material advisor last made a tax statement relating to the transaction,[1624] or (2) the date the transaction was last entered into, if known. The list must be maintained even if a person claims a privilege with respect to the information required to be included in the list.[1625] In the case of an entity material advisor that is dissolved or liquidated before the end of the seven-year period, the person responsible for winding up the entity under state law assumes the responsibility for preparing, maintaining and furnishing the list on behalf of such material advisor, unless the responsible person submits the list to the IRS Office of Tax Shelter Activity ("OTSA") within 60 days after such dissolution or liquidation, and provides OTSA with notice of such dissolution or liquidation within the same period.[1626]

(3) Furnishing of List

Each material advisor required to maintain a list of advisees for a reportable transaction must make each component of the list available to the IRS upon written request.[1627] Each component must be furnished to the IRS in a form that enables

[1614] §6112(a).

[1615] §6112(b)(1).

[1616] Reg. §301.6112-1(a). See discussion at VIII.A.3.a.(3)(e), above.

[1617] Reg. §301.6112-1(b)(1). The IRS may publish guidance granting a longer period to prepare the list. Reg. §301.6112-1(b)(1).

[1618] Reg. §301.6112-1(b)(1). The meaning of substantially similar is discussed at VIII.A.2.a.(2)(a), above.

[1619] Reg. §301.6112-1(b)(2). However, an advisee is not required to be included if the advisee entered into a listed transaction or a transaction of interest more than six years before the transaction was identified by the IRS in published guidance as a listed transaction or a transaction of interest. Reg. §301.6112-1(b)(2).

[1620] Reg. §301.6112-1(b)(3).

[1621] The reportable transaction number is discussed at VIII.A.3.a.(4)(c), above.

[1622] A person is a related party to a material advisor if such person bears a relationship to the material advisor that is described in §267(b) or §707(b). Reg. §301.6112-1(c)(6).

[1623] Reg. §301.6112-1(d).

[1624] A tax statement is discussed at VIII.A.3.a.(3)(b), above.

[1625] Reg. §301.6112-7(e)(2). The federal tax practitioner privilege under §7525 expressly excludes communications with respect to a tax shelter. §7525(b).

[1626] Reg. §301.6112-1(d). The list and notice to OTSA must be sent to: Internal Revenue Service, OTSA Mail Stop 4915, 1973 North Rulon White Blvd., Ogden, Utah 84404 or such other address as the IRS may provide. Reg. §301.6112-1(d).

[1627] Reg. §301.6112-1(e)(1). The penalty imposes certain time limits. See discussion at VIII.A.4.c., below.

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the IRS to determine, without undue delay or difficulty, the information required to be included in the list.[1628]

(4) Designation Agreement

If more than one material advisor is required to maintain a list of advisees for a reportable transaction, the material advisors, by written agreement, may designate one of them to maintain the list or a portion of the list. The designation agreement does not relieve any material advisor from its obligation to maintain a list of advisees or to furnish the list to the IRS if the designated material advisor fails to do so. The existence of a designation agreement does not affect the IRS's ability to request the list from any material advisor who is a party to the designation agreement. In such case, the material advisor receiving the request must furnish the list to the IRS.[1629]

The rules are discussed further in 648 T.M., *Reportable Transactions.*

Comment: The list maintenance requirements impose a substantial burden on a material advisor. Compiling the items on the extensive list is both time consuming and expensive. Moreover, a material advisor with respect to one aspect of the transaction may not know the overall tax structure or expected tax treatment of the transaction. A designation agreement may not fully protect a material advisor, even if it contains an indemnity. In addition, it can be risky for a material advisor to discard prior drafts of documents.

c. Penalty

(1) In General

A material advisor who is required to maintain a list of advisees and who fails to make the list available to the IRS upon written request within 20 business days after the request, is subject to a penalty of $10,000 for each calendar day after the 20th day (as it may be extended) that the failure continues.[1630] An exception is available for any day on which the failure is due to reasonable cause.[1631] In no event, however, is the failure to maintain a list considered reasonable cause for failing to make a list available to the IRS.[1632] The penalty is in addition to any other penalty that might apply.[1633]

The 20 business-day period within which a material advisor must provide the list begins on the first business day following the earlier of the date that the IRS:[1634] (1) mails a request for the list by certified or registered mail to the material advisor, (2) hand-delivers the written request to the material advisor, or (3) leaves the written request with an individual 18 years old or older at the material advisor's usual place of business. If the due date is a Saturday, Sunday or legal holiday in the District of Columbia, furnishing the list is considered timely if it is made on the next business day.[1635]

The IRS may, in its discretion, extend the 20-business day period from good cause.[1636] For this purpose, "good cause" is shown if the material advisor establishes that the deadline cannot reasonably be met despite diligent efforts.[1637] A request for an extension of time to furnish the list must be made in writing to the IRS agent who requested the list, and (1) must briefly describe the information and documents that comprise the list, (2) explain the circumstances that warrant additional time, (3) propose a schedule to complete production of the list, (4) state that to the best of the material advisor's knowledge, as of the date of the IRS's request, all information and records relating to the list under the material advisor's possession, custody or control had been maintained in accordance with procedures and policies that are consistent with §6001 and §6112, and (5) state that the extension request is not being made to avoid the person's list maintenance obligation under §6112 and the regulations thereunder.[1638] In making its determination, whether to grant the requested extension in whole or in part, the IRS will consider whether granting the extension may impair its ability to make a timely assessment against any participant in the underlying reportable transaction. A pending extension request by itself does not constitute reasonable cause to avoid the penalty.[1639]

Comment: Compared to the pre-2004 AJCA penalty, the current penalty is time-sensitive, substantially increased, and no longer subject to a cap.

> *Example:* Firm X is a large law firm that is a material advisor with respect to a reportable transaction. Firm A conducts annual training sessions to educate its professionals about reportable transactions and the firm's obligations with respect to them. Firm X instructs its professions to provide information on tax engagements that involve reportable transactions and to provide the documents required to be maintained under §6112 to the firm's compliance officer for list maintenance purposes. Firm X's policy provides that, for each engagement involving a reportable transaction, one firm professional will email the compliance officer about the engagement and then direct a subordinate to send the documents required to be maintained to the compliance officer. Firm X has policies and procedures in place to monitor compliance with these rules and to address noncompliance.
>
> Firm X received a request from the IRS for §6112 list. In compiling the list to turn over to the IRS during the 20-business day period, Firm X discovers that the subordinate did not provide the documentation as required by firm policy. In addition, Firm X had difficulty locating the required documents as both the professional and the subordinate who worked on the transaction were no longer employed by the firm, requiring Firm X to undertake an extensive search for the information. Firm X also requested the information from its client. Despite these efforts, Firm X reasonably determined that it would not be able to furnish the required list timely. Within the 20-business day

[1628] Reg. §301.6112-1(e)(1).
[1629] Reg. §301.6112-1(f).
[1630] §6708(a)(1).
[1631] §6708(a)(2), as amended by 2004 AJCA §817(a). The failure to maintain a list can never be considered reasonable cause for failing to make a list available, however. H.R. (Conf.) Rep. No. 108-755 at 610 (2004). Reasonable cause is discussed at XI., below.
[1632] H.R. (Conf.) Rep. No. 108-755 at 610 n. 505 (2004).
[1633] §6708(b).
[1634] Reg. §301.6708-1(b).
[1635] Reg. §301.6708-1(c)(1); §7502.
[1636] Reg. §301.6708-1(c)(3)(i).
[1637] Reg. §301.6708-1(c)(3)(i).
[1638] Reg. §301.6708-1(c)(3)(ii).
[1639] Reg. §301.6708-1(c)(3)(ii).

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period, Firm X submitted a written request for an extension of time to provide the information by an additional 10 business days, advising the IRS of the difficulties Firm X was experiencing.

Because the facts and circumstances indicate that Firm X made a diligent effort to maintain the components constituting the list as required by §6112, the requested extension with respect to the portion of the list where records were not maintained in accordance with the firm's policies and procedures should be granted.[1640]

Comment: The penalty also applies if the material advisor fails to maintain the required list, maintains an incomplete list, or furnishes the list in an improper form. In each case, the material advisor is failing to turn over the list that is required to be maintained under §6112.

The list may be made available to the IRS by mailing or delivering a copy to the IRS. Alternatively, the list may be made available to the IRS for inspection and copying during normal business hours or an agreed on date within the 20-business day period, or by another agreed-upon method.[1641]

If material advisors with respect to a reportable transaction entered into a designation agreement, separate penalties will be imposed on the designated material advisor and the other material advisors who are parties to the agreement for their respective periods of failure or noncompliance. The §6708 penalty will continue to accrue with respect to a material advisor who is a party to a designation agreement until the required list is furnished by that material advisor or another material advisor who is a party to the designation agreement.[1642]

Multiple material advisors are not jointly and severally liable for the §6708 penalty.[1643] In addition, the penalty is a divisible penalty for purposes of establishing refund suit jurisdiction, i.e., a person may pay a portion of the penalty and then file a refund suit.[1644]

(2) Exception to Advisee List Penalty for Reasonable Cause

The §6708 penalty is not imposed for any day for which the material advisor shows that the failure to furnish the required list to the IRS was due to reasonable cause.[1645] The determination of whether a person had reasonable cause is made on a case-by-case basis, taking into account all the relevant facts and circumstances (including facts and circumstances arising after the IRS's request for the list).[1646] The most important factors in establishing reasonable cause are those that reflect the person's good-faith efforts to comply with the requirements of §6112, including:[1647]

- The person's efforts to determine or assess its status as a material advisor;
- The person's efforts to determine the information and documentation required to be maintained under §6112;
- The person's efforts to meet its obligations to maintain a readily producible list as required by §6112;
- The person's efforts, upon receiving the list request, to make the list available to the IRS within the 20-business day period or any extended period; and
- The person's efforts to ensure that the list furnished to the IRS is accurate and complete.

Whether reasonable cause exists for a period of time is determined based on all the relevant facts and circumstances, including those arising after the list has been reposted by the IRS. If a material advisor established that, in its efforts to comply with §6112, it acted in good faith (as defined in Reg. §301.6708-1(g)(2)),[1648] the material advisor will be deemed to have reasonable cause for the periods of time the IRS takes to review a furnished list for compliance with §6112 and to inform the material advisor of any identified failures in the list. If the material advisor does not establish that it acted in good faith, the IRS will not consider there to be reasonable cause for the time it takes the IRS to review the list or to notify the material advisor of identified failures.[1649]

The exercise of ordinary business care may constitute reasonable cause.[1650] To show ordinary business care, the person may, for example, show that he established and adhered to procedures reasonably designed and implemented to ensure compliance with §6112. In all instances, when ordinary business care is claimed as constituting reasonable cause, the material advisor must show that upon discovering any failure relating to the list, he took immediate steps to correct the failure. The failure to take immediate steps to correct a failure is a factor weighing against a conclusion that the material advisor exercised ordinary business care. Notwithstanding the occurrence of an isolated and inadvertent failure, a person still may be able to demonstrate that he exercised ordinary business care, considering all the relevant facts and circumstances, but only if the person had established and adhered to procedures reasonably designed and implemented to ensure compliance with the §6112 requirements.[1651]

A person may establish reasonable cause where, considering all the relevant facts and circumstances, the failure to timely furnish the list was due solely to a supervening event that was beyond such person's control. Such a supervening event may include a fire, flood, storm or other casualty, illness, theft, or other unexpected event that damages or impairs the person's relevant business records or system for producing these records, or that affects the person's ability to maintain the §6112 list or make it available to the IRS. Reasonable cause may only be established for the period that a person who exercised ordinary business care would need to provide the list from alternative records, or make the list available, under the specific facts and circumstances.[1652]

[1640] Reg. §301.6708-1(c)(4) *Ex.* 1.
[1641] Reg. §301.6708-1(c)(2).
[1642] Reg. §301.6708-1(e)(3).
[1643] FAA 20032901F.
[1644] CCA 200646016.
[1645] §6708(a)(2); Reg. §301.6708-1(g)(1).
[1646] Reg. §301.6708-1(g)(1).
[1647] Reg. §301.6708-1(g)(2).
[1648] The requirements of §6112 are discussed at VIII.A.4., above.
[1649] Reg. §301.6708-1(h)(2).
[1650] Reg. §301.6708-1(g)(3).
[1651] Reg. §301.6708-1(g)(3).
[1652] Reg. §301.6708-1(g)(4).

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Example: On August 11, the IRS sends a list request to Firm Y, a material advisor. The firm's sole practitioner A was away on vacation. A had arranged for a colleague to review the firm's mail, email and telephone messages during his absence. When A returned to the office on September 5, he notified the IRS of his absence. Firm Y furnished the list to the IRS on September 19, 10 business days after A returned from vacation. Under the circumstances, Firm A is considered to have exercised ordinary business care and prudence, and to have made a good faith effort to comply with the requirements of §6112. Firm Y established reasonable cause for the entire period between the expiration of the 20-business day period following the list request and the date the list was made available to the IRS.[1653]

Example: On August 11, the IRS sends a list request to Firm Z, a material advisor. B, the sole practitioner at Firm Z, begins compiling the documents to respond to the request. Firm Z maintains the materials electronically in a manner consistent with IRS guidance. Before responding, within the 20-business day period, B suffers a temporary but debilitating illness on September 3 that lasts through September 19. Upon returning to work on September 20, B contacts the IRS and explains about his illness and absence, and that he intends to furnish the list shortly. Firm Z furnishes the list to the IRS on September 22. In this situation, Firm Z has reasonable cause for the full period of the delay due to B's illness.[1654]

If in the above example, B had not begun compiling the documents until days after returning to work, Firm Z would not have reasonable cause for any day, including the period, including during B's illness, since the failure was not due solely to the supervening event.[1655]

A person may rely on advice from an independent tax professional to establish reasonable cause.[1656] To qualify, the reliance must be reasonable and in good faith in light of all the facts and circumstances. For a person to be considered to have relied on advice, the advice must have been received by the person before the date the list is required to be made available to the IRS. Reliance on advice is considered reasonable only if the independent tax professional reasonably believed it is more likely than not that the person does not have an obligation under §6112. For example, the advice may conclude that the person is not a material advisor; that the transaction is not a reportable transaction as of the date the advice was given; or that the information or documents requested were not required to be produced. The advice must also: (1) take into account and consider all relevant facts and circumstances, (2) not rely on unreasonable legal or factual assumptions, (3) not rely on or take into account the possibility that the IRS may not request the list, and (4) not rely on unreasonable representation or statements from the person seeking the advice.[1657]

For this purpose, an "independent tax professional" is a person who is knowledgeable in the relevant aspects of federal tax law and who is not a material advisor with respect to the specific transaction that is the subject of the list request. In the case of a listed transaction, a material advisor with respect to any transaction that is the same or substantially similar to the type of transaction that is the subject of the list request is not considered independent.[1658]

Tax advice from an independent tax professional is not required to establish reasonable cause for failing to furnish a list under §6112, and the failure to obtain advice from an independent tax professional does not preclude a finding of reasonable cause. However, advice from a tax profession who is not independent is not sufficient by itself to establish reasonable cause. Such advice may still be considered in determining reasonable cause if, in light of and in relation to all the other facts and circumstances, taking such advice into account is reasonable.[1659]

Example: Firm L, a law firm, is a material advisor with respect to a reportable transaction (the "L transaction") and provides advice to various clients regarding the tax benefits of the L transaction. Firm L also provided advice to accountants, Firm A, regarding the L transaction and is a material advisor to Firm A. Unrelated law firm, Firm U, advises its own clients who are unrelated to Firm A regarding other reportable transactions that are not the same as of substantially similar to the L transaction. The IRS delivers a list request to Firm A with respect to the L transaction. Before the expiration of the 20-business day period to respond to the request, Firm A seeks advice from Firm L and Firm U about the propriety of withholding certain documents related to the L transaction. Because Firm L provided advice with respect to the L transaction — the particular transaction that is the subject of the list request — it is not an independent tax advisor. Firm U, however, is independent; it did not provide material advice with respect to the L transaction.[1660]

If a material advisor has dissolved, been liquidated or otherwise is no longer in existence, the person required by §6112 to maintain the list (the "responsible person") is subject to the §6708 penalty for failure to make the list available.[1661] In considering whether a responsible person or successor in interest has reasonable cause for any failure to timely make the list available to the IRS, the IRS will consider all of the facts and circumstances, including those relating to the dissolution, liquidation and winding up of the original material advisor's business and any efforts the original material advisor made to comply with the requirements of §6112 before the dissolution or liquidation. When appropriate or applicable, due diligence, if any, performed by a responsible person or successor in interest will be considered, and due consideration will be given for acts

[1653] Reg. §301.6708-1(g)(6) *Ex.* 1.
[1654] Reg. §301.6708-1(g)(6) *Ex.* 6.
[1655] Reg. §301.6708-1(g)(6) *Ex.* 5.
[1656] Reg. §301.6708-1(g)(5)(i). Reliance on a tax profession is discussed further at XI.D.1., below.
[1657] Reg. §301.6708-1(g)(5)(i).
[1658] Reg. §301.6708-1(g)(5)(ii).
[1659] Reg. §301.6708-1(g)(5)(i).
[1660] Reg. §301.6708-1(g)(6) *Ex.* 8.
[1661] Reg. §301.6708-1(h)(1). The responsible person is discussed at VIII.A.4.b.(2), above.

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taken by the responsible person to minimize the potential for violating the §6112 requirements.[1662]

d. Action to Enjoin Material Advisor

The IRS can seek to enjoin a material advisor from further engaging in conduct that is subject to penalty under §6708 due to a failure to maintain, or to furnish to the IRS upon written request, a list of advisees with respect to a reportable transaction.[1663]

B. Aiding and Abetting an Understatement of Tax Penalty

1. In General

Section 6701 imposes a civil penalty on any person who:[1664]

- Aids or assists in, procures, or advises with respect to the preparation or presentation of any portion of a return, affidavit, claim or other document;
- Knows or has reason to believe that such portion will be used in connection with a material matter arising under the tax law; and
- Knows that such portion, if it is so used, would result in an understatement of another person's tax liability will result.

The penalty is $1,000 for each document ($10,000 if it relates to the tax liability of a corporation).[1665]

2. Prohibited Conduct

a. Activities Subject to Penalty

The penalty is triggered by any person's act of aiding, assisting, procuring, or advising, not by the taxpayer's act of filing an understated return.[1666] The advisor does not have to be a preparer of the return. It is sufficient if he aids or assists in the preparation or presentation of any portion of the document. Merely furnishing typing, reproducing, or other mechanical assistance with respect to a document, however, is not considered aiding or assisting in the preparation of such document.[1667]

There is no requirement that the person materially advises the taxpayer. Nor does the overlap with the tax return preparer penalties under §6694 prevent a §6701 penalty from being imposed,[1668] although both penalties may not be imposed.[1669]

The prohibited activity need not be undertaken by the advisor directly. Actions by an advisor's subordinates can also subject him to the penalty. For this purpose, the term "procures" is defined to include ordering or otherwise causing a subordinate to do an act, or knowing of a subordinate's participation in an act and not attempting to prohibit it.[1670] A "subordinate" is any other person over whom the advisor has direct and immediate direction, supervision, or control.[1671] Such person's status as a director, officer, employee, or agent of the taxpayer is irrelevant. As a result, a law firm, accounting firm, or other entity can also be liable for the penalty.

Comment: Because of this provision, the §6701 penalty reaches a broader range of people than the §6694 preparer penalty (which, for example, can be imposed on only one preparer per firm). In addition, the "reason to believe" standard is more lenient than the "reasonably should have known" test of §6694(a). On the other hand, only a person who is directly involved in the preparation or presentation of the false or fraudulent document or who directly procures a subordinate to do so is subject to the aiding and abetting penalty.

The penalty also applies in the case of appraisers whose appraisals result in an understatement.[1672]

Treasury and the IRS issued proposed amendments to Circular 230 that would establish new standards for appraisals and the disqualification of appraisers. The proposed rules would require appraisals submitted to the IRS conform to either the Uniform Standards of Professional Appraisal Practice (USPAP) or the International Valuation Standards (IVS). Appraisers who submit appraisals that do not conform to the USPAP or IVS may be subject to disqualification. Appraisers who know, or should know, that an appraisal will be used in an administrative proceeding by taxpayers to support a substantial valuation misstatement, a substantial estate or gift tax valuation understatement, or a gross valuation misstatement, would be subject to disqualification.[1673]

For purposes of this penalty, a "document" can be a return (or a portion thereof, for example, a Schedule K-1), an affidavit, a claim for refund or credit, or any other document used in connection with a material tax matter.[1674] Such other documents may include, for example, promotional materials describing a transaction, a partnership agreement, a bill of sale, a warehouse receipt, articles of incorporation, or corporate minutes.

[1662] Reg. §301.6708-1(h)(1).

[1663] §7408. The authority to obtain injunctions also extends to actions or failures to act in violation of Circ. No. 230. §7408. See VIII.A.2., above, for the procedure for an injunction.

[1664] §6701(a).

[1665] §6701(b).

[1666] *See* §6701(a)(1); *Kuchan v. United States*, 679 F. Supp. 764 (N.D. Ill. 1988). *See also Berger v. United States*, 1997 BL 316 (D. Conn. Apr. 11, 1997). *Cf.* CCA 201519029 (act of filing refund claim after statute of limitations for refund claims has expired does not automatically trigger §6701 or §6694 penalties; both penalties require claim due to "understatement of liability," defined under §6694(e), which by definition does not include time barred refund claims. Thus, filing a refund claim too late does not by itself invoke understatement penalties).

[1667] §6701(e).

[1668] *Swaney v. United States*, 2011 BL 315800 (M.D. Fla. Dec. 12, 2011).

[1669] *Carlson v. United States*, 2011 BL 315528 (M.D. Fla. Dec. 12, 2011), rev'd and rem'd on other issue, 754 F.3d 1223 (11th Cir. 2014).

[1670] §6701(c)(1).

[1671] §6701(c)(2). *See* 1982 Act Senate Report at 276.

[1672] The legislative history of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, indicates that Congress specifically authorized the IRS to assess the §6701 penalty against appraisers. *See* H.R. Rep. No. 98-432 (Part II) (1984). Under Reg. §1.170A-13(c)(5)(i)(D), an appraiser's intentionally false or fraudulent overstatement of the value of the property described in the qualified appraisal or appraisal summary may subject the appraiser to a §6701 penalty. See also CCA 200512016 for a comprehensive discussion of the §6701 penalty as it applies to appraisers.

[1673] Prop. Circular 230 §10.60, §10.61, §10.62, REG-116610-20, 89 Fed. Reg. 104,915 (Dec. 26, 2024), to be effective 30 days after final regulations are published in the Federal Register.

[1674] *See* §6701(a)(1). *See also Berger v. United States*, 87 F.3d 60 (2d Cir. 1996), partial summ. judgment *granted*, 1997 BL 316 (D. Conn. Apr. 11, 1997) (filing of false Forms 5300).

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b. Knowledge Required

To be subject to the penalty, the person must know or have reason to believe that the document will be used in connection with any material matter under the tax law.[1675] In addition, the person must know that the use of that document will result in an understatement of the taxpayer's tax liability.[1676] The "reason to believe" language allows an objective or a subjective standard to be used to prove the first factor. The second factor, however, does not contain this language. As a result, actual knowledge of the second factor is required.

The knowledge requirement is intended to limit the penalty to cases involving willful attempts to accomplish an understatement of the tax liability of a third party.[1677] According to one district court, it requires the advisor's awareness both of the facts and of the ultimate result of the conduct.[1678] Therefore, it is a higher standard than the willfulness standard required by other penalties (which can be proven on the basis of a conscious disregard of the facts or legal standards).

A tax advisor should not be subject to the aiding and abetting penalty for suggesting an aggressive but supportable filing position to a client, even though that position is later rejected by the courts and even though the client is ultimately subject to a substantial understatement penalty.[1679] Moreover, the knowledge must relate to the document (or items to which the document relates).[1680]

There is no requirement that the taxpayer must actually rely on the subject document or must actually have understated his tax liability.[1681] Moreover, the taxpayer need not consent to or even have knowledge of the understatement.[1682] In other words, the taxpayer does not have to be a party to the plan.

The government is not required to prove a specific understatement amount; it need only prove that the tax advisor knew that tax documents he produced would result in understatements.[1683]

Comment: Although there is no specific provision authorizing the IRS to waive the penalty, the subjective knowledge requirement of §6701(a)(3) provides leeway.

c. False or Fraudulent Return Standard

When considered alone, the requirement of §6701(a)(3) — that the advisor knows that the false or fraudulent portion of the document, if used, will result in an understatement of tax — appears unambiguous. Yet, when considered in the context of the Code's overall penalty scheme (and especially §7206(2), the criminal aiding and abetting penalty), the meaning of §6701(a)(3) is not so clear. The courts, therefore, have looked to the legislative history to conclude that a false or fraudulent tax document (or portion thereof) is a necessary element for the penalty.[1684]

Comment: Having determined that a false or fraudulent document is a separate element of the penalty, one case — *Warner v. United States*[1685] — then eliminated the requirement by holding that a document is necessarily false or fraudulent if the advisor knows that its use will result in an understatement of the taxpayer's tax liability. Commentators have severely criticized this part of the *Warner* decision.[1686] Not only does it eviscerate the false or fraudulent document standard intended by Congress, but it is contrary to the requirements imposed on tax return preparers by the Code and professional organizations. For example, §6694, the American Bar Association, and the American Institute of Certified Public Accountants clearly allow a preparer to recommend a position that has a realistic possibility of being sustained on its merits even though, more likely than not, it will be disallowed.[1687] Moreover, they expressly authorize the recommendation of a nonfrivolous position if adequate disclosure is made. Nothing in any of these provisions prohibits advice merely because the advisor believes the position will be disallowed or that it will result in an understatement of tax. Yet, this is exactly the effect of the *Warner* decision.

The courts are split as to whether §6701 requires the IRS to prove fraud.[1688] In holding that fraud is not required, the Eighth Circuit relied on the fact that: (1) §6701 does not refer to "fraud" or an "evasion of tax," (2) §6701 was part of the integrated enactment of §6700–§6703, which do not require fraud, and (3) §6701 is just part of the expansive non-fraud penalty scheme. The Eleventh Circuit, on the other hand, found that: (a) §6701 requires the preparer to actually know that the return would result in an understatement of the taxpayer's tax,

[1675] §6701(a)(2).

[1676] §6701(a)(3). For an example of a case where the court concluded that a tax return preparer had actual knowledge that use of the tax documents he had prepared would result in an understatement of other taxpayers' tax liability, *see Kapp v. Commissioner*, T.C. Memo 2019-84.

[1677] 1982 Act General Explanation at 220–21.

[1678] *Sansom v. United States*, 703 F. Supp. 1505, 1510 (N.D. Fla. 1988).

[1679] 1982 Act General Explanation at 221. *See* §6701(a)(3).

[1680] See discussion of *Warner v. United States*, 698 F. Supp. 877 (S.D. Fla. 1988), motion granted in part and denied in part, 700 F. Supp. 532 (S.D. Fla. 1988), summary judgment *granted in part and denied in part*, 726 F. Supp. 1287 (S.D. Fla. 1989), aff'd by unpub. op., 979 F.2d 212 (11th Cir. 1992), at VIII.B.2.c., below, in which the court ostensibly would not favor the imposition of a penalty against an advisor who prepares a document which is correct in all respects, even though he knows of other positions on the return over which he has no control and has rendered no assistance or advice, that are fraudulent. *But see Cheshire v. United States*, 991 F.Supp. 1391 (M.D. Ala. 1997).

[1681] *Golletz v. United States*, 91-1 USTC ¶50,233 ((N.D. Ill. 1991); *Kuchan v. United States*, 679 F. Supp. 764 (N.D. Ill. 1988); *Kapp v. Commissioner*, T.C. Memo 2019-84 (tax advisor's preparation of tax documents containing understatements was sufficient for application of §6701, even if taxpayers never filed documents resulting in deficiency).

[1682] §6701(d).

[1683] *Kapp v. Commissioner*, T.C. Memo 2019-84.

[1684] *Sansom v. United States*, 703 F. Supp. 1505 (N.D. Fla. 1988); *Warner v. United States*, 698 F. Supp. 877 (S.D. Fla. 1988), motion granted in part and denied in part, 700 F. Supp. 532 (S.D. Fla. 1988), summary judgment *granted in part and denied in part*, 726 F. Supp. 1287 (S.D. Fla. 1989), aff'd by unpub. op., 979 F.2d 212 (11th Cir. 1992); *Kuchan v. United States*, 679 F. Supp. 764 (N.D. Ill. 1988); 1982 Act Senate Report at 275.

[1685] 698 F. Supp. 877 (S.D. Fla. 1988), motion granted in part and denied in part, 700 F. Supp. 532 (S.D. Fla. 1988), summary judgment *granted in part and denied in part*, 726 F. Supp. 1287 (S.D. Fla. 1989), aff'd by unpub. op., 979 F.2d 212 (11th Cir. 1992).

[1686] *See, e.g.*, Jeffrey A. Ritholz and Bryan C. Skarlatos, *Is the Preparer Understatement Penalty in Conflict With Ethical Guidelines?* 77 J. Tax'n 104 (Aug. 1992).

[1687] ABA Formal Opinion 85-352; AICPA Statements on Standards for Tax Services No. 1, "Tax Return Positions" (Aug. 2000). *Cf.* 31 C.F.R. §10.34(a), 31 C.F.R. §10.34(b) (practitioner may not advise a client to take a position that lacks a reasonable basis or is frivolous). See discussion at VII.C.4.a., above.

[1688] *Compare Mattingly v. United States*, 924 F.2d 785 (8th Cir. 1991) and *Barr v. United States*, 67 F.3d 469 (2d Cir. 1995) (fraud not required) *with Carlson v. United States*, 754 F.3d 1223 (11th Cir. 2014) (fraud required).

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(b) nothing in §6700–§6703 specify a standard of proof, and (c) the penalty structure suggests a higher burden. Whether or not fraud is an element of the §6701 penalty affects the level of proof required. Fraud must be shown by clear and convincing evidence.[1689]

3. Amount of Penalty

The amount of the penalty is $1,000 with respect to any false or fraudulent document for any tax period (or taxable event if there is no tax period).[1690] If, however, the document relates to the tax liability of a corporation, the penalty is $10,000.[1691] Accordingly, in the case of an S corporation, the Ninth Circuit has held that the $10,000 amount does not apply unless the document relates to the built-in gains tax or excess passive income tax on the S corporation.[1692] The Schedule K-1s relate to the individual shareholders' tax, not the corporation's tax.

Only one aiding and abetting penalty can be imposed on an advisor with respect to a particular document relating to any taxpayer for any tax period (or taxable event).[1693] The period limitation is based on the period in which the prohibited conduct occurs, rather than the period in which the underlying tax document was prepared.[1694] As a result, a second penalty cannot be imposed where a loss attributable to an understatement document in one tax period is carried over to another period.[1695] Similarly, where a preparer's falsification of forms for one taxable year ultimately affects multiple taxable years of a corporation, the §6701 penalty may be imposed only for the years in which those forms were prepared, and not for each affected year in which a corporation return was filed.[1696] On the other hand, by referring to the tax period (or taxable event) rather than the taxable year, a separate §6701 penalty can apply with respect to each quarterly (or monthly) employment tax return.[1697] Similarly, five separate penalties for each client were assessed against a consultant-engineer who provided clients with a study that mischaracterized components of depreciable property, which resulted in each client front loading depreciation during the first five years.[1698] The study overstated the depreciation claimed in each of the five years. No amount was carried over from a prior year.

A separate penalty can be applied with respect to a partnership return and each Schedule K-1 filed with it.[1699] For example, an advisor who prepares a false partnership return and 10 false Schedule K-1s (for 10 individual partners) can be subject to an $11,000 penalty. Similarly, an organizer who supplies information for an S corporation return and 34 related Schedule K-1s is subject to 35 penalties.[1700] In addition, an accountant who prepares only the transmittal letter for Schedule Cs sent to each investor, which he knows are false, is subject to the penalty with respect to each Schedule C.[1701]

Multiple penalties also can be imposed with respect to different documents, different taxpayers, and different advisors. As indicated earlier, there can be various advisors with respect to a single document.

In CCA 201531015, the Chief Counsel's Office advised that only one aiding and abetting penalty applies to a single plan application. The penalty does not apply to each false document submitted as part of the plan application. Additionally, it advised that the penalty is not imposed based on the number of taxpayers who understate their tax liability. Thus, if multiple taxpayers understate their tax liability based on the same plan application, only one penalty is imposed against the person who submitted the false document.

Query: Can a partnership and its partners be treated as different advisors?[1702]

4. Action to Enjoin Advisor

The IRS can seek to enjoin an advisor from further engaging in conduct that is subject to the aiding and abetting penalty under §6701.[1703]

5. Disciplinary Action

If a penalty under §6701(a) is assessed against an appraiser, the IRS's Office of Professional Responsibility may reprimand the appraiser or institute a proceeding to disqualify the appraiser from practice before the IRS.[1704] A disqualified appraiser is barred from presenting evidence or testimony in any administrative proceeding before the IRS, unless specifically authorized to do so by the IRS, even if such evidence or testimony relates to an appraisal made before his disqualification.[1705] In addition, any appraisal made by a disqualified appraiser after his disqualification does not have any probative effect in an administrative proceeding before the IRS. The appraisal, however, may be admitted as evidence solely for the purpose of determining the taxpayer's good faith reliance on the appraisal.[1706]

[1689] See discussion at V.B., above.

[1690] §6701(b)(1).

[1691] §6701(b)(2).

[1692] *Mitchell v. United States*, 977 F.2d 1318 (9th Cir. 1992).

[1693] §6701(b)(3).

[1694] *Kuchan v. United States*, 679 F. Supp. 764 (N.D. Ill. 1988) (191 §6701 penalties were imposed where plaintiff attached 191 false Schedule C's to transmittal letter); CCA 201531015 (only one §6701 penalty applies per false document, even if it results in multiple taxpayers understating income).

[1695] *Mattingly v. United States*, 924 F.2d 785 (8th Cir. 1991); *Emanuel v. United States*, 705 F. Supp. 434 (N.D. Ill. 1989).

[1696] *See Berger v. United States*, 1997 BL 316 (D. Conn. Apr. 11, 1997) (§6701 penalty is imposed based on year in which Form 5300 is prepared, and not for each affected year for which return is filed).

[1697] *Mullikin v. United States*, (6th Cir. 1991), cert. denied, 506 U.S. 827 (1992).

[1698] CCA 201805001.

[1699] 1982 Blue Book at 221. *See also* 1989 Act House Report at 1399.

[1700] *Mitchell v. United States*, 977 F.2d 1318 (9th Cir. 1992).

[1701] *Kuchan v. United States*, 679 F. Supp. 764 (N.D. Ill. 1988).

[1702] See discussion at VIII.A.1.b., above, with respect to the disagreement among the authorities as to whether separate §6700 penalties for promoting an abusive tax shelter can be imposed against a partnership and its partners for the same conduct.

[1703] §7408. *See, e.g., Abdo v. United States*, 234 F. Supp. 2d 553 (M.D.N.C. 2002), aff'd, 63 Fed. App'x 163 (4th Cir. 2003), cert. denied, 540 U.S. 1120 (2004). See VIII.A.2., above, for the procedure for an injunction.

[1704] 31 C.F.R. §10.60(b). A practitioner may be reprimanded or sanctioned for violating any rule of practice before the IRS under Circular 230. 31 C.F.R. §10.60(a), §10.52(a). Sanctions may include monetary penalties, up to the gross income derived (or to be derived) from the conduct giving rise to the penalty. 31 C.F.R. §10.50(c). *See also* REG-116610-20, 89 Fed. Reg. 104,915 (Dec. 26, 2024) (proposed reorganization of Circular 230 rules affecting appraisers into new Subpart D) to be effective 30 days after final regulations are published in the Federal Register.

[1705] 31 C.F.R. §10.50(b)(1).

[1706] 31 C.F.R. §10.50(b)(2).

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C. Frivolous Position Penalty

1. Frivolous Tax Return Penalty

a. Penalty

A $5,000 penalty may be imposed on any individual who files what purports to be a return of tax imposed by the Code but which:

- does not contain information on which the substantial correctness of the self-assessment of the tax may be judged, or contains information that on its face indicates the self-assessment is substantially incorrect; and
- is based on a frivolous position that has been identified by the IRS in published guidance or reflects a desire to delay or impede the administration of the federal tax laws.[1707]

Similarly, a person is subject to a $5,000 penalty if:

- the person submits a request for a collection due process hearing under §6320 or §6330, an application for an installment agreement under §6159, an offer in compromise under §7122, or a taxpayer assistance order under §7811; and
- that submission is based on a frivolous position as identified by the IRS in published guidance or reflects a desire to delay or impede the administration of federal tax laws.[1708]

For the penalty to apply, the frivolous position must have previously been identified by the IRS. Section 6702(c) requires the IRS to publish and periodically revise a list of positions that it has identified as being frivolous for purposes of this penalty. Such list, however, may not include any position that meets the reasonable basis standard under §6662(d)(2)(B)(ii)(II) to avoid a substantial understatement of tax penalty.[1709]

The §6702 penalty for frivolous tax submissions may be assessed automatically through electronic means or by an independent determination of an IRS employee. If the penalty is assessed electronically, no written supervisor approval is required. When the penalty is assessed after an independent determination by an IRS employee, §6702 is subject to preassessment written management approval provisions under §6751(b)(1).[1710]

Like §6673, the purpose of §6702 is to compel taxpayers to conform their conduct to settled principles, regardless of their subjective beliefs.[1711] Neither intent nor reasonable cause is relevant.[1712] Frivolous returns divert the time and energy of the IRS from more serious claims, and impose needless costs on the government. People who wish to express their displeasure with taxes must choose other forums.[1713]

The penalties under §6702 are in addition to any other penalties that may apply.[1714] However, the frivolous submission penalty under §6702(b) does not apply if the taxpayer withdraws the submission within 30 days after receiving notice from the IRS that such a submission is frivolous.[1715] In addition, the IRS may reduce the amount of a §6702 penalty if the IRS determines that the reduction would promote compliance with and administration of the federal tax law.[1716]

Taxpayers may be eligible for a one-time reduction of §6702 penalties. Generally, if a taxpayer satisfies certain eligibility criteria, including filing all tax returns and paying all outstanding taxes, penalties (other than §6702), and interest, the IRS will reduce all assessed but unpaid §6702 penalties to a single $500 penalty. However, a taxpayer who: (1) previously received a reduction of a §6702 penalty, (2) submitted an offer-in-compromise under §7122, (3) entered into a partial pay installment agreement, (4) entered into a closing agreement, (5) files a new frivolous return or makes a frivolous submission after filing a reduction request but before a reduction is granted, or (6) has an open bankruptcy case or seeks to file for bankruptcy, is not eligible for the penalty reduction. An eligible taxpayer may request a reduction by filing Form 14402, *IRC Section 6702(d) Frivolous Tax Submissions Penalty Reduction*.[1717] The individual against whom a §6702 penalty is imposed need not be the taxpayer or the taxpayer's authorized representative. For example, the IRS may assess penalties under §6701 and §6702 against a person who, without filing a valid power of attorney and declaration of representative, files frivolous documents on behalf of a taxpayer.[1718] However, if both the taxpayer and the tax return preparer sign the return, the IRS generally imposes the §6702 penalty on the taxpayer, regardless of who files the return.[1719]

b. Definition of Frivolous Returns

(1) Return

The penalty applies with respect to returns with respect to any tax imposed by the Internal Revenue Code.[1720] That includes income tax returns, withholding tax returns, estate tax returns, gift tax returns, employment tax returns and excise tax returns. In addition, for this purpose, an administrative adjustment request under §6227 and a partnership adjustment tracking report under §6226(b)(4)(A) are treated as a return.[1721] The penalty also applies to a purported return.[1722]

[1707] §6702(a).

[1708] §6702(b).

[1709] Such test is described at IV.C.4.b. and IV.B.3.a., above.

[1710] Chief Counsel Notice CC-2014-004. *See* PMTA 2014-02 (fully automated decisions do not require supervisor approval). The IRS's position is that the penalty may be assessed at any time, i.e., no assessment statute of limitations applies. For further discussion of the approval provisions under §6751, see XII.A., below. *See* CCA 201348015 (citing *Crites v. Commissioner*, T.C. Memo 2012-267 and *O'Brien v. Commissioner*, T.C. Memo 2012-326).

[1711] *Coleman v. Commissioner*, 791 F.2d 68, 71 (7th Cir. 1986) (dicta).

[1712] CCA 201623010.

[1713] *Coleman v. Commissioner*, 791 F.2d at 72.

[1714] §6702(e).

[1715] §6702(b)(3).

[1716] §6702(d).

[1717] *See* Rev. Proc. 2012-43.

[1718] SCA 200102047.

[1719] CCA 200135024. In appropriate cases, the IRS may also penalize the tax return preparer under §6701 for aiding and abetting. CCA 200135024. See discussion at VIII.B., above.

[1720] §6701(a)(1).

[1721] §6702(f), added by the Consolidated Appropriations Act of 2018, Pub. L. No. 115-141, Div. U, §206(n)(4), effective as if included in the Bipartisan Budget Act of 2015, Pub. L. No. 114-74, §1101 (applicable to to returns filed for partnership tax years beginning after December 31, 2017).

[1722] *See Kestin v. Commissioner*, 153 T.C. 14 (2019) (distinguishing a purported tax return from a mere copy of a tax return — inclusion of copies of 1040X as attachments to letters or notices did not constitute "fil[ing] what pur-

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(2) Frivolous Position

The penalty applies if a position on a return is frivolous.[1723] Although the Code does not define frivolous, the legislative history and case law provide some examples. According to the legislative history, a position is frivolous only if it is patently improper.[1724] One court defined a frivolous position as one which is contrary to established law and is not supported by a reasoned, colorable argument to change the law.[1725] For example, a frivolous position is one: (1) where the information on the return is insufficient to calculate the tax, (2) where the information given is clearly inconsistent (e.g., where an individual taxpayer claims 99 personal exemptions but lists only a few dependents), (3) or where the taxpayer claims clearly unallowable deductions (e.g., a "gold standard deduction" discount because the federal government is not on the gold standard or a "war tax" deduction under which the taxpayer reduces his income or tax based on his estimate of the amount of his taxes going to the defense budget).[1726]

For the penalty to be imposed, the frivolous position must have previously been identified as such by the IRS on the list it is required to publish and periodically revise under §6702(c). That list, however, may not include any position that meets the reasonable basis test under §6662(d)(2)(B)(ii)(II).[1727] That list is set forth in Notice 2010-33.[1728]

Positions that are the same as or similar to the following are considered frivolous:

- Compliance with the internal revenue laws is voluntary or optional and not required by law;
- The Code is not law or its provisions are ineffective or inoperative;
- A taxpayer's income is excluded from tax when the taxpayer rejects or renounces U.S. citizenship;
- Compensation for the performance of personal services is not taxable or is offset by an equivalent deduction for the personal services rendered;
- U.S. citizens and residents are not subject to tax on U.S. source income;
- A taxpayer has been untaxed, detaxed or removed from the federal tax system;
- Only certain types of taxpayers are subject to income and employment taxes;
- Only certain types of income are taxable;
- Federal income taxes are unconstitutional or a taxpayer has a constitutional right not to comply with the federal tax laws (including any of the following: the First Amendment permits a taxpayer to refuse to pay taxes on religious or moral grounds; a taxpayer may withhold payment of taxes or filing tax returns until the government responds to a First Amendment petition for redress; mandatory compliance with or enforcement of the tax laws invades a taxpayer's right to privacy under the Fourth Amendment; the requirement to file a tax return is an unreasonable search and seizure under the Fourth Amendment; taxation is a taking of property without due process in violation of the Fifth Amendment; the Fifth Amendment privilege against self-incrimination grants taxpayers the right not to file returns or to withhold all financial information from the IRS;[1729] the Ninth Amendment exempts those with religious or other objections to military spending from paying taxes to the extent the taxes will be used for military spending;[1730] mandatory or compelled compliance with the tax laws constitutes involuntary servitude prohibited by the Thirteenth Amendment; individuals may not be taxed unless they are a "citizen" within the meaning of the Fourteenth Amendment; the Sixteenth Amendment was not ratified, has no effect, lacks an enabling clause, or does not authorize an unapportioned, direct income tax; or taxation of income to a trust violates the prohibition against impairment of contracts);
- A taxpayer is not a person under the Code;
- Only fiduciaries are taxpayers, or only persons with a fiduciary relationship to the U.S. are obligated to pay taxes and the U.S. must prove such status or relationship;
- Federal Reserve Notes are not taxable income;
- In a transaction using gold and silver coins, the value of the coins is excluded from income or the amount realized

ports to be a return" for purposes of §6702(a)(1)); *Callahan v. Commissioner*, 130 T.C. 44 (2008) (documents requesting refunds are purported returns); *Kelly v. United States*, 789 F.2d 94 (1st Cir. 1986) (correspondence is purported return where taxpayer included sufficient documentation for refund request); *Olson v. United States*, 760 F.2d 1003 (9th Cir. 1985) (unsigned return with no listed wages is purported return); *Lovell v. United States*, 755 F.2d 517 (7th Cir. 1984) (tax returns signed "not a tax return" is still a purported return when filed for refund); *Smith v. Commissioner*, T.C. Memo 2021-29 (Form 1040 copy was intended as evidence of taxpayer's initial purported return claiming refund and thus Form 1040 copy was not considered separate purported return seeking another refund; §6702 penalty was inapplicable to Form 1040 copy), aff'd by unpub. op., No. 22-70051, 2023 BL 233655 (9th Cir. July 10, 2023).

[1723] §6702(a)(1).

[1724] 1982 Act Senate Report at 277.

[1725] *Coleman v. Commissioner*, 791 F.2d 68 (7th Cir. 1986). *Cf.* Reg. §1.6662-3(b)(3) (which defines frivolous as patently improper with respect to standards of conduct for rendering advice regarding tax return position or for signing return); Fed. R. Civ. P. 11 (which uses same standard for sanctions in civil litigation); 28 U.S.C. §1927 (awards of fees); Fed. R. App. P. 38 (awards of damages).

[1726] 1982 Act Senate Report at 278. *But see* FAA 20133303F (taxpayer not subject to §6702 penalty because filed return did not show insufficient information to determine substantial correctness of self-assessment where taxpayer correctly filed tax return with accurate self-assessment, but withheld payment based on "conscientious objection" to military spending).

[1727] §6702(c). The reasonable basis test is described at IV.C.4.b. and IV.B.3.a., above.

[1728] A further discussion of frivolous tax arguments and positions is available on the IRS's website at https://www.irs.gov/privacy-disclosure/the-truth-about-frivolous-tax-arguments-introduction, and at IRM Exhibit 25.25.10-1 (09-13-2018).

[1729] *See Youssefzadeh v. Commissioner*, 2015 BL 373102 (T.C. Order Nov. 6, 2015) (nonprecedential order holding that where taxpayer included correct amount of total interest on Form 1040, Schedule B, yet omitted source and amount information on specific lines, and refused to answer certain Schedule B questions, invoking Fifth Amendment privilege against self-incrimination, return was not frivolous because it was substantially correct and taxpayer showed real and appreciable danger of incriminating himself for failure to file Report of Foreign Bank and Financial Accounts (FBAR)).

[1730] *Compare* FAA 20133303F, discussed above.

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in the transaction is the face value of the coins and not its fair market value;

• A taxpayer who is employed on board a ship that provides meals at no cost to the taxpayer as part of the employment may deduct the cost of such meals;

• A taxpayer may deduct personal expenses or the cost of maintaining the taxpayer's residence in connection with a home-based business;

• A "reparations" tax credit exists;

• A taxpayer who is not an employer may claim the Indian employment credit under §45A;

• A taxpayer's wages are excluded from Social Security taxes if the taxpayer waives the right to receive Social Security benefits, or may claim a charitable contribution deduction for the Social Security taxes paid;

• A taxpayer may reduce or eliminate its federal tax liability by striking out the penalty-of-perjury declaration or by attaching a statement disclaiming liability;

• A taxpayer is not obligated to pay income tax because the government has created an entity separate and distinct from the taxpayer;

• A taxpayer may use a Form 1099 as a financial or other instrument to obtain money from the government;

• A taxpayer may claim a credit for an amount withheld despite it being obviously false;[1731]

• Inserting the phrase "nunc pro tunc" on a return has retroactive effect;

• A taxpayer may avoid tax on income by attributing the income to a trust;

• A taxpayer may avoid tax on income by sending the income offshore;

• A taxpayer can claim the disabled access credit under §44 by purportedly purchasing equipment or services for an inflated price;

• A taxpayer may claim a refund based on purported advance payments to employees of the earned income tax credit that reports an amount of purported compensation but does not report any other information;

• A taxpayer may claim the fuels tax credit under §6421 even though the taxpayer did not purchase the gasoline or the gasoline was not used for an off-highway business use;

• A taxpayer may buy or sell the right to claim a child as a qualifying child for purposes of the earned income credit under §32;

• A Form 23C (Assessment Certificate — Summary Record of Assessment) is not a valid record of assessment, and must be signed personally by the Secretary of the Treasury or must be provided to the taxpayer, if requested;

• A tax cannot be assessed from a substitute for return under §6020(b);

• A statutory notice of deficiency is invalid because the taxpayer did not file a tax return reporting the deficiency or because the notice was not signed by a particular IRS official;

• A notice of the federal tax lien is invalid because it was not signed by a particular IRS official;

• The form or content of a notice of federal tax lien is controlled by state or local law;

• A collection due process notice under §6320 or §6330 is invalid because it was not signed by a particular IRS official, or if no certificate of assessment is attached;

• Verification under §6330 that the requirements of any applicable law or administrative procedure have been met may only be based on particular forms or documents, or that the forms or documents on which the verification was determined must be provided to the taxpayer;[1732]

• Notice and demand is invalid because it was not signed, was not on the correct form or was not accompanied by a certificate of assessment;

• The Tax Court is not a legitimate court or does not have the authority to hear or decide matters within its jurisdiction;

• Federal courts may not enforce the internal revenue laws;

• IRS revenue officers are not authorized to issue levies or notices of federal tax liens, or to seize property to satisfy unpaid taxes;

• IRS employees lack the authority to carry out their duties for the IRS;

• Any person may represent a taxpayer before the IRS or in a court proceeding without a power of attorney and without being enrolled to practice before the IRS or without being admitted to practice before the court;

• A civil action to collect taxes must be personally authorized by the Secretary of the Treasury and the Attorney General;

• A taxpayer's income is not taxable if the taxpayer assigns or attributes the income to a religious organization claimed to be exempt from tax under §501(c)(3);

• The IRS is not an agency of the U.S. government, and has no authority to administer the internal revenue laws; and

[1731] *See Stanojevich v. Commissioner*, 160 T.C. No. 7 (April 10, 2023) (frivolous return penalty and notice of federal tax lien upheld because claiming refund for an obviously false amount of tax withheld equal to amount of taxable income reported on trust income tax returns is indicative that self-assessment is substantially incorrect and reflects a position IRS has identified as frivolous; as trustee, petitioner had responsibility to file the trust returns and, thus, was liable for the penalty).

[1732] *See May v. Commissioner*, T.C. Memo 2014-194 (taxpayer subject to penalty for frivolous argument that verification under §6330 may only be based on particular form or document), supplemented at T.C. Memo 2016-43, aff'd sub nom. *MacPherson v. Commissioner*, 702 Fed. App'x 621 (9th Cir. 2017), cert. denied, 139 S. Ct. 122 (2018).

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• Any position described as frivolous in any revenue ruling or other published guidance before the return or submission adopting the position is filed.

A frivolous filing penalty under §6702 may be imposed if the taxpayer knew or should have known that the position was frivolous or groundless.[1733] Whether the taxpayer should have known is an objective test.[1734] The taxpayer's good faith is irrelevant. Once a frivolous return has been filed, the taxpayer cannot avoid the penalty by filing a corrected, amended return.[1735] In addition, the penalty cannot be abated due to the mental incapacity of the taxpayer.[1736]

Comment: The IRS maintains a Frivolous Return Program database, which keeps track of trends in filing frivolous returns over a period of time.[1737] The database assists the IRS in timely identifying frivolous arguments promoted by a particular individual or group, so that taxpayers can be informed of the frivolous nature of these positions before they become too widespread. The IRS believes that such database is not prohibited by 1998 IRS Reform Act §3707, which prohibits the IRS from designating taxpayers as illegal tax protesters or making any similar designation since the database is separate from and does not interact with the illegal tax protester or similar designations. Congress was concerned that innocent taxpayers might be mislabeled as illegal tax protesters. However, Congress did not intend to limit the IRS's ability to maintain records or make appropriate designations (other than illegal tax protester). The frivolous return database is maintained on a separate computer that does not communicate with, or put the illegal tax protester or any similar designation in, the IRS computer master file.

c. Desire to Delay or Impede Administration of Federal Tax Laws

A document is considered to be filed with a desire to delay or impede administration of the tax laws where, for example, it is not filed in processible form because of altered or incorrect descriptions of line items or other provisions.[1738] Similarly, failing to sign a return,[1739] altering or deleting the jurat which declares that the return is filed under penalties of perjury,[1740] omitting items for spurious constitutional reasons,[1741] or filing "zero returns" (that have zeroes on lines reflecting income and tax despite having wages)[1742] subjects the taxpayer to the penalty. However, a district court has held that the penalty does not apply if the taxpayer merely adds the words "under protest," without otherwise modifying the jurat's words, because the action does not cast doubt on the validity of the jurat and, thus, does not invalidate the document as a tax return.[1743]

In addition, returns or submissions that contain positions that were not identified by the IRS as being frivolous, but which on their face have no basis for validity in existing law or which have been held to be frivolous by a court, may be determined to reflect a desire to delay or impede the administration of federal tax laws.[1744]

Comment: Based on analogies to other provisions, whether a position reflects a desire to delay or impede appears to be a subjective inquiry.[1745] In such case, a good faith belief by the taxpayer in a nonfrivolous position could avoid the delay penalty.

The penalty also does not apply to a taxpayer:[1746]

• Who has a valid dispute with the IRS;[1747]

• Who inadvertently makes a mathematical or clerical error (e.g., inadvertently uses a wrong table);[1748] or

• Who files a return that shows the correct tax but refuses to pay the tax.

[1733] *Coleman v. Commissioner*, 791 F.2d 68 (7th Cir. 1986); *Rakosi v. United States*, 91-2 USTC ¶50,373 (D. Ariz. 1991). *See May v. Commissioner*, 752 F.2d 1301 (8th Cir. 1985) (with respect to §6673 penalty for bringing frivolous suit in Tax Court).

[1734] *Coleman v. Commissioner*, 791 F.2d 68 (7th Cir. 1986); *Rakosi v. United States*, 91-2 USTC ¶50,373 (D. Ariz. 1991).

[1735] *Lydon v. United States*, 84-2 USTC ¶9670 (D.N.H. 1984). *Cf. Badaracco v. Commissioner*, 464 U.S. 386 (1984) (once fraudulent return is filed, case remains one of a "false or fraudulent return," regardless of later filing of correct amended return).

[1736] CCA 201623010.

[1737] IRM Exhibit 25.25.10-2 (09-13-18).

[1738] 1982 Act Senate Report at 278. *Cf.* SCA 200107035 (advising that taxpayer who files altered Form 1040 or homemade income tax form is filing a purported return within meaning of §6702 and, thus, may be subject to frivolous return penalty).

[1739] *See, e.g., McNally v. United States*, 85-2 USTC ¶9544 (N.D. Ohio 1985); *Johns v. United States*, 84-2 USTC ¶9899 (D.N.H. 1984); *Schneider v. United States*, 594 F. Supp. 611 (E.D. Mich. 1984). *But see Hoefker v. United States*, 86-1 USTC ¶9360 (E.D. Ky. 1985).

[1740] *See, e.g.,* 1982 Act Senate Report at 278; *Borgeson v. United States*, 757 F.2d 1071 (10th Cir. 1985); *McNally v. United States*, 85-2 USTC ¶9544 (N.D. Ohio 1985); *Hewlett v. United States*, 84-2 USTC ¶9664 (S.D. Ohio 1984); *Silkman v. United States*, 84-2 USTC ¶9558 (D.S.D. 1984); *Williams v. United States*, 84-2 USTC ¶9778 (E.D. Mich. 1984); *Johnson v. IRS*, 84-2 USTC ¶9812 (N.D. Cal. 1984).

[1741] *See, e.g.,* 1982 Act Senate Report at 278; *Todd v. United States*, 849 F.2d 365 (9th Cir. 1988); *Leogrande v. United States*, 811 F.2d 147 (2d Cir. 1987) cert. denied, 484 U.S. 819 (1987); *Kahn v. United States*, 753 F.2d 1208 (3d Cir. 1985); *Eicher v. United States*, 774 F.2d 27 (1st Cir. 1985); *Buck v. United States*, 756 F. Supp. 1014 (S.D. Tex. 1991), appeal dismissed per curiam, 967 F.2d 1060 (5th Cir. 1992), cert. denied, 506 U.S. 1082 (1993); *Stamp v. United States*, 579 F. Supp. 168 (N.D. Ill. 1984); *Milazzo v. United States*, 578 F. Supp. 248 (S.D. Cal. 1984). *But see Youssefzadeh v. Commissioner*, 2015 BL 373102 (T.C. Order Nov. 6, 2015) (not answering the question on Schedule B relating to foreign bank accounts, because a willful failure to file an FBAR is a crime, but otherwise including the total amount of interest income, was a legitimate invocation of the Fifth Amendment).

[1742] *See, e.g., Sisemore v. United States*, 797 F.2d 268 (6th Cir. 1986); *Coleman v. Commissioner*, 791 F.2d 68 (7th Cir. 1986); *Sullivan v. United States*, 788 F.2d 813 (1st Cir. 1986); *Olson v. United States*, 760 F.2d 1003 (9th Cir. 1985); *Carrillo v. United States*, 2003-1 USTC ¶50,370 (D. Nev. 2003), aff'd, 72 Fed. App'x 732 (9th Cir. 2003); *Smith v. Commissioner*, T.C. Memo 2021-29, aff'd by unpub. op., No. 22-70051, 2023 BL 233655 (9th Cir. July 10, 2023); *Hiland v. Commissioner*, T.C. Memo 2004-225; *Evans v. Commissioner*, T.C. Summ. Op. 2016-34.

[1743] *McCormick v. Peterson*, 94-1 USTC ¶50,026 (E.D.N.Y. 1993), acq. in part, 1998-35 I.R.B. 4 and 1999-1 I.R.B. 5. For further discussion of alteration of the jurat clause, see II.B.3.b., above.

[1744] Notice 2008-14.

[1745] *See Coleman v. Commissioner*, 791 F.2d 68 (7th Cir. 1986) (with respect to §6673. The court also linked §6673 and §6702 as having the same purpose); *In re TCI, Ltd.*, 769 F.2d 441 (7th Cir. 1985) (with respect to 28 U.S.C. §1927).

[1746] 1982 Act Senate Report at 278; *Kahn v. United States*, 753 F.2d 1208 (3d Cir. 1985); *Jenney v. United States*, 755 F.2d 1384 (9th Cir. 1985) (penalty applied because return self-assessed incorrect tax even though statement attached to the return showed correct tax). In such case, however, the IRS can proceed to collect the self-assessed tax immediately and assert the relevant failure to pay penalties.

[1747] 1982 Act Senate Report at 277.

[1748] 1982 Act Senate Report at 277–78. If, however, the error was a deliberate attempt to impede the tax system, the penalty applies.

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The IRS has also not imposed the penalty where the position was based on improper advice given by a tax professional.[1749]

2. Frivolous Positions in Court Penalty

a. Penalty

The Tax Court may impose a penalty under §6673 of up to $25,000 on a taxpayer whenever the court determines that:

- the taxpayer has instituted or maintained proceedings before the court primarily for delay;
- the taxpayer's position in such proceeding is frivolous or groundless; or
- the taxpayer has unreasonably failed to pursue administrative remedies.[1750]

The Tax Court's imposition of penalties under §6673(a)(1) is not subject to the presassessment written management approval requirement contained in §6751(b)(1).[1751]

Comment: The Committee Report to the 1989 Act (which increased the maximum penalty from $5,000 to $25,000) states that this increased penalty is intended to be applied primarily, but not exclusively, to tax shelter cases, for which the prior law maximum was an ineffective deterrent.[1752] Larger penalties have been imposed for repeated failures despite prior warnings and penalties. The 1989 Act also changed the terminology of §6673(a), replacing "damages" with "penalty." The purpose of the change was to make it clear that the United States need not prove specific damages in order for the Tax Court to impose the penalty.[1753]

Attacks on the imposition of a §6673 penalty because the statutory standards are too vague have been rejected.[1754] In upholding the penalty, the Seventh Circuit found:

> The purpose of §6673 … is to induce litigants to conform their behavior to the governing rules, regardless of their subjective beliefs. Groundless litigation diverts the time and energies of judges from more serious claims; it imposes needless costs on other litigants. Once the legal system has resolved a claim, judges and lawyers must move on to other things. They cannot endlessly rehear stale arguments. Both appellants say that the penalties stifle their right to petition for redress of grievances. But there is no constitutional right to bring frivolous suits. People who wish to express displeasure with taxes must choose other forums, and there are many available.[1755]

The Tax Court also can impose costs on an attorney (or other person admitted to practice before the Tax Court) if it determines that the attorney (or other person) has "unreasonably and vexatiously" multiplied the proceedings. In such cases, the Tax Court can require the attorney (or other person) or the government (if the attorney represents the IRS) to pay any excess costs, expenses, and attorneys' fees reasonably incurred because of the conduct. This is similar to a federal court's ability under 28 U.S.C. §1927[1756] to require an attorney (or other person admitted to conduct cases before the court) who unreasonably and vexatiously multiplies the proceedings to satisfy personally the excess costs, expenses, and attorneys' fees reasonably incurred because of such conduct — the statutes serve the same purpose, just in different forums.[1757] As a result, the Tax Court has often looked to cases under 28 U.S.C. §1927 for guidance in interpreting §6673(a)(2).[1758]

District courts can impose a penalty of up to $10,000 on a taxpayer if the taxpayer's position in a proceeding under §7433 asserting unauthorized collection action by the IRS is frivolous or groundless.[1759] Similarly, U.S. Circuit Courts of Appeal may impose sanctions for frivolous litigation.[1760]

In any tax-related court proceeding (other than in Tax Court), any monetary sanctions, penalties, or costs awarded to the government can be assessed by the IRS and, upon notice and demand, collected in the same manner as a tax.[1761] Such amounts awarded by an appeals court or by the Supreme Court can be registered in district court and enforced as a district court judgment.[1762] The IRS can assess such amounts and, upon notice and demand, collect them in the same manner as a tax.[1763]

The penalty is imposed on the taxpayer. In the case of an S corporation, the corporation is not a taxpayer within the meaning of §7701(a)(14). Rather, each shareholder is a taxpayer.

The court can impose the penalty on its own initiative.[1764]

In addition, a United States Court of Appeals or the Supreme Court may impose penalties on a taxpayer in a case where the decision of the Tax Court is affirmed, and either the taxpayer instituted or maintained the appeal primarily for delay

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[1749] CCA 200503031.

[1750] §6673(a)(1). *See, e.g., Smith v. Commissioner*, T.C. Memo 2021-29 (sanction imposed for taxpayer claiming, first in 29-page petition and again in 46-page brief, that money she received from employer for her services was not income), aff'd by unpub. op., No. 22-70051, 2023 BL 233655 (9th Cir. July 10, 2023); *Hill v. Commissioner*, T.C. Memo 2013-264; *Hill v. Commissioner*, T.C. Memo 2013-265 ($10,000 penalty in each of two consolidated cases); *Sawukaytis v. Commissioner*, T.C. Memo 2002-156 ($12,500 penalty), aff'd, 102 Fed. App'x 29 (6th Cir. 2004) (sanctions upheld; additional sanctions imposed jointly and severally against petitioner and attorney under 28 U.S.C. §1912 and Fed. R. App. P. 38), cert. denied, 543 U.S. 1022 (2004). *See also Wheeler v. Commissioner*, 127 T.C. 200 (2006) (IRS fails to satisfy burden of production as to two additions to tax under §6651 and §6654, but Tax Court nevertheless imposes §6673 penalty against taxpayer who maintained proceedings primarily for delay and advanced positions that were frivolous and groundless), aff'd, 528 F.3d 777 (10th Cir. 2008); *Goff v. Commissioner*, 135 T.C. 231 (2010) (sanctions imposed for frivolous grounds and delay where taxpayer argued that liabilities were satisfied on presentation of promissory note).

[1751] *Williams v. Commissioner*, 151 T.C. 1 (2018).

[1752] 1989 Act House Report at 1399.

[1753] 1989 House Report at 1399.

[1754] *See, e.g., Coleman v. Commissioner*, 791 F.2d 68 (7th Cir. 1986); *In re TCI, Ltd.*, 769 F.2d 441 (7th Cir. 1985). Statutes need not be unambiguous in every application to be constitutional. Many words acquire meaning through judicial and administrative construction over the years.

[1755] *Coleman v. Commissioner*, 791 F.2d 68, 72 (7th Cir. 1986).

[1756] A discussion of 28 U.S.C. §1927 is beyond the scope of this Portfolio.

[1757] H.R. Rep. No. 101-247, 101st Cong., 1st Sess. at 1400 (1989).

[1758] *See, e.g., Dixon v. Commissioner*, 132 T.C. 55 (2009); *Tabaka v. Commissioner*, 119 T.C. 285 (2002); *Harper v. Commissioner*, 99 T.C. 533 (1992); *Gillespie v. Commissioner*, T.C. Memo 2007-202, aff'd, 292 Fed. App'x 517 (7th Cir. 2008).

[1759] §6673(b)(1).

[1760] Fed. Rul. App. P. 38. *See, e.g., Szopa v. United States*, 453 F.3d 455 (7th Cir. 2006).

[1761] §6673(b)(2).

[1762] §6673(b)(3).

[1763] §6673(b)(3).

[1764] *See, e.g., Pierson v. Commissioner*, 115 T.C. 576 (2000); *Davenport v. Commissioner*, T.C. Memo 2009-248.

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or the taxpayer's position in the appeal is frivolous or groundless.[1765]

b. Primarily for Delay

Whether a taxpayer has instituted or maintained a case primarily for delay is a subjective test.[1766] Notwithstanding the foregoing, certain actions tend to indicate an intent to delay:[1767]

- Failing to cooperate with the IRS during audit or litigation;
- Failing to comply with discovery requests or orders;
- Failing to diligently prosecute the case;
- Failing to address the merits of the case;
- Making arguments the taxpayer knows are frivolous; and
- Making the same arguments that the taxpayer knows failed in prior cases brought by the taxpayer or others.

The taxpayer's good faith belief in the argument, however, negates the penalty based on delaying tactics.

The suit does not have to be initially brought with a purpose to delay; it is sufficient if it is maintained for such purposes. Accordingly, the penalty may be imposed if the taxpayer continues the proceeding after learning his position is frivolous. Withdrawing the argument after being warned that the position is frivolous may prevent the penalty from being imposed.[1768] In addition, subsequently conceding a position that was brought to delay does not cure the position.[1769]

c. Frivolous or Groundless Position

A petition to the Tax Court is frivolous if it is contrary to established law and is unsupported by a reasoned, colorable argument for a change in the law.[1770] Groundless is similarly defined as being without a basis in law or fact.[1771] The penalty may be imposed if the taxpayer knew or should have known that the argument is groundless.[1772] Should have known is an objective test. The taxpayer's belief in a frivolous position, no matter how sincere, does not prevent the imposition of the penalty.[1773]

Comment: Although an objective test is applied, reasonable reliance on the advice of counsel that a litigation position has merit will negate the penalty.[1774]

Comment: There is no requirement that the taxpayer be warned about the potential imposition of a penalty before it can be imposed. Yet, the Tax Court seems to bend over backward not to impose a penalty if the IRS or the court has not previously advised the taxpayer that his actions could lead to the imposition of a penalty.[1775] In those cases, the court strongly admonished the taxpayer that if he persists in such behavior, a penalty will be imposed.

The Tax Court understands that there is a difference between a frivolous position and one that is ultimately found to be without merit.[1776] Only the former is subject to sanction. The court intends to remain open to all who invoke the protection of the law in good faith; it does not want to impede anyone's ability to bring a good faith claim.

Subsequently conceding a frivolous position does not render the position nonfrivolous.[1777] A penalty may still be imposed. However, abandoning the position promptly after being warned that it is frivolous may prevent the penalty from being imposed.[1778]

d. Failure to Exhaust Administrative Remedies

Section 6673(a)(1)(C) allows the Tax Court to penalize a taxpayer who needlessly involves the court in a dispute that should have been resolved at the Appeals division of the IRS.[1779] As a result, penalties have been imposed, for example, where:

- The taxpayer repeatedly failed to comply with IRS requests for documents, especially where the documents would have resolved the issues,[1780] or
- The taxpayer repeatedly failed to meet with the IRS.[1781]

e. Unreasonably and Vexatiously Multiplied the Proceedings

There are three prerequisites to the Tax Court's ability to make an attorney or other person personally liable for excess costs, expenses and attorney's fees:[1782]

[1765] §7482(c)(4).

[1766] *Coleman v. Commissioner*, 791 F.2d 68 (7th Cir. 1986).

[1767] *See, e.g., The Nis Family Tr. v. Commissioner*, 115 T.C. 523 (2000); *Rollercade, Inc. v. Commissioner*, 97 T.C. 113 (1991); *Birth v. Commissioner*, 92 T.C. 769 (1989); *Davenport v. Commissioner*, T.C. Memo 2009-248; *Cary v. Commissioner*, T.C. Memo 1988-128, aff'd without published op., 900 F.2d 262 (9th Cir. 1990). See discussion at VIII.C.1.c., above, relating to filing a return with an intent to delay.

[1768] *Martens v. Commissioner*, T.C. Memo 2015-213.

[1769] *See, e.g., Sloan v. Commissioner*, 102 T.C. 137 (1994), aff'd, 53 F.3d 799 (7th Cir. 1995), cert. denied, 516 U.S. 897 (1995); *Marville v. Commissioner*, T.C. Memo 1985-250.

[1770] *Coleman v. Commissioner*, 791 F.2d 68, 71 (7th Cir. 1986).

[1771] *Horn v. Commissioner*, 90 T.C. 908 (1988).

[1772] *Horn v. Commissioner*, 90 T.C. 908 (1988); *May v. Commissioner*, 752 F.2d 1301 (8th Cir. 1985).

[1773] *See, e.g., Coleman v. Commissioner*, 791 F.2d 68 (7th Cir. 1986).

[1774] *See, e.g., Neonatology Assocs., P.A. v. Commissioner*, 115 T.C. 43 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002).

[1775] *See, e.g., Pierson v. Commissioner*, 115 T.C. 576 (2000); *Briggsdaniels v. Commissioner*, T.C. Memo 2001-321; *Olmos v. Commissioner*, T.C. Memo 2007-82; *Shireman v. Commissioner*, T.C. Memo 2004-155; *Licha v. Commissioner*, T.C. Memo 2011-275; *Kaye v. Commissioner*, T.C. Memo 2014-145; *Martens v. Commissioner*, T.C. Memo 2015-213; *Hardin v. Commissioner*, T.C. Memo 2016-141; *Snodgrass v. Commissioner*, T.C. Memo 2016-235.

[1776] *See, e.g., Johnson v. Commissioner*, T.C. Memo 1986-488; *Bowen v. Commissioner*, T.C. Memo 2001-47; *Booker v. Commissioner*, T.C. Memo 1996-261.

[1777] *See, e.g., Page v. Commissioner*, 58 F.3d 1342 (8th Cir. 1995).

[1778] *Martens v. Commissioner*, T.C. Memo 2015-213.

[1779] 1986 Blue Book at 1300.

[1780] *See, e.g., Rollercade, Inc. v. Commissioner*, 97 T.C. 113 (1991); *Birth v. Commissioner*, 92 T.C. 769 (1989); *Chook v. Commissioner*, T.C. Memo 2007-17.

[1781] *See, e.g., Suri v. Commissioner*, T.C. Memo 2004-71, aff'd, 96 AFTR 2d 2005-6526 (2d Cir. 2005); *Chook v. Commissioner*, T.C. Memo 2007-17.

[1782] §6673(a)(2); *Gillespie v. Commissioner*, T.C. Memo 2007-202, aff'd, 292 Fed. App'x 517 (7th Cir. 2008); *Davis v. Commissioner*, T.C. Memo 2007-201, aff'd, 301 Fed. App'x 398 (6th Cir. 2008), cert. denied, 558 U.S. 877 (2009), *May v. Commissioner*, T.C. Memo 2014-194, supplemented at T.C. Memo 2016-43 and *Best v. Commissioner*, T.C. Memo 2014-72, supplemented at T.C. Memo 2016-32, aff'd sub nom. *MacPherson v. Commissioner*, 702 Fed. App'x 621 (9th Cir. 2017), cert. denied, 129 S. Ct. 122 (2018). *See Amlong & Amlong, P.A. v. Denny's Inc.*, 457 F.3d 1180 (11th Cir. 2006) (with respect to 28 U.S.C. §1927), amended by 500 F.3d 1230 (11th Cir. 2006), cert. denied, 568 U.S. 813 (2012).

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• The attorney or other person must engage in unreasonable and vexatious conduct;

• Such conduct must multiply the proceedings in the case; and

• The sanction may not exceed the costs, expenses and attorney's fees reasonably incurred because of such conduct.

The penalty can apply against a government attorney as well as against an attorney for the taxpayer.[1783]

Comment: The purpose of the penalty is to deter frivolous litigation and abusive practices by attorneys by ensuring that those who create unnecessary costs personally bear such costs.[1784]

Congress did not specify the degree of culpability required for the penalty. While most Courts of Appeals have required a showing of bad faith before awarding costs under the analogous provision 28 U.S.C. §1927, a few courts have only required a showing of recklessness, which is a lesser degree of culpability.[1785] Many of the courts that required bad faith have determined that bad faith is not a subjective concept, but that reckless or extremely negligent conduct constitutes bad faith for this purpose.[1786] The Tax Court has adopted this approach.[1787]

Cases which should not be brought, for example, because the attorney knows the arguments are frivolous or groundless are considered to multiply the proceeding.[1788] Attorneys have a duty to ensure there is merit to every action they bring before the Tax Court.[1789] There is some disagreement in the Courts of Appeals in interpreting 28 U.S.C. §1927 as to whether it is only possible to multiply or prolong a proceeding after a case has been initiated.[1790] The issue has not been addressed by the Tax Court under §6673.[1791]

The amount of the penalty cannot exceed the additional cost incurred as a result of the culpable conduct. The additional cost need not actually be borne by the opposing party; it is sufficient if it is incurred by his counsel.[1792] That way the deterrent still applies to pro bono, fixed fee and contingent fee cases.

The maximum penalty, called the "lodestar amount," is equal to the product of additional hours expended on the case as a result of the sanctioned conduct, multiplied by a reasonable hourly rate.[1793] In the case of an attorney in private practice, his actual hourly rate is probative of the market rate. Where the attorney is on salary, such as a government lawyer, the hourly rate of an attorney with similar skills in the area is used.[1794]

D. Procedural Rules

1. Coordination of Penalties

The penalties described above in this section VIII are in addition to any other penalty provided by law.[1795] Nevertheless, if an aiding and abetting penalty is imposed under §6701, no preparer understatement penalty under §6694 or penalty for promoting an abusive tax shelter under §6700 can be imposed.[1796]

2. Burden of Proof

The IRS bears the burden of proving that a person is liable for any penalty for promoting an abusive tax shelter under §6700, aiding and abetting an understatement of tax under §6701, or making a frivolous tax submission under §6702.[1797]

With respect to the penalties under §6700 and §6702, the government has the burden of proof and must be sustained by a preponderance of the evidence.[1798] With respect to the aiding and abetting penalty under §6701, however, the courts are divided, depending on whether §6701 is viewed as the equivalent of a fraud statute.[1799] The Second, Eighth and Ninth Circuits ap-

[1783] §6673(a)(2)(B).

[1784] *Dixon v. Commissioner*, 132 T.C. 55 (2009). *See Riddle & Assoc., P.C. v. Kelly*, 414 F.3d 832 (7th Cir. 2005); *Kapco Mfg. Co. v. C & O Enters., Inc.*, 886 F.2d 1485 (7th Cir. 1989) (with respect to 28 U.S.C. §1927).

[1785] Compare, e.g., *In re Prudential Ins. Co. Am. Sales Practices Litig. Agent Actions*, 278 F.3d 175 (3d Cir. 2002); *Fox Valley Constr. Workers Fringe Benefit Funds v. Pride of the Fox Masonry & Expert Restorations*, 140 F.3d 661 (7th Cir. 1998) (requiring bad faith) with *Reliance Ins. Co. v. Sweeney Corp.*, 792 F.2d 1137 (D.C. Cir. 1986) *and Red Carpet Studios Div. of Source Advantage, Ltd. v. Sater*, 465 F.3d 642 (6th Cir. 2006) (requiring only recklessness).

[1786] *See, e.g., IDS Life Ins. Co. v. Royal Alliance Assoc. Inc.*, 266 F.3d 645 (7th Cir. 2001); *McLane, Graf, Raulerson & Middleton, P.A. v. Rechberger*, 280 F.3d 26 (1st Cir. 2002); *Proctor & Gamble Co. v. Amway Corp.*, 280 F.3d 519 (5th Cir. 2002); *B.K.B. v. Maui Police Dep't*, 276 F.3d 1091 (9th Cir. 2002), amended, 2002 U.S. App. LEXIS 2602 (9th Cir. 2002), amended, 2002 Cal. Daily Op. Service 1594 (9th Cir. 2002).

[1787] *See, e.g., Johnson v. Commissioner*, 116 T.C. 111 (2001), aff'd, 289 F.3d 452 (7th Cir. 2002); *Tabaka v. Commissioner*, 119 T.C. 285 (2002).

[1788] *See, e.g., Gillespie v. Commissioner*, T.C. Memo 2007-202, aff'd, 292 Fed. App'x 517 (7th Cir. 2008); *Davis v. Commissioner*, T.C. Memo 2007-201, aff'd, 301 Fed. App'x 398 (6th Cir. 2008), cert. denied, 558 U.S. 877 (2009).

[1789] Tax Court Rules 33(b), 50(a). *See* ABA Model Rules of Professional Conduct 3.1.

[1790] Compare, e.g., *Moore v. Keegan Mgt. Co.*, 78 F.3d 431 (9th Cir. 1996) (applies only to unnecessary filings and tactics once a lawsuit has begun) with *In re TCI Ltd.*, 769 F.2d 441 (7th Cir. 1985) (judge has authority to award the fees incurred from the beginning).

[1791] *See Davis v. Commissioner*, T.C. Memo 2007-201, aff'd, 301 Fed. App'x 398 (6th Cir. 2008), cert. denied, 558 U.S. 877 (2009).

[1792] *Dixon v. Commissioner*, 132 T.C. 55 (2009). The court distinguished the prevailing party statutes, which apply only to actual out-of-pocket costs, as having a compensatory as opposed to a punitive purpose. *See Wisconsin v. Hotline Indus., Inc.*, 236 F.3d 363 (7th Cir. 2000) (with respect to 28 U.S.C. §1927).

[1793] *See, e.g., Tabaka v. Commissioner*, 119 T.C. 285 (2002).

[1794] *Dixon v. Commissioner*, 132 T.C. 55 (2009).

[1795] §6700(c), §6701(f)(1), §6702(e), §6708(b). Cf. §7408.

[1796] §6701(f)(2), §6701(f)(3). See discussion at VII.C.6. and VII.F.1., above.

[1797] §6703(a). Burden of proof is discussed at XII.A.3., below.

[1798] *See, e.g., Lemay v. Commissioner*, No. 20-9001, 2021 BL 333937 (10th Cir. Sept. 2, 2021) (No error where Tax Court applied preponderance-of-the-evidence standard; even if court applied clear-and-convincing standard of proof, government still presented more than sufficient evidence to establish promoter's liability under §6700); *United States v. H & L Schwartz, Inc.*, 87-2 USTC ¶9643 (C.D. Cal. 1987), aff'd sub nom., *Bond v. United States*, 872 F.2d 898 (9th Cir. 1989); *Barr v. United States*, 67 F.3d 469 (2d Cir. 1995), *United States v. Estate Pres. Servs.*, 202 F.3d 1093 (9th Cir. 2000); *Franklet v. United States*, 578 F. Supp. 1552 (N.D. Cal. 1984), aff'd, 761 F.2d 529 (9th Cir. 1985); and *Martens v. Commissioner*, T.C. Memo 2015-213.

[1799] *Compare Mattingly v. United States*, 924 F.2d 785 (8th Cir. 1991); *Barr v. United States*, 67 F.3d 469 (2d Cir. 1995); *Mitchell v. United States*, 109 B.R. 434 (Bankr. W.D. Wash. 1989), aff'd, 90-2 USTC ¶50,495 (W.D. Wash. 1990), rev'd on other issue, 977 F.2d 1318 (9th Cir. 1992); *Rodrigues v. United States*, 797 F. Supp. 122 (D.R.I. 1992); and *United States v. Schiff*, 269 F. Supp. 2d 1262 (D. Nev. 2003), aff'd, 379 F.3d 621 (9th Cir. 2004), cert. denied, 546 U.S. 812 (2005) (requires proof by preponderance of the evidence), with *Warner v. United States*, 700 F. Supp. 532 (S.D. Fla. 1988), summ. judgment *denied*, partial summ. judgment *granted*, 726 F. Supp. 1287 (S.D. Fla. 1989), aff'd without published op., 979 F.2d 212 (11th Cir. 1992) and *Carlson v. United States*, 754 F.3d 1223 (11th Cir. 2014) (requires proof by clear and convinc-

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ply the general preponderance of the evidence rule, while the Eleventh Circuit applies the higher clear and convincing evidence standard that applies to fraud provisions.

The burden of production is on the government in any court proceeding related to an individual's liability for a penalty.[1800]

3. Statute of Limitations

The penalties under §6700 (relating to organizing or promoting a tax shelter), §6701 (relating to aiding and abetting an understatement of tax), and §6708 (relating to maintaining a list of advisees in a reportable transaction) can be assessed at any time.[1801] Because they do not depend on the filing of a return, the three-year statute of limitations under §6501 does not apply.[1802] Moreover, the default provision of 28 U.S.C. §2462, which generally provides a five-year statute of limitations where no other statute is provided, does not apply. This is consistent with other anti-fraud provisions that typically provide an unlimited period for assessment.

The §6700 and §6701 penalties may be assessed against a promoter or preparer after their death and collected from their estate.[1803]

In the case of a §6702 frivolous return penalty, the statute of limitations depends on the sufficiency of the return. For example, if the return is a valid return that includes an obvious frivolous position, the three-year statute of limitations applies.[1804] On the other hand, if the document does not contain sufficient information from which to compute the tax, it is not a valid return, and the penalty may be assessed at any time.[1805]

The penalty under §6707 (relating to a taxpayer's failure to report information relating to a reportable transactions) or §6707A (relating to a material advisor's failure to report information relating to a reportable transaction) generally must be assessed within three years from the date the return is filed.[1806] If no return is filed, the assessment can be made at any time.[1807] In addition, an assessment of a §6707 penalty may be made within the extended statute of limitations under §6501(c)(10).[1808]

Once an assessment is made, the 10-year statute of limitations on collection applies in each case.[1809] The statute, however, is extended for the period during which the IRS is prohibited from collecting the penalty by levy or proceeding in court.[1810]

4. Deficiency Procedures/Appeals Do Not Apply

The §6211–§6216 deficiency procedures do not apply to penalty assessments or collection for any promoter or protester nor to penalties relating to frivolous positions.[1811] A pre-assessment hearing is not required.[1812] As a result, subject to the special rule described below, the only remedy is to pay the entire penalty and sue for a refund.[1813]

A penalty is not abated as a result of a promoter's death and may be assessed against the promoter's estate.[1814]

IRS Independent Office of Appeals consideration is not available for administrative determinations based on a frivolous position, which include any cases solely involving the failure or refusal to comply with tax laws because of frivolous moral, religious, political, constitutional, conscientious or similar grounds. Similarly, Appeals consideration is not available for penalty assessments related to frivolous positions or submissions, or providing false information.[1815]

5. Special Procedures to Contest §6700 or §6701 Penalty

A special procedure allows a promoter or advisor to contest a §6700 abusive tax shelter or §6701 aiding and abetting penalty without first having to pay the entire amount of the penalty.[1816] The special procedure, however, does not apply in the case of a frivolous income tax return penalty under

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ing evidence; §6701 is essentially a fraud statute since it requires the person to have known the position would result in an understatement of tax). See also discussion relating to the statute of limitations on assessment at VIII.D.3., below.

[1800] §7491(c).

[1801] *Capozzi v. United States*, 980 F.2d 872 (2d Cir. 1992); *Sage v. United States*, 908 F.2d 18 (5th Cir. 1990); *In re Tax Refund Litig.*, 766 F. Supp. 1248 (E.D.N.Y. 1991), aff'd in part and rev'd in part, 989 F.2d 1290 (2d Cir. 1993); *Armstrong v. United States*, No. 18-CV-06532-LHK, 2019 BL 228436 (N.D. Cal. Jun. 20, 2019); *Agbanc, Ltd. v. United States*, 707 F. Supp. 423 (D. Ariz. 1988); *Hargrove & Costanzo v. United States*, 2008-2 USTC ¶50,545 (E.D. Cal. 2008); *Groves v. United States*, No. 16 C 2485 (N.D. Ill. May 5, 2017) and IRM 4.32.2.12.5(1) (with respect to §6700); *Mullikin v. United States*, 952 F.2d 920 (6th Cir. 1991), cert. denied, 506 U.S. 827 (1992); *Kuchan v. United States*, 679 F. Supp. 764 (N.D. Ill. 1988); IRM 4.32.2.12.6 and CCA 201531015 (with respect to §6701); *Lamb v. United States*, 977 F.2d 1296 (8th Cir. 1992); *Emanuel v. United States*, 705 F. Supp. 434 (N.D. Ill. 1989) (with respect to §6700 and §6701); IRM 4.32.2.12.8 (with respect to §6708).

[1802] *See Crim v. Commissioner*, No. 21-1260, 2023 BL 147735 (D.C. Cir. May 2, 2023), where the court found that an assessment of §6700 abusive tax shelter promoter penalties was not barred by the statute of limitations under §6501(a) or 28 U.S.C. §2462, since the statute of limitations was triggered only when a return was filed. *See also Armstrong v. United States*, No. 18-CV-06532-LHK, 2019 BL 228436 (N.D. Cal. Jun. 20, 2019) (28 U.S.C. §2462 applies only to action, suit or proceeding).

[1803] *See* CCA 201235017, CCA 201039028; *Reiserer v. United States*, 479 F.3d 1160 (9th Cir. 2007).

[1804] *See* §6501(a).

[1805] FSA 200035015 (§6501 limitations period applies to assessment of the §6702 penalty only if the refund claim is valid or the IRS waives defects and processes the claim). See discussion with respect to the sufficiency of a return at II.B.3., above.

[1806] CCA 201047022; IRM 20.1.13.3.3 (07-13-22), IRM 20.1.13.3.3.1 (07-13-22) (re §6707A), former IRM 20.1.6.21(1)(e) (re §6707), IRM 4.32.2.11 (06-08-12). *See May v. United States*, 691 Fed. App'x 334 (9th Cir. 2017).

[1807] §6501(c)(3); IRM 20.1.13.3.3.2(2).

[1808] See discussion at VIII.A.2.a.(7), above.

[1809] §6502(a), §6703(c).

[1810] §6703(c). See discussion of special contest procedures at VIII.D.5., below.

[1811] §6703(b) (§6700 penalty for promoting an abusive tax shelter, §6701 penalty for aiding and abetting an understatement of tax, and §6702 penalty for filing a frivolous return); CCA 200112003 (§6707 penalty for a material advisor's failure to furnish information with respect to a reportable transaction); *Smith v. Commissioner*, 133 T.C. 424 (2009); IRM 33.1.2.8(10).

[1812] *Bob Jones Univ. v. Simon*, 416 U.S. 725 (1974); *Phillips v. Commissioner*, 283 U.S. 589 (1931); *United States v. Sullivan*, 274 U.S. 259 (1927); *Todd v. United States*, 849 F.2d 365 (9th Cir. 1988).

[1813] *See, e.g., Hansen v. Commissioner*, T.C. Memo 1996-158; *Meeker v. Commissioner*, T.C. Memo 2005-146; *Sherwood v. Commissioner*, T.C. Memo 2005-268.

[1814] *Reiserer v. Commissioner*, 479 F.3d 1160 (9th Cir. 2007).

[1815] Reg. §301.7803-2(c)(1), §301.7803-2(c)(2), T.D. 10030, 90 Fed. Reg. 3645 (Jan. 15, 2025), applicable to requests for Appeals consideration made after February 13, 2025. *See also* §6702(c), §7803(e)(5)(D); Reg. §601.106(b); Notice 2010-33; IRM 8.22.5.5.3.

[1816] §6703(c). The special procedure is generally similar to that provided for tax return preparers under §6694(c), which is described at VII.E.5., above. 1982 Act Senate Report at 270.

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§6702.[1817] Thus, taxpayers wishing to contest a frivolous return penalty must pay the full penalty before seeking a judicial review of the penalty's imposition.

Under the special procedure, a person against whom the IRS assesses a §6700 or §6701 penalty can delay collection action by paying at least 15% of the penalty amount and filing a claim for refund within 30 days after the date on which the IRS gives notice and demand for payment.[1818] In such case, the IRS is barred from levying or proceeding in court for the collection of the remainder of the penalty until 30 days after the claim for refund is denied (or 30 days after the expiration of six months from the filing of the claim, if earlier).[1819]

If the claim for refund is denied (or the six-month period expires), the person can extend the bar on collection by filing a petition in federal district court within 30 days.[1820] In such case, the IRS cannot collect the balance of the penalty until the proceeding is finally resolved. For this purpose, final resolution generally occurs when the district court decision becomes final.[1821]

The prohibition on collection can be enforced by an injunction from the proper court, notwithstanding the anti-injunction rule of §7421(a).[1822]

The IRS can file a counterclaim against such person in the proceeding.[1823] This permits all issues related to the penalty to be considered in the same lawsuit.

Although failure to file a petition within the 30-day period allows the IRS to collect the balance of the penalty, it does not prohibit the promoter or advisor from paying the penalty in full and bringing a refund suit under the general provisions, within the normal statute of limitations.[1824]

The statute of limitations for collection of the penalty is suspended during the time that the IRS is prohibited from levying or instituting a collection proceeding.[1825]

E. COVID-ERTC Promoter Penalty

1. In General

Any promoter of the §3134 COVID employee retention tax credit (COVID-ERTC) that provides aid, assistance, or advice for any COVID-ERTC document after July 4, 2025, is subject to a $1,000 penalty for each failure to comply with due diligence requirements for determining eligibility or the amount of any credit or advance payment of the credit.[1826] The §3134 credit or credit refund is disallowed after July 4, 2025, unless a credit or refund claim was filed by the taxpayer before February 1, 2024.[1827] For further discussion of the COVID-ERTC, see 392 T.M., *Withholding, Social Security, and Unemployment Taxes on Compensation.*

In addition to the COVID-ERTC promoter penalty, after July 4, 2025 the §6676 penalty applies to erroneous claims for COVID-ERTC refund or credit.[1828] For further discussion of the §6676 penalty, see IV.K., above.

2. Requirements

A "COVID-ERTC promoter" provides aid, assistance, or advice for any COVID-ERTC document and:

- charges or receives a fee based on the refund or credit amount and for the service or preceding tax year aggregate gross receipts for providing the services exceed 20% of gross receipts for that year; or
- for the preceding or service tax year:
  - gross receipts for all COVID-ERTC document services exceed 50% of total gross receipts for that tax year; or
  - such person's[1829] service aggregate gross receipts exceed 20% of total gross receipts and exceed $500,000.[1830]

Section 7705 certified professional employer organizations are excluded.[1831] The same promoter criteria apply to short tax years.[1832]

"COVID-ERTC document" comprises any return, affidavit, claim, or other document related to any COVID-ERTC or credit advance payment, including any document related to eligibility or determining credit or advance payment amount.[1833]

The COVID-ERTC penalty applies to any COVID-ERTC document associated with a return or refund claim.[1834] The penalty is treated as a §6695(g) penalty for failure to be diligent in determining eligibility for certain tax benefits.[1835] Due diligence requirements are like those under §6695(g) and thus likely governed by guidance similar to Reg. §1.6695-2 and provided by Form 8867, *Paid Preparer's Due Diligence Checklist.*[1836] The penalty is not subject to deficiency procedures because it is treated as a §6695(g) penalty.[1837]

The COVID-ERTC promoter penalty is assessable under §6201.[1838] An extended six-year assessment period applies for any amount attributable to a deduction for improperly claimed

[1817] 1989 Act House Report at 1399.
[1818] §6703(c)(1).
[1819] §6703(c)(1), §6703(c)(2).
[1820] §6703(c)(2).
[1821] 1982 Act Senate Report at 271.
[1822] 1982 Act Senate Report at 271; §6703(c)(1).
[1823] §6703(c)(1).
[1824] *Dalton v. United States*, 85-2 USTC ¶9754 (W.D.N.C. 1985), aff'd, 800 F.2d 1316 (4th Cir. 1986), cert. denied, 481 U.S. 1024 (1987).
[1825] §6703(c)(3).
[1826] The One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70605(a)(1).
[1827] *See* the OBBBA, §70605(d), applicable to credits and refunds allowed or made after July 4, 2025.
[1828] *See* the OBBBA, §70605(f).
[1829] All persons treated as a single employer under §52(a), §52(b), §414(m), or §414(o) are treated as one person. *See* the OBBBA, §70605(b)(3).
[1830] *See* the OBBBA, §70605(b)(1).
[1831] *See* the OBBBA, §70605(b)(2).
[1832] *See* the OBBBA, §70605(b)(4).
[1833] *See* the OBBBA, §70605(c).
[1834] *See* the OBBBA, §70605(a)(3).
[1835] *See* the OBBBA, §70605(a)(4), applicable to COVID-ERTC aid, assistance, and advice provided after July 4, 2025.
[1836] *See* the OBBBA, §70605(a)(2). For further discussion of the §6695(g) due diligence requirements, see VII.D., above.
[1837] *See* §6696(b) penalty. For further discussion of the §6695(g) assessment procedures, see VII.E., above.
[1838] *See* the OBBBA, §70605(a)(4).

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ERTC wages.[1839] For assessments made after July 4, 2025, the IRS can assess up to six years after the latest of:

- the original return date including the calendar quarter the credit is determined filed;
- the date the return is treated as filed under §6501(b)(2); or
- the date the claim for the credit or refund is made.[1840]

For further discussion of the COVID-ERTC, see 392 T.M., *Withholding, Social Security, and Unemployment Taxes on Compensation.*

[1839] For purposes of the COVID-ERTC, the term "improperly claimed ERTC wages" means the wages for a deduction that would not have been allowed if the portion of the credit for such assessment relates had been properly claimed. *See* §3134(l), amended by the OBBBA, §70605(e), applicable to assessments made after July 4, 2025. *See also* §3134(e) (referencing §280C(a), disallowing deduction for wages for which a credit is taken).

[1840] §3134(l). For further discussion of procedural rules for promoter penalties, see VIII.D., above.

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IX. Compensation Statements, Pension Plans, Exempt Organizations, Education Programs and Other Reporting

A. *Compensation*

1. *Employee Statements*

Every employer is required to furnish each employee with a statement describing, among other things, the amount of wages paid by the employer to the employee and the taxes withheld from such wages during the calendar year.[1841] The statement, made on Form W-2 (Wage and Tax Statement), must be provided to the employee by January 31 of the succeeding year.[1842]

If the employer willfully fails to furnish a timely statement showing all of the required information or willfully furnishes a false or fraudulent statement, the employer is penalized $50 for each failure. The penalty is in addition to any criminal penalty imposed under §7204 and is assessed and collected in the same manner as the employer portion of the FICA tax.[1843]

2. *False Information with Respect to Withholding*

Every employee is required to file a Form W-4, *Employee's Withholding Certificate*, with his employer, advising the employer of the number of withholding allowances that the employee is permitted.[1844] In addition, recipients of certain types of payments must furnish their taxpayer identification numbers or claim exemption from backup withholding on a Form W-9, *Request for Taxpayer Identification Number and Certification*.[1845]

A $500 penalty is imposed on any individual who makes a withholding statement for which there is no reasonable basis if it results in a reduction in the amount of tax deducted and withheld from the individual's wages.[1846] There is a reasonable basis for the number of exemptions claimed on a Form W-4 if it is computed in accordance with its instructions.[1847] In the case of a Form W-9, there is a reasonable basis if the individual includes his correct taxpayer identification number and, with respect to interest or dividends, if before filing the statement, the IRS has not notified the individual that he is subject to backup withholding or, if previously subject to backup withholding, the IRS has notified him in writing that the backup withholding has terminated.[1848]

In addition, the IRS can waive the penalty (in whole or in part) if the individual's income tax for the taxable year is not more than the amount of credits available and estimated tax payments made with respect to that tax.[1849]

If the penalty applies, the IRS can collect it without regard to the deficiency procedures of subchapter 63B.[1850]

3. *Tips*

Any person who, during any month in the course of his employment, receives tips that are treated as wages under §3121(a) or §3401(a) or as compensation under §3231(e) must report such tips to the employer on or before the 10th day of the following month and may do so on Form 4070, *Employee's Report of Tips to Employer*.[1851]

If the employee fails to report his tips at the time and in the manner required, he is subject to a penalty equal to 50% of the employee's portion of the FICA tax or Railroad Retirement tax on such amount, whichever applies.[1852] The penalty is not imposed, however, if the failure is due to reasonable cause and not willful neglect.[1853]

B. *Reports Relating to Plan Participants*

1. *In General*

The plan administrator of a qualified employee retirement benefit plan must file special reports that meet the ERISA vesting standards (a "Reporting Plan"). The plan administrator is personally liable for a penalty if the report is not timely filed. The penalty is collectible upon notice and demand, in the same manner as a tax.[1854] If more than one person is liable for the penalty, they all are jointly and severally liable.[1855]

2. *Annual Registration*

The plan administrator of a Reporting Plan must file a registration statement with the IRS relating to the deferred vested retirement benefit of plan participants who separated from service during the plan year.[1856] The statement is made on a Form 8955-SSA, filed with the plan's Form 5500, *Annual Return/Report of Employee Benefit Plan*, which is due on or before the last day of the seventh month after the end of the plan year (plus any extensions).[1857]

[1841] §6051(a), §6053(b).

[1842] §6051(a), §6053(b); Reg. §31.6051-1(d), §31.6053-2(b). Extensions of time to file Form W-2 with the SSA are not automatic, and filers may request one 30-day extension to file Form W-2 by submitting Form 8809, *Application for Extension of Time to File Information Returns*, including a detailed explanation of why additional time is needed. Extensions generally are granted only in extraordinary circumstances or due to catastrophe. *See* General Instructions for Forms W-2 and W-3. An extension of time to file payee statements may be obtained by filing Form 15397, *Application for Extension of Time to Furnish Recipient Statements*.

[1843] §6674.

[1844] §3402(f). The Secretary of the Treasury may administer §3402 for tax years beginning before January 1, 2019, without regard to the amendments made by Pub. L. No. 115-97, §11041(c). Pub. L. No. 115-97, §11041(f)(2).

[1845] *See* §3406; Reg. §31.3406(h)-3.

[1846] §6682(a).

[1847] Reg. §31.6682-1(a).

[1848] *See* Reg. §31.3406(h)-2(g), §31.6682-1(a).

[1849] §6682(b).

[1850] §6682(c). *See* §6665 and §6671(a), discussed at XII., below.

[1851] §6053(a); Reg. §31.6053-1(b)(2).

[1852] §6652(b). The penalty is in addition to the FICA or Railroad Retirement tax.

[1853] §6652(b). See discussion at XI., below.

[1854] Reg. §301.6652-3(d).

[1855] Reg. §301.6652-3(c).

[1856] §6057(a). For further discussion of reporting requirements, see 361 T.M., *Reporting and Disclosure Under ERISA*.

[1857] Reg. §301.6057-1(a)(4); Instructions for Form 5500. This filing is among the acts whose deadlines may be postponed under §7508 and §7508A when the IRS publishes guidance providing relief related to a specific combat zone, qualifying deployment in a contingency operation, federally declared disaster, significant fire, or terroristic or military action. §7508A was amended by the Infrastructure Investment and Jobs Act to include significant fires for which assistance is provided after November 15, 2021. Pub. L. No. 117-58, §80504. See Tables, Charts & Lists > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or*

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A penalty of $10 a day is imposed with respect to each separated participant who is not included in the annual registration statement, up to a maximum of $50,000 for any plan year, unless the failure is due to reasonable cause.[1858]

3. Notification of Change

If there is a change in the name of the Reporting Plan, or the plan administrator, or if there is a termination, merger, consolidation, or division of the Reporting Plan, the plan administrator must notify the IRS.[1859]

Failure to notify the IRS of the change in status subjects the plan administrator to a penalty of $10 for each day that the failure continues, up to a maximum of $10,000 on any person.[1860] The penalty does not apply, however, if the failure is due to reasonable cause.[1861]

4. Statement to Plan Participants

A Reporting Plan must provide each participant who separated from service during the plan year a statement describing his deferred vested benefit under the plan and any benefits that are forfeitable if he dies before a certain date.[1862] The statement must be delivered to the participant (or sent to his last known address) no later than the due date for filing Form 5500 for the plan year (including any extensions of time to file the return).[1863]

A plan administrator who willfully fails to furnish the statement showing the required information, in the manner and at the time required, is subject to a $50 penalty for each failure. The penalty is assessed and collected in the same manner as the FICA tax on employers.[1864]

5. Reasonable Cause Exception

The penalties do not apply if the failure is due to reasonable cause.[1865] The plan administrator must make an affirmative showing of reasonable cause in the form of a written statement, made under penalties of perjury, setting forth all facts alleged as reasonable cause.[1866] Reasonable cause is discussed at XI., below.

C. Notices to Recipients of ERISA Qualified Plan Distributions

1. Notices Regarding Withholding

The payor of a distribution from an ERISA qualified plan must notify the participant of his right to elect not to have tax withheld from the distribution.[1867] In the case of a periodic payment, the notice must be given not earlier than six months before the first payment is made and not later than the first payment.[1868] For nonperiodic distributions, the payor must give notice not earlier than six months before the distribution and not later than a date that gives the payee reasonable time, under the facts and circumstances, to elect not to have withholding apply and to reply to the payor with the election information.[1869]

A payor who does not timely provide the required notice is subject to a penalty of $100 for each failure, unless the failure is due to reasonable cause and not willful neglect, up to a maximum of $50,000 in any calendar year.[1870] The penalty is due upon notice and demand, in the same manner as a tax.[1871]

2. Notices Regarding Rollovers

If a distribution from an ERISA qualified plan qualifies for rollover treatment, the plan administrator must provide the recipient with a written explanation of the rollover provisions.[1872]

If the plan administrator does not provide the required statement, he is subject to a penalty of $100 for each failure, but the total amount imposed for all such failures in any calendar year cannot exceed $50,000. The penalty is payable on notice and demand, in the same manner as a tax. The penalty, however, may not be imposed if the failure is due to reasonable cause and not willful neglect.[1873] Reasonable cause is discussed at XI., below.

D. Exempt Organizations and Certain Trusts

1. In General

Information returns, excise tax returns, and other types of reports must be filed by exempt organizations and trusts, including political groups organized under §527, unless an exception applies. Such returns and reports must be filed electronically, effective for tax years beginning after July 1, 2019.[1874]

Note: Transitional relief from the filing requirements is provided for certain small organizations and others for which the IRS determines that e-filing would constitute an undue hardship in the absence of additional transitional time. Relief also may be granted for the filing of Form 990-T.[1875]

Terroristic or Military Actions, for an updated list of acts whose deadlines may be postponed.

[1858] §6652(d)(1).

[1859] §6057(b).

[1860] §6652(d)(2).

[1861] §6652(d)(2).

[1862] §6057(e).

[1863] Reg. §301.6057-1(e). The making of this report is among the acts whose deadlines may be postponed under §7508 and §7508A when the IRS publishes guidance providing relief related to a specific combat zone, qualifying deployment in a contingency operation, federally declared disaster, significant fire, or terroristic or military action. §7508A was amended by the Infrastructure Investment and Jobs Act to include significant fires for which assistance is provided after November 15, 2021. Pub. L. No. 117-58, §80504. See Tables, Charts & Lists > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions* for an updated list of acts whose deadlines may be postponed.

[1864] §6690.

[1865] *See generally* §6652.

[1866] Reg. §301.6652-3(b)(3).

[1867] §3405(e)(10)(B).

[1868] §3405(e)(10)(B); Reg. §35.3405-1T, Q-4, d-4.

[1869] Reg. §35.3405-1T, Q-9, d-9.

[1870] §6652(h). For returns, statements, and notifications required to be filed, and notices required to be provided, before January 1, 2020, the penalty was $10 per failure with a maximum of $5,000 per calendar year.

[1871] §6652(h).

[1872] §402(f).

[1873] §6652(i).

[1874] §6033(n).

[1875] Pub. L. No. 116-25, §3101(d)(2). A small organization means any organization: (1) the gross receipts of which for the tax year are less than $200,000;

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Various penalties may apply to the organization or to an officer, director, trustee, employee, or other individual who has responsibility to perform the required task.[1876] Once imposed, a penalty is due on notice and demand, in the same manner as a tax.[1877] In addition, if the penalty applies to more than one person, joint and several liability attaches.[1878]

2. Failure to File Exempt Organization Annual Return

With limited exceptions, every organization that is exempt from tax under §501(a) must file an annual return.[1879] The return generally is filed on Form 990, *Return of Organization Exempt from Income Tax*, on or before the 15th day of the fifth month following the close of the period for which the return is required to be filed.[1880]

An exempt organization that does not timely file the required return or fails to include the required information is subject to a penalty of $20 for each day the failure continues. The maximum penalty with respect to any one return cannot exceed the lesser of $10,000 or five percent of the gross receipts of the organization for the year. In the case of an organization having gross receipts exceeding $1 million (adjusted for inflation) for any year, the penalty is $100 per day, with a maximum penalty not to exceed $50,000 (adjusted for inflation).[1881]

Political organizations under §527(e)(1) that have gross receipts of $25,000 or more for the taxable year, or $100,000 or more in the case of qualified state or local political organizations under §527(e)(5), generally must file an annual return.[1882] Certain political organizations are exempt from this requirement by statute, such as entities to which §527 applies only because the entities are §501(c) organizations that pay taxes under §527(f)(1). Other political organizations may be excepted from this filing requirement at the discretion of the IRS.[1883] Organizations that must file, but fail to do so, are subject to a $20 per day penalty for failure to file an income tax return by the due date, failure to include required information, or inclusion of incorrect information, on such a return.[1884]

If the exempt organization fails to file the annual return, the IRS will demand that the organization file it within 90 days.[1885] Failure to comply with the demand subjects the responsible individual to a penalty of $10 for each day the failure continues, up to a maximum of $5,000 with respect to any single return.[1886]

Certain exempt organizations that otherwise are exempt from filing information returns (e.g., organizations with gross receipts not exceeding $25,000), must provide notice to the IRS to continue their exemption from the filing requirements. No monetary penalty applies, but if an organization fails to provide the required notice for three consecutive years, its tax-exempt status is revoked.[1887]

The §6652(c)(1) penalty is not subject to the deficiency procedures. Thus, a taxpayer cannot petition the Tax Court. If a penalty is proposed and the taxpayer agrees, the penalty is assessed. If the taxpayer disagrees, the IRS will issue a 30-day letter and the taxpayer may file a protest with Appeals. If the taxpayer loses before Appeals, the penalty is assessed and the taxpayer must pay and then file a claim for refund. A taxpayer may be able to challenge the penalty assessment in a CDP hearing.[1888]

3. Public Inspection and Copies of Annual Returns

An exempt organization under §501(c) or §501(d) must make the annual information return that it files under §6033[1889] and its exempt status application materials available for public inspection for three years after the due date of the return, as determined with regard to extensions, at the organization's principal office and at any regularly maintained regional or district offices that have three or more employees.[1890] A §501(c)(3) organization also must make any unrelated business income tax return (Form 990-T) available for public inspection.[1891] An exempt organization also must comply with an individual's request for a copy of the annual information return or the exempt status application materials.[1892]

A private foundation must allow public inspection at its principal office (and at certain regional or district offices) and must comply with requests for copies of the organization's application for recognition of exemption and the organization's three most recent annual information returns.[1893] In addition, nonexempt charitable trusts described in §4947(a)(1) and

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and (2) the aggregate gross assets of which at the end of the tax year are less than $500,000. Pub. L. No. 116-25, §3101(d)(2).

[1876] §6652(c).

[1877] §6652(c)(6)(A).

[1878] §6652(c)(6)(B).

[1879] §6033(a).

[1880] Reg. §1.6033-2(a), §1.6033-2(e), T.D. 9892, 85 Fed. Reg. 5323 (Jan. 30, 2020), applicable to returns filed on or after January 30, 2020. The temporary regulation removed by T.D. 9892 (Reg. §1.6033-2T(e)) applies to returns filed before January 30, 2020. Reg. §1.6033-2(k). An automatic six-month extension is available using Form 8868, Application for Extension of Time To File an Exempt Organization Return or Excise Taxes Related to Employee Benefit Plans. See the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, §2006(b)(4); Reg. §1.6081-9(a), §1.6081-9(b)(1), T.D. 9892, 85 Fed. Reg. 5323 (Jan. 30, 2020), applicable to requests for extensions of time to file on or after January 30, 2020. The temporary regulation removed by T.D. 9892 (Reg. §1.6081-9T) applies to extensions requested before January 30, 2020. Reg. §1.6081-9(f). Note that no extension under Reg. §1.6081-1 is available until an automatic extension has been allowed. Reg. §1.6081-9(e).

[1881] §6652(c)(1)(A). The penalty amounts in §6652(c)(1)(A) are adjusted for inflation. §6652(c)(7). For inflation-adjusted amounts, see Tables, Charts & Lists > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions.*

[1882] §6033(g)(1).

[1883] §6033(g)(3), §6033(g)(4).

[1884] §6652(c)(1)(A). The penalty amounts in §6652(c)(1)(A) are adjusted for inflation. §6652(c)(7). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Failure to File Certain Information Returns, Registration Statements, Etc.*

[1885] §6652(c)(1)(B)(i); Reg. §301.6652-2(b).

[1886] §6652(c)(1)(B)(ii), §6652(c)(6)(C). The penalty amounts in §6652(c)(1)(B) are adjusted for inflation. §6652(c)(7). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Failure to File Certain Information Returns, Registration Statements, Etc.*

[1887] *See* §6033(i), §6033(j), and §6652(c)(1)(E).

[1888] *See* CCA 201411033; *SEIU v. Commissioner*, 125 T.C. 63 (2005).

[1889] The annual information return includes any return that must be filed under §6033, such as Forms 990, 990-EZ, 990-PF, 4720, and 1065. *See* Reg. §301.6104(d)-1(b)(4)(i). Reg. §301.6104(d)-1(b)(4)(ii) identifies the forms that are not considered annual information returns for these purposes.

[1890] §6104(d)(1), §6104(d)(2); Reg. §301.6104(d)-1(a).

[1891] *See* §6104(d)(1)(A)(ii).

[1892] §6104(d)(1)(B).

[1893] Reg. §301.6104(d)-1(b).

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nonexempt private foundations must comply with the expanded public disclosure requirements.[1894]

An organization is not required to provide copies of its returns and materials, however, if the requested documents are widely available or the IRS determines, upon application by the organization, that the copies are sought as part of a harassment campaign.[1895]

The person responsible for making the returns available for inspection is subject to a penalty of $20 (adjusted for inflation) for each day of noncompliance, up to a maximum of $10,000 (adjusted for inflation) for any one return.[1896] An additional penalty of $20 a day applies if the exempt status application materials are not made available for public inspection.[1897]

Example: An exempt organization uses an agent for processing requests for copies of documents. If the agent fails to provide the documents as required, the organization is subject to the penalty provisions of §6652(c)(1).[1898]

Special rules apply for an exempt organization that did not file its own application for tax exemption because it is a local or subordinate organization covered by a group exemption letter. If such an organization fails to make available for inspection or to provide the group exemption letter or group annual return, it is subject to penalties for failure to comply with these inspection and copy requirements.[1899]

If an organization fails to comply with a request that it believes is part of a harassment campaign, but the IRS determines that the organization did not have a reasonable basis for such a determination or a reasonable belief that the request was part of such a campaign, then that organization is subject to these penalties under §6652(c)(1)(C) and §6652(c)(1)(D).[1900]

Note: The IRS has indicated that, although the regulations issued for public inspection of annual returns and applications for exemption do not limit the penalties that may be retroactively imposed if an organization claiming a harassment campaign is later determined to have lacked a reasonable belief for suspending compliance, the IRS recognizes that penalty mitigation may sometimes be appropriate, particularly where the organization requesting the determination has no control over a delay in the issuance of a determination. Therefore, the IRS plans to publish a revenue procedure providing further detail concerning harassment campaign determination procedures. Further, the IRS may prescribe rules concerning the imposition and mitigation of penalties.[1901]

In imposing campaign finance restrictions, §527 and §6104(d) require that groups organized under §527 — exempt political organizations — must notify the IRS of their status as §527 organizations and must disclose their contributions and expenditures. These requirements do not apply to organizations that reasonably anticipate that they will have annual gross receipts of less than $25,000, §501(c) organizations that pay taxes under §527(f), organizations that are qualified local or state political organizations, or organizations that report to the Federal Election Commission.[1902]

A political organization generally must notify the IRS electronically that it is a §527 organization within 24 hours after the date on which it is established.[1903] However, in the case of any material change that occurs to the information required to be provided in the notice, the organization must provide the notification no later than 30 days after the material change.[1904] If the group fails to comply with the notice requirements as indicated for any period, §527(i)(4) requires that the organization's taxable income will be computed by taking into account exempt function income and deductions directly connected with the production of such income. If the group fails to comply with the notice requirement relating to a material change, the organization's taxable income will be computed by taking into account such income and deductions only during the period beginning on the date on which the material change occurs and ending on the date on which the group provides the notice.[1905] In addition, a person who fails to make the notice materials[1906] available for public inspection as required by §6104(d), as amended, is subject to a penalty.[1907] The IRS may waive all or a part of the tax assessed on an organization for failing to comply with the requirements of §527(i) on a showing that the failure was due to reasonable cause and not due to willful neglect.[1908]

Entities provide the IRS with the required notice of status by filing Form 8871, *Political Organization Notice of §527 Status.*

Political organizations under §527 also must disclose their contributions and expenditures.[1909] The political organization that accepts a contribution, or makes an expenditure, for an exempt function during any calendar year must file with the IRS either monthly reports or quarterly or semiannual reports showing its contributors of more than $200, and the dates of the contributions, and expenditures of more than $500 during the calendar year, and the dates and the purposes of the expenditures.[1910] The reports are made on Form 8872, *Political Orga-*

[1894] §6104(d)(8); Reg. §301.6104(d)-1(b).

[1895] §6104(d)(4); Reg. §301.6104(d)-1(d), §301.6104(d)-2(b) (widely available applications and returns), §301.6104(d)-3(b) (harassment campaigns and what constitutes "harassment" for purposes of a harassment campaign determination); PLR 201123046.

[1896] §6652(c)(1)(C). The penalty amounts in §6652(c)(1)(C) are adjusted for inflation. §6652(c)(7). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Failure to File Certain Information Returns, Registration Statements, Etc.*

[1897] §6652(c)(1)(D). The penalty amounts in §6652(c)(1)(D) are adjusted for inflation. §6652(c)(7). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Failure to File Certain Information Returns, Registration Statements, Etc.*

[1898] Reg. §301.6104(d)-1(d)(1)(iii) (in-person requests), §301.6104(d)-1(d)(2)(ii)(C) (written requests).

[1899] *See* Reg. §301.6104(d)-1(f)(3).

[1900] *See* Reg. §301.6104(d)-3(e).

[1901] Preamble to T.D. 8818, 64 Fed. Reg. 17,279 (Apr. 9, 1999).

[1902] §527(i)(5), §527(j)(5).

[1903] §527(i).

[1904] §527(i)(2).

[1905] §527(i)(4).

[1906] The term "notice materials" encompasses the notice of status filed under §527(i) and any papers submitted in support of the notice and any letter or other document issued by the IRS regarding such notice. §6104(d)(6).

[1907] §6652(c)(1)(D).

[1908] §527(l).

[1909] §527(j).

[1910] §527(j)(2), §527(j)(3). The report must be filed electronically. §527(j)(7), as amended by the Taxpayer First Act, Pub. L. No. 116-25, §3101(b)(1), applicable to tax years beginning after July 1, 2019. Previously, electronic filing was required if the organization had, or had reason to expect to have, con-

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nization Report of Contributions and Expenditures. If the organization fails to make the disclosures to the IRS in a timely manner or fails to include required information or to show the correct information, the organization must pay under §527(j)(1) an amount equal to its tax rate multiplied by the amount to which the failure relates. The amount imposed will be assessed and collected in the same manner as penalties imposed by §6652(c).[1911] In addition, a person who fails to make the reports filed under §527(j) available for public inspection as required by §6104(d) is subject to a penalty of $20 per day, up to a maximum of $10,000 per report.[1912] The IRS may waive all or a part of the penalty imposed under §527(j) on a showing that the failure to comply was due to reasonable cause and not due to willful neglect.[1913]

IRS guidance concerning these disclosure requirements is provided in question and answer format in Rev. Rul. 2003-49.

For further discussion of public inspection of exemption applications and annual information returns, see 452 T.M., *Tax-Exempt Organizations: Reporting, Disclosure, and Other Procedural Aspects* (Estates, Gifts and Trusts Series), and 625 T.M., *Obtaining Information from the Government — Disclosure Statutes.*

4. Willful Failure to Allow Public Inspection

Any person who willfully fails to permit public inspection of an exempt organization or private foundation return or application is subject to a penalty of $5,000 for each return or application.[1914]

5. Return Reporting Liquidation of Exempt Organization

An organization that was exempt from tax during any of its last five taxable years preceding its liquidation, dissolution, termination, or substantial contraction generally must file a return with respect to such transaction.[1915] Failure to file the return subjects the organization to a penalty of $10 a day, but not more than $5,000 with respect to any one return.[1916]

In addition, the IRS can demand in writing that the organization file the required return by a specified due date. If the return is still not filed by that date, an additional penalty of $10 per day, up to $5,000 per return, can be imposed on the individual responsible for the filing.[1917]

6. Failure to File Trust Return

Split-interest trusts described under §4947(a)(2) and certain trusts claiming charitable deductions under §642(c) are required to file annual informational returns.[1918] A split-interest trust files Form 5227, *Split-Interest Trust Information Return*,[1919] and a trust claiming charitable deductions files Form 1041-A (U.S. Information Return Trust Accumulation of Charitable Amounts).[1920] A trust claiming charitable deductions that is otherwise required to file under this rule is exempt from the filing requirement if all the net income of the trust, as determined under the applicable principles of the law of trusts, is required to be distributed currently to the beneficiaries.[1921]

A split-interest trust that fails to file an information return or include any of the information required to be shown on the return is subject to a penalty of $20 (adjusted for inflation) for each day the failure continues, up to a maximum of $10,000 (adjusted for inflation) for any one return. For split-interest trusts with gross income over $250,000, the penalty is $100 (adjusted for inflation) for each day the failure continues up to a maximum of $50,000 (adjusted for inflation) for any one return.[1922]

A trust claiming charitable deductions that fails to file a return or include any of the information required to be shown on the return is liable for a penalty of $10 (adjusted for inflation) for each day during which the failure continues, up to a maximum of $5,000 (adjusted for inflation) per return.[1923]

The IRS may make a written demand on a trust that failed to file a return as required under §6034, in which the IRS specifies a reasonable future date by which the return must be filed (or the information furnished).[1924] If any defined person[1925] fails to comply with this demand on or before the date specified in the demand, a penalty will be imposed on the person for failing to do so of $10 (adjusted for inflation) for each day after the expiration of the time specified in the demand during which

tributions exceeding $50,000 or expenditures exceeding $50,000 in a calendar year. Pre-2019 §527(j)(7).

[1911] §527(j)(1).

[1912] §6652(c)(1)(C). The penalty amounts in §6652(c)(1)(C) are adjusted for inflation. §6652(c)(7). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Failure to File Certain Information Returns, Registration Statements, Etc.*

[1913] §527(l).

[1914] *See* §6685.

[1915] §6043(b).

[1916] §6652(c)(2)(A). The penalty amounts in §6652(c)(2)(A) are adjusted for inflation. §6652(c)(7). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Failure to File Certain Information Returns, Registration Statements, Etc.*

[1917] §6652(c)(2)(B). The penalty amounts in §6652(c)(2)(B) are adjusted for inflation. §6652(c)(7). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Failure to File Certain Information Returns, Registration Statements, Etc.*

[1918] §6034(a), §6034(b).

[1919] *See* PMTA 2022-05 (Chief Counsel's Office advised that upon finalization of proposed regulations, failure to file certain specified information returns electronically, including Form 5227, may result in additions to tax under §6651 and §6652).

[1920] The maximum extension allowed is a single automatic six-month extension. Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, §2006(b)(6). *See* Reg. §1.6081-9(a), §1.6081-9(b)(1), T.D. 9892, 85 Fed. Reg. 5323 (Jan. 30, 2020), applicable to requests for extensions of time to file on or after January 30, 2020. The temporary regulation removed by T.D. 9892 (Reg. §1.6081-9T) applies to extensions requested before January 30, 2020. Reg. §1.6081-9(f).

[1921] §6034(b)(2). For taxable years beginning before January 1, 2007, the exemption also applied to split-interest trusts described under §4947(a)(2) that must distribute all net income currently to beneficiaries. §6034(b), before amendment by 2006 PPA, §1201(b)(1).

[1922] §6652(c)(2)(C). The penalty amounts in §6652(c)(2)(C) are adjusted for inflation. §6652(c)(7). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Failure to File Certain Information Returns, Registration Statements, Etc.*

[1923] §6652(c)(2)(A). The penalty amounts in §6652(c)(2)(A) are adjusted for inflation. §6652(c)(7). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Failure to File Certain Information Returns, Registration Statements, Etc.*

[1924] §6652(c)(2)(B).

[1925] A "person" for purposes of the above rules means any officer, director, trustee, employee, or other individual who is under a duty to perform the act in respect of which the violation occurs. §6652(c)(6)(C).

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the failure continues. The maximum penalty on all persons for failures with respect to any one return is $5,000 (adjusted for inflation).[1926]

7. Reasonable Cause Exception

No penalty will be imposed if it can be shown that the failure to timely file, or to include the required information in, an exempt organization's or a trust's return is due to reasonable cause.[1927] To claim the reasonable cause exception, the person liable for the penalty must make an affirmative showing (in a written statement, signed under penalties of perjury) of the facts on which the person relies.[1928] Reasonable cause is discussed at XI., below.

8. Chapter 42 Excise Taxes on Private Foundations

Chapter 42 imposes an excise tax on a private foundation and its management for the following:

- Acts of self-dealing involving the foundation manager or substantial contributors to the foundation;[1929]
- The foundation's failure to distribute sufficient income for exempt purposes;[1930]
- Excessive holdings by the foundation in a business enterprise;[1931]
- Investment of the assets in a manner that jeopardizes the foundation's exempt purpose (i.e., imprudent investments);[1932] and
- Certain "taxable expenditures" by the foundation and its manager, including expenditures for a noncharitable purpose, expenditures for lobbying or other activities to influence legislation or elections, and grants to individuals for travel or study (with certain exceptions).[1933]

Any person who is liable for any of these excise taxes by reason of any act or failure to act without reasonable cause is subject to a penalty equal to such tax if (1) the person has previously been liable for any of these excise taxes, or (2) the act or failure to act giving rise to the excise tax is both willful and flagrant.[1934] An act is "willful and flagrant" if it is voluntarily, consciously, and knowingly committed in violation of a Chapter 42 provision (other than §4940 or §4948(a)) and, to a reasonable man, appears to be a gross violation of any of such provisions.[1935] The IRS has the burden of proof by clear and convincing evidence on the willful and flagrant issue.[1936]

The penalty does not apply if the violation of the excise tax provision is due to reasonable cause. The showing of reasonable cause must be made to the satisfaction of either the field office director or the service center director in a written statement, made under the penalties of perjury and detailing all of the facts alleged as reasonable cause.[1937] Reasonable cause is discussed at XI., below.

Under §4965 an excise tax is imposed on certain tax-exempt entities (and their managers) if the entity becomes a party to a prohibited tax shelter transaction (i.e., a listed or prohibited reportable transaction as defined in §6707A).[1938]

The amount of the tax under §4965 depends on whether a tax-exempt entity knew or had reason to know that the transaction was a prohibited tax shelter transaction at the time the entity became a party to the transaction. If a transaction is a prohibited transaction at the time the entity becomes a party to the transaction, the entity must pay a penalty equal to the product of the highest corporate tax rate under §11 and the greater of (1) the entity's net income for such year that is attributable to such transaction, or (2) 75% of the proceeds received by the entity that are attributable to the transaction.[1939]

If the tax-exempt entity knows or has reason to know that a transaction is a prohibited transaction at the time the entity becomes a party to the transaction, the penalty is increased to the greater of (1) 100% of the entity's net income for such year that is attributable to such transaction, or (2) 75% of the proceeds received by the entity that are attributable to the transaction.[1940]

In the case of a non-plan entity that is a party to a subsequently listed transaction, the tax-exempt entity's income and proceeds attributable to the transaction are allocated between the periods before and after the listing and the tax for each taxable year the penalty is the highest rate of tax under §11 multiplied by the greater of (i) the entity's net income with respect to the subsequently listed transaction for the taxable year that is allocable to the period beginning on the later of the date such transaction is listed or the first day of the taxable year; or (ii) 75% of the proceeds received by the entity for the taxable year that are attributable to such transaction and allocable to the period beginning on the later of the date such transaction is listed or the first day of the taxable year.[1941]

A $20,000 penalty is imposed on an entity manager that approves or otherwise causes the tax-exempt entity to be a party to a prohibited tax shelter transaction.[1942]

[1926] §6652(c)(2)(B). The penalty amounts in §6652(c)(2)(B) are adjusted for inflation. §6652(c)(7). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Failure to File Certain Information Returns, Registration Statements, Etc.*

[1927] §6652(c)(5).

[1928] Reg. §301.6652-2(f).

[1929] §4941.

[1930] §4942.

[1931] §4943.

[1932] §4944.

[1933] §4945.

[1934] §6684.

[1935] Reg. §301.6684-1(c) (referring to the definition set forth in §507(a)(2)(A) and the related regulations). The definition is at Reg. §1.507-1(c)(2).

[1936] *Larchmont Found., Inc. v. Commissioner*, 72 T.C. 131 (1979), vacated on another issue by unpub. opin., 659 F.2d 1085 (7th Cir. 1981); *Moody v. Commissioner*, T.C. Memo 1995-440. *See Thorne v. Commissioner*, 99 T.C. 67 (1992).

[1937] §6684; Reg. §301.6684-1(b).

[1938] *See* Pub. L. No. 109-222, §516(a). The excise taxes under §4965 apply to taxable years ending after May 17, 2006, with respect to transactions entered into before, on, or after such date, except that no §4965(a) excise tax applies with respect to income or proceeds that are properly allocable to any period ending on or before August 15, 2006 (2005 TIPRA §516(d)(1)). However, the increase in the entity-level tax imposed under §4965(a)(1) on certain knowing transactions does not apply to any prohibited tax shelter transaction to which a tax-exempt entity becomes a party on or before May 17, 2006 (§4965(b)(1)(B)).

[1939] §4965(a)(1), §4965(b)(1)(A). Note that only non-plan entities are subject to the entity level tax under §4965(a)(1). *See* Notice 2006-65, Q&A-5.

[1940] §4965(b)(1)(B).

[1941] §4965(b)(1)(A)(i)(II), §4965(b)(1)(A)(ii)(II). *See* Notice 2006-65, Q&A-9.

[1942] §4965(a)(2), §4965(b)(2).

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A tax-exempt entity that is a party to a prohibited tax shelter transaction also is required to meet certain disclosure requirements imposed by §6033(a)(2). Section 6652(c)(3) imposes a $100 per day penalty (up to a maximum of $50,000) if the tax-exempt entity does not make the required disclosures. A taxable party to a prohibited transaction is required by §6011(g) to disclose to the tax-exempt entity that the transaction is a prohibited tax shelter transaction.[1943]

For purposes of §4965, §6033(a)(2) and §6011(g), a tax-exempt entity is a party to a transaction if it: (1) facilitates the transaction by reason of its tax-exempt, tax indifferent or tax-favored status; or (2) is identified in published guidance, by type, class or role, as a party to a prohibited tax shelter transaction.[1944]

9. Charitable Contributions

a. Quid Pro Quo Contributions

Charitable organizations described in §170(c) (other than a State, a U.S. possession or a political subdivision) that receive a quid pro quo contribution in excess of $75 must notify the donor in writing (1) that the amount of the contribution that is deductible for federal income tax purposes is limited to the excess of the amount of money and the value of any property contributed by the donor over the value of the goods or services provided by the charity, and (2) of the charity's good faith estimate of the value of such goods or services.[1945] For this purpose, a quid pro quo contribution is a payment made by the donor partly as a contribution and partly in consideration for goods or services provided by the charity to the donor.[1946] A payment to a charity organized exclusively for religious purposes solely in return for an intangible religious benefit that generally is not sold in a commercial transaction outside the donative context, however, is excluded.[1947]

An organization that fails to provide the required notice is subject to a penalty of $10 for each quid pro quo contribution to which the failure related, up to a maximum of $5,000 for any particular fundraising event or mailing.[1948] Each pledge drive or mass offering-envelope mailing is subject to a single penalty cap. However, where there is no evidence of a discrete fundraising event or mailing (e.g., where participants hear about a program by word of mouth), the cap applies separately to each contribution.[1949] No penalty is imposed if the failure is due to reasonable cause.[1950] Reasonable cause is discussed at XI., below.

Because the penalty is not based on a deficiency, the deficiency procedures under §6665 do not apply.[1951]

b. Donations of Motor Vehicles, Boats and Airplanes

A charitable organization that accepts charitable contributions of motor vehicles, boats and airplanes is subject to additional substantiation requirements for such donations for which the claimed value exceeds $500.[1952] Under the rules, no deduction is allowed unless the taxpayer receives a written acknowledgement of the contribution by the donee organization within 30 days after the contribution, and the taxpayer includes the acknowledgement with its tax return on which the deduction is claimed.[1953]

If the organization sells the motor vehicle, boat or airplane without any significant intervening use or material improvement by the organization, the amount of the deduction cannot exceed the gross proceeds received from such sale.[1954] Within 30 days after such a sale, the organization must notify the donor of the sale, the gross proceeds, and the fact that the deductible amount cannot exceed the amount of such gross proceeds.

If the donee organization knowingly fails to timely furnish a proper written acknowledgement or knowingly furnishes a false or fraudulent acknowledgement, a penalty is imposed on the donee organization.[1955] In the case of a failure relating to an acknowledgement for a contribution, the amount of the penalty is equal to the greater of (1) the claimed value of the motor vehicle, boat or airplane contributed multiplied by the highest rate of tax specified in §1, or (2) $5,000.[1956] If the acknowledgement was required in connection with a sale by the donee organization, the penalty is equal to the greater of (a) the sale price stated on the acknowledgment multiplied by the highest tax rate specified in §1, or (b) the gross proceeds of the sale.[1957]

Comment: The amount of the penalty is at least equal to the tax savings realized by the donor. Overstating the amount of the contribution or sale proceeds proportionally increases the amount of the penalty.

[1943] The penalty amounts in §6652(c)(3) are adjusted for inflation. §6652(c)(7). For inflation-adjusted amounts, see Tables, Charts & Lists > Penalties > *Failure to File Certain Information Returns, Registration Statements, Etc.*

[1944] See Notice 2007-18, which provides examples illustrating when a tax-exempt entity is/is not a party to a prohibited transaction. The IRS noted that the term "party" as used in §4965 applies more broadly than as defined for purposes of Notice 2007-18, and, therefore, it anticipates that proposed regulations will define "party" to include a tax-exempt entity that enters into a prohibited tax shelter transaction that reduces such entity's liability for applicable federal taxes (i.e., employment taxes, excise taxes, and in appropriate cases, unrelated business income tax). Notice 2007-18 also addresses how the IRS intends to exercise its allocation authority under §4965(f), particularly with respect to transactions entered into before the enactment of §4965.

[1945] §6115(a).

[1946] §6115(b).

[1947] §6115(b). For discussion of intangible religious benefits, see 521 T.M., *Charitable Contributions: Income Tax Aspects.* A disguised tuition payment program so plainly violates the provision that it is unlikely that an organization engaged in such program could establish reasonable cause. CCA 200623063.

[1948] §6714(a).

[1949] CCA 200623063.

[1950] §6714(b).

[1951] CCA 200623063.

[1952] §170(f)(12).

[1953] §170(f)(12)(A)(i), §170(f)(12)(C)(ii). The required contents of the acknowledgement are set forth in §170(f)(12)(B).

[1954] §170(f)(12)(A)(ii).

[1955] §6720.

[1956] §6720(2).

[1957] §6720(1).

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10. Fundraising Solicitations

a. Nondeductible Contributions

Fundraising solicitations by certain tax-exempt organizations must contain an express statement that contributions and gifts to the organization are not deductible as charitable contributions for federal income tax purposes.[1958] The statement must be in a conspicuous and easily recognizable format.[1959]

The disclosure requirement applies to:

- Tax-exempt organizations that are not eligible to receive tax deductible contributions under §170(c);
- Political organizations under §527(e); and
- Any organization that was at any time within the previous five years an organization described in either of the foregoing bullets, or the successor to such an organization.[1960]

Thus, for example, social welfare organizations, labor unions, social clubs, certain fraternal organizations, political campaigns, political action committees, and, for a period of five years, their successors must make the required disclosure. The requirement does not apply, however, if the organization's aggregate gross receipts for the current year and the previous two taxable years do not exceed $300,000 (i.e., where gross receipts do not normally exceed $100,000 for each year).[1961]

The nondeductibility disclosure requirement applies to any solicitation of contributions or gifts that is made in written or printed form, by television or radio, or by telephone.[1962] Accordingly, it does not apply to a nontelephonic oral request for contributions (e.g., an oral solicitation made during door-to-door fundraising), but does apply to any written or printed materials distributed in connection with the oral solicitation.[1963] An exception is provided, however, for letter or telephone-call solicitations that are not part of a coordinated fundraising campaign soliciting more than 10 persons during the calendar year.[1964]

Fundraising can be in the form of contributions, donations, gifts, membership dues or fees, voluntary assessments, or any other form of support.[1965] The form of the support is also irrelevant.

If the required, nondeductibility disclosure requirement is not met with respect to a fundraising solicitation on any particular day, the organization is subject to a penalty of $1,000 for each day.[1966] The same $1,000 penalty applies regardless of the number of solicitations that occur on that particular day. For this purpose, a solicitation by mail is treated as occurring on the date it is mailed; any other written or printed solicitation, on the date it is distributed; a solicitation by television or radio, on the date it is broadcast; and a solicitation by telephone, on the date it is made.[1967] The maximum penalty that can be imposed on an organization during any calendar year for failing to comply with the nondeductibility disclosure requirements is $10,000.[1968]

Example: K, a tax-exempt organization subject to the disclosure requirement, mails 5,000 fundraising solicitation letters on May 1, and 1,000 copies of the same letter on each day from May 2 through May 10. K follows up the letters with telephone solicitations on May 11 through May 20. None of the solicitations provides the required disclosure. As a result, K is subject to a $10,000 penalty: $1,000 for each of the 20 days, regardless of the number of solicitations, subject to a maximum penalty of $10,000.

If the failure to comply is due to intentional disregard of the disclosure requirement, the penalty for the day on which the failure occurs is equal to the greater of $1,000 or 50% of the aggregate cost of all fundraising solicitations that occur on that day and for which there was a failure to comply.[1969] The cost of a fundraising solicitation includes all direct and indirect expenses incurred in connection with the solicitation, such as publishing and printing costs, staff salaries and overhead, telephone costs, the fair market value of donated services, and payments to fundraising businesses.[1970] In the case of intentional disregard, the $10,000 limitation does not apply, and these failures are not taken into account in computing any other nondeductibility nondisclosure penalty.[1971]

The penalty does not apply to any failure that is due to reasonable cause.[1972] Reasonable cause is discussed at XI., below.

b. Premium Available from Federal Government

When a tax-exempt or political organization offers to sell, or solicits money for, specific information or a routine service that any individual can readily obtain either free or for a nominal charge from a federal agency, the organization must include an express statement, in a conspicuous and easily recognizable format, in its offers and solicitations that the information can be obtained from the federal government.[1973] For this purpose, a nominal charge is less than $2.50 (including postage and handling and user fees).[1974]

The disclosure requirement applies only with respect to information or services that are specific to the particular individual being solicited (e.g., obtaining the social security earnings record for the individual).[1975] It does not apply, for example, to furnishing copies of newsletters issued by federal agencies or providing descriptive material on pending legislation, since this is not specific to the individual. Moreover, disclosure is required only with respect to routine services (e.g., routine infor-

[1958] §6113(a).
[1959] §6113(a). Notice 88-120 provides safe harbors with respect to the format of the disclosure statement.
[1960] §6113(b)(1).
[1961] §6113(b)(2); Notice 88-120.
[1962] §6113(c)(1).
[1963] H.R. Rep. No. 391 (Part II), 100th Cong., 1st Sess. 1610 (1987).
[1964] §6113(c)(2).
[1965] H.R. Rep. No. 391 (Part II), 100th Cong., 1st Sess. 1610 (1987).
[1966] §6710(a).
[1967] §6710(d).
[1968] §6710(a).
[1969] §6710(c)(1).
[1970] H.R. Rep. No. 391 (Part II), 100th Cong., 1st Sess. 1611 (1987).
[1971] §6710(c)(2), §6710(c)(3).
[1972] §6710(b).
[1973] §6711(a); Notice 88-120 (which describes the required format of the disclosure statement).
[1974] Notice 88-120; H.R. Rep. No. 391 (Part II), 100th Cong., 1st Sess. 1619 (1987).
[1975] Notice 88-120; H.R. Rep. No. 391 (Part II), 100th Cong., 1st Sess. 1619 (1987).

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mation retrieval services).[1976] Professional services (e.g., tax return preparation, grant application preparation, or medical services) are not subject to the disclosure requirement.[1977]

The penalty for intentionally disregarding this disclosure requirement for any day is the greater of $1,000 or 50% of the aggregate cost of the noncomplying offers or solicitations on that day.[1978] The day on which a failure occurs is determined under rules similar to the nondeductibility disclosure requirement penalty.[1979]

11. Failure to File Notice Required Under Section 506

A failure by an organization to submit a notice required by §506 (intent to operate as a §501(c)(4)) is subject to a penalty of $20 per day the failure continues, up to $5,000. The IRS may make a written demand for the notice to organizations subject to penalty. If the person required to submit the notice fails to do so, he or she is subject to a penalty of $20 per day the failure continues, up to $5,000.[1980]

Section 501(c)(4) organizations are required to provide notice that they intend to operate as a §501(c)(4) organization to the IRS online via Form 8976, *Notice of Intent to Operate Under Section 501(c)(4)*.[1981] Form 8976 must be filed within 60 days of the organization of the entity.[1982] Even though an application for exemption is not required except in certain circumstances, a §501(c)(4) organization may still apply using Form 1024-A, *Application for Recognition of Exemption Under Section 501(c)(4) of the Internal Revenue Code*, pursuant to §506(f),[1983] however, submitting Form 1024-A does not satisfy the requirement to notify the IRS via Form 8976.[1984]

E. ERISA Qualified Plan Trusts and ESOPs

1. Owner-Employees

If contributions to a tax-exempt ERISA trust with respect to an owner-employee during the calendar year total $10 or more, the trustee must report the amount of these payments for the owner-employee.[1985] The report is made by filing a separate Form 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, with respect to each payee, by February 28 following the calendar year to which it relates.[1986] If the trustee files the return electronically, the deadline is extended to March 31 of the year following the calendar year to which the return relates.[1987] A similar report must be filed by every person who issues an annuity contract to the trust.[1988]

Every owner-employee, on whose behalf contributions have been paid, is required to notify the trustee of such contributions on or before February 28 of the next year.[1989] The trustee is then required to notify the issuer of the annuity contract of the contributions, either when the contract is purchased or within 90 days after the notice from the owner-employee is received, if later.[1990]

2. Designated Distributions

An employer or plan administrator of a plan from which "designated distributions" may be made, and any person issuing an annuity contract under which designated distributions may be made, must make such reports and returns as may be required by the regulations (if and when issued).[1991] A designated distribution is any distribution or payment from an employer deferred compensation plan, an individual retirement plan, or a commercial annuity; however, it does not include any amount normally considered wages for withholding purposes, any amount that is reasonable to believe is not includible in gross income, any amount subject to withholding as a payment to a foreign person or that would be so subject but for a tax treaty, and certain dividends paid on employer securities.[1992]

3. Employee Stock Ownership Plans

The plan administrator of, or the employer maintaining, an employee stock ownership plan must file a return with respect to the plan and any securities acquired in a transaction to which former §133 applied before its repeal effective for loans made after August 20, 1996.[1993] The return is filed on Schedule E (ESOP Annual Information), as an attachment to Form 5500, on or before the close of the seventh month following the end of the plan year.

4. Certain Fringe Benefit Plans

An employer must file a return with respect to each group-term life, accident, and health insurance; qualified group legal services; educational assistance; dependent care assistance; adoption assistance; or a cafeteria plan under which all or a portion of the benefits are excludible from gross income.[1994]

[1976] Notice 88-120; H.R. Rep. No. 391 (Part II), 100th Cong., 1st Sess. 1619 (1987).

[1977] Notice 88-120; H.R. Rep. No. 391 (Part II), 100th Cong., 1st Sess. 1619 (1987).

[1978] §6711(a), §6711(b).

[1979] §6711(c)(2). See discussion in IX.D.9.a., above.

[1980] §6652(c)(4).

[1981] Form 8976 may only be filed online at https://www.irs.gov/charities-non-profits/electronically-submit-your-form-8976-notice-of-intent-to-operate-under-section-501c4, along with the appropriate user fee ($50 payable through https://www.pay.gov). Reg. §1.506-1(a)(3); Rev. Proc. 2016-41, §4.02.

[1982] §506; Reg. §1.506-1. The notice must include: (1) the organization's name, address, and taxpayer identification number; (2) the date of organization and the state under whose laws the organization is organized; and (3) a statement of the organization's purpose. §506(b); Reg. §1.506-1(a)(2); Rev. Proc. 2016-41, §4.04(1).

[1983] §506(f); Rev. Proc. 2025-5, §4.02(4); Instructions for Form 1024-A. For a detailed discussion of either the reporting requirements under §506 or Form 1024-A, see 450 T.M., *Tax-Exempt Organizations — Organizational and Operational Requirements*.

[1984] Reg. §1.506-1(e).

[1985] §6047(a), §6047(d)(1).

[1986] Reg. §1.6047-1(a)(1), §1.6047-1(a)(6). An automatic 30-day extension of time to file is available by filing Form 8809, *Request for Extension of Time to File Information Returns*. *See* Reg. §1.6081-8(a)(1), T.D. 9838, 83 Fed. Reg. 38,212 (Aug. 3, 2018). The IRS may allow one additional 30-day non-automatic extension of time to file if it is submitted before the automatic extension period expires. Reg. §1.6081-8(a)(2); Reg. §1.6081-8(c). An extension of time to file payee statements is made using Form 15397, *Application for Extension of Time to Furnish Recipient Statements*.

[1987] §6071(b); Reg. §1.6047-1(a)(6).

[1988] §6047(a).

[1989] §6047(b); Reg. §1.6047-1(b).

[1990] Reg. §1.6047-1(a)(3).

[1991] §6047(d). *See* Notice 2004-10 (payee statements may be furnished electronically).

[1992] §3405(e)(1).

[1993] §6047(e). *See* Instructions for Form 5500 and Schedule E.

[1994] §6039D.

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The reporting requirements imposed under the Code are independent of the reporting requirements imposed under Title I of ERISA. The IRS has suspended indefinitely its requirement that annual information returns (Forms 5500, Schedule F) be filed with the IRS for each of these fringe benefit plans except group-term life insurance plans.[1995]

5. Penalty

A person required to file any report described in IX.E.1. through IX.E.4., above, is subject to a penalty of $250 a day, up to $150,000 per return for failing to do so.[1996] The penalty must be paid on notice and demand by the IRS in the same manner as the tax. The penalty, however, does not apply if the failure is due to reasonable cause.[1997]

In addition, any person who has a duty to retain information with respect to designated distributions is subject to $50 penalty with respect to each individual for whom he failed to retain the proper records, up to a maximum of $50,000 for any calendar year.[1998] The penalty applies whether or not reports are due for the period.[1999] The penalty, however, does not apply for any failure that is due to reasonable cause and not willful neglect.[2000] Also, no penalty is imposed on a person for a record-keeping failure if the failure is attributable to a prior failure that has been penalized under this provision, if all reasonable efforts have been made to correct the failure.[2001]

F. Deductible Employee Contributions — Prior Law

If an ERISA plan accepted a qualified voluntary employee contribution, the plan administrator was required report to each participant: (1) the amount of contributions made by the participant during the calendar year; and (2) the amount of the withdrawals of contributions during the calendar year.[2002] The plan administrator was generally required to furnish the report to the employee by January 31 following the year to which it related.[2003]

Failure to furnish the required report to a participant subjected the plan administrator to a penalty of $25 for each participant, multiplied by the number of years during which the failure continued.[2004] The amount of the penalty under this section could not exceed $10,000.[2005]

The penalty was not imposed if the failure was shown to be due to reasonable cause and not willful neglect.[2006] Reasonable cause is discussed at XI., below.

G. IRA, SEP, and SIMPLE Reports

1. Annual Reports

The trustee of an individual retirement account ("IRA") and the issuer of an individual retirement annuity are required to make annual reports concerning the status of the account or annuity, including the amount of contributions and distributions for the calendar year.[2007] The report for a calendar year is due by the following May 31.[2008] In addition, the trustee and issuer must furnish a disclosure statement for the calendar year by January 31 of the following year.[2009]

Similarly, in the case of a simplified employee plan ("SEP"), the employer must furnish each benefited employee with a written statement indicating the amount of the employer contributions made on behalf of the employee during the calendar year.[2010] The statement must be provided on or before January 31 following the calendar year to which it relates.[2011]

Any trustee, issuer, or employer who fails to file the required report or furnish the required information in the time and manner required is subject to a penalty of $50 for each failure, unless the failure is due to reasonable cause.[2012] Reasonable cause must be shown by a written statement, made under penalties of perjury, setting forth all of the facts constituting the reasonable cause for the failure.[2013] The deficiency procedures do not apply to the assessment or collection of the penalty.[2014]

[1995] Notice 2002-24, *modifying and* superseding Notice 90-24.

[1996] §6652(e), as amended by the Setting Every Community Up for Retirement Enhancement Act of 2019, Pub. L. No. 116-94, Div. O, §403, effective for returns, statements, and notifications required to be filed, and notices required to be provided after December 31, 2019. For returns, statements, and notifications required to be filed, and notices required to be provided, before January 1, 2020, the penalty was $25 a day with a maximum of $15,000. The IRS may provide administrative relief from this penalty. *See, e.g.*, Notice 2014-35, Rev. Proc. 2015-32. Section 6047(f) requires the plan administrator of an applicable retirement plan to make returns and reports regarding designated Roth contributions to the IRS, participants, beneficiaries, and others, as provided by regulation. *See also* PMTA 2017-03 (§6652(e) penalty applies to failure to file Form 1098-Q, not §6721 or §6722).

[1997] §6652(e).

[1998] §6704(a), §6704(b).

[1999] 1982 Act Senate Report at 291.

[2000] §6704(c)(1).

[2001] §6704(c)(2).

[2002] Former §219(f)(4); Prop. Reg. §1.219(a)-5(g)(1). The Tax Increase Prevention Act of 2014 (2014 TIPA) removed §219(f)(4) and §6652(g) effective December 19, 2014.

[2003] Prop. Reg. §1.219(a)-5(g)(2).

[2004] Former §6652(g).

[2005] Former §6652(g).

[2006] Former §6652(g).

[2007] §408(i); Reg. §1.408-5.

[2008] The making of this report is among the acts that may be postponed under §7508 and §7508A when the IRS publishes guidance providing relief related to a specific combat zone, qualifying deployment in a contingency operation, federally declared disaster, significant fire, or terroristic or military action. §7508A was amended by the Infrastructure Investment and Jobs Act to include significant fires for which assistance is provided after November 15, 2021. Pub. L. No. 117-58, §80504. See Tables, Charts & Lists > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions*, for an updated list of acts whose deadlines may be postponed.

[2009] §408(i)(2); Reg. §1.408-6. The issuance of this statement is among the acts that may be postponed under §7508 and §7508A when the IRS publishes guidance providing relief related to a specific combat zone, qualifying deployment in a contingency operation, federally declared disaster, significant fire, or terroristic or military action. §7508A was amended by the Infrastructure Investment and Jobs Act to include significant fires for which assistance is provided after November 15, 2021. Pub. L. No. 117-58, §80504. See Tables, Charts & Lists > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions*, for an updated list of acts whose deadlines may be postponed.

[2010] §408(l); Prop. Reg. §1.408-9(b).

[2011] Prop. Reg. §1.408-9(b)(2).

[2012] §6693(a)(1), §6693(a)(2)(A). The penalty does not apply to any report which is an information return or paper statement filed under §6724(d). §6693(a) (flush language).

[2013] Reg. §301.6693-1(b). Reasonable cause is discussed at XI., below.

[2014] §6693(d); Reg. §301.6693-1(c). *See also* §6665 and §6671(a), discussed at XII., below.

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2. Nondeductible Contributions to or Distributions from IRAs

An individual who makes a designated nondeductible contribution to an individual retirement account for a taxable year or who receives any amount from an individual retirement plan for a taxable year must report such amounts on his personal income tax return for that taxable year and any succeeding taxable year.[2015]

A $100 penalty is imposed if the individual taxpayer overstates the amount of the designated nondeductible contributions.[2016] If the taxpayer does not provide the information, the penalty is $50.[2017] The IRS can assess the penalty without complying with the notice of deficiency procedures.[2018] In either case, no penalty is imposed if it is shown that the failure is due to reasonable cause.[2019] Reasonable cause is discussed at XI., below.

3. Notices Relating to SIMPLE Retirement Accounts

An employer who maintains a qualified salary reduction arrangement on behalf of employees must notify the employees of their eligibility to participate in the qualified salary reduction arrangement or to modify the amounts subject to the arrangement.[2020] An employer who fails to provide one or more such notices is subject to a penalty of $50 per day.[2021] Similarly, a trustee who fails to provide one or more statements to a participant required under §408(i) or summary descriptions under §408(l)(2)(B) to an employer is subject to a penalty of $50 per day.[2022] No penalty is imposed if the failure was due to reasonable cause.[2023] Reasonable cause is discussed at XI., below.

H. Actuarial Reports

1. Periodic Reports

The administrators of a qualified defined benefit plan must file an actuarial report with the IRS for the first plan year to which the ERISA funding requirements apply and at least every third plan year thereafter (or more frequently if the IRS requires).[2024]

Each administrator who fails to file a required actuarial report or who omits a material item of information called for in the actuarial report is jointly and severally liable for a $1,000 penalty.[2025] The penalty is payable in the same manner as a tax, following the issuance of a notice and demand by the IRS.[2026]

The penalty does not apply if the failure is due to reasonable cause.[2027] To claim the reasonable cause exception, the administrator must set forth all of the facts alleged as reasonable cause in a written statement, signed under penalties of perjury.[2028] Reasonable cause is described at XI., below.

For a full discussion of these reporting requirements, see 361 T.M., *Reporting and Disclosure Under ERISA*.

2. Merger or Consolidation

Not less than 30 days before a merger, consolidation, or transfer of assets or liabilities from a funded plan to another plan, the plan administrator must file an actuarial statement of valuation showing that each participant's benefit immediately after the transaction is not less than it would be if the plan had terminated.[2029]

Absent reasonable cause, any failure to file the actuarial statement properly subjects the plan administrator to a penalty of $250 for each day the failure continues, up to a maximum of $150,000.[2030] Reasonable cause is described at XI., below. For a full discussion of these reporting requirements, see 361 T.M., *Reporting and Disclosure Under ERISA*.

I. Savings Accounts

1. Archer Medical Savings Accounts

The IRS may require the trustee of an Archer medical savings account to make reports to the IRS and the account holder with respect to contributions to and distributions from the account, and such other matters as the IRS may determine.[2031] Contributions are reported on Form 5498-SA, *HSA, Archer*

[2015] §408(o)(4).

[2016] §6693(b)(1).

[2017] §6693(b)(2).

[2018] §6693(d). *See also* §6665 and §6671(a), discussed at XII., below.

[2019] §6693(b)(1), §6693(b)(2).

[2020] §408(l)(2)(C). For a discussion of SIMPLE retirement accounts, see 367 T.M., *IRAs*, and 368 T.M., *SEPs and SIMPLEs*.

[2021] §6693(c)(1).

[2022] §6693(c)(2).

[2023] §6693(c)(3).

[2024] §6059(a). The filing of this report is among the acts that may be postponed under §7508 and §7508A when the IRS publishes guidance providing relief related to a specific combat zone, qualifying deployment in a contingency operation, federally declared disaster, significant fire, or terroristic or military action. §7508A was amended by the Infrastructure Investment and Jobs Act to include significant fires for which assistance is provided after November 15, 2021. Pub. L. No. 117-58, §80504. See Tables, Charts & Lists > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions*, for an updated list of acts whose deadlines may be postponed.

[2025] §6692; Reg. §301.6692-1(a), §301.6692-1(d). The IRS may provide administrative relief from this penalty. *See, e.g.,* Notice 2014-35; Rev. Proc. 2015-32.

[2026] Reg. §301.6692-1(e).

[2027] §6692. The IRS may provide administrative relief from this penalty. *See, e.g.*, Notice 2014-35; Rev. Proc. 2015-32.

[2028] Reg. §301.6692-1(c).

[2029] §6058(b). The filing of this statement is among the acts that may be postponed under §7508 and §7508A when the IRS publishes guidance providing relief related to a specific combat zone, qualifying deployment in a contingency operation, federally declared disaster, significant fire, or terroristic or military action. §7508A was amended by the Infrastructure Investment and Jobs Act to include significant fires for which assistance is provided after November 15, 2021. Pub. L. No. 117-58, §80504. See Tables, Charts & Lists > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions*, for an updated list of acts whose deadlines may be postponed.

[2030] §6652(e), as amended by the Setting Every Community Up for Retirement Enhancement Act of 2019, Pub. L. No. 116-94, Div. O, §403, effective for returns, statements, and notifications required to be filed, and notices required to be provided after December 31, 2019. For returns, statements, and notifications required to be filed, and notices required to be provided, before January 1, 2020, the penalty was $25 a day with a maximum of $15,000. The IRS may provide administrative relief from this penalty. *See, e.g.,* Notice 2014-35; Rev. Proc. 2015-32.

[2031] §220(h). The reports must be filed at such times and in such manner as the IRS may require. A Medicare Advantage medical savings account is an Archer medical savings account that has been designated as such by the individual account holder. H.R. Conf. Rep. 217, 105th Cong., 1st Sess. 656 (1997). For a discussion of Archer medical savings accounts, see 335 T.M., *Health Care Reforms — Implications for Employee Benefit Plans*.

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MSA, or Medicare Advantage MSA Information. Copies must be filed with the IRS and furnished to the account holder by May 31.[2032] Form 1099-SA (Distributions From an HSA, Archer MSA, or Medicare Advantage MSA) is used to report distributions. The Form 1099-SA must be filed with the IRS by February 28 (March 31 if it is filed electronically), and a copy must be furnished to the account holder by January 31.[2033]

If the trustee fails to timely make the required reports, the trustee is subject to a penalty of $50 for each failure, unless the failure is due to reasonable cause.[2034] Reasonable cause is discussed at XI., below. The deficiency procedures of Chapter 63B do not apply to the assessment or collection of the penalty.[2035]

2. Health Savings Accounts

The IRS may require the trustee of a health savings account to make such reports regarding the account to the IRS and to the account beneficiary with respect to contributions, distributions, the return of excess contributions and such other matters as the IRS deems appropriate.[2036] Form 5498-SA (HSA, Archer MSA, or Medicare Advantage MSA Information) is used to report contributions. The form must be filed with the IRS and a copy furnished to the account beneficiary by May 31.[2037] Distributions are reported on Form 1099-SA (Distributions From an HSA, Archer MSA, or Medicare Advantage MSA). The Form 1099-SA must be filed with the IRS by February 28 (March 31 if it is filed electronically), and a copy must be furnished to the account beneficiary by January 31.[2038]

In addition, the IRS can require any person providing a high deductible health plan to an individual to make such reports to the IRS and the individual with respect to the plan as the IRS may determine.[2039] Such reports must be filed at such times and in such manner as the IRS determines.[2040]

A person who fails to timely file a required report is subject to a penalty of $50 for each such failure.[2041] The penalty does not apply, however, if the failure is due to reasonable cause.[2042] Reasonable cause is discussed at XI., below. The deficiency procedures of Chapter 63B do not apply to the penalty[2043]

3. Coverdell Educational Savings Accounts

The trustee of a Coverdell education savings account[2044] must make such reports to the IRS and to the account beneficiary as the IRS may determine.[2045] Contributions are reportable on Form 5498-ESA, *Coverdell ESA Contribution Information*. The report must generally be filed with the IRS by May 31 and must be furnished to the account beneficiary by April 30.[2046]

If the trustee fails to file such reports in the time and manner required, the trustee must pay a penalty of $50 for each such failure.[2047] No penalty is imposed if the failure was due to reasonable cause.[2048] The deficiency procedures do not apply to the assessment or collection of the penalty.[2049]

4. Qualified ABLE Programs

Officers or employees with control over qualified ABLE programs must make reports to the IRS and the beneficiaries regarding contributions, distributions, the return of excess contributions, and such other matters as the Secretary may require.[2050] Additionally, the program shall submit notice to the Secretary at formation of an ABLE program. The notice must contain the name and such other information as the Secretary may require.[2051]

[2032] Instructions for Form 5498-SA. This filing is among the acts that may be postponed under §7508 and §7508A when the IRS publishes guidance providing relief related to a specific combat zone, qualifying deployment in a contingency operation, federally declared disaster, significant fire, or terroristic or military action. §7508A was amended by the Infrastructure Investment and Jobs Act to include significant fires for which assistance is provided after November 15, 2021. Pub. L. No. 117-58, §80504. *See* Notice 2020-35 (Form 5498 series due date postponed from May 31, 2020 to August 31, 2020; postponement period disregarded for failure to file penalties). See Tables, Charts & Lists > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions*, for an updated list of acts whose deadlines may be postponed.

[2033] Instructions for Form 1099-SA. This filing is among the acts that may be postponed under §7508 and §7508A when the IRS publishes guidance providing relief related to a specific combat zone, qualifying deployment in a contingency operation, federally declared disaster, significant fire, or terroristic or military action. §7508A was amended by the Infrastructure Investment and Jobs Act to include significant fires for which assistance is provided after November 15, 2021. Pub. L. No. 117-58, §80504. See Tables, Charts & Lists > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions*, for an updated list of acts whose deadlines may be postponed.

[2034] §6693(a)(1), §6693(a)(2)(B).

[2035] §6693(d).

[2036] §223(h)(1).

[2037] Instructions for Form 5498-SA. The due date may be extended under §7508A. *See* Notice 2020-35 (Form 5498 series due date postponed from May 31, 2020 to August 31, 2020; postponement period disregarded for failure to file penalties). See Tables, Charts & Lists > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions*, for an updated list of acts whose deadlines may be postponed.

[2038] Instructions to Form 1099-SA. The IRS has the authority to postpone the due date under §7508A. See Tables, Charts & Lists > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions*, for an updated list of acts whose deadlines may be postponed.

[2039] §223(h)(2). A high deductible health plan is defined in §223(c)(2)(A).

[2040] §223(h) (flush language).

[2041] §6693(a)(1), §6693(a)(2)(C).

[2042] §6693(a)(1).

[2043] §6693(d).

[2044] Previously called an education IRA, but renamed as of July 26, 2001, pursuant to Pub. L. No. 107-22, §1(b)(2). For a discussion of Coverdell education savings accounts, see 517 T.M., *Educational Expenses and Credits*.

[2045] §530(h).

[2046] *See* Instructions for Form 5498-ESA. This filing is among those acts that may be postponed under §7508 and §7508A when the IRS publishes guidance providing relief related to a specific combat zone, qualifying deployment in a contingency operation, federally declared disaster, significant fire, or terroristic or military action. §7508A was amended by the Infrastructure Investment and Jobs Act to include significant fires for which assistance is provided after November 15, 2021. Pub. L. No. 117-58, §80504. For an updated list of postponed deadlines, see Tables, Charts & Lists, *Listing of Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions (Excerpt from Rev. Proc. 2018-58)*.

[2047] §6693(a)(1), §6693(a)(2)(F). The making of this report is among the acts that may be postponed under §7508 and §7508A when the IRS publishes guidance providing relief related to a specific combat zone, qualifying deployment in a contingency operation, federally declared disaster, significant fire, or terroristic or military action.

[2048] §6693(a)(1).

[2049] §6693(d).

[2050] §529A(d)(1). *See* REG-102837-15, RIN 1545-BM68, 80 Fed. Reg. 35,602 (June 22, 2015), and interim guidance provided in Notice 2015-81.

[2051] §529A(d)(3).

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If the officer or employee fails to file such reports in the time and manner required, the officer or employee must pay a penalty of $50 for each such failure.[2052] No penalty is imposed if the failure was due to reasonable cause.[2053] The deficiency procedures do not apply to the assessment or collection of the penalty.[2054]

J. Qualified Tuition Programs

Each officer or employee, or designee, having control of a qualified tuition program must make such reports as are required by the IRS regarding any contributions, distributions, or other matters to the IRS and to designated beneficiaries of the program.[2055] If the distribution is made from a qualified tuition program of a designated beneficiary after December 31, 2023, the officer or employee having control of the qualified tuition program (or their designee) must provide a report to the trustee of the Roth IRA to which the distribution is made.[2056] Such reports must be filed as required by the IRS and must include information regarding the contributions, distributions, and earnings of the qualified tuition program as of the date of the distribution.[2057] If the officer, employee, or designee fails to file such reports in the time and manner required, that person must pay a penalty of $50 for each failure to file the report.[2058] No penalty is imposed if the failure was due to reasonable cause.[2059] Reasonable cause is discussed at XI., below.

K. Mortgage Credit Certificates

In lieu of issuing tax-exempt bonds to assist taxpayers in purchasing a principal residence, a state or local government can issue mortgage credit certificates to qualified taxpayers.[2060] A mortgage credit certificate entitles the recipient to an income tax credit equal to a portion of the interest paid on qualified indebtedness used to finance the acquisition, qualified rehabilitation, or improvement of a qualified residence.

A state official must certify that the program meets the requirements for mortgage credit certificates.[2061] To receive a mortgage credit certificate, the taxpayer must certify his eligibility to the issuer.[2062] Each of the statements must be signed under penalties of perjury.[2063]

A person who makes a material misstatement in any verified written statement made under penalties of perjury with respect to the issuance of a mortgage credit certificate, which misstatement is due to such person's negligence, is subject to a $1,000 penalty for each mortgage credit certificate with respect to which the misstatement was made.[2064] If the misstatement was due to fraud, the penalty is $10,000 for each mortgage credit certificate.[2065]

The lender is required to file an annual report on Form 8329, *Lender's Information Return for Mortgage Credit Certificates*, for each issue of mortgage credit certificates with respect to which the lender made mortgage loans during the year.[2066] The issuer must file quarterly reports on Form 8330 (Issuer's Quarterly Information Return for Mortgage Credit Certificates) relating to the mortgage credit certificates issued during the quarter.[2067]

A lender or issuer who fails to file a required report is subject to a $200 penalty for each failure, unless it is shown that the failure is due to reasonable cause and not willful neglect.[2068] In the case of an issuer, the aggregate penalty cannot exceed $2,000.[2069]

L. Transfers at Death and by Gift

The executor of a estate must file an estate tax return where the gross estate at the death of a citizen or resident exceeds the basic exclusion amount in effect under §2010(c) for the calendar year which includes the date of death.[2070] In the case of the estate of every nonresident who is not a U.S. citizen, an estate tax return must be filed if the portion of the gross estate situated in the United States exceeds $60,000.[2071]

§6035 requires an executor of an estate required to file a return under §6018(a), to file with the IRS and each person acquiring an interest in property included in the decedent's gross estate, a statement identifying the value of each interest in the property as reported on the §6018(a) return.[2072] The IRS is permitted to set the due date, but it cannot be earlier than 30 days after the date the §6018(a) return was due, including extensions, or 30 days after the return is filed.[2073] If there is an adjustment to the property values, the executor must file a supplemental statement no later than 30 days after the adjustment.[2074]

[2052] §6693(a)(1), §6693(a)(2)(E).

[2053] §6693(a)(1).

[2054] §6693(d).

[2055] §529(d)(1), as amended by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §126(c), applicable to distributions after December 31, 2023. For recordkeeping and reporting requirements, see Notice 2001-81. For a discussion of qualified tuition programs, see 518 T.M., *Exclusion of Scholarships and Other Receipts for Education.*

[2056] §529(d)(2) (reference to §529(c)(3)(E)), added by SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §126(c)(3).

[2057] §529(d)(2).

[2058] §6693(a)(1), §6693(a)(2)(D).

[2059] §6693(a)(1).

[2060] §25.

[2061] Reg. §1.25-4T(d).

[2062] Reg. §1.25-3T.

[2063] Reg. §1.25-1T(c).

[2064] §6709(a).

[2065] §6709(b).

[2066] §25(g); Reg. §1.25-8T(a). The return is due on January 31 of the following year.

[2067] §25(g); Reg. §1.25-8T(b). The returns are due April 30 (for the quarter ended March 31), July 31 (for the quarter ended June 30), October 31 (for the quarter ended September 30), and January 31 (for the quarter ended December 31).

[2068] §6709(c). *See* Reg. §1.25-8T(a)(1), §1.25-8T(b)(2). Reasonable cause is discussed at XI., below.

[2069] §6709(c).

[2070] §6018(a)(1).

[2071] §6018(a)(2).

[2072] §6035(a)(1). *See* §1014(f) (consistent basis requirement for property received from decedent). For §6035 statements due prior to June 30, 2016, the IRS extended the due date for filing or furnishing the statements to June 30, 2016. Reg. §1.6035-2(a), added by T.D. 9797, 81 Fed. Reg. 86,953 (Dec. 2, 2016); Notice 2016-27. Previous extensions were issued to allow the IRS time to develop guidance and forms regarding §6035 statements. Notice 2016-19 (executors and other persons required to file a §6035 statement before March 31, 2016, need not do so until March 31, 2016), Notice 2015-57 (Feb. 29, 2016 deadline).

[2073] §6035(a)(3)(A).

[2074] §6035(a)(3)(B).

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An executor who fails to file the required statement is subject to penalties under §6721 and §6722.[2075]

Proposed regulations providing guidance on §6035 information reporting for the value of property acquired from a decedent were published in March 2016.[2076] The proposed regulations would provide that an executor required to file an estate tax return is also required to file Form 8971, *Information Regarding Beneficiaries Acquiring Property from a Decedent*, with the IRS to report the final value of certain property, and that the executor also would be required to furnish Schedule A to Form 8971 to each beneficiary who has acquired (or will acquire) property from the decedent or by reason of the death of the decedent to report that property and its final value.[2077]

A donor must file gift tax returns with respect to certain transfers.[2078]

For discussion of the consistent basis rules for persons acquiring property from a decedent, see 560 T.M., *Income Tax Basis: Overview and Conceptual Aspects*. For discussion of estate tax returns, gift tax returns, and the §6035 reporting requirements, see 822 T.M., *Estate, Gift, and Generation-Skipping Tax Returns and Audits* (Estates, Gifts, and Trusts Series).

M. Penalty for Failing to Maintain Minimum Essential Health Coverage

Individuals failing to maintain minimum essential health coverage for himself/herself or dependents are subject to a penalty.[2079] *See* 335 T.M., *Health Care Reforms — Implications for Employee Benefit Plans*, for a discussion of the §5000A penalty.

N. Penalty for Failure to Provide Notice Regarding Small Employer Health Reimbursement Arrangements

Any employer funding a qualified small employer health reimbursement arrangement as described under §9831(d)(2) must provide written notice to each eligible employee no later than 90 days before the beginning of each year (or, in the case of an employee that is not eligible to participate as of the beginning of the year, no later than the date such employee is first eligible).[2080] The notice must include: (1) the amount of the eligible employee's permitted benefit; (2) a statement that the employee should provide the amount of the permitted benefit to any health insurance exchange to which the employee applies for advance payment of the premium assistance tax credit under §36B; and (3) a statement that if the employee is not covered under minimum essential coverage for any month the employee may be subject to the penalty under §5000A (as discussed at IX.M., above).[2081]

If the employer fails to provide such notice, the employer is subject to a penalty of $50 per employee per incident of failure, not to exceed $2,500 for all such failures during any calendar year, unless such failure is shown to be due to reasonable cause, and not willful neglect.[2082]

O. Penalty for Failure to Provide Notice Regarding Qualified Equity Grants

In the case of each failure to provide notices as required by §83(i)(6) with respect to qualified equity grants, a $100 per failure penalty applies on notice and demand from the Secretary. The total penalty for all failures in any calendar year cannot exceed $50,000. The penalty is not applied if the failure is due to reasonable cause and not willful neglect.[2083] Reasonable cause is discussed at XI., below.

For a discussion of §83(i) qualified equity grants, see 385 T.M., *Deferred Compensation Arrangements*.

P. Penalty for Failure to Notify Health Plan of Cessation of Eligibility for Continuation Coverage Premium Assistance

Any person who fails to notify a group health plan when premium assistance ceases to apply due to eligibility for other group health plan coverage or Medicare benefits shall pay a penalty of $250 for each such failure.[2084] Where the failure is fraudulent, the penalty is the greater of $250, or 110% of the premium assistance provided under Pub. L. No. 117-2, §9501(a)(1)(A) after termination of eligibility.[2085] The penalty does not apply if the failure is due to reasonable cause, not willful neglect.[2086]

For a discussion of COBRA continuation coverage premium assistance, see 338 T.M., *COBRA — Consolidated Omnibus Budget Reconciliation Act of 1985*.

[2075] §6724(d)(1)(D), §6724(d)(2)(II). The reasonable cause defense is available. §6724(a).

[2076] REG-127923-15, 81 Fed. Reg. 11,486 (Mar. 4, 2016); Prop. Reg. §1.6035-1(i) (noting that the proposed regulations would apply to property acquired from a decedent, or by reason of the death of a decedent, whose estate tax return is filed after July 31, 2015, and that taxpayers may rely on the proposed regulations prior to the adoption of final rules).

[2077] Prop. Reg. §1.6035-1(a)(1).

[2078] §6019.

[2079] §5000A.

[2080] §9831(d)(4)(A). Notice 2017-20 stated that the requirement to furnish initial written notice to eligible employees would be extended until 90 days after the IRS released further guidance. The IRS released further guidance in Notice 2017-67 and stated that employers that offer a qualified small employer health reimbursement arrangement during 2017 or 2018 must furnish initial written notice to eligible employees by the later of (1) February 19, 2018, or (2) 90 days before the first day of the plan year of the qualified small employer health reimbursement arrangement. For employers that provided initial written notice to employees prior to the release of Notice 2017-67, the standard for the contents of the written notice was held to a reasonable good faith interpretation of Pub. L. No. 114-255. Following the release of Notice 2017-67, employers must furnish initial written notice to each eligible employee in compliance with the guidance in Notice 2017-67. See 335 T.M., *Health Care Reforms — Implications for Employee Benefit Plans*, for further discussion of the notice requirement.

[2081] §9831(d)(4)(B).

[2082] §6652(o). The penalty does not apply to failures under this provision if the notice is provided within 90 days after the date of enactment. *See* Notice 2017-67 (extending the deadline for furnishing initial written notice for employers that provided qualified small employer health reimbursement arrangements during 2017 and 2018 to the later of (1) February 19, 2018, or (2) 90 days before the first day of the plan year of the qualified small employer health reimbursement arrangement).

[2083] §6652(p) (reference to §83(i)(6)).

[2084] §6720C(a) (reference to Pub. L. No. 117-2, §9501(a)(2)(B)), added by the American Rescue Plan Act of 2021, Pub. L. No. 117-2, §9501(b)(2), effective March 11, 2021. The Secretary of Labor will set the time and manner of notification. §6720C(a).

[2085] §6720C(b).

[2086] §6720C(c).

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Q. Penalty for Sale of Designated Drugs During Noncompliance Periods

An excise tax is imposed on the sale of a designated drug by the manufacturer, producer, or importer during a noncompliance period.[2087] See 507 T.M., *Income Tax Liability: Concepts and Calculation*, for a discussion of the §5000D penalty.

[2087] §5000D, added by Inflation Reduction Act, Pub. L. No. 117-169, §11003, applicable to sales after August 16, 2022. *See Excise Tax Navigator*, at Federal 5.15.

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X. Reporting for Certain Foreign Persons

A. Foreign Persons Investing in U.S. Real Property

To the extent provided in regulations, a foreign person who holds a direct investment in a U.S. real property interest must file an annual return describing this interest.[2088] The IRS has declined to exercise its authority to issue regulations under §6039C. Instead, it is relying on the §1445 withholding rules for dispositions of U.S. real property interests as a means of enforcing the tax imposed on such dispositions under §897.[2089] The IRS has indicated that it will consider imposing the reporting requirement at a future date if it finds that the §1445 withholding requirements are inadequate.[2090]

A foreign person is treated as holding a direct investment if, at any time during the calendar year: (1) the person does not engage in any trade or business in the United States; and (2) the fair market value of the directly-held U.S. real property interests is at least $50,000.[2091] For this purpose, U.S. real property interests held by a partnership, trust, or estate are treated as owned proportionately by the partners and beneficiaries, and interests held by an individual's spouse or minor children are treated as owned by such individual.[2092]

Should the IRS implement reporting rules under §6039C,[2093] the penalty rules are already in place. A foreign person who does not timely file a proper return, as required by §6039C, is subject to a penalty of $25 for each day during which the failure continues, up to a maximum of $25,000 or five percent of the fair market value of the U.S. real property interests, whichever is less. The property's fair market value is determined as of the last day of the calendar year (or if the property has been disposed of during the calendar year, as of the date of disposition).[2094] The penalty does not apply, however, if the failure is due to reasonable cause and not willful neglect.[2095] Reasonable cause is discussed at XI., below.

For a discussion of foreign persons investing in U.S. real property, see 912 T.M., *U.S. Taxation of Foreign Investment in U.S. Real Estate* (Foreign Income Series).

B. Foreign Bank and Financial Accounts

1. FinCEN Form 114 (FBAR) — In General

The Bank Secrecy Act (BSA) authorizes the Treasury Secretary to require citizens or residents of the United States, or persons in, and doing business in, the United States, to maintain records and/or file reports related to certain foreign transactions and foreign accounts.[2096] Pursuant to this authority, Treasury promulgated regulations under 31 C.F.R. §1010.350 that require each person subject to the jurisdiction of the United States (except a foreign subsidiary of a U.S. person) having a financial interest in, or signature or other authority over, any bank, securities or other financial account in a foreign country to report such relationship to the IRS and to provide the information specified in a form prescribed by Treasury, which uses FinCen Form 114, *Report of Foreign Bank and Financial Accounts*, commonly referred to as an "FBAR."

Note: The U.S. Supreme Court has upheld the constitutionality of the foreign financial transaction reporting requirements.[2097]

The Treasury Department has delegated to the IRS enforcement authority over FBAR reporting.[2098] The FBAR instructions provide that the form must be filed by a U.S. person that has a financial interest in, or has signature or other authority over, any foreign financial accounts, if the aggregate value of such financial accounts exceeds $10,000 *at any time* during the calendar year.[2099]

Note: Foreign accounts holding virtual currency only currently are not reportable but FinCEN intends to modify the regulations to require such foreign accounts to be reported.[2100]

Certain exceptions to the filing requirements apply.[2101]

The FBAR is an annual report separate from a tax return that must be filed with Treasury. The report must be filed electronically using Treasury's BSA E-Filing System on or before April 15 of the year following the calendar year reported. An automatic six-month extension is available (and no extension form filing is required).[2102]

A corporation that owns, directly or indirectly, more than 50% of one or more other entities may file a consolidated FBAR for itself and such other entities.[2103] Individuals and certain entities also must answer a question on their respective tax returns about their ownership or signatory authority over a foreign account.[2104]

[2088] §6039C(a).

[2089] *See* Preamble to T.D. 8000, 49 Fed. Reg. 50,667 (Dec. 31, 1984), corrected by 50 Fed. Reg. 9614 (Mar. 11, 1985).

[2090] *See* T.D. 8000.

[2091] §6039C(b).

[2092] §6039C(c)(3).

[2093] *See* §6039(a).

[2094] §6652(f)(2), §6652(f)(3).

[2095] §6652(f)(1).

[2096] 31 U.S.C. §5314.

[2097] *See, e.g., Calif. Bankers Ass'n v. Schultz*, 416 U.S. 21 (1974), aff'g on this issue *Stark v. Connally*, 347 F. Supp. 1242 (N.D. Cal. 1972).

[2098] *See* 31 C.F.R. §1010.810(g).

[2099] Instructions to FinCen Form 114. See IRS Pub. 4261, *Do You Have a Foreign Financial Account?*, for guidance on determining when reporting is required for a financial account located outside the United States.

[2100] *See* FinCEN Notice 2020-2 (FBAR regulations do not currently define a foreign account holding solely virtual currency as a type of reportable account, but FinCEN intends to modify regulations).

[2101] Instructions to FinCen Form 114. For example, reporting is not required for a foreign bank account that is in a U.S. military banking facility or a U.S. military finance facility operated by a U.S. institution designated by the U.S. government to serve U.S. government installations abroad. In certain circumstances, employees and officers of commercial banks and employees and officers of large public domestic corporations (and their domestic and foreign subsidiaries in certain circumstances) do not have to file, if the individual does not have a personal financial interest in the account.

[2102] FinCen Form 114 and filing instructions are available on the Treasury website. The FBAR filing due date is April 15, which coincides with the federal income tax filing due date. FinCEN will grant filers failing to meet the annual April 15 due date an automatic extension to October 15. A specific request for an extension is not required. FinCEN will follow the federal income tax due date guidance such that when the federal income tax filing due date falls on a Saturday, Sunday, or legal holiday, the due date is delayed until the next day that is not a Saturday, Sunday, or legal holiday. Note that for tax years before 2016, the form was due on June 30 for the prior tax year.

[2103] Instructions to FinCen Form 114.

[2104] *See* Schedule B of Form 1040; Form 1065 and Form 1041.

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2. FinCEN Form 114 (FBAR) — Penalties

Failing to file the required report or maintain records can be punished under both civil and criminal law.[2105] The circuit courts are split on the constitutionality of the civil penalty.[2106]

The civil penalty can be imposed even if a criminal penalty is imposed with respect to the same violation.[2107] Criminal violations of the foreign account reporting rules include a fine of not more than $250,000, five years in prison, or both.[2108] If the failure to file an FBAR is part of a pattern of illegal activity involving more than $100,000 in a 12-month period, the statute allows the imposition of a fine of up to $500,000 and imprisonment of up to 10 years.[2109]

a. Penalties for Nonwillful FBAR Failures

Nonwillful failures to report may be subject to a penalty of up to $10,000 (adjusted for inflation).[2110] In *Bittner v. United States*,[2111] the Supreme Court held that penalties for nonwillful FBAR failures accrue on a per-report basis, ***not*** on a per-account basis. That is, nonwillful failure to file a compliant FBAR for a specific calendar year results in a single violation subject to a single penalty. (For willful reporting violations, penalties still apply per account.) The taxpayer in *Bittner* filed both late and inaccurate FBARs over a period of five years, collectively involving 272 accounts. The government argued that a penalty was applicable to each account not accurately or timely reported, and therefore issued a fine totaling $2.72 million, corresponding to $10,000 per account. Pointing to the rule of lenity,[2112] the Supreme Court stated that, "[b]est read, the BSA treats the failure to file a legally compliant report as one violation carrying a maximum penalty of $10,000, not a cascade of such penalties calculated on a per-account basis."[2113] In so holding, the Court resolved a conflict between the Fifth and Ninth Circuits, and remanded the case back to the Fifth Circuit for further proceedings.[2114] However, it did not address whether similarly situated taxpayers who paid nonwillful FBAR penalties on a per-account basis are entitled to a refund. The IRS administrative and/or legal pathways available to a taxpayer seeking to recover what may be an excessive penalty following *Bittner* are unclear.[2115]

> *Example:* Taxpayer (T) maintained six foreign bank accounts, each with a $50,000 balance. T was unaware of the obligation to file an FBAR for Year 1 and Year 2. Following an audit of T's Year 1 and Year 2 returns, the IRS informed T that he would be subject to FBAR penalties. The maximum penalty that can be imposed on T is $20,000: $10,000 for failing to file a Year 1 report and $10,000 for failing to file a Year 2 report.

b. Penalties for Willful FBAR Failures

Any person that willfully violates the reporting or recordkeeping requirements may be subject to a civil penalty of up to the *greater* of $100,000 (adjusted for inflation) or 50% of the balance in the account at the time of the violation.[2116] The timing of an FBAR violation for penalty calculation purposes is deemed to be the value of the account balance as of the annual FBAR filing deadline, i.e., April 15 (June 30 for tax years before 2016).[2117]

Willfulness can be attributed to a person under the concept of "willful blindness,"[2118] as discussed further below.

[2105] 31 U.S.C. §5321 (civil); 31 U.S.C. §5322 (criminal). The Secretary has six years to assess an FBAR civil penalty and, once assessed, has two years to bring an action to recover an unpaid penalty. 31 U.S.C. §5321(b)(1). The statute of limitations for criminal violations is five years. 18 U.S.C. §3282. See IRM 4.26.16.5 *et seq.* and IRM 4.26.7 for IRS guidance on imposing FBAR penalties.

[2106] *Compare United States v. Toth*, 33 F.4th 1 (1st Cir. 2022) (civil penalty imposed under 31 U.S.C. §5321(a)(5)(C)–31 U.S.C. §5321(a)(5)(D) is not a "fine," so the Excessive Fines Clause of the Eighth Amendment to U.S. Constitution does not apply), *cert. denied*, No. 22-177, 2023 BL 20167 (U.S. 2023) *with United States v. Schwarzbaum*, 127 F.4th 259 (11th Cir. 2025) (FBAR penalty has a substantial punitive purpose and thus subject to the Clause; some FBAR penalties assessed against taxpayer violated the Eighth Amendment because amounts were grossly disproportionate to offense of failure to report foreign account). Additionally, when the Ninth Circuit in *United States v. Bussell*, 699 Fed. App'x 695 (9th Cir. 2017), was presented with the opportunity to decide whether the Clause applies to willful FBAR penalties, it assumed without analysis that the Clause applies (9th Cir. 2017). At least two district courts in the Ninth Circuit have followed *Bussell* and assumed the Clause applies to FBAR penalties: *United States v. Leeds*, No. 1:22-cv-00379-AKB, 2025 BL 75357 (D. Idaho 2025) (FBAR penalties assessed against taxpayer were not grossly disproportionate but were grossly disproportionate as to his widow, who had no access to the accounts in question and no knowledge about them until the IRS began its investigation into the taxpayer after he had closed the accounts); *United States v. Kerr*, No. CV-19-05432-PHX-DJH, 2022 BL 107789 (D. Ariz. 2022).

[2107] 31 U.S.C. §5321(d).

[2108] 31 U.S.C. §5322(a); 31 C.F.R. §1010.840(b).

[2109] 31 U.S.C. §5322(b); 31 C.F.R. §1010.840(c).

[2110] 31 U.S.C. §5321(a)(5)(A), 31 U.S.C. §5321(a)(5)(B)(i). For inflation-adjusted amounts, see Tables, Charts & Lists, *FinCEN Civil Penalties*. There are two negligence penalties that generally apply only to trades or businesses and not to individuals. 31 U.S.C. §5321(a)(6). *See* IRM 4.26.16.5.3. A penalty of up to $500 may be assessed against a business for a negligent violation, and an additional penalty of up to $50,000 may be assessed for a pattern of negligence. 31 U.S.C. §5321(a)(6). For inflation-adjusted amounts, see Tables, Charts & Lists, *FinCEN Civil Penalties*.

[2111] 598 U.S. 85 (2023).

[2112] *Bittner*, 598 U.S. at 101 (citing *Commissioner v. Acker*, 361 U.S. 87 (1959)). Under the rule of lenity, statutes imposing penalties are to be construed strictly against the government and in favor of individuals. *Id.*

[2113] *Bittner*, 598 U.S. at 103.

[2114] *Compare United States v. Boyd*, 991 F.3d 1077 (9th Cir. 2021) (late filed, but accurate FBAR subject to one penalty), *with United States v. Bittner*, 19 F.4th 734 (5th Cir. 2021) (nonwillful FBAR penalty accrues on a per-account basis), rev'd and rem'd, 598 U.S. 85 (2023) (Bank Secrecy Act treats failure to file compliant FBAR as one violation carrying a maximum penalty of $10,000 per report).

[2115] *See IRS Penalty Refund Options for Foreign Account Holders Uncertain*, DTR (Mar. 20, 2023). For a further discussion of refund claims, see 631 T.M., *Refund Litigation*.

[2116] 31 U.S.C. §5321(a)(5)(C)(i), for violations occurring after October 22, 2004. For inflation-adjusted amounts, see Tables, Charts & Lists, *FinCEN Civil Penalties*. Note that there have been several instances of a voluntary disclosure program for not reporting foreign accounts. For further discussion, see 6085 T.M., *Report of Foreign Bank and Financial Accounts (FBAR)* (Foreign Income Series).

[2117] *See* 31 C.F.R. §1010.306(c); *United States v. Schwarzbaum*, 24 F.4th 1355 (11th Cir. 2022) (case remanded in part to properly calculate FBAR penalties as initial penalties were calculated based on highest account balances during year rather than balances on June 30).

[2118] *See United States v. Williams*, 489 Fed. App'x 655, 658 (4th Cir. 2012); *United States v. McBride*, 908 F. Supp. 2d 1186 (D. Utah 2012); IRM 4.26.16.5.5.1.

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Willfulness with respect to 31 U.S.C. §5321(a)(5)(C) includes recklessness.[2119] The Supreme Court defines recklessness as conduct objectively entailing an "unjustifiably high risk of harm that is either known or so obvious that it should be known."[2120] In *Bedrosian v. United States*,[2121] the taxpayer acted recklessly when he disregarded the warning of his accountant and willfully filed an inaccurate FBAR omitting a foreign account. The Third Circuit stated the taxpayer clearly ought to have known there was a grave risk that he was not meeting the FBAR filing requirement and was in a position to easily verify account information.[2122] The court further noted that if the taxpayer simply looked at the forms he was signing and submitting, he should have noticed the amount stated for the accounts was inaccurate.[2123]

The penalty for a nonwillful violation is not imposed if the violation was due to "reasonable cause."[2124]

Comment: Neither the statute nor the regulations define reasonable cause. As a result, the courts have looked to the rules under §6651(a) and §6664(c)(1) to define reasonable cause which requires ordinary business care and prudence.[2125] Taxpayers with a financial interest in or signature authority over a foreign financial account have a particular obligation to review Form 1040, Schedule B, Part III regarding specific questions about foreign accounts.

Comment: Willful penalty amounts were amended in 2004.[2126] Before amendment, 31 U.S.C. §5321(a)(5) provided a penalty cap of $100,000.

Note: Whether the FBAR civil penalty was capped at $100,000 by regulation or at the higher amounts in the amended statute has been litigated in several courts. Some courts held the IRS could not impose a penalty in excess of the $100,000 cap provided by regulation.[2127] For example, one court found the statute granted discretion to assess the penalties and the regulation was not clearly inconsistent with the amended statute; the lower regulatory cap was a subset of the penalties that could be assessed under the statute and the statute did not mandate imposition of the highest possible penalty.[2128] Other courts found the regulatory cap inconsistent with the new statutory cap, so the statute superseded the regulation and the FBAR civil penalty was not limited to $100,000.[2129]

For example, in *Kimble v. United States*,[2130] the Court of Federal Claims agreed with the IRS statement in IRM 4.26.16.4.5.1 that the statute was self-executing and the new penalty ceilings applied. The *Kimble* court also noted that the contrary holdings in *Wadhan* and *Colliot* were inconsistent with a Federal Circuit case,[2131] which held that the policies of one regulatory agency were invalidated when a statute transferred policy-making authority to a different agency; that the policy had never been formally withdrawn did not prevent it from being invalidated by the statute. The *Kimble* court reasoned, "like the legislation that [transferred authority from one agency to another], the [AJCA of 2004] replaced the prior penalty for willful violations … thereby nullifying any inconsistent regulations governing the pre-2004 statute."

3. *IRS Guidance on Imposing FinCEN Form 114 (FBAR) Penalties*

As an initial matter, an IRS examiner may determine that the facts and circumstances of a particular case do not justify asserting an FBAR penalty and that a warning letter should be issued instead. Aside from the mitigation guidelines for willful violations, examiners may determine that a penalty is not appropriate, or that a lesser (or greater) penalty amount than the guidelines would otherwise provide is appropriate. Examiners are instructed to consider whether compliance objectives would be achieved by issuance of a warning letter; whether the person

[2119] *United States v. Hughes*, 113 F.4th 1158 (9th Cir. 2024) (relying on *Safeco*, 551 U.S. 47 (2007), holding that willfulness includes both knowing and reckless violations); *United States v. Kelly*, 92 F.4th 598 (6th Cir. 2024) (same); *United States v. Rum*, 995 F.3d 882 (11th Cir. 2021) (same), cert. denied, 142 S. Ct. 591 (2021); *United States v. Horowitz*, 978 F.3d 80 (4th Cir. 2020) (same); *Norman v. United States*, 942 F.3d 1111 (Fed. Cir. 2019) (same); *Bedrosian v. United States*, 912 F.3d 144 (3d Cir. 2018) (same). *See also United States v. Collins*, 36 F.4th 487 (3d Cir. 2022) (omission deemed reckless with intent to deceive when taxpayer avoided receiving foreign account mail at U.S. address and desired to discreetly transfer funds for personal transactions); *United States v. Schwarzbaum*, 24 F.4th 1355 (11th Cir. 2022) (district court applied correct legal standard to determine that taxpayer recklessly violated FBAR requirements by reviewing FBAR instructions and then failing to report foreign assets for next three years); *Kimble v. United States*, 141 Fed. Cl. 373 (Fed. Cl. 2018), aff'd, 991 F.3d 1238 (Fed. Cir. 2021) (willful, reckless disregard when taxpayer maintained foreign account with numbers to avoid using name, had constructive knowledge of duty to disclose foreign account, and indicated no foreign accounts on returns), cert. denied, 142 S. Ct. 98 (2021).

[2120] *Safeco Ins. Co. of Am. v. Burr*, 551 U.S. 47, 68 (2007) (quoting *Farmer v. Brennan*, 511 U.S. 825, 836 (1994)).

[2121] 42 F.4th 174 (3d Cir. 2022), cert. denied, 143 S. Ct. 2636, 2023 BL 208463 (U.S. 2023).

[2122] *Bedrosian*, 42 F.4th 174 (3d Cir. 2022).

[2123] *Bedrosian*, 42 F.4th 174 (3d Cir. 2022).

[2124] 31 U.S.C. §5321(a)(5)(B)(ii), 31 U.S.C. §5321(a)(5)(C)(ii). While civil enforcement has been delegated to the IRS, the IRC collection and enforcement powers are not available to enforce FBAR civil penalties, which remain collectible only in accordance with the procedures for nontax collections. *See* 31 U.S.C. §3711(g); *United States v. Collins*, 36 F.4th 487 (3d Cir. 2022) (while Bank Secrecy Act offers no independent authority to collect additional failure-to-pay penalties through the Federal Claims Collection Act (31 U.S.C. §3717), FBAR penalties fall within auspices of act as nontax debt under 31 U.S.C. §5321(a)(5)).

[2125] *Jarnagin v. United States*, 134 Fed. Cl. 368 (2017). Reasonable cause is discussed further at XI., below.

[2126] AJCA of 2004, Pub. L. No. 108-357, §821.

[2127] The regulatory $100,000 cap had been held to apply per violation, so the IRS could impose an aggregate penalty in excess of $100,000, as long as the penalty amount for each year was less than the limit. *United States v. Shinday*, No. 2:18-cv-06891-CAS-Ex, 2018 BL 447173 (C.D. Cal. 2018).

[2128] *United States v. Wadhan*, 325 F. Supp. 3d 1136 (D. Colo. 2018). *See United States v. Colliot*, No. AU-16-CA-01281-SS, 2018 BL 175652 (W.D. Tex. May 15, 2018).

[2129] *United States v. Kahn*, No. 19-3920, 2021 BL 260918 (2d Cir. 2021) (following *Norman* and *Rum*); *United States v. Rum*, 995 F.3d 882 (11th Cir. 2021) (following *Norman*); *United States v. Park*, 389 F. Supp. 3d 561 (N.D. Ill. 2019) (regulations implement statutes, not make law; 31 U.S.C. §5321(a)(5)(C) intentionally increased penalty maximum and no regulation can reduce that amount); *United States v. Cohen*, No. CV 17-1652-MWF (JCx), 2019 BL 364461 (C.D. Cal. 2019) (because 31 U.S.C. §5321(a)(5) was revised after 31 C.F.R. §1010.820(g)(2) was issued, logically statute raised maximum penalty and superseded regulation); *Norman v. United States*, 942 F.3d 1111 (Fed. Cir. 2019).

[2130] 141 Fed. Cl. 373 (Fed. Cl. 2018), aff'd, 991 F.3d 1238 (Fed. Cir. 2021) (imposed maximum 50% penalty); *cert. denied*, No. 20-1697 (S. Ct. Oct. 4, 2021). *See also United States v. Toth*, No. 15-cv-13367-ADB, 2020 BL 353453 (D. Mass. 2020) (following *Kimble*), *aff'd*, 33 F.4th 1 (1st Cir. 2022); *United States v. Horowitz*, 361 F. Supp. 3d 511 (D. Md. 2019), aff'd, 978 F.3d 80 (4th Cir. 2020) (following *Kimble*); *United States v. Cohen*, No. CV 17-1652-MWF (JCx), 2019 BL 364461 (C.D. Cal. 2019) (following *Kimble*); *United States v. Schoenfeld*, 396 F. Supp. 3d 1064 (M.D. Fla. 2019) (following *Kimble*).

[2131] *Barseback Kraft AB v. United States*, 121 F.3d 1475 (Fed. Cir. 1997).

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who committed the violation previously was issued a warning letter or was assessed an FBAR penalty; the nature of the violation and the amounts involved; and the cooperation of the taxpayer during the examination.[2132]

In most cases of nonwillful violations, the IRS will recommend one $10,000 penalty (subject to an inflation adjustment) per violation. In ascertaining the penalty amount for nonwillful violations (assuming reasonable cause, which is discussed further below, does not apply), the IRS instructs examiners to use discretion to calculate a penalty commensurate with the facts and circumstances of the case[2133]

Following the *Bittner* decision, discussed above, the IRS eliminated the mitigation guidelines for nonwillful FBAR violations as the prior per-account penalty interpretation no longer is relevant in such cases.[2134]

The mitigation provisions nevertheless continue to apply in the case of willful violations. If the filer qualifies for mitigation, the IRS will calculate a mitigated penalty amount using the applicable guidelines in IRM Exhibit 4.26.16-2 in conjunction with the guidance in IRM 4.26.16.5.5 to complete the willful penalty determination. The following criteria are used by the IRS when making a mitigation determination:

- the person has no history of past FBAR penalty assessments or criminal tax or Bank Secrecy Act convictions for the preceding 10 years;
- no money passing through any of the foreign accounts associated with the person was from an illegal source or used to further a criminal purpose;
- the person cooperated during the examination (i.e., the IRS did not have to resort to a summons to obtain nonprivileged information; the taxpayer responded to reasonable requests for documents; meetings, and interviews; or the taxpayer back-filed correct reports); and
- the IRS did not sustain a civil fraud penalty against the person for an underpayment for the year in question due to the failure to report income related to any amount in a foreign account.[2135]

Pursuant to the IRS mitigation guidelines for willful FBAR violations, there are four penalty levels depending on the highest amount in the account during the period for which the FBAR should have been filed. Under Level I (willful), if the maximum aggregate balance for all accounts to which the violations relate did not exceed $50,000 during the calendar year, the penalty is the greater of $1,000 per year or 5% of the maximum aggregate balance of the accounts during the year to which the violations relate. The penalties under Levels II through IV are computed on a per account basis. Under Level II (willful), if the maximum aggregate balance for all accounts to which the violations relate exceeds $50,000 but does not exceed $250,000, then for each account for which there was a violation, the penalty is the greater of $5,000 or 10% of the maximum account balance during the calendar year at issue. Under Level III (willful), if the maximum aggregate balance for all accounts to which the violations relate exceeds $250,000 but does not exceed $1,000,000, then for each account for which there was a violation, the penalty is the greater of 10% of the maximum account balance during the calendar year at issue or 50% of the account balance on the day of the violation. Under Level IV (willful), if the maximum aggregate balance for all accounts to which the violations relate exceeds $1,000,000, then for each account for which there was a violation, the penalty is the greater of 50% of the balance in the account at the time of the violation or $100,000 (i.e., the statutory maximum penalty).[2136]

In some cases, the IRS may assert a negligence penalty. In determining whether to apply the negligence penalty, the IRS utilizes principles under Reg. §1.6664-4 as guidance in understanding the factors to consider.[2137]

In yet other cases, the IRS may determine that the filer's failure was due to reasonable cause. Factors that may weigh in favor of finding that an FBAR violation was due to reasonable cause include, but are not limited to: (1) reliance upon the advice of a professional tax advisor who was informed of the existence of the foreign financial account; (2) the unreported account was established for a legitimate purpose and there were no indications of efforts taken to intentionally conceal the reporting of income or assets; and (3) that there was no deficiency related to the unreported foreign account (or the deficiency was de minimis). Factors that may weigh against finding that an FBAR violation was due to reasonable cause include, but are not limited to: (1) whether the taxpayer's background and education indicate that he should have known of the FBAR reporting requirements; (2) whether there was a deficiency related to the unreported foreign account; and (3) whether the taxpayer failed to disclose the existence of the account to the person preparing his tax return.[2138]

Example: Reasonable Cause — Taxpayer (T) is a U.S. citizen who lives and works in Country B as a computer programmer. T has checking and savings accounts with a bank that is located in the city where he lives. The aggregate balance of the checking and savings accounts is $50,000 during the tax year. T complied with Country B's tax laws and properly reported all his income on Country B tax returns. T failed to file federal income tax returns

[2132] See IRM 4.26.16.5.2.1 (06-24-21).

[2133] SBSE-04-0723-0034 (Jul. 6, 2023) (revising IRM 4.26.16.5.4.1).

[2134] *See* SBSE-04-0723-0034 (Jul. 6, 2023). Previously, there were three penalty levels depending on the highest amount in the account during the period for which the FBAR should have been filed. If the aggregate balance of all accounts held during the year did not exceed $50,000, the penalty for each violation was $500, not to exceed a total of $5,000 in penalties. If the aggregate balance of the accounts was over $50,000, but less than $250,000, the penalty was $5,000 per violation. For violations regarding an account exceeding $250,000, the penalty per violation was the statutory maximum of $10,000. *See* former IRM Exhibit 4.26.16-2 (06-24-21), *amended by* SBSE-04-0723-0034 (Jul. 6, 2023).

[2135] *See* IRM Exhibit 4.26.16-2 (06-24-21), *modified by* SBSE-04-0723-0034 (Jul. 6, 2023).

[2136] IRM Exhibit 4.26.16-2 (06-24-21), *modified by* SBSE-04-0723-0034 (Jul. 6, 2023). *See, e.g., Kimble v. United States*, 141 Fed. Cl. 373 (Fed. Cl. 2018), aff'd, 991 F.3d 1238 (Fed. Cir. 2021), *cert. denied*, No. 20-1697 (S. Ct. Oct. 4, 2021) (IRS applied mitigation guidelines to facts and concluded that statutory maximum willful penalty applied: taxpayer had no significant connection to foreign country where account was located, taxpayer actively managed foreign account, and taxpayer had direct interest in account, regardless of whether she was sole beneficiary of account).

[2137] IRM 4.26.16.5.3.1 (06-24-21).

[2138] IRM 4.26.16.5.4 (06-24-21).

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> and failed to file FBARs to report his financial interest in the checking and savings accounts. After reading recent press and thus learning of his federal income tax return and FBAR reporting obligations, T filed delinquent FBARs, reporting both foreign accounts, and attached statements to the FBARs explaining that he was previously unaware of his obligation to report the accounts on an FBAR. T also filed federal income tax returns properly reporting all income and no tax was due. Based on all the facts and circumstances, the IRS determines that T had a legitimate purpose for maintaining the foreign accounts, there were no indications of efforts taken to intentionally conceal the reporting of income or assets, no tax was due, and T's explanation for why he failed to timely file an FBAR appears reasonable. Accordingly, the IRS determines that the FBAR violation was due to reasonable cause and that no FBAR penalty will be asserted.[2139]

Other nontax sections of the U.S. Code contain numerous provisions relating to monitoring and controlling the flow of money abroad.[2140] Civil penalties are provided to enforce each of these provisions. Such penalties, however, are beyond the scope of this Portfolio.

For a further discussion of the rules on reporting foreign bank and financial accounts and the exceptions to reporting, see 6085 T.M., *Report of Foreign Bank and Financial Accounts (FBAR)* (Foreign Income Series).

C. *Specified Foreign Financial Assets*

Section 6038D requires individual taxpayers with an interest in a "specified foreign financial asset" during the tax year to attach a disclosure statement to their income tax return if the aggregate value of all such assets is greater than $ 50,000 (or any higher dollar amount that the Secretary may prescribe). "Specified foreign financial assets" are depository or custodial accounts at foreign financial institutions and, to the extent not held in an account at a financial institution, include (1) stocks or securities issued by foreign persons, (2) any other financial instrument or contract held for investment that is issued by or has a counterparty that is not a U.S. person, and (3) any interest in a foreign entity.[2141]

Individuals who fail to furnish the required information on specified foreign financial assets are subject to a penalty of $10,000 for the tax year.[2142] An additional penalty may apply if the Secretary notifies an individual by mail of the failure to disclose and the failure to disclose continues. If the failure continues beyond 90 days following the mailing, the penalty increases by $10,000 for each 30-day period (or a fraction thereof), up to a maximum penalty of $50,000 for one tax year.[2143] No penalty is imposed as a result of a failure that was due to reasonable cause and not willful neglect.[2144] Foreign law prohibitions against disclosure of the required information cannot be relied upon to establish reasonable cause.[2145]

Comment: The information requested under §6038D is similar to that required on an FBAR, and certain assets may be reportable on both reports; however, the information required is not identical. Regulatory exceptions avoid duplicative reporting requirements for assets reported on other forms.[2146]

Additional penalties may apply if there are undisclosed foreign financial assets. A 40% accuracy-related penalty can be imposed on any understatement of tax attributable to an undisclosed foreign financial asset.[2147] In addition, a six-year limitations period is authorized for assessment of tax on understatements of income attributable to foreign financial assets. The six-year limitations period applies if there is an omission of gross income in excess of $5,000 and the omitted gross income is attributable to an asset with respect to which information reports are required under §6038D, as applied without regard to the dollar threshold and certain exceptions provided by regulations.[2148]

For a further discussion of the reporting requirements of §6038D, see the Instructions for Form 8938 and 6085 T.M., *Report of Foreign Bank and Financial Accounts (FBAR)* (Foreign Income series).

D. *Information with Respect to Foreign Trusts*

1. *In General*

Under §6048(a), a U.S. person generally must file Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, to notify the IRS of a "reportable event" with respect to a foreign trust by their income tax return due date, including extensions.[2149] Reportable event includes: (1) the creation of any foreign trust by a U.S. person; (2) the transfer of any money or property (directly or indirectly) to such a trust by a U.S. person, including by reason of death; and (3) the death of a U.S. citizen or resident if such person was treated as the owner of any portion of such a trust or any portion of such a trust was included in the decedent's gross estate.[2150] Exceptions exist for certain fair market value sales and deferred compensation and charitable trusts.[2151]

Note: The IRS issued proposed regulations under §6048 and §6677 to provide information reporting guidance for transactions with foreign trusts.[2152] For a detailed discussion of the

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[2139] *See* IRS Fact Sheet FS-2011-13 (Dec. 7, 2011). The fact sheet does not provide for a definition of "de minimis" and such an analysis would rely on a facts and circumstances approach.

[2140] *See, e.g.*, Bank Secrecy Act, 12 U.S.C. §1951 *et seq.*; International Money Laundering Abatement and Financial Anti-Terrorism Act, 31 U.S.C. §5301 *et seq.*; International Investment and Trade in Services Survey Act, 22 U.S.C. §3101 *et seq.*; Trading with the Enemy Act, 50 App. U.S.C. §1 *et seq.*; Foreign Narcotics Kingpin Designation Act, 21 U.S.C. §1901 *et seq.*; International Emergency Economic Powers Act, 50 U.S.C. §1701 *et seq.*; USA Patriot Act, 18 U.S.C. §1 *et seq.*

[2141] §6038D(b); Reg. §1.6038D-3(a), §1.6038D-3(b).

[2142] §6038D(d)(1).

[2143] §6038D(d)(2); Reg. §1.6038D-8(a); Instructions for Form 8938.

[2144] §6038D(g); Reg. §1.6038D-8(c).

[2145] §6038D(g); Reg. §1.6038D-8(e)(3).

[2146] Reg. §1.6038D-7(a).

[2147] *See* §6662(j). A further discussion of this penalty under §6662(j) is provided at IV.K., above.

[2148] §6501(e)(1)(A).

[2149] §6048(a); Instructions for Form 3520 (*Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*). Until the IRS issues regulations under §6048, taxpayers must comply with Notice 97-34.

[2150] §6048(a)(3)(A).

[2151] §6048(a)(3)(B).

[2152] See Prop. Reg. §1.6048-1–§1.6048-7, Prop. Reg. §1.6677-1, REG-124850-08, 89 Fed. Reg. 39,440 (May 8, 2024). Taxpayers can rely on

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§6048 proposed regulations, see 6500 T.M., *U.S. Taxation of Foreign Estates, Trusts and Beneficiaries* (Foreign Income Series). For a detailed discussion of the §6677 penalty for failing to report under §6048, see X.D.2., *below*.

Reporting must be done within 90 days (or such later day as the Secretary may prescribe) of any reportable event.[2153] Notwithstanding, Form 3520 is due by April 15, with a maximum extension period of six months.[2154]

Section §7701(a)(30) includes as U.S. persons a U.S. citizen or resident alien, a domestic or partnership, any estate other than a foreign estate within the meaning of §7701(a)(31)(A), and any domestic trust.[2155]

Under §6048(b), a U.S. person that is treated as the owner of any portion of a foreign trust under the grantor trust rules[2156] must submit information as may be required with respect to the trust and, in addition, is responsible for ensuring that the trust files an annual information return.[2157] The U.S. person that is treated as the owner of any portion of a foreign trust under the grantor trust rules[2158] must annually file Form 3520.[2159] The foreign trust is required to file Form 3520-A, *Annual Information Return of Foreign Trust with a U.S. Owner*[2160] and provide information about the trust and each U.S. person (1) who is treated as the owner of any portion of such trust or (2) who receives any direct or indirect distribution from the trust.[2161] Under proposed regulations, where a foreign trust fails to comply with its reporting requirements, the U.S. owner must file both Form 3520, Part II, and Form 3520-A and related statements, by the 15th day of the 4th month after the close of the U.S. owner's tax year.[2162]

Any U.S. person receiving a distribution from a foreign trust (as a beneficiary) is required under §6048(c) to file a return with respect to such trust reporting the name of the trust and aggregate amount of distributions received from the trust during the tax year and information that will allow the IRS to determine the distribution's proper treatment.[2163] If such information is not provided, the IRS can treat the distribution as an accumulation distribution, subject to §668.[2164]

A "foreign trust" is any trust that is not treated as a "United States person" ("U.S. person") under §7701(a)(30)(E).[2165] To the extent provided in regulations, a trust that is a U.S. person is treated as a foreign trust for purposes of the penalties for failing to file under §6048 if the trust has substantial activities, or holds substantial property outside the United States.[2166] Until additional guidance is issued, domestic trusts will not be treated as foreign trusts.[2167]

Note: U.S. persons who hold interests in Canadian registered retirement savings plans and registered retirement income funds do not have to report any transactions with respect to those interests under §6048.[2168]

For a detailed discussion of the §6048 information reporting requirements, see 6500 T.M., *U.S. Taxation of Foreign Estates, Trusts and Beneficiaries* (Foreign Income Series).

2. *Penalty for Failing to Timely File or Provide Information with Respect to Foreign Trusts*

Section 6677 imposes penalties on U.S. persons for failing to comply with §6048.

Note: The IRS issued proposed regulations under §6048 and §6677 to provide information reporting guidance for transactions with foreign trusts.[2169] For a detailed discussion of the §6048 proposed regulations, see 6500 T.M., *U.S. Taxation of Foreign Estates, Trusts and Beneficiaries* (Foreign Income Series).

Reporting must be done within 90 days (or such later day as the Secretary may prescribe) after any reportable event.[2170] Any person who does not timely file any notice or return required by §6048(a) or §6048(c) or who does not provide complete and accurate information on such notice or return is subject to a penalty equal to the greater of 35% of the "gross reportable amount," or $10,000.[2171] For failures to file under §6048(b) by a U.S. person treated as the owner of any portion of a foreign trust under the grantor trust rules, the penalty is equal to the greater of 5% (rather than 35%) of the "gross reportable amount" or $10,000.[2172] The U.S. owner of a foreign trust for that fails to file a Form 3520-A, or that does not provide all information or required attachments, is also subject to the same 5% or $10,000 penalty.[2173] The proposed regulations

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the proposed regulations for tax years ending after May 8, 2024, and beginning on or before the date final regulations are published.

[2153] §6048(a)(1).

[2154] Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, §2006(b)(10).

[2155] *See* CCA 201325013 (where married nonresident alien taxpayer does not make a §6013(g) election to be treated as a resident alien for certain tax purposes, taxpayer is not subject to reporting requirements of §6048 and thus not subject to §6677(a) penalty for failure to file information returns under §6048).

[2156] For a discussion of foreign grantor trusts, see 6500 T.M., *U.S. Taxation of Foreign Estates, Trusts and Beneficiaries* (Foreign Income Series).

[2157] §6048(b).

[2158] *See* §671–§679.

[2159] *See* §6048(b)(1). Form 3520 filing instructions require the U.S. owner to attach a copy of the Foreign Grantor Trust Owner Statement from Form 3520-A, if such statement has been provided to the U.S. owner.

[2160] Form 3520-A is due by the 15th day of the third month after the close of the trust's tax year. Notice 97-34; Instructions to Form 3520-A. The maximum extension is six months. Pub. L. No. 114-41, §2006(b)(9).

[2161] *See* §6048(b)(1). A Foreign Grantor Trust Owner Statement must be provided to each U.S. person treated as an owner of the foreign trust and a Foreign Grantor Trust Beneficiary Statement must be provided to each U.S. beneficiary who receives a distribution from the foreign trust during the tax year.

[2162] Prop. Reg. §1.6048-3(a)(2).

[2163] *See* §6048(c). "Distribution" generally means any transfer of property, including cash, from a foreign trust to the extent such property exceeds the fair market value of any property or services received by the foreign trust in exchange for the property transferred. Prop. Reg. §1.6048-4(b)(1). See Prop. Reg. §1.6048-4(b)(2)–§1.6048-4(b)(7) for specific types of reportable distributions.

[2164] *See* Notice 97-34, §V.B.

[2165] *See* §7701(a)(30).

[2166] *See* §6048(d)(2).

[2167] Notice 97-34.

[2168] *See* Rev. Proc. 2014-55, *superseding* Notice 2003-75 (beneficiaries and annuitants are not required to report contributions to, distributions from, and ownership of Canadian retirement plan under simplified reporting regime of Notice 2003-75 or pursuant to reporting obligations imposed by §6048, and thus are not subject to §6677 penalties).

[2169] Prop. Reg. §1.6048-1–§1.6048-7, Prop. Reg. §1.6677-1, REG-124850-08, 89 Fed. Reg. 39,440 (May 8, 2024).

[2170] §6048(a)(1).

[2171] *See* §6677(a). *See also* Prop. Reg. §1.6677-1(a)(1).

[2172] *See* §6677(b). The U.S. owner may be able to avoid penalties by attaching a substitute Form 3520-A to a timely filed Form 3520. *See* IRM 20.1.9.14(2) (01-29-21).

[2173] §6677(b).

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would further provide that if the foreign trust fails to file under §6048(b), the U.S. owner must file that information and failure to do so subjects the U.S. owner to the 5% or $10,000 penalty.[2174]

If a penalty is imposed because of inaccurate information, the penalty applies only to the extent that the transaction is reported inaccurately.[2175] If a failure, as described above, continues for more than 90 days after the day on which the IRS mails a notice to such person, the IRS will impose an additional penalty of $10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of such 90 day period.[2176] The maximum penalty cannot exceed the gross reportable amount and to the extent that the aggregate penalty amount already collected exceeds the gross reportable amount, the IRS must issue a refund of the excess amount.[2177] The penalty applies only to the extent that the transaction is not reported or is reported inaccurately.[2178] The term "gross reportable amount" means the gross value of the property involved in the reportable event (in the case of a failure relating to §6048(a)), the gross value of the portion of the trust's assets at the close of the tax year treated as owned by the U.S. person (in the case of a failure relating to §6048(b)), and the gross amount of the distributions (in the case of a failure relating to §6048(c)).[2179]

Note: Multiple penalties under §6677 may apply to a related series of transfers.[2180] For example, a U.S. person who is treated as a grantor of a foreign trust and who receives a distribution from the trust as a beneficiary is required to file under both §6048(b), subject to the 5% penalty, and §6048(c), subject to the 35% penalty. The statute is not clear on which penalty would apply in this case, or if both could apply. On the other hand, penalties that could be imposed under both §6677 and another Code section may be mitigated.[2181] At least one court has refused to apply the 5% penalty and 35% penalty simultaneously where the taxpayer was both the owner and beneficiary.[2182] On appeal, the Second Circuit vacated the district court's judgment, holding that the 35% penalty applies even when the sole beneficiary is the owner of the trust.[2183]

Editor's Note: The Second Circuit did not address whether the IRS may assess both penalties against the sole owner and sole beneficiary of a foreign trust; however, given the Second Circuit statements that "nothing in the statute indicates that … §6048(b) displaces or merges with the separate requirement to report distributions under §6048(c)" and "the 5% penalty under §6677(b) does not supplant the 35% penalty," it leaves open the possibility of liability as to both penalties.[2184]

An estate is liable for the initial penalty for a decedent's failure to file Form 3520-A.[2185] The estate assumes the decedent's liabilities, including a liability for failing to file the required return. The estate also may be liable for the additional penalty if it fails to file the form after being notified by the IRS.[2186]

None of the penalties discussed above are imposed, however, if the failure is due to reasonable cause and not due to willful neglect.[2187] The meaning of reasonable cause for purposes of this penalty has not been defined specifically other than by providing examples of what does not constitute reasonable cause. The fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the required information is not reasonable cause.[2188] Nor is there reasonable cause if the foreign trustee refuses to provide information for any other reason, including difficulty in producing the required information or provisions in the trust instrument that prevent the disclosure of required information.[2189] Reasonable cause is discussed at XI., below.

The penalties are payable on notice and demand and can be assessed and collected in the same manner as taxes.[2190] The deficiency procedures of subchapter 63B do not apply to the assessment or collection of the penalties discussed above.[2191] An accuracy-related penalty under §6662(b)(7) imposes a 40% penalty to any understatement attributable to any transaction involving an asset with respect to which information was required to be provided under §6038, §6038B, §6038D, §6046A or §6048, but which was not provided as required. The §6662(b)(7) penalty is discussed at IV.K., above.

Note: The IRS's position is that the §6677 penalty is not a "divisible tax," meaning that a taxpayer that seeks to challenge the entire assessment must pay the entire penalty before bringing a refund suit. However, because the penalty may be imposed for a variety of failures, the IRS's position is that a taxpayer that chooses to contest only a portion of the penalty relating to one or more particular failures to report may pay that portion and sue for a refund.[2192]

For a discussion of foreign trusts, see 6500 T.M., *U.S. Taxation of Foreign Estates, Trusts and Beneficiaries* (Foreign Income Series).

[2174] *See* Prop. Reg. §1.6677-1(b).

[2175] Notice 97-34, §VII. IRM 20.1.9.13.4(1)(d) (01-29-21).

[2176] §6677(a). Prop. Reg. §1.6677-1(a)(2).

[2177] *See* §6677(a).

[2178] Notice 97-34, §VII. Thus, if a U.S. person transfers property worth $1 million to a foreign trust, but reports only $400,000 of that amount, penalties may be imposed only on the unreported $600,000. Notice 97-34, §VII.

[2179] §6677(c). Prop. Reg. §1.6677-1(c)(1). Proposed regulations determine gross value by §2512 and §2031 valuation principles and the corresponding regulations, without regard to any taxes, expenses, liabilities, or restrictions on the sale or use of the property. Prop. Reg. §1.6677-1(c)(2).

[2180] *See* FAA 20062701F (§6677(a) 35% penalty, §6677(b) 5% penalty, and penalties under §6038 may apply for failures arising from related series of transactions between grantor and trusts).

[2181] *See* Notice 97-34, §VII.

[2182] *Wilson v. United States*, No. 19-cv-5037 (BMC), 2019 BL 443595 (E.D.N.Y. Nov. 17, 2019), *vacated and rem'd*, No. 20-603, 2021 BL 282871 (2d Cir. July 28, 2021).

[2183] *Wilson v. United States*, No. 20-603, 2021 BL 282871 (2d Cir. July 28, 2021).

[2184] *Wilson v. United States*, No. 20-603, 2021 BL 282871 (2d Cir. July 28, 2021).

[2185] CCA 201208028.

[2186] CCA 201208028.

[2187] §6677(d); Notice 97-34, §VII.

[2188] §6677(d).

[2189] Notice 97-34, §VII.

[2190] *See* §6671(a).

[2191] §6677(e).

[2192] *See* CCA 201150029.

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E. Gifts from Foreign Persons

1. In General

Section 6039F(a) requires U.S. persons (other than §501(c) and §501(a) entities) to report foreign gifts exceeding $10,000 in any tax year on Form 3520, Part IV, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, by the 15th day of the 4th month after the close of the tax year.[2193]

Note: The IRS issued proposed regulations under §6048 and §6677 to provide information reporting guidance for transactions with foreign trusts.[2194] For a detailed discussion of the §6048 proposed regulations, see 6500 T.M., *U.S. Taxation of Foreign Estates, Trusts and Beneficiaries* (Foreign Income Series). For a detailed discussion of the §6677 penalty for failing to report under §6048, see X.D.2., *below*.

"Foreign gift" means any amount received from a non-U.S. person that a recipient or spouse treats as a gift, bequest, devise, or inheritance for income tax purposes, but does not include §2503(e)(2) qualified transfers (certain educational and medical expense transfers) or any distribution from a foreign trust reported under §6048(c).[2195]

Gifts from a nonresident alien or foreign estate are reportable only if the aggregate amount of gifts from that nonresident alien or foreign estate exceeds $100,000 during the tax year.[2196] For gifts from foreign corporations and foreign partnerships, the threshold is $10,000 during the tax year.[2197] The reporting thresholds are increased by the §1(f)(3) cost of living adjustment, except that 1995 is substituted for 2016 in the §1(f)(3)(A)(ii) calendar year CPI.[2198] Gifts from foreign persons that the U.S. person knows or has reason to know are related, within the meaning of §643(i)(2)(B), must be aggregated to determine if the gifts exceed the threshold.[2199]

2. Penalty for Failing to Timely File or Provide Information with Respect to Foreign Gifts

A U.S. person who does not properly report a foreign gift on Form 3520 by the due date, including extensions, or who fails to include all required information, or includes incorrect information, is subject to a 5% penalty on the amount of the gift for each month that the failure continues, up to a maximum penalty of 25%.[2200] The penalty does not apply if the failure to report the foreign gift is due to reasonable cause and not due to willful neglect.[2201] Reasonable cause is discussed at XI., below. The estate's liability for a decedent's failure to file a return is discussed at X.B.2., above.

The penalty must be paid on notice and demand by the IRS in the same manner as a tax.[2202]

For a discussion of §6039F proposed regulations, *see* 6500 T.M., U.S. Taxation of Foreign Estates, Trusts and Beneficiaries.

F. Expatriate Returns

Section 6039G(a) requires U.S. citizens and long-term residents who give up their U.S. citizenship or U.S. permanent residency status and who are subject to (i) the alternative tax regime imposed under §877(b) for pre-June 17, 2008 expatriations, or (ii) the §877A rules for post-June 16, 2008 expatriations, to file a return for the initial expatriation year and, in certain instances, for post-expatriation tax years. The prescribed form is Form 8854 (Initial and Annual Expatriation Statement). Form 8854 is required even if no U.S. federal income tax is due.

An individual who must file Form 8854 for any tax year, and who fails to do so on or before the date the form is required to be filed, or who fails to include all of the required information or includes incorrect information, is subject to a $ 10,000 penalty unless it is shown that the failure is due to reasonable cause and not to willful neglect.[2203] Reasonable cause is discussed at XI., below.

Comment: Individuals who expatriate on or after June 17, 2008 and are required to file Form 8854 for the tax year of the expatriation will be considered to have timely filed the initial Form 8854 if it is filed by the due date of the original Form 1040-NR or Form 1040 (including extensions) for such tax year.[2204] Individuals who expatriated before June 17, 2008 (but after June 3, 2004) continued to be taxed as U.S. citizens or

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[2193] Prop. Reg. §1.6039F-1(a)(1), Prop. Reg. §1.6039F-1(c)(1), REG-124850-08, 89 Fed. Reg. 39,440 (May 8, 2024). For extensions of time to file under §6081, Form 3520 must be filed by the 15th day of the 10th month following the close of the tax year. U.S. citizens and residents living abroad must file Form 3520 by the 15th day of the 6th month (or 15th day of the 10th month in case of extension) after the close of the tax year. Section 7701(a)(30) includes as U.S. persons a U.S. citizen or resident alien, a domestic or partnership, any estate other than a foreign estate within the meaning of §7701(a)(31)(A), and any domestic trust. Under Prop. Reg. §1.6039F-1(f), dual resident and dual status taxpayers are not treated as a U.S. person for a tax year or any portion of a tax year that the taxpayer is treated as a nonresident alien for purposes of computing U.S. tax liability.

[2194] See Prop. Reg. §1.6048-1–§1.6048-7, Prop. Reg. §1.6677-1, REG-124850-08, 89 Fed. Reg. 39,440 (May 8, 2024).

[2195] §6039F(b). Prop. Reg. §1.6039F-1(b)(1).

[2196] Prop. Reg. §1.6039F-1(c)(2)(i)(A). Section 2801(e) covered gifts and bequests are included if they exceed the per-donee exclusion in effect under §2503(b), adjusted for inflation. See Prop. Reg. §1.6039F-1(c)(2)(ii). The reporting threshold applies separately to each spouse for joint filers. See Prop. Reg. §1.6039F-1(c)(2)(iv).

[2197] Prop. Reg. §1.6039F-1(c)(2)(iii)(A). If the aggregate amount exceeds the reporting threshold, the U.S. person must separately identify each foreign gift and provide identifying information (name and address) about the transferor and each such foreign person, including a foreign individual or foreign estate. See Prop. Reg. §1.6039F-1(c)(2)(iii)(B). For inflation adjusted amounts for recent years and for further discussion of gifts from foreign persons, see 845 T.M., *Gifts* (Estates, Gifts and Trusts Series).

[2198] Prop. Reg. §1.6039F-1(c)(2)(v).

[2199] Prop. Reg. §1.6039F-1(c)(2)(i)(B), Prop. Reg. §1.6039F-1(c)(2)(iii)(B).

[2200] §6039F(c)(1)(B). Prop. Reg. §1.6039F-1(e)(1). For purposes of determining the tax consequences of the receipt of the foreign gift, the IRS can take into account the purported gift rules in Reg. §1.672(f)-4 addressing the treatment of a purported gift from a partnership or foreign corporation. Reg. §1.672(f)-4 generally requires a U.S. person who receives a purported gift or bequest, directly or indirectly, from a partnership or foreign corporation to include the purported gift or bequest in gross income as ordinary income. Preamble to REG-124850-08, 89 Fed. Reg. 39,440 (May 8, 2024). If the penalties under both §6039F and §6677 could apply to the failure to report a distribution from a foreign trust treated as a gift, the penalty under §6677 will be assessed, and will reduce any penalty otherwise imposed under §6039F. *See* Notice 97-34.

[2201] §6039F(c)(2). Prop. Reg. §1.6039F-1(d).

[2202] §6039F(c)(1)(B). Prop. Reg. §1.6039F-1(e)(1)(ii).

[2203] §6039G(c). Legislative history indicated that a $5,000 penalty would be imposed. However, the statute itself imposes a $10,000 penalty. H.R. Rep. No. 548, 108th Cong., 2d Sess. 256 (2004).

[2204] Notice 2009-85.

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residents until they filed Form 8854, so there was no due date for the initial Form 8854.[2205] Because there was no due date for the initial Form 8854 for these expatriates, there is no penalty associated with such form.[2206]

For a further discussion of the reporting requirements of §877A and §877, see the Instructions to Form 8854 and 6080 T.M., *Section 911 and Other International Tax Rules Relating to U.S. Citizens and Residents* (Foreign Income series).

G. Returns with Respect to Foreign Corporations, Foreign Partnerships, and Foreign Disregarded Entities

1. Organization, Reorganization or Acquisition of Stock in Foreign Corporation

Section 6046 requires the following persons to file a Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*: (1) a U.S. citizen or resident who is an officer or director of a foreign corporation in which a U.S. person acquires (a) 10% or more of the stock's value or voting power, or (b) an additional interest that brings his interest in the foreign corporation to 10%; (2) a U.S. person who acquires a 10% or greater interest in a foreign corporation, or an additional interest that brings his interest in a foreign corporation to 10% or more; (3) in the case of a foreign captive insurance company, each person who is treated as a U.S. shareholder; (4) each person who becomes a U.S. person while owning 10% or more of the value or voting power of a foreign corporation;[2207] and (5) a U.S. person who disposes of enough stock in the foreign corporation to reduce his ownership to less than 10%.[2208]

Form 5471 must be attached to the person's timely filed (including extensions) income tax return.[2209]

For discussion of the penalties imposed for noncompliance, see X.G.6., below.

For further discussion of the reporting requirements under §6046, see 6840 T.M., *Reporting Requirements Under the Code for International Transactions and Foreign Assets* (Foreign Income Series).

2. Interests in Controlled Foreign Corporations

Section 6038 authorizes the IRS to prescribe rules for reporting information for certain controlled foreign corporations and partnerships. Regulations under §6038 require a U.S. person who owns more than 50% of the value or voting power (i.e., has "control") of a foreign corporation during the annual accounting period of the foreign corporation to file Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations.*[2210]

Each U.S. person who is a "U.S. shareholder" in a controlled foreign corporation ("CFC") during the annual accounting period of the CFC and who owned stock in the CFC on the last day of the annual accounting period is required to file Form 5471.[2211]

For discussion of the penalties imposed for noncompliance, see X.G.6., below.

For further discussion of the reporting requirements under §6038, see 6840 T.M., *Reporting Requirements Under the Code for International Transactions and Foreign Assets,* and 6280 T.M., *CFCs — Sections 959–965 and 1248* (Foreign Income Series).

3. Interests in Foreign Partnerships

Section 6046A requires any U.S. person who: (1) acquires an interest in a foreign partnership; (2) disposes of an interest in a foreign partnership; or (3) has an interest in a foreign partnership that changes substantially, to file Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, with the U.S. person's timely filed (including extensions) income tax return for the year in which the reportable event occurs.[2212] The first two categories of U.S. persons who must file a return apply in the case of acquisitions or dispositions only if the U.S. person directly or indirectly holds at least a 10% interest in such partnership either before or after such acquisition or disposition. The third category applies only if the person's direct proportional interest has increased or decreased by the equivalent of a 10% interest.[2213]

Regulations under §6038(a)(5) require every U.S. person who owns more than a 50% interest in a foreign partnership (i.e., "controls" the foreign partnership) and every U.S. person who owns a 10% or greater interest in a foreign partnership that is controlled (i.e., more than a 50% interest) by U.S. persons to file Form 8865.[2214]

Section 6038B and related regulations require a U.S. person to report on Form 8865 contributions to a foreign partnership in a §721 transaction if certain contribution and ownership requirements are met.[2215]

For discussion of the penalties imposed for noncompliance, see X.G.6., below.

For further discussion of the reporting requirements under §6046A and §6038B, see 6680 T.M., *Partners and Partnerships — International Tax Aspects* (Foreign Income Series), and 711 T.M., *Partnerships — Formation and Contributions of Property or Services,* and 6840 T.M., *Reporting Requirements Under the Code for International Transactions and Foreign Assets* (Foreign Income Series).

4. Outbound Transfers to Foreign Corporation

Section 6038B and related regulations require a U.S. person to report on Form 926, Return by U.S. Transferor of Property to a Foreign Corporation. certain information related to the

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[2205] §7701(n), before deletion by HEART Act, Pub. L. No. 110-245, §301(c)(1), which was effective for any individual whose expatriation date (as so defined) is on or after June 17, 2008.

[2206] *See* IRM 20.1.9.11.1 (01-29-21).

[2207] §6046(a). *See also* Instructions for Form 5471.

[2208] *See* Reg. §1.6046-1(c)(1)(ii)(c). *See also* Instructions for Form 5471.

[2209] Instructions to Form 5471 provides the due date, as contemplated by §6046(d) and Reg. §1.6046-1(j)(1).

[2210] Reg. §1.6038-2. *See also* Instructions for Form 5471.

[2211] *See* §6038(a)(4), Instructions for Form 5471. A taxpayer must file Forms 5471 for the CFCs with tax years that end with or within the taxpayer's tax year. However, a taxpayer that has no CFCs with tax years that end with or within its short tax year is not legally required to file Forms 5471 for its short tax year and should not be subject to a penalty under §6038(b). FAA 20064602F.

[2212] §6046A(a); Reg. §1.6046A-1(b)(1).

[2213] §6046A(a) (flush language), §6046A(d).

[2214] *See* §6038(a)(5), Reg. §1.6038-3(a).

[2215] §6038B(a)(1)(B); Reg. §1.6038B-2(a).

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transfer of property to a foreign corporation in an exchange described in §332, §351, §354, §355, §356 or §361.[2216]

For discussion of the penalties imposed for noncompliance, see X.G.6., below.

For further discussion of the reporting requirements under §6038B as it relates to transfers to foreign corporations, see 6100 T.M., *U.S.-to-Foreign Transfers Under Section 367(a)* (Foreign Income Series) and 6840 T.M., *Reporting Requirements Under the Code for International Transactions and Foreign Assets.*

5. Foreign Disregarded Entities and Foreign Branches

The IRS requires that certain U.S. persons file an information return with respect to foreign disregarded entities (FDEs) and foreign branches (FBs). An FDE is an entity that is created or organized in a foreign jurisdiction and that is disregarded as separate from its owner for U.S. income tax purposes. A foreign branch (FB) is an integral business operation carried on by a U.S. person outside the United States.[2217]

Note: Due to the COVID-19 pandemic, some taxpayers may not be required to take certain activities into consideration that would otherwise require the creation of a foreign branch separate unit for purposes of the dual consolidated loss rules under §1503(d), or require taxpayers to file Form 8858.[2218]

Form 8858, *Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs),* must be filed by U.S. persons that are tax owners of FDEs, operate an FB, or that own certain interests in foreign tax owners of FDEs or FBs. Such persons also may be required to file Schedule M (Form 8858), *Transactions Between Foreign Disregarded Entity (FDE) or Foreign Branch (FB) and the Filer or Other Related Entities.*[2219]

Form 8858 must be attached to the tax owner's timely filed income tax return (including extensions). In the case of a filer that is not the tax owner of the FDE or operator of the FB, the filer must attach Form 8858 to any form filed by the filer with respect to the foreign entity that is the tax owner of the FDE (e.g., Form 8858 is attached to a Form 5471 or Form 8865 filed with respect to the CFC or CFP that is the tax owner of the FDE or operates the FB).

For discussion of the penalties imposed for noncompliance, see X.G.6., below.

For further discussion of the rules on reporting with respect to FDEs, see 6840 T.M., *Reporting Requirements Under the Code for International Transactions and Foreign Assets* (Foreign Income Series).

6. Penalties

A penalty of $10,000 applies to any person who does not timely file a return or include the information required by §6038, §6046 or §6046A.[2220] If the failure to file continues for more than 90 days after the day the IRS mails notice of such failure, an additional penalty of $10,000 applies for each 30-day period, or fraction thereof, beyond the 90-day period, up to a maximum of $50,000.[2221]

Practice Point: In *Farhy*, the Tax Court ruled against the IRS, which had assessed a §6038(b) penalty of $10,000 with a continuation up to the $50,000 maximum for each year at issue. The court ruled the IRS may recover §6038(b)(1) and §6038(b)(2) penalties only through civil action in a district court, finding no statutory provision authorizes direct assessment of §6038(b) penalties.[2222] However, in reversing the Tax Court, the Court of Appeals for the D.C. Circuit found "Congress can make a penalty assessable by implication," which in the court's opinion Congress did for §6038(b).[2223] Accordingly, the Tax Court is highly likely to rule the IRS cannot assess §6038(b) penalties for any future litigation appealable to a circuit other than the D.C. Circuit.

Note: Notice 2021-39 provided transition relief for tax years beginning in 2021 (processing year 2022) from the §6038(b) and §6038(c) penalties with respect to the new Schedules K-2 and K-3 to Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships.*[2224] During this transition period, a U.S. partner required to file Form 8865 (Schedule K-2 or K-3 filer) will not be subject to the relevant penalties for any incorrect or incomplete reporting on the Schedules K-2 and K-3 if the filer establishes to the satisfaction of the IRS that it made a good faith effort to comply with the Schedules K-2 and K-3 filing requirements (and the Schedule K-3 furnishing requirements) per the instructions. This penalty relief is in addition to the reasonable cause exception to the §6038 penalty.[2225]

The IRS provided additional 2021 tax year transition relief with respect to certain domestic partnerships and S corporations obligated to file Schedules K-2 and K-3 to Form 8865. To qualify for this relief:

- In tax years beginning in 2021, the direct partners in a domestic partnership must not be foreign partnerships, foreign corporations, foreign individuals, foreign estates, or foreign trusts, and the domestic partnership or S corporation must have no foreign activity, including foreign taxes paid or accrued or ownership of assets that generate, have generated or may reasonably expected to generate foreign source income;

[2216] §6038B(a)(1)(A); Reg. §1.6038B-1.

[2217] *See* Reg. §301.7701-2, §301.7701-3, and Reg. §1.367(a)-6T(g). An FB also includes a qualified business unit as defined in Reg. §1.989-1(b)(2)(i). The IRS requires this filing under the authority of §6011, §6012, §6031, and §6038 and the related regulations.

[2218] *See* Rev. Proc. 2020-30 (excluding certain temporary activities due to COVID-19 pandemic for determining whether domestic corporation has foreign branch separate unit, or whether U.S. person must file Form 8858).

[2219] The Instructions to Form 8858 provide detailed information as to who must file the form.

[2220] §6038(b)(1), §6679 (failure to file under §6046 and §6046A). *See also* Notice 2017-71, *amplifying, clarifying, and superseding* Notice 2017-47, providing relief to certain partnerships. For additional information and requirements, see II.D., above.

[2221] §6038(b)(2), §6679(a)(2).

[2222] *Farhy v. Commissioner*, 160 T.C. No. 6 (Apr. 03, 2023). *See also Mukhi v. Commissioner*, 162 T.C. No. 8 (Apr. 8, 2024), *aff'd* 163 T.C. No. 8 (Nov. 18, 2024) (granting partial summary judgment to taxpayer under *Farhy*).

[2223] Farhy v. Commissioner, 2024 BL 152514 (D.C. Cir. May 03, 2024).

[2224] *See* IRS News Release IR-2021-140 (June 30, 2021) (IRS released new Schedules K-2 and K-3 for Forms 1065, 1120-S, and 8865 for tax year 2021).

[2225] Notice 2021-39.

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• In tax years beginning in 2020, a qualifying domestic partnership or an S corporation must not have provided its partners or shareholders, and the partners or shareholders must not have requested information regarding:

o Line 16, Form 1065, Schedules K and K-1 (line 14 for Form 1120-S), and

o Line 20c, Form 1065, Schedules K and K-1 (Controlled Foreign Corporations, Passive Foreign Investment Companies, 1120-F, §250, §864(c)(8), §721(c) partnerships, and §7874) (line 17d for Form 1120-S).

• The domestic partnership or S corporation must not have knowledge that the partners or shareholders requested such information for tax year 2021.[2226]

If a domestic partnership or S corporation qualifies for this exception, the domestic partnership or S corporation does not need to file Schedules K-2 and K-3 with the IRS or with its partners or shareholders. However, if the partnership or S corporation is subsequently notified by a partner or shareholder that all or part of the information contained on Schedule K-3 is needed to complete their tax return, then the partnership or S corporation must provide the information to the partner or shareholder. If a partner or shareholder notifies the partnership or S corporation before the partnership or S corporation files its return, the conditions for the exception are not met and the partnership or S corporation must provide the Schedule K-3 to the partner or shareholder and file the Schedules K-2 and K-3 with the IRS.[2227]

Note: In Notice 2019-20, the IRS provided penalty relief for missing negative tax basis account information for tax years that began after December 31, 2017, but before January 1, 2019. In Notice 2019-66, the IRS provided penalty relief for failure to report partners' shares of partnership capital on the tax basis method for tax years beginning in calendar year 2019. These notices are discussed in II.D., above.

In addition to the dollar penalty, §6038(c) imposes a penalty that may reduce the U.S. person's foreign tax credit. For the failure to file as required by §6038, the amount of foreign taxes paid or deemed paid (other than those deemed paid under §904(c)) by the U.S. person for purposes of determining the foreign tax credit under §901 is reduced by 10%.[2228] If the U.S. person required to report the information is a corporation, its taxes paid or deemed paid under §960 (with respect to any and all foreign corporations for which such U.S. person was required to file Form 5471 under §6038 for such accounting period) are reduced by 10%.[2229] Both 10% reductions are increased an additional 5% for each three-month period, or fraction thereof, during the period beyond 90 days after the day on which the IRS mails notice of such failure.[2230] Taxes reduced for purposes of §960 are not again reduced for purposes of §901.[2231]

The reduction of foreign taxes paid cannot exceed the greater of $10,000 or the income of the foreign entity for its annual accounting period with respect to which the failure occurs.[2232] The reduction in foreign taxes, as so limited, is then reduced by the dollar penalty imposed by §6038(b).[2233]

Both the dollar penalty and the foreign tax reduction penalty under §6038 apply to the failure related to each foreign entity with respect to which the U.S. person has a reporting obligation.[2234] However, no tax may be reduced more than once for the same failure.[2235]

If two or more persons are required to file an information return under §6038 or §6046 with respect to the same foreign corporation, such persons may jointly make one return.[2236] In the case of such a joint return, the penalty applies to each person.[2237] The IRS can assess and collect the penalty without resorting to the deficiency procedures provided by subchapter 63B.[2238]

If the failure to file or provide the required information under §6038, §6046 or §6046A is due to reasonable cause, the penalty does not apply.[2239] To claim a reasonable cause exception, the taxpayer must set forth the facts on which he relies in a written statement, signed under penalties of perjury.[2240]

Regulations under §6679 provide that, for purposes of filing under §6046 and §6046A, reasonable cause requires the taxpayer to exercise ordinary business care and prudence.[2241] A taxpayer who exercises such care and is nevertheless unable to comply is not subject to the penalty. In determining the extent of a taxpayer's ability to obtain information, the percentage of stock owned by the taxpayer and the nature of the other interests in the foreign corporation is considered.[2242] Neither the statute nor the regulations under §6038 defines reasonable cause for failure to furnish the required information within the time prescribed.[2243] However, the regulations under §6038 do

[2226] IRS News Release IR-2022-38 (Feb. 16, 2022). For the most current information about the adoption of Schedules K-2 and K-3 by affected pass-through entities and their partners and shareholders, see the *IRS Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865).*

[2227] IRS News Release IR-2022-38 (Feb. 16, 2022).

[2228] §6038(c)(1)(A).

[2229] §6038(c)(1)(B), as amended by Pub. L. No. 115-97, §14301(c)(36), effective for tax years of foreign corporations beginning after December 31, 2017, and to tax years of United States shareholders in which or with which such tax years of foreign corporations end. Pub. L. No. 115-97, §14301(d). Before amendment, the reduction also applied to deemed paid credits allowed under §902, which was repealed by §14301(a) of Pub. L. No. 115-97.

[2230] §6038(c)(1) (flush language).

[2231] §6038(c)(4)(A).

[2232] §6038(c)(2).

[2233] §6038(c)(3).

[2234] *See* §6038(b)(2); Reg. §1.6038-2(a), §1.6038-2(k)(2). However, if two or more U.S. persons would be required to furnish the information with respect to the same foreign business entity for the same period, such persons may file a joint return. §6038(d); Reg. §1.6038-2(j)(1).

[2235] §6038(c)(4)(A).

[2236] Reg. §1.6038-2(j), §1.6046-1(e)(3)(i).

[2237] Reg. §301.6679-1(a)(2) specifically provides that the penalty applies to each person filing a joint return. Section 6038(b) and Reg. §1.6038-2(k) apply to "any person required to file Form 5471 under section 6038.".

[2238] §6679(b). This applies to the monetary penalties under §6038(b) but not the reduction in the foreign tax credit under §6038(c). *See generally* §6211–§6216; IRM Exhibit 20.1.9-4 (07-08-15). *See also* §6665 and §6671(a), discussed at XII., below.

[2239] §6679(a), §6038(c)(4)(B); Reg. §1.6038-2(k)(3) (providing that the §6038 dollar and foreign tax credit reduction penalties do not apply for the period for which reasonable cause exists).

[2240] Reg. §1.6038-2(k)(3), §301.6679-1(a)(3).

[2241] Reg. §301.6679-1(a)(3).

[2242] Reg. §301.6679-1(a)(3). *See also* CCA 200645023.

[2243] Neither of the §6038 nor the §6679 reasonable cause provisions includes the additional requirement "and not due to willful neglect" that is part of the §6651 reasonable cause provision or the "acted in good faith" requirement that is part of the §6664 reasonable cause provision. In CCA 200748006, the IRS Chief Counsel concluded that there is no prohibition on using the same

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provide that an omission of, or error with respect to, some of the information required to be reported may not constitute a failure to file if the taxpayer establishes that it has substantially complied with the section.[2244]

Reasonable cause is discussed in greater detail at XI., below.

Section 6038B imposes its own penalty. Failure to furnish the information required under §6038B results in a penalty equal to 10% of the fair market value of the property transferred to the foreign corporation, unless such failure is due to reasonable cause and not willful neglect.[2245] The penalty is limited to $100,000 unless the failure is due to intentional disregard.[2246] "Intentional disregard" exists if the U.S. transferor does not meet the reasonable cause exception and if the U.S. transferor knew of the rule or regulation that was disregarded.[2247] Reasonable cause is discussed at XI., below.

The instructions to Form 8858 provide the penalties applicable to the failure to file information required by §6038(a). The $10,000 penalty can be imposed for each annual accounting period of each CFC or CFP for the failure to furnish the required information on Form 8858 within the time prescribed. If the information is not filed within 90 days after the IRS has mailed a notice of the failure to the U.S. person, an additional $10,000 penalty, per CFC or CFP, may be charged for each 30-day period, or fraction thereof, during which the failure continues after the 90-day period has expired. The additional penalty is limited to a maximum of $50,000 for each failure. Any person who fails to file or report all of the information required within the time prescribed will be subject to a reduction of the foreign taxes available for credit under §901 and §960. If the failure continues 90 days or more after the date the IRS mails notice of the failure to the U.S. person, an additional 5% reduction is made for each three-month period, or fraction thereof, during which the failure continues after the 90-day period has expired. Criminal penalties under §7203, §7206, and §7207 may apply for the failure to file the information required.

An accuracy-related penalty under §6662(b)(7) imposes a 40% penalty to any understatement attributable to any transaction involving an asset with respect to which information was required to be provided under §6038, §6038B, §6038D, §6046A or §6048, but which was not provided as required. The §6662(b)(7) penalty is discussed at IV.K., above.

H. Foreign-Owned Corporations

Section 6038A requires certain U.S. corporations ("reporting corporations") of which 25% or more, by vote or value, is owned by foreign persons to file Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*, and maintain records prescribed by regulations.[2248]

The information required to be furnished to the IRS relates to the identity and other details of related parties, transactions with related parties, and certain other information.[2249] Form 5472 is generally filed with the reporting corporation's income tax return for the tax year by the due date (including extensions) of that return.[2250] A separate Form 5472 must be filed for each related party with which the reporting corporation had a reportable transaction during the tax year.

Each reporting corporation that is a §59A applicable taxpayer is required to file an annual information return on Form 8991, *Tax on Base Erosion Payments of Taxpayers With Substantial Gross Receipts*.[2251] Form 8991 is used to determine an applicable taxpayer's base erosion minimum tax amount for the year. Form 8991, Schedule A, is used to determine the amount of base erosion payments and base erosion tax benefits for purposes of determining the applicable taxpayer's base erosion percentage, and determining the applicable taxpayer's modified taxable income. Form 8991, Schedule B, is used to determine the credits that reduce regular tax liability in computing the

criteria to abate the §6038 penalty for a late-filed Form 5471 where the IRS has abated the §6651(a)(1) failure to file penalty for a late-filed Form 1120 using the reasonable cause criteria in IRM 20.1.1.3.2 (11-21-17). The IRS Chief Counsel further concluded that there was no legal reason why the same criteria could not be used even where Form 1120 was timely filed but Form 5471 was not. According to the IRS Chief Counsel, the irrelevance of reasonable cause with respect to one form does not preclude a reasonable cause determination with respect to the other form. *See also* CCA 200645023 (applying the §6664 "ordinary business care and prudence" requirement in analyzing a §6038 and §6679 penalty and taking into account the §6651 "undue hardship" consideration in analyzing a §6679 penalty). *See also* IRM 20.1.9.3.5 (01-29-21).

[2244] Reg. §1.6038-2(k)(3)(ii). The IRS International Practice Unit has released training materials that advise IRS personnel on what it means for certain international forms to be "substantially complete," which can be found at https://www.irs.gov/pub/int_practice_units/iga_c_17_03_01_02.pdf. *See also* Monetary Penalties for Failure to Timely File a Complete and Accurate Form 8865 — Category 1 & 2 Filers, at https://www.irs.gov/pub/int_practice_units/iga_p_17_4_01.pdf.

[2245] §6038B(c)(1), §6038B(c)(2); Reg. §1.6038B-1(f)(1)(i), §1.6038B-1(f)(3).

[2246] §6038B(c)(3); Reg. §1.6038B-1(f)(1)(i).

[2247] Reg. §1.6038B-1(f)(4).

[2248] §6038A. Reg. §1.6038A-3 sets forth the record maintenance requirements. Reg. §1.6038A-1(h) includes a small corporation exception. Reg. §1.6038A-1(h) was amended by T.D. 9796, 81 Fed. Reg. 89,849 (Dec. 13, 2016), to provide that the small corporation exception does not apply to a domestic disregarded entity that is wholly owned by a foreign person. The amendment applies to tax years of reporting corporations beginning after December 31, 2016, and ending on or after December 13, 2017. Reg. §1.6038A-1(n)(1). The TCJA added reporting rules related to the post-TCJA base erosion and anti-abuse tax for a reporting corporation that qualifies as a §59A "applicable taxpayer."§6038A(b)(2) (reference to §59A), as amended by Pub. L. No. 115-97, §14401(b)(1), effective for base erosion payments paid or incurred in tax years beginning after December 31, 2017. If the reporting corporation is a §59A applicable taxpayer, then the reporting corporation must furnish certain information necessary for a determination of the base erosion minimum tax amount, base erosion payments, and base erosion tax benefits of the taxpayer for the tax year, as determined by the Secretary of the Treasury, and other information that the Secretary of the Treasury determines necessary to carry out §59A. §6038A(b)(2)(A), §6038A(b)(2)(B); Reg. §1.6038A-2(b)(7), T.D. 9885, 84 Fed. Reg. 66,968 (Dec. 6, 2019). The IRS delayed the qualified derivative payment reporting requirements under Reg. §1.6038A-2(b)(7)(ix) for a reporting corporation that qualifies as a §59A applicable taxpayer until tax years beginning on or after January 1, 2027. Notice 2024-43, *modifying and superseding* Notice 2022-30. For further discussion of the reporting requirements under Reg. §1.6038A-2(b)(7), see 6125 T.M., *Base Erosion and Anti-Abuse Tax (BEAT)* (Foreign Income Series).

[2249] §6038A(b)(1), as amended by Pub. L. No. 115-97, §14401(b) effective for base erosion payments (as defined in §59A(d)) paid or accrued in tax years beginning after December 31, 2017. Pub. L. No. 115-97, §14401(e), The 2017 tax act added additional reporting requirements for base erosion payments. §6038A(b)(2) (referenced to §6038C and §59A). *See* Reg. §1.6038A-2(b), applicable to tax years of reporting corporations beginning after December 31, 2016 and ending on or after December 13, 2017. Reg. §1.6038A-1(n)(2).

[2250] Reg. §1.6038A-2(d); Form 5472.

[2251] Reg. §1.6038A-2(a)(3).

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base erosion minimum tax amount.[2252] A taxpayer is an applicable taxpayer if the taxpayer:[2253]

- Is a corporation other than a regulated investment company, a real estate investment trust, or an S corporation;
- Satisfies the gross receipts test by having average annual gross receipts, for the three tax year period ending with the preceding tax year, of at least $500,000,000; and
- Satisfies the base erosion percentage test.

A corporation that fails to file a required return in a timely manner or maintain the prescribed records is subject to a penalty of $25,000 ($10,000 for each tax years beginning before January 1, 2018) for each tax year with respect to which such failure occurs.[2254] A failure to file that continues for more than 90 days after the IRS mails notice of such failure to the corporation results in an additional penalty of $25,000 ($10,000 for each tax years beginning before January 1, 2018) for each 30-day period (or fraction thereof) during which the failure continues after the 90-day period.[2255] Filing a "substantially incomplete" return is deemed to be a failure to file the return.[2256] There is no specific guidance in the regulations or case law regarding the meaning of the term "substantially incomplete" as that term is used in the statute or the regulations under §6038A.[2257] Whether a taxpayer has failed to maintain the proper records depends upon the taxpayer's overall compliance with the record maintenance requirements.[2258]

The time prescribed by regulations to furnish information or maintain records (and the beginning of the 90-day period after notice by the IRS) is treated as not earlier than the last day on which reasonable cause existed for failure to furnish the information or maintain records.[2259] The regulations add the requirement that the taxpayer must establish that it acted in good faith, in addition to the existence of reasonable cause.[2260] The regulations provide that an analysis of reasonable cause and good faith involves an inquiry into the facts and circumstances of the particular failure. An honest misunderstanding of fact or law that is reasonable in light of the experience and knowledge of the taxpayer may indicate reasonable cause and good faith.[2261] Reliance on professional advice may constitute reasonable cause and good faith if, under all circumstances, the reliance was reasonable.[2262] The taxpayer must make an affirmative showing of reasonable cause by a written statement that contains a declaration that it is made under penalties of perjury and sets forth all the facts alleged as reasonable cause.[2263] Reasonable cause is discussed in greater detail at XI., below.

For further discussion of the reporting requirements under §6038A, see 6840 T.M., *Reporting Requirements Under the Code for International Transactions and Foreign Assets* (Foreign Income Series).

I. Foreign Corporations Engaged in a U.S. Trade or Business

Section 6038C provides that a foreign corporation that is engaged in a trade or business in the United States at any time during the tax year must furnish certain required information and must maintain such records as may be appropriate to determine the tax liability of such corporation. The information that must be furnished under §6038C is the same information described under §6038A(b), discussed above at X.G., plus any additional information prescribed by regulations.[2264] Section 6038C was designed to provide the IRS with access to books and records of foreign corporations to determine the amount of their income that is taxable as effectively connected with a U.S. trade or business.

Foreign corporations doing business in the United States that are exempt from the information reporting include:

- a foreign corporation engaged in a U.S. trade or business, regardless of the percentage of foreign ownership, which does not have a permanent establishment in the United States under an applicable income tax convention,[2265] and
- a foreign corporation engaged in a U.S. trade or business, regardless of the percentage that a foreign company owns in it, whose gross income is exempt from U.S. taxation under §883, and which has timely and fully complied with the information reporting requirements under Rev. Proc. 91-12.[2266]

[2252] Instructions to Form 8991.

[2253] §59A(e); Reg. §1.59A-2(b) (references to Reg. §1.59A-2(d) and §1.59A-2(e)), T.D. 9885, 84 Fed. Reg. 66,968 (Dec. 6, 2019). For a detailed discussion of §59A applicable taxpayers, see 6125 T.M., *Base Erosion and Anti-Abuse Tax (BEAT)* (Foreign Income Series).

[2254] §6038A(d)(1), as amended by Pub. L. No. 115-97, §14401(b), effective for base erosion payments (as defined in §59A(d)) paid or accrued in tax years beginning after December 31, 2017. Pub. L. No. 115-97, §14401(e), Reg. §1.6038A-4.

[2255] §6038A(d)(2), as amended by Pub. L. No. 115-97, §14401(b), effective for base erosion payments (as defined in §59A(d)) paid or accrued in tax years beginning after December 31, 2017. Pub. L. No. 115-97, §14401(e), Reg. §1.6038A-4(d). In addition, under the "noncompliance rule," where (1) a foreign related party (see below) doesn't authorize the reporting corporation to act as its agent in certain limited circumstances, (2) the reporting corporation doesn't substantially comply with an IRS summons, or (3) the summons is quashed because the requested records haven't been properly maintained, the IRS at its sole discretion and based on its own knowledge or on information that it may get will determine: (a) the amount of deductions allowed for any amount paid or incurred by the reporting corporation in a transaction with the related party, (b) the cost to the reporting corporation of any property acquired from the related party in the transaction, and (c) the cost to the reporting corporation of any property transferred to the foreign related party in the transaction. §6038A(e).

[2256] Reg. §1.6038A-4(a)(1).

[2257] In CCA 200429007, the IRS Chief Counsel provided a list of facts and circumstances that should be considered in making a determination of whether underreporting or overreporting a particular type of reportable transaction, or including an amount not specifically required to be reported, renders the return "substantially incomplete" under Reg. §1.6038A-4(a)(1). The IRS International Practice Unit has released training materials that advise IRS personnel on what it means for certain international forms to be "substantially complete." See discussion of the penalties imposed for noncompliance at X.G.6., above.

[2258] Reg. 1.6038A-4(c).

[2259] §6038A(d)(3); Reg. §1.6038A-4(b)(1).

[2260] Reg. §1.6038A-4(b)(1). *See also* CCA 200429007.

[2261] Reg. §1.6038A-4(b)(2)(iii).

[2262] Reg. §1.6038A-4(b)(2)(iii). See the discussion of reasonable reliance at XI.D.1.b., below.

[2263] Reg. §1.6038A-4(b)(2)(i). *See also* IRM 20.1.9.5.5 (01-29-21).

[2264] §6038C(b). The 2017 tax act added additional reporting requirements for base erosion payments. §6038A(b)(2) (reference to §6038C and §59A).

[2265] Reg. §1.6038A-1(c)(5)(i).

[2266] Reg. §1.6038A-1(c)(5)(ii). *See* Rev. Proc. 91-12. Section 883 relates to exclusions from gross income for foreign corporations engaged in business involving shipping, aircraft and similar activities.

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A corporation required to report under §6038C that fails to furnish information or maintain records will be subject to the same penalties as imposed under §6038A(d), as discussed at X.H., above.[2267]

For further discussion of the reporting requirements under §6038C, see 891 T.M., *Transfer Pricing: Audits, Appeals, and Penalties* (Foreign Income Series).

J. Foreign-Owned U.S. Disregarded Entities

A domestic entity treated as a disregarded entity ("DRE") under Reg. §301.7701-3(b)(1)(ii), such as a single member LLC, generally does not have any federal income tax filing obligations. However, final regulations under §6038A issued on December 13, 2016, require a DRE that is wholly-owned by a foreign person to file Form 5472, *Information Return of a 25% Foreign Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*, to report certain transactions with the foreign owner or other foreign related parties and to maintain records prescribed by regulations.[2268] This filing is required for tax years of reporting DREs beginning on or after January 1, 2017, and ending on or after December 13, 2017.[2269] The expanded reporting requirement is part of the IRS's effort to enhance the United States' compliance with international transparency standards and exchange of information for tax purposes and to strengthen the enforcement of U.S. tax laws. If a DRE that is wholly-owned by a foreign person and is required to report under §6038A fails to furnish such information or maintain such records it will be subject to the same penalties as imposed under §6038A(d), as discussed at X.H., above, with respect to foreign-owned corporations.

Comment: These regulations apply, for example, to a domestic LLC that is treated under the Treas. Reg. §301.7701-3(b)(1)(ii) as a DRE that is wholly-owned directly by a foreign individual, foreign corporation, foreign partnership, foreign nongrantor trust, or foreign estate. A disregarded LLC owned by a foreign or domestic grantor trust with one foreign owner would also have a filing obligation. These rules would also apply to a domestic LLC wholly-owned by a foreign exempt entity, such as a foreign charity or pension fund.

The regulations require the form to be filed "at such time and in such manner as the Commissioner may prescribe in forms or instructions."[2270] Form 5472 instructions as revised December 2017 provide that the foreign-owned wholly-owned DRE will be required to file a pro forma Form 1120 with Form 5472 attached. The forms can be filed by fax or by mail.[2271] For most foreign-owned DREs, the tax year will be the calendar year, unless the foreign owner files a U.S. income tax or information return and has a different tax year.[2272]

Comment: Foreign-owned DREs that have not otherwise been required to obtain an EIN will need to obtain one to file a Form 5472.

K. Foreign Corporation Personal Holding Company Return

A foreign corporation that is classified as a personal holding company is subject to the §541 personal holding company tax with respect to its U.S. source-income.[2273] As a result, it must file a personal holding company tax return.

L. FSC and DISC Returns

Section 6011(c) requires Foreign Sales Corporations ("FSCs"), Domestic International Sales Corporations ("DISCs") and former FSCs and DISCs to file annual returns with the IRS and to furnish certain information to the IRS and the shareholders.

Any person who fails to supply the required information is subject to a $100 penalty for each failure, up to a maximum of $25,000 in any calendar year.[2274] The penalty for failing to file a required FSC or DISC return is $1,000.[2275] These penalties are in addition to any criminal penalty that may apply under §7203 (relating to the willful failure to file a return, supply information, or pay tax).[2276]

The penalty is not imposed if the failure to file or the failure to supply information is due to reasonable cause.[2277] To establish reasonable cause, the taxpayer must make an affirmative showing of reasonable cause by a written statement that contains a declaration that it is made under penalties of perjury and sets forth all the facts alleged as reasonable cause.[2278] Reasonable cause is discussed at XI., below.

M. Notice of Redetermination of Foreign Tax and Deductions for Qualified Foreign Plan

Foreign tax credits under §901 are based on the amount of tax paid or accrued to a foreign government.[2279] If, after the credit is allowed, the amount of the foreign tax is adjusted, the taxpayer must notify the IRS of the redetermination within 180 days (in the case of a reduction in the foreign taxes) or 10 years from the due date of the return (if the foreign tax paid or

[2267] §6038C(c). Under the "noncompliance rule," the IRS may also, in its sole discretion, from its own knowledge or from information that IRS may secure through testimony or otherwise, determine the treatment of any transaction or the amount and treatment of any item where (a) a foreign related party doesn't authorize a reporting corporation, to act as its agent in certain limited circumstances, (b) the reporting corporation doesn't substantially comply with an IRS summons, or (c) the summons is quashed because the requested records haven't been properly maintained or the reporting corporation cannot provide the records requested in the summons. §6038C(d).

[2268] §6038A. Reg. §1.6038A-3 sets forth the record maintenance requirements. Reg. §1.6038A-1(h) was amended by T.D. 9796, 81 Fed. Reg. 89,849 (Dec. 13, 2016), to provide that the small corporation exception does not apply to a domestic disregarded entity that is wholly owned by a foreign person. The amendment applies to tax years of reporting corporations beginning after December 31, 2016, and ending on or after December 13, 2017. Reg. §1.6038A-1(n)(1). See the discussion, in X.H., above, of the §6038A filing requirement for foreign corporations.

[2269] *See* T.D. 9796, 81 Fed. Reg. at 89,850 (Dec. 13, 2016). Reg. §301.7701-2(e)(9) states that the new Form 5472 filing requirement "applies to taxable years of entities beginning after December 31, 2016, and ending on or after December 13, 2017.".

[2270] Reg. §1.6038A-2(d).

[2271] Form 5472 instructions (Dec. 2018).

[2272] *See* Reg. §301.7701-2(c)(2)(vi)(C).

[2273] Reg. §1.541-1(b). Personal holding companies are described in 797 T.M., *Personal Holding Companies.*

[2274] §6686.

[2275] §6686.

[2276] §6686.

[2277] §6686.

[2278] Reg. §301.6686-1(b).

[2279] For a general discussion of the foreign tax credit, see 6020 T.M., *The Creditability of Foreign Taxes — General Issues* (Foreign Income Series).

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deemed paid is increased).[2280] The IRS then recomputes the taxpayer's foreign tax credit. The IRS can assess any additional tax caused by the recomputation at any time. Neither the statute of limitations nor the deficiency procedures apply.[2281]

U.S. taxpayer is allowed a deduction for amounts paid or accrued under a qualified foreign plan, provided that the taxpayer furnishes certain plan information to the IRS, including a statement from the foreign tax authority as to the amount of the deduction allowable under foreign law.[2282] The taxpayer must notify the IRS of any adjustment in the amount of the foreign deduction under rules similar to §905(c).[2283] The IRS then recomputes the U.S. tax.

Section 6689 imposes a penalty on any taxpayer who fails to notify the IRS, as provided in §905(c) or §404A(g)(2), of any foreign tax redetermination or allowed qualified foreign plan deduction within the prescribed time. The amount of the penalty is equal to 5% of the deficiency attributable to the redetermination if the failure does not continue for more than one month, plus an additional 5% for each additional month (or fraction thereof) during which the failure continues, up to a maximum of 25%.[2284] If the §6689 penalty applies, the negligence penalty does not apply.[2285] Deficiency proceedings under Subchapter B of chapter 63 of the Code will not apply with respect to the amount of a §6689 penalty.[2286]

The penalty does not apply if the failure is due to reasonable cause and not willful neglect.[2287] The reasonable cause exception is claimed in a written statement, made under penalties of perjury, setting forth facts that show reasonable cause.[2288] If the taxpayer has exercised ordinary business care and prudence and has nevertheless been unable to file the notice within the prescribed time, the delay will be considered to be due to reasonable cause and not willful neglect.[2289] The statement must be filed with the §905(c) or §404A(g) statement.[2290] Reasonable cause is discussed in greater detail at XI., below.

For further discussion of the reporting requirements under §905(c), see 6020 T.M., *The Creditability of Foreign Taxes — General Issues* (Foreign Income Series).

N. Residents of U.S. Possessions

Section 7654 contains provisions for the coordination of U.S. individual income taxes and the individual income taxes of bona fide residents of the U.S. possessions — Guam, American Samoa, the Northern Mariana Islands, and the Virgin Islands.[2291] The regulations require that certain information be reported to the IRS by individuals who are subject to tax under the laws applicable to Guam.[2292] An individual who, for any tax year, claims that he became or ceased to be a bona fide resident of a U.S. possession must file notice of that position with the IRS at the time and in the manner prescribed by the IRS.[2293] The position is reported on Form 8898, *Statement for Individuals Who Begin or End Bona Fide Residence in a U.S. Territory*.

A civil penalty of $1,000, as well as criminal penalties, can be imposed for failing to provide the required information.[2294] The penalty does not apply if the failure is due to reasonable cause and not willful neglect.[2295] Reasonable cause is discussed at XI., below.

O. Treaty-Based Return Positions

A taxpayer who takes a position on a return that a U.S. treaty overrides or modifies any provision of the Code and thereby reduces the taxpayer's tax liability, must disclose this position to the IRS.[2296] This disclosure requirement is waived if the total payments or income items required to be reported by the taxpayer do not exceed $100,000 in the aggregate.[2297] The statement must be made on a separate Form 8833 (Treaty-Based Return Position Disclosure under §6114 or §7701(b)) for each such position taken, and must be attached to the affected return.[2298] Moreover, a return must be filed to claim the treaty benefit, even if a return is not otherwise required.[2299]

A taxpayer who claims a treaty benefit but fails to make the required disclosure is subject to a $1,000 penalty ($10,000 in the case of a C corporation) for each failure.[2300] This penalty is in addition to any other penalty that may apply.[2301] The IRS, however, may waive all or a portion of the penalty if there is reasonable cause for the failure and the taxpayer has acted in good faith.[2302] To qualify for the waiver, the taxpayer must establish to the satisfaction of the IRS that the taxpayer's failure to disclose the required information was not due to willful neglect. An affirmative showing of the absence of willful neglect must be made in a written statement that sets forth all the facts alleged to show lack of willful neglect and contains a declaration that the statement is made under the penalties of perjury.[2303] Reasonable cause is discussed at XI., below.

[2280] §905(c); Reg. §1.905-4(b). For further discussion of notification requirements for foreign tax redeterminations under Reg. §1.905-4, see 6020 T.M., *The Creditability of Foreign Taxes — General Issues* (Foreign Income Series).

[2281] Reg. §1.905-4(d). For further discussion of notification requirements for foreign tax redeterminations under Reg. §1.905-4, see 6020 T.M., *The Creditability of Foreign Taxes — General Issues* (Foreign Income Series).

[2282] §404A.

[2283] §404A(g)(2)(B).

[2284] §6689(a).

[2285] Reg. §301.6689-1T(b)(2) (referring to former §6653(a), which has been incorporated into §6662).

[2286] Reg. §301.6689-1T(a).

[2287] §6689(a).

[2288] Reg. §301.6689-1T(d).

[2289] Reg. §301.6689-1T(d).

[2290] Reg. §301.6689-1T(d).

[2291] For the definition of a "bona fide resident," see §937(a). In Notice 2017-56, *modified by* Notice 2018-19, the IRS provided relief for individuals who may otherwise lose their status as a "bona fide resident" of Puerto Rico or the U.S. Virgin Islands as a result of Hurricane Irma and Hurricane Maria, absent an extension of the 14-day period allowed outside the U.S. territory in the case of a major disaster. The IRS extended that period to 268 days, effective beginning September 6, 2017, and ending May 31, 2018. Additionally, an individual who is outside of an impacted U.S. territory on any day during this 268-day period will be treated as leaving or being unable to return to the relevant U.S. territory on such day.

[2292] Reg. §301.7654-1(d).

[2293] §937(c).

[2294] §6688.

[2295] §6688.

[2296] §6114. The reporting requirements are waived in certain situations set forth in Reg. §301.6114-1(c).

[2297] Reg. §301.6114-1(c)(2).

[2298] Reg. §301.6114-1(a)(1)(i), §301.6114-1(d).

[2299] Reg. §301.6114-1(a)(1)(ii).

[2300] §6712(a); Reg. §301.6712-1.

[2301] §6712(c).

[2302] §6712(b).

[2303] Reg. §301.6712-1(b).

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Note: There is a separate (although identical) disclosure requirement specific to an alien claiming a treaty position with respect to determining their U.S. residency under the §7701(b) regulations, in addition to the disclosure requirement under §6114.[2304] The IRS has previously taken the position that aliens not required to disclose a treaty position under §6114 (e.g., under the $100,000 threshold noted above) are still required to disclose the position under the §7701(b) regulations.[2305] The IRS has recognized that neither the §7701(b) regulations nor the §6114 regulations threaten to deprive a tie-breaker alien of his treaty benefits if he fails to file a timely Form 8833.[2306]

P. Penalties for Improper Use and Disclosure of Beneficial Ownership Information

Pursuant to the Corporate Transparency Act (CTA), certain business entities must report their beneficial ownership information (BOI) to the Financial Crimes Enforcement Network (FinCEN), a bureau of the Department of Treasury.[2307]

In addition to promulgating beneficial ownership information (BOI) reporting rules, FinCEN promulgated rules to ensure that only authorized recipients have access to BOI and only for purposes permitted by the CTA.[2308] The BOI reporting rules and the BOI access and disclosure rules are discussed further in 636 T.M., *Tax Crimes*, and 6565 T.M., *FATCA — Information Reporting and Withholding Under Chapter 4* (Foreign Income Series).

The Corporate Transparency Act (CTA) makes it unlawful to willfully provide, or attempt to provide, false or fraudulent BOI, including a false or fraudulent identifying photograph or document, to FinCEN, or willfully fail to report complete or updated BOI to FinCEN.[2309] The CTA further makes it unlawful to knowingly disclose or use BOI obtained through a report submitted to or an authorized disclosure made by FinCEN, unless such disclosure or use is authorized under the CTA.[2310] Regulations issued under the CTA make it unlawful to knowingly disclose or use BOI obtained directly or indirectly through a report submitted to or a disclosure made by FinCEN.[2311] Unlawful use includes unauthorized access to BOI and violations of BOI security and confidentiality requirements of 31 C.F.R. §1010.955(d).[2312]

Under the CTA, unauthorized use or disclosure carries a civil penalty of $500 per day for each day the violation continues or is otherwise not remedied.[2313] Criminal penalties for unauthorized use or disclosure include a maximum fine of $250,000, imprisonment for a maximum period of five years, or both.[2314] The CTA also provides for enhanced criminal penalties in situations where a person accesses or uses BOI for an unauthorized reason while also violating another law of the United States, or as part of a pattern of any illegal activity involving more than $100,000 in a 12-month period, that increases the fine to a maximum of $500,000 and increases the maximum prison sentence to 10 years, or both.[2315] Unlike reporting penalties, neither the CTA nor the regulations include any safe harbor for unauthorized access, use, or disclosure.

[2304] *See* Reg. §301.7701(b)-7(b)–§301.7701(b)-7(c).

[2305] *See* FSA 1998-50.

[2306] *See* PMTA 01188 (Aug. 3, 2007).

[2307] *See* 31 U.S.C. §5336(b), added by Pub. L. No. 116-283, Div. E, Title LXIV, §6403(a).

[2308] See 31 U.S.C. §5336(h)(2); FinCEN Notice, 88 Fed. Reg. 62,889 (Sept. 13, 2023), effective October 13, 2023, unless otherwise modified in response to comments.

[2309] 31 U.S.C. §5336(h)(1); 31 C.F.R. §1010.380(g). Likewise, unless otherwise permitted under the statute, it is unlawful to knowingly disclose or use the BOI obtained through a report submitted to FinCEN or a disclosure made by FinCEN. 31 U.S.C. §5336(h)(2), 31 U.S.C. §5336(h)(3)(B).

[2310] *See* 31 U.S.C. §5336(h)(2).

[2311] 31 C.F.R. §1010.955(f)(1), 88 Fed. Reg. 88,732 (Dec. 22, 2023), effective February 20, 2024.

[2312] 31 C.F.R. §1010.955(f)(2).

[2313] 31 U.S.C. §5336(h)(3)(B)(i). For inflation-adjusted penalty amounts, see Tables, Charts & Lists, *FinCEN Civil Penalties.*

[2314] 31 U.S.C. §5336(h)(3)(B)(ii)(I).

[2315] 31 U.S.C. §5336(h)(3)(B)(ii)(II).

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XI. Reasonable Cause Exception

A. *Purpose of the Exception*

Certain provisions above discuss the reasonable cause exception as it relates to specific penalties. This section describes the reasonable cause exception generally, including the requirements for the exception to apply, as well as some of the more commonly asserted reasons.

Although timely performance of the required conduct is necessary for the proper administration of the tax laws, Congress recognizes that a taxpayer should not be penalized for certain circumstances that are beyond his control. As a result, most of the civil penalties provide an exception if the required performance is not forthcoming as a result of reasonable cause.[2316] Many penalties have other requirements, in addition to reasonable cause, before the penalty can be waived. For example, to negate a §6651 failure to file or failure to pay penalty, the taxpayer must also show that the failure is not due to willful neglect.[2317] To avoid an accuracy-related penalty under §6662 or §6662A, or a fraud penalty under §6663, the taxpayer must have acted in good faith, in addition to having reasonable cause.[2318] In such cases, both requirements must be satisfied to avoid the penalty.[2319] A lack of fraudulent intent alone is not sufficient.

The IRS must either waive or impose the penalty in full.[2320] By requiring the penalty to be imposed "unless" the failure is due to reasonable cause, the statute precludes any partial waiver.

Before a penalty may be assessed, it must first be approved in writing by the immediate supervisor of the individual making the determination to impose the penalty.[2321] In addition, in any court proceeding involving a civil penalty of an individual, the IRS has the burden of producing evidence to support the imposition of a penalty before a court can impose it.[2322] Then the burden shifts to the taxpayer to prove reasonable cause,[2323] by a preponderance of the evidence.[2324]

Whether the elements that constitute reasonable cause, willful neglect, or good faith are present is a question of fact. However, the determination of what elements must be present to avoid the penalty is a question of law.[2325] The taxpayer also may obtain penalty relief through a statutory exception or an administrative waiver.[2326]

Comment: Although taxpayers should strive to comply with the law, they should not ignore the potential for a reasonable cause exception if they are unable to do so. As discussed below, each case is evaluated on its own merits. Accordingly, the right combination of facts may be sufficient to avoid a penalty. Additionally, the IRS has First-Time Abatement rules that might allow for an administrative waiver of a failure to file, failure to pay, or failure to make deposit of taxes penalty.[2327]

B. *Time and Manner of Claiming the Exception*

1. *General Rule*

A taxpayer may request the nonassertion or abatement of a penalty at any time, whether:[2328]

- During or after an examination (but before the penalty is assessed),
- With a return that is either filed or paid late, or
- After assessment of the penalty and notification thereof is given to the taxpayer.

Where possible, the taxpayer should submit documentary evidence with the request since the taxpayer generally bears the burden of proving that he is entitled to relief.[2329]

If the request is denied, the taxpayer may make a subsequent request for penalty relief. The subsequent request is generally considered an appeal of the denial.[2330]

[2316] *See, e.g.*, §6651(a), §6652, §6664(c), §6694(a)(3), §6695(a)–§6695(e), §6698(a), §6699(a), §6724(a), §7519(f)(4). *See also* Notice 746, *Information About Your Notice, Penalty and Interest* (discussing removal of penalties due to reasonable cause). For a chart illustrating when reasonable cause relief and other relief is available, refer to IRM Exhibit 20.1.1-1 Penalty Relief Application Chart (03-29-23), included in the Worksheets of this Portfolio, below. For an updated list and discussion of relevant key factors used to determine if reasonable cause exists, see the LB&I Concept Unit on Reasonable Cause and Good Faith. Merely being beyond the taxpayer's control is not sufficient. *United States v. Boyle*, 469 U.S. 241 (1985).

[2317] §6651(a). The absence of willful neglect is also required, for example, by §6652, §6656, §6695(a)–§6695(e), §6724, and §7519(f)(4). Willful neglect is a conscious, intentional failure or reckless indifference. *United States v. Boyle*, 469 U.S. 241 (1985).

[2318] §6664(c), §6664(d). *See Roco v. Commissioner*, 121 T.C. 160 (2003) (return position taken by taxpayer, an accountant, regarding includibility in income of whistleblower reward payment was not supported by substantial authority and was not taken in good faith; withdrawal of letter ruling request upon learning that ruling would be adverse did not suggest good faith). Good faith is also required to avoid a penalty, for example, under §6657, §6694(a), and §6712.

[2319] *See, e.g.*, *United States v. Boyle*, 469 U.S. 241 (1985); *Cavallaro v. Commissioner*, T.C. Memo 2014-189, aff'd in part, rev'd in part and rem'd, 842 F.3d 16 (1st Cir. 2016); *Elec. & Neon, Inc. v. Commissioner*, 56 T.C. 1324 (1971), acq., 1973-2 C.B. 1, aff'd without op., 496 F.2d 876 (5th Cir. 1974); *Charles E. Pearsall & Son v. Commissioner*, 29 B.T.A. 747 (1934); *Hornsby v. Commissioner*, 26 B.T.A. 591 (1932).

[2320] *United States v. Sanford* (*In re Sanford*), 979 F.2d 1511 (11th Cir. 1992).

[2321] §6751(a). See discussion at XII.A.1., below.

[2322] §7491(c). See discussion at XII.A.3., below.

[2323] Tax Court Rule 142(a). *See, e.g.*, *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537 (5th Cir. 2009); *Hoefle v. Commissioner*, 114 F.2d 713 (6th Cir. 1940); *Sabatini v. Commissioner*, 98 F.2d 753 (2d Cir. 1938); *In re Wyly*, 552 B.R. 338 (Bankr. N.D. Tex. 2016); *Montgomery v. Commissioner*, 127 T.C. 43 (2006); *Bixby v. Commissioner*, 58 T.C. 757 (1972), *acq.*, 1975-2 C.B. 1; *Shomaker v. Commissioner*, 38 T.C. 192 (1962). If the penalty is asserted for the first time in the IRS's answer, however, the IRS bears the burden of proof. Tax Court Rule 142(a); *Sarcone v. Commissioner*, T.C. Memo 1985-548. See discussion at XII.A.3., below.

[2324] *See, e.g.*, *CNT Investors, LLC v. Commissioner*, 144 T.C. 161 (2015); *Neonatology Assocs., P.A. v. Commissioner*, 115 T.C. 43 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002); *In re Wyly*, 552 B.R. 338 (Bankr. N.D. Tex. 2016); *McClellan v. Commissioner*, T.C. Memo 2013-251; *Lehrer v. Commissioner*, T.C. Memo 2006-156.

[2325] *United States v. Boyle*, 469 U.S. 241 (1985); *Commissioner v. Lane-Wells Co.*, 321 U.S. 219 (1944).

[2326] *See, e.g.*, §6654(e)(1) (excepting individuals whose tax due, as reduced by withholding, is less than $1,000 from penalty for failure to pay estimated taxes); Notice 93-22 (allowing individuals automatic four-month extension of time to file income tax returns).

[2327] *See* IRM 20.1.1.3.6.1 (03-29-23), IRM 20.1.1.3.3.2.1 (03-29-23).

[2328] IRM 20.1.1.3.5(1) (10-19-20).

[2329] IRM 20.1.1.3.5(2) (10-19-20).

[2330] IRM 20.1.1.3.5.1(1) (03-29-23). *See also* SBSE-20-0424-0577 (Apr. 30, 2024) (interim guidance for IRM 20.1.1.3.5.1; clarified instructions to transfer cases to Appeals).

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Comment: The request for waiver of a penalty should be made as soon as possible. The IRS has full authority to commence proceedings to collect the penalty 10 days after the notice of assessment is sent. Significantly, the deficiency proceedings of subchapter 63B do not apply.

The regulations generally require the taxpayer's request for waiver of the penalty be in writing and signed under penalties of perjury.[2331] The IRS will also examine requests for reasonable cause consideration from third parties.[2332] The IRS may request additional information if it is needed to make a determination.[2333]

Note: Failure to comply with a properly issued discovery order may prevent the offending party from later raising affirmative defenses.[2334]

2. Special Rule for Partnership Items

Under the Bipartisan Budget Act partnership audit procedures (BBA procedures), which generally are effective for partnership tax years beginning after December 31, 2017, applicability of penalties related to partnership-related items adjusted for the reviewed year is determined at the partnership level. The partnership is treated as the taxpayer and, therefore, the facts and circumstances taken into account in determining whether the partnership has established reasonable cause and good faith are those facts and circumstances applicable to the partnership. This may include facts and circumstances with respect to partners or other individuals acting on behalf of the partnership.[2335] Partner-level defenses, including a reasonable cause defense that is based on the personal circumstances of the partner, may not be raised in a partnership proceeding, except to the extent that the defense is allowed pursuant to the rules governing modifications for partner amended returns or partner closing agreements.[2336]

If a partnership elects to push out the penalty to the partners, a partner claiming a defense to the penalty must first pay the penalty and then file a claim for refund. Partner-level defenses are limited to defenses personal to the partner (e.g., reasonable cause and good faith based on facts and circumstances particular to the partner).[2337]

Absent a push-out election, if a partnership fails timely to pay an imputed underpayment, the partnership is liable for additional interest and penalties. Any unpaid amount is treated as if it were an underpayment of tax for purposes of computing penalties, and the penalty under §6651(a) is applied by treating the unpaid amount of the imputed underpayment as the unpaid amount shown as tax on a required return.[2338]

For partnership tax years to which TEFRA applies, there is some confusion as to whether a reasonable cause defense with respect to a penalty arising out of a partnership item may be considered at a partnership-level proceeding or a partner-level proceeding. See discussion at XII.A.2., below. Clearly, a reasonable cause defense based on a characteristic or action that is personal to a partner or depends on his separate return must be raised by the partner in a separate partner-level refund proceeding under §6230(c).[2339] But where can the defense be raised if it is based on an act of the partnership?[2340]

According to the Court of Federal Claims, a reasonable cause defense may only be raised in a separate partner-level proceeding, regardless of the facts. The court relies primarily on Reg. §301.6221-1(d). The regulation states that partner-level defenses to a penalty that relates to an adjustment to a partnership item may not be asserted in the partnership-level proceeding, and specifically cites the reasonable cause defense under §6664(c)(1) as an example of such a precluded partner-level defense. In addition, reasonable cause under §6664(c)(1) requires the taxpayer to have acted in good faith. In the case of a partnership, the taxpayer is the partner, not the partnership.[2341] Moreover, the court found that jurisdiction over partner-level defenses should not depend on whether the tax matters partner chooses to raise the defense.

Despite the foregoing, a majority of the courts have allowed the partnership to raise the reasonable cause defense on its own behalf where such reasonable cause depends on the action of the managing partner or where the facts generally are relevant to all partners or a class of partners, and have not permitted such defense to be raised separately by the partners.[2342] These courts rely on the portion of the Regulation that limits partner-level defenses to those that are personal to a partner, or

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[2331] *See, e.g.*, Reg. §301.6651-1(c)(1), §301.6652-1(f), §301.6652-2(f), §301.6652-3(b)(3), §301.6679-1(a)(3), §301.6684-1(b), §301.6686-1(b), §301.6688-1(c), §301.6689-1T(d), §301.6692-1(c), §301.6693-1(b), §301.6708-1(g), §301.6724-1(m), T.D. 9984, 88 Fed. Reg. 87,696 (Dec. 19, 2023), effective for information returns required to be filed and payee statements required to be furnished after December 31, 2023.

[2332] IRM 20.1.1.3(3) (10-19-20). However, the IRS may not disclose taxpayer information to the third party unless he has a power of attorney.

[2333] IRM 20.1.1.3(3) (10-19-20).

[2334] *See* Fed. R. Civ. P. 37(b)(2)(A); *United States v. Buff*, No. 19-CV-5549 (GBD) (JW), 2023 BL 235669 (S.D.N.Y. July 11, 2023), *aff'd* No. 23-1070-cv, 2024 BL 332902 (2d Cir. 2024) (taxpayer prohibited from raising reasonable cause defense after refusing to sit for deposition).

[2335] §6221(a); Prop. Reg. §301.6233(a)-1(c)(1); Prop. Reg. §301.6233(a)-1(c)(2)(v).

[2336] Prop. Reg. §301.6233(a)-1(c)(2)(v).

[2337] Prop. Reg. §301.6226-3(i)(3).

[2338] Prop. Reg. §301.6233(b)-1(d).

[2339] Reg. §301.6221-1(d). A defense is personal to a partner if it is unique to that partner, generally requiring a factual finding that is unique to that partner. A defense depends on a partner's separate return if relevant facts can be established only by examination of or reference to the partner's separate return. *Tigers Eye Trading, LLC v. Commissioner*, T.C. Memo 2009-121, *supp.*, 138 T.C. 67 (2012), aff'd in part and rev'd in part on other grounds sub. nom. *Logan Trust v. Commissioner*, 616 Fed. App'x. 426 (D.C. Cir. 2015).

The Bipartisan Budget Act of 2015, Pub. L. No. 114-74, §1101, repealed the TEFRA provisions, including §6230, effective for partnership tax years beginning after December 31, 2017, and replaced them with new partnership audit provisions. Partnerships may elect to apply the amended partnership audit provisions to any partnership return filed for partnership tax years beginning after November 2, 2015, and before January 1, 2018. Pub. L. No. 114-74, §1101(g)(4).

[2340] For this purpose, a partnership does not include a small partnership which elects under §6231(a)(1)(B) not to have the TEFRA partnership rules apply. See discussion at XII.A.2., below.

[2341] §7701(a)(14).

[2342] *Am. Boat Co., LLC v. United States*, 583 F.3d 471 (7th Cir. 2009); *Tigers Eye Trading, LLC v. Commissioner*, T.C. Memo 2009-121; *Klamath Strategic Inv. Fund, LLC v. United States*, 472 F. Supp. 2d 885 (E.D. Tex. 2007), aff'd on this issue, 568 F.3d 537 (5th Cir. 2009); *Stobie Creek Invs. LLC v. United States*, 82 Fed. Cl. 636 (2008), aff'd, 608 F.3d 1366 (Fed. Cir. 2010); *New Millennium Trading, LLC v. Commissioner*, 131 T.C. 275 (2008); *Santa Monica Pictures, LLC v. Commissioner*, T.C. Memo 2005-104; *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004), aff'd by unpub. op., 150 Fed. App'x 40 (2d Cir. 2005); *Krause v. United States*, 2010 BL 370276 (W.D. Tex. Jan. 22, 2010), aff'd, 398 Fed. App'x 35 (5th Cir. 2010).

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depend on the partner's separate return and that cannot be determined at the partnership level.[2343] The reasonable cause defense is merely an example of a partner-level item. All defenses that are neither personal to the partner nor dependent on the partners separate return can be determined at the partnership level. The courts found nothing in the Regulation that precluded reasonable cause from also being raised by the partnership.

Comment: It would make sense for the defense based on partnership action to be raised by the partnership. The facts relating to the imposition of the penalty are determined at the partnership level. This should include any actions of the partnership that would constitute a defense against the imposition of the penalty. Any determinations about partnership intent would be based on the intent of the managing partner. Allowing the court that determines the applicability of the penalty to also determine whether the partnership had reasonable cause for its actions would avoid the time and expense of separate proceedings. And it is not just one separate partner-level proceeding that would be avoided, but potentially one for each partner in the partnership. The IRS seems to agree.[2344]

The Supreme Court, in *United States v. Woods*,[2345] held that TEFRA gives courts in partnership-level proceedings the power to determine the applicability of any penalty that could result from adjustments to a partnership item, even if imposing the penalty would also require determining affected or nonpartnership items. The partnership-level determination, however, is provisional. Each partner is free to raise in a subsequent partner-level proceeding any reasons why the penalty should not be imposed on him specifically. Even the managing partner, who acts on behalf of the partnership and whose good faith was tested at the partnership level, is entitled to raise defenses in a separate partner-level proceeding.[2346]

C. Requirements for the Reasonable Cause Exception

1. Reasonable Cause

A taxpayer has reasonable cause when his conduct justifies the nonassertion or abatement of the penalty.[2347] Reasonable cause relief is generally granted when a taxpayer exercises ordinary business care and prudence in determining his tax obligations, but nevertheless is unable to comply with those obligations.[2348] Any reason that establishes that the taxpayer exercised ordinary business care and prudence may be considered.[2349]

In *United States v. Boyle*, the Supreme Court, reciting from the Internal Revenue Manual, listed reasons that the IRS might deem to constitute "reasonable cause," including: unavoidable postal delays, the taxpayer's timely filing of a return with the wrong IRS office, the taxpayer's reliance on the erroneous advice of an IRS officer or employee, the death or serious illness of the taxpayer or a member of his immediate family, the taxpayer's unavoidable absence, destruction by casualty of the taxpayer's records or place of business, failure of the IRS to furnish the taxpayer with the necessary forms in a timely fashion, and the inability of an IRS representative to meet with the taxpayer when the taxpayer makes a timely visit to an IRS office in an attempt to secure information or aid in the preparation of a return.[2350] These reasons suggest impossibility. That is, to make out a claim for refund of penalties due to "reasonable cause," the taxpayer must plead it was unable to file its returns and pay taxes through no fault of its own.[2351]

[2343] Reg. §301.6221-1(d).

[2344] Chief Counsel Notice CC-2009-027, Q&A–D-1 (stating that the IRS considers partnership-level defenses by reference to the actions and state of mind of the managing partner [citations omitted], while contrasting *Clearmeadow Invs., LLC v. United States*, 87 Fed. Cl. 509 (2009), which held that the court lacked jurisdiction at partnership level to consider applicability of reasonable cause exception to the gross valuation misstatement penalty, and noted that partners may raise partner-level personal defenses to a penalty, or defenses that depend on the partner's separate return, only through a refund action).

[2345] 571 U.S. 31 (2013).

[2346] *McNeill v. United States*, 836 F.3d 1282 (10th Cir. 2016).

[2347] *See* IRM 20.1.1.3.2(5) (11-21-17). *See also F.E. Schumacher Co. v. United States*, 308 F. Supp. 2d 819 (N.D. Ohio 2004) (concerns over EFTPS's integrity, taxpayer's ability to maintain greater internal control over its taxes using its own payment method, and Y2K implications, while genuine, do not compel finding that taxpayer acted with reasonable cause). As this is a factual determination, a court could properly exclude, as an inadmissible legal opinion, an expert's response to hypothetical questions asked to show that an estate was reasonable in its failure to timely pay estate tax. *Estate of Sowell v. United States*, 198 F.3d 169 (5th Cir. 1999).

[2348] *See* IRM 20.1.1.3.2.1(1) (03-29-23). *See also* Reg. §301.6651-1(c), §1.6664-4, §1.6694-2(d), §301.6707-1T, §1.6695-1(b)(4), §301.6724-1, T.D. 9984, 88 Fed. Reg. 87,696 (Dec. 19, 2023), effective for information returns required to be filed and payee statements required to be furnished after December 31, 2023; *United States v. Boyle*, 469 U.S. 241 (1985); *Fran Corp. v. United States*, 164 F.3d 814 (2d Cir. 1999) (financial difficulties not reasonable cause for failures to pay and deposit employment taxes where electrical contractor made payments to president, to employees, and to creditors not directly related to projects it was trying to complete); *United States v. Craddock*, 149 F.3d 1249 (10th Cir. 1998) (ordinary business care and prudence not shown where outside accountants not hired despite awareness that accounting staff always filed returns late), *withdrawing* 143 F.3d 595 (10th Cir. 1998); *Haywood Lumber & Mining Co. v. Commissioner*, 178 F.2d 769 (2d Cir. 1950); *Southeastern Fin. Co. v. Commissioner*, 153 F.2d 205 (5th Cir. 1946). *See Henningsen v. Commissioner*, 26 T.C. 528, 536 (1956) ("Mere uninformed and unsupported belief by a taxpayer, no matter how sincere that belief may be, that he is not required to file a tax return, is insufficient to constitute reasonable cause for his failure so to file."), *aff'd*, 243 F.2d 954 (4th Cir. 1957); *Nurumbi v. Commissioner*, T.C. Memo 2021-79 (taxpayer's mistaken belief that he filed his tax return on time, regardless of how sincere that belief was, did not constitute reasonable cause); *Padda v. Commissioner*, T.C. Memo 2020-154 (reasonable cause not found in reliance on professional accountants that filed return late where same accountants repeatedly filed returns late in past years); *In re Refco Public Commodity Pool, L.P.*, 554 B.R. 736 (Bankr. D. Del. 2016) (where taxpayer did not receive essential financial information from partnership in which taxpayer invested its assets, taxpayer was found to have reasonable cause for nonfiling; court determined that taxpayer acted responsibly before and after failure to file occurred, noting risk of accuracy-related penalties if taxpayer knowingly filed inaccurate returns; court also found absence of willful neglect and significant mitigating factors in taxpayer's established filing history and absence of prior penalties); *Broker v. United States*, 2000-2 USTC ¶50,823 (E.D. Pa. 2000) (ordinary business care and prudence in providing for payment of tax liability shown); *Crocker v. Commissioner*, 92 T.C. 899 (1989); *Ward v. United States*, 58-2 USTC ¶9922 (E.D. Tenn. 1958); CCA 201414017 (taxpayer did not meet second requirement of reasonable cause exception: while taxpayer may have exercised ordinary business care and prudence, taxpayer's reliance on third-party payroll processing company's faulty system that led to untimely deposits did not render taxpayer unable to meet its filing responsibilities); *George v. Commissioner*, T.C. Memo 2019-128 (incarcerated taxpayer's failure to have family members assist in assembling documents necessary to file, to file for extension, or to estimate deductions in order to itemize shows lack of ordinary business care and prudence), *aff'd*, 821 Fed. App'x. 76, 2020 BL 355484 (3d Cir. 2020).

[2349] IRM 20.1.1.3.2(3) (11-21-17). *See* IRM 20.1.1.3.2.2 (02-22-08).

[2350] *United States v. Boyle*, 469 U.S. 241, 243 n.1 (1985). For an updated list and discussion of relevant key factors used to determine if reasonable cause exists, see the LB&I Concept Unit on Reasonable Cause and Good Faith.

[2351] *Valen Mfg. Co. v. United States*, 90 F.3d 1190, 1193 (6th Cir. 1996) (even if a taxpayer exercised ordinary business care and prudence, taxpayer

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Lee v. United States confirmed the applicability of the *Boyle* bright-line test to e-filed returns.[2352] In *Lee*, the taxpayer hired a CPA to prepare 2014, 2015, and 2016 tax returns that were required to be filed electronically, authorized the CPA to file the returns, and thought the CPA had filed the returns, but the CPA never filed the returns. When the taxpayer was informed by the IRS in 2018 that the returns were never filed, he filed the returns himself and paid the tax, interest, and penalties. The taxpayer then sued for a refund of taxes and fees assessed due to the failure to file and pay, arguing *Boyle*'s bright-line test does not apply to e-filed returns and reasonable cause existed. Because he relied on his CPA and the CPA failed to file the returns, the taxpayer argued the filing of returns was beyond his control. He also relied on the signed Forms 8879, *IRS e-file Signature Authorization*, provided to the CPA to argue that the burden of e-filing had been shifted to the tax preparer and that e-filing is fundamentally different than paper filing. The court disagreed, finding *Boyle* applied to e-filed returns, the taxpayer retained full control over the process, could have filed the paper returns himself at any time, and retained the obligation to exercise ordinary business care. Citing *Boyle*, the court noted that reliance on an agent without more is not reasonable cause.[2353] "Reasonable cause" means "the taxpayer exercised ordinary business care and prudence," which in this situation means ensuring that his tax return has been submitted to the IRS.[2354]

Practice Tip: Taxpayers would be well advised to ensure that their return preparer provides them with the IRS acknowledgement that the return was accepted before the filing deadline.

In *Whitsett v. Commissioner*,[2355] the Tax Court held the taxpayer exercised ordinary business care and prudence to determine her correct tax liability, despite that her longtime preparer provided her with the improper year to report gain from the sale of stock. The taxpayer tendered her stock for redemption in Year 1. However, the redemption documents she was given stated the sale was "processed" in Year 2, and the "payment date" was in Year 1. The taxpayer forwarded her tax documents to her preparer for his review and specifically discussed with him the proper year to report the stock sale proceeds. He erroneously advised that Year 1 was the applicable year and instructed the taxpayer to make payments to the IRS accordingly, which she did in a timely manner. The court reasoned that as a lay person unfamiliar with tax law, stock redemptions, and corporate reorganizations, the taxpayer was understandably confused by this documentation and reasonably referred the timing question to her preparer. The court further noted the taxpayer displayed admirable business care and prudence by accepting her preparer's advice, given the time value of money, it would have been advantageous for her to report her million-dollar gain in Year 2.

Ordinary business care and prudence requires a taxpayer to provide for his reasonably foreseeable obligations. A taxpayer may establish reasonable cause by showing that he exercised ordinary business care and prudence, taking the degree of care that would be exercised by a reasonably prudent person, but nevertheless was unable to comply with the law.[2356] The determination is made on a case-by-case basis, taking into account all pertinent facts and circumstances.[2357] Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability.[2358] Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge and education of the taxpayer. As isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith.[2359] Reliance on an information return, professional advice or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.[2360]

The taxpayer's obligation to meet the tax law requirements is ongoing. Ordinary business care and prudence requires that the taxpayer continue to attempt to satisfy the requirements, even though late.[2361] Reasonable cause does not exist if, after the facts and circumstances that explain the taxpayer's noncompliant behavior cease to exist, the taxpayer fails to comply with the tax obligation within a reasonable period of time.[2362]

However, the taxpayer's exercise of ordinary business care and prudence is not sufficient to meet the requirements of the reasonable cause exception. The taxpayer also must demonstrate that, despite its exercise of ordinary business care and prudence, it was rendered unable to meet its responsibilities.[2363]

Reasonable cause is never presumed.[2364] It must be proved by the taxpayer based on the facts and circumstances. In determining whether the taxpayer exercised ordinary business care and prudence, the IRS reviews all available information including:[2365]

still does not qualify for reasonable cause exception unless taxpayer demonstrates that, despite its exercise of ordinary business care and prudence, it was "rendered unable to meet its responsibilities"); *All Stacked Up Masonry, Inc. v. United States*, 150 Fed. Cl. 540 (Fed. Cl. 2020).

[2352] 84 F.4th 1271 (11th Cir. 2023).

[2353] *Lee v. United States*, 84 F.4th 1271 (11th Cir. 2023) (citing *United States v. Boyle*, 469 U.S. 241 (1985).

[2354] The Eleventh Circuit also noted that an electronically filed return is not considered filed until the IRS acknowledges acceptance. Thus, the taxpayer's signing Form 8879 each year did not complete the filing process; he needed to obtain acknowledgment from the IRS that his return had been accepted.

[2355] T.C. Memo 2017-100.

[2356] IRM 20.1.1.3.2.2 (02-22-08). *See, e.g.*, Reg. §301.6651-1(c)(1); *Streber v. Commissioner*, 138 F.3d 216 (5th Cir. 1998); *Phemister v. Commissioner*, T.C. Memo 2009-201; *Probandt v. Commissioner*, T.C. Memo 2016-135.

[2357] Reg. §1.6664-4(b)(1).

[2358] Reg. §1.6664-4(b)(1).

[2359] Reg. §1.6664-4(b)(1).

[2360] Reg. §1.6664-4(b)(1). See discussion at XI.D.1., below.

[2361] IRM 20.1.1.3.2.2 (2-22-08).

[2362] IRM 20.1.1.3.2.2(2)(c) (02-22-08).

[2363] *Valen Mfg. Co. v. United States*, 90 F.3d 1190 (6th Cir. 1996); *In re Cent. La. Home Healthcare, LLC*, 617 B.R. 263, 2020 BL 123392 (Bankr. W.D. La. 2020) (requirements for reasonable cause are conjunctive rather than disjunctive, therefore taxpayer must exercise ordinary business care and prudence, and nevertheless be rendered unable to meet its responsibilities). *See, e.g.*, CCA 201414017 (while taxpayer may have exercised ordinary business care and prudence, taxpayer's reliance on third-party payroll processing company's faulty system that led to untimely deposits did not render taxpayer unable to meet its filing responsibilities).

[2364] IRM 20.1.1.3.2.2.6(3) (11-25-11).

[2365] IRM 20.1.1.3.2(5) (11-21-17), IRM 20.1.1.3.2.2(2) (02-22-08).

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• What is the taxpayer's reason for not complying with the law? What facts and circumstances prevented the taxpayer from complying? How did they prevent the taxpayer from complying?

• When did these facts and circumstances occur? Do the dates clearly correspond to the events on which the penalty is based?

• Should the taxpayer have reasonably anticipated the event that caused his noncompliance? Could the taxpayer reasonably have avoided the occurrence of the event or have planned for it?

• How did the taxpayer handle the rest of his affairs during the time of the noncompliance?

• Once the facts and circumstances changed, what attempt did the taxpayer make to comply with his obligation? How much time elapsed between the end of the event cited as the reason for noncompliance and his subsequent compliance?

• What is the taxpayer's overall compliance record? Has the same or a similar penalty previously been assessed or abated?

The ordinary business care and prudence standard, however, applies only to the "ordinary person" — i.e., one who is physically and mentally capable of knowing, remembering, and complying with the statutory requirement.[2366] Where a taxpayer demonstrates that, because of incompetence or infirmity, he is unable to meet the standard of ordinary business care and prudence, there is no reason for the IRS to impose a penalty.

Comment: Although much of the case law has been developed with respect to the delinquency penalties, the same standards and inquiries have been applied with respect to other penalties.[2367]

2. Good Faith or Absence of Willful Neglect

As discussed earlier, various penalties require the taxpayer to show not only that there is reasonable cause for the failure, but also that the taxpayer has acted in good faith or that there is an absence of willful neglect. Good faith refers to an honest belief, without any knowledge of circumstances that would put the taxpayer under a duty to inquire further, and free of any intention to defraud. Willful neglect, on the other hand, is defined as a conscious, intentional failure or reckless indifference.[2368]

Comment: Although these are additional statutory requirements, the requirement for reasonable cause tends to encompass the others. As a result, the courts and the IRS generally discuss the exception under the heading of reasonable cause.

A taxpayer's withdrawal of his request for a private letter ruling upon learning that it would be adverse was found to suggest that the taxpayer did not exercise good faith.[2369]

Comment: An analysis of the taxpayer's good faith should take into account the fact that a private letter ruling is, in one sense, an insurance policy that the IRS may determine not to issue, for example, where the law is not clear. In any event, a private letter ruling is merely an opinion of the IRS. It is not law. It is not binding on any taxpayer other than the recipient, and cannot be used as precedent.[2370] A taxpayer should be free to disagree with the IRS's position in good faith.

The taxpayer's failure to disclose a reportable transaction under Reg. §1.6011-4 is a strong indication that the taxpayer did not act in good faith with respect to the portion of an underpayment attributable to the reportable transaction.[2371]

In the case of a tax shelter, the IRS will not consider a taxpayer's reliance on tax advice from an advisor who has a financial arrangement or referral agreement with the tax shelter promoters to be reasonable and in good faith.[2372]

3. Causation and Duration

To qualify for a waiver, the events constituting reasonable cause must be directly connected to the taxpayer's failure to comply[2373] and must continue throughout the delinquency peri-

[2366] *United States v. Boyle*, 469 U.S. 241 (1985) (concurring opinion); *United States v. Isaac*, 91-2 USTC ¶50,314 (E.D. Ky. 1991), aff'd by unpub. op., 968 F.2d 1216 (6th Cir. 1992); *Brown v. United States*, 630 F. Supp. 57 (M.D. Tenn. 1985); *Ward v. United States*, 58-2 USTC ¶9922 (E.D. Tenn. 1958).

[2367] *See, e.g., Vorsheck v. Commissioner*, 933 F.2d 757 (9th Cir. 1991); *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990); *Estate of Spruill v. Commissioner*, 88 T.C. 1197 (1987).

[2368] *United States v. Boyle*, 469 U.S. 241 (1985). *See also PARCC Health Care, Inc. v. United States*, 238 F. Supp. 2d 435 (D. Conn. 2002) (declining to adopt per se rule that entity's placement of payment responsibility in one individual without instituting safeguards to ensure compliance is willful neglect as a matter of law).

[2369] *Roco v. Commissioner*, 121 T.C. 160 (2003).

[2370] §6110(k)(3). However, despite the express language of §6110(k)(3), courts have cited private letter rulings in their decisions. *See, e.g., Wolpaw v. Commissioner*, 47 F.3d 787, 792 (6th Cir. 1995) ("While this Private Letter Ruling is not binding precedent upon the Internal Revenue Service as to other taxpayers, or upon this Court, 26 U.S.C. section 6110(j)(3) (1988) [now §6110(k)(3)], in the absence of any Treasury Regulations directly on point, we view it as evidence. …"); *Seymour v. Commissioner*, 109 T.C. 279, 284 (1977) ("Although private letter rulings are not precedent, sec. 6110(j)(3) [now §6110(k)(3)], they 'do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws'" quoting *Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962)). Moreover, private letter rulings issued after October 31, 1976 constitute authority for purposes of avoiding the substantial understatement of tax penalty. Reg. §1.6662-4(d)(3). See discussion at IV.C.3.b., above.

[2371] §6664(d)(3); Reg. §1.6664-4(d) (promulgated before enactment of §6662A).

[2372] Memorandum from IRS Commissioner Mark W. Everson dated December 29, 2003 regarding Penalty Policy Statement of the IRS, available at: https://www.irs.gov/pub/irs-utl/penalty_policy_statement-circular_230.pdf. The statement is intended to apply retroactively. *See* §6664(d)(4)(B)(i), §6664(d)(4)(B)(ii)(II), §6664(d)(4)(B)(ii)(III) (taxpayer cannot rely on opinion provided by disqualified tax advisor, i.e., a tax advisor compensated indirectly by a material advisor with respect to the transaction or a tax advisor who has a fee arrangement with respect to the transaction that is contingent on intended tax benefits from the transaction being sustained). See discussion at IV.C.5., above.

[2373] *Crocker v. Commissioner*, 92 T.C. 899 (1989); *Paula Constr. Co. v. Commissioner*, 58 T.C. 1055 (1972), aff'd by unpub. op., 474 F.2d 1345 (5th Cir. 1973); *Elec. & Neon, Inc. v. Commissioner*, 56 T.C. 1324 (1971), acq., 1973-2 C.B. 1, aff'd by unpub. op., 496 F.2d 876 (5th Cir. 1974); *Seckel v. Commissioner*, T.C. Memo 1974-170; *Hayes v. Commissioner*, T.C. Memo 1967-80. See *Photographic Assistance Corp. v. United States*, 99-2 USTC ¶50,773 (N.D. Ga. 1999) (reasonable cause standard is one-time test that taxpayer passes or fails at tax due date; thus, penalties for failure to pay tax shown upheld when due date passed before fire destroyed business); *Estate of Hinz v. Commissioner*, T.C. Memo 2000-6 (no reasonable cause to excuse §6651(a)(1) penalty for estate tax return; failure to file was not due to lawyer's provision of misinformation where true due date had already passed when lawyer gave

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od.[2374] If either is lacking, the penalty applies, at least with respect to that period. The longer the delay, the more likely it is that the IRS will impose a penalty.[2375] In addition, reasonable cause does not exist if the taxpayer did not comply within a reasonable period of time after the facts and circumstances that explain the taxpayer's noncompliant behavior cease to exist.[2376]

D. Common Reasons Given as Reasonable Cause

1. Reliance on Tax Advisor

a. IRS Guidance

Reliance on the advice of a tax advisor generally relates to the reasonable cause exception under §6664(c) for the accuracy-related penalty on underpayments under §6662 or under §6664(d) for the accuracy-related penalty on understatements related to reportable transactions under §6662A.[2377] In limited circumstances, however, reliance on the advice of a tax advisor may apply to other penalties when the tax advisor provides advice on the substantive tax issue.[2378] Reliance on the advice of a tax advisor is limited to issues that are generally considered technical or complicated. A taxpayer's responsibility to file, pay, or deposit taxes is not excused by reliance on the advice of a tax advisor.[2379]

Such advice, however, cannot be relied on: (1) if it was received after the date the return was filed, (2) if it is not related to an item included on the return, or (3) after the taxpayer receives notice from the advisor that the advice is no longer correct.[2380] In the case of advice from the IRS, the taxpayer is considered placed on notice that the advice is no longer correct or no longer represents the IRS's position if there is any subsequent (a) written correspondence from the IRS, (b) enactment of legislation or ratification of a tax treaty, (c) Supreme Court decision, (d) final or temporary regulation, or (e) publication of a revenue ruling, revenue procedure or other statement in the Internal Revenue Bulletin, presents a contrary position.[2381]

b. Filing Return vs. Substantive Law

In *United States v. Boyle*,[2382] the Supreme Court drew as bright a line as possible in determining when reliance on a tax advisor constitutes reasonable cause for avoiding a failure to file penalty under §6651(a). The Court ruled that a taxpayer cannot avoid the penalty by relying on his advisor to file the return. Reliance on a tax advisor with respect to a question of substantive law, on the other hand, may constitute reasonable cause when such advice turns out to be mistaken. As the Court reasoned:

> Congress has placed the burden of prompt filing on the [taxpayer], not on some agent or employee of the [taxpayer]. The duty is fixed and clear; Congress intended to place upon the taxpayer an obligation to ascertain the statutory deadline and then to meet that deadline, except in a very narrow range of circumstances. … That the attorney, as the [taxpayer's] agent, was expected to attend to the matter does not relieve the principal of his duty to comply with the statute. … This case is not one in which a taxpayer has relied on the erroneous advice of counsel concerning a question of law. … When an accountant or attorney advises a taxpayer on a matter of tax law, such as when a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. … "Ordinary business care and prudence" do not demand such actions. … By contrast, one does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due. … It requires no special training or effort to ascertain a deadline and make sure that it is met. The failure to make a timely filing of a return is not excused by the taxpayer's reliance on an agent, and such reliance is not "reasonable cause" for late filing under §6651(a)(1).[2383]

Accordingly, a taxpayer cannot avoid the penalty by delegating his statutory duty to an advisor or another person.[2384]

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incorrect date). *See also* IRM 20.1.1.3.2(4) (11-21-17), IRM 20.1.1.3.2.2(2) (02-22-08).

[2374] *Stevens Bros. Found. Inc. v. Commissioner*, 39 T.C. 93 (1962), aff'd in part and rev'd in part on other grounds, 324 F.2d 633 (8th Cir. 1963), cert. denied, 376 U.S. 969 (1964); *Williams v. Commissioner*, 16 T.C. 893 (1951), acq., 1951-2 C.B. 4; *Fluet v. Commissioner*, T.C. Memo 1986-555; *Estate of Plotkin v. Commissioner*, T.C. Memo 1972-202; *United States v. Isaac*, 91-2 USTC ¶50,314 (E.D. Ky. 1991), aff'd by unpub. op., 968 F.2d 1216 (6th Cir. 1992); *In re Hill Mailing & Printing, Inc.*, 1988 Bankr. LEXIS 2554 (Bankr. M.D. Fla. 1988); *Cotto-Vázquez v. United States*, No. 16-2807 (SCC), 2021 BL 91523 (D.P.R. Mar. 11, 2021) (court clarified that for §6651(a)(2) penalty, reasonable cause must exist from date original return is due until payment is received by IRS, whereas for §6651(a)(3), reasonable cause must exist as of 21 days from date of notice and demand (10 business days if the amount for which such notice and demand is made equals or exceeds $100,000) and until IRS receives payment). *See also* IRM 20.1.1.3.2(4) (11-21-17), IRM 20.1.1.3.2.2(2)(c) (02-22-08).

[2375] *See, e.g.*, *Estate of Curie v. Commissioner*, 4 T.C. 1175 (1945), nonacq., 1945 C.B. 8; *Fluet v. Commissioner*, T.C. Memo 1986-555; *Estate of Plotkin v. Commissioner*, T.C. Memo 1972-202.

[2376] *Estate of Maltaman v. Commissioner*, T.C. Memo 1997-110 (where preparer represented that he could get second extension of time to file, reliance on advice became unreasonable where estate filed four months after denial of request); IRM 20.1.1.3.2(6) (11-21-17).

[2377] *See* IRM 20.1.1.3.3.4.3 (11-21-17).

[2378] IRM 20.1.1.3.3.4.3(2) (11-21-17).

[2379] IRM 20.1.1.3.3.4.3(3) (11-21-17). See discussion at XI.D.1.b., below.

[2380] IRM 20.1.1.3.3.4(3) (08-05-14).

[2381] IRM 20.1.1.3.3.4(4) (08-05-14).

[2382] 469 U.S. 241 (1985).

[2383] *United States v. Boyle*, 469 U.S. 241 at 249–52.

[2384] *See, e.g.*, *Specht v. United States*, 661 Fed. App'x 357 (6th Cir. 2016), aff'g 2015 BL 1651 (S.D. Ohio Jan. 6, 2015) (despite taxpayer's attorney-advisor had brain cancer, that was not considered reasonable cause justifying taxpayer's duty to file return and pay outstanding liability on time); *Freeman v. United States*, 2012 BL 19968 (E.D. Pa. Jan. 30, 2012) (penalty imposed for failing to file estate tax return despite repeated assurances by attorney who suffered from litany of physical ailments and embezzled funds from estate); *United States v. Craddock*, 149 F.3d 1249 (10th Cir. 1998) (§6651 penalty proper where decision made to not use outside accountants despite awareness that accounting staff always filed returns late; owner of fast-growing business did not show he was unable to file returns timely), *withdrawing* 143 F.3d 595 (10th Cir. 1998); *Padda v. Commissioner*, T.C. Memo 2020-154 (reasonable cause

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Does Boyle Extend to E-Filing? It is not entirely clear whether a taxpayer's reliance on their preparer to timely electronically file the return, by itself, can constitute reasonable cause under §6651(a)(1). In *Haynes v. United States*,[2385] the taxpayers' preparer timely transmitted the returns to the IRS and notified the taxpayers. The returns were processed by the transmitter but later rejected by the IRS due to an incorrect EIN. The taxpayers did not receive a rejection notice from the IRS, the preparer, or the transmitter, and only learned of the problem on receiving a notice of nonpayment months later. The taxpayers thereafter filed a paper return and sought an abatement of the late-filing penalty for reasonable cause. The taxpayers eventually filed a refund suit, but the district court granted the government's summary judgment motion on the grounds that, as a matter of law, the taxpayers' reliance on their preparer to timely electronically file their return could not constitute reasonable cause under §6651(a)(1). The taxpayers appealed. The Fifth Circuit vacated the district court's judgment and remanded the case after concluding that there was a dispute of a material fact as to whether the preparer's actions could meet the reasonable cause standard. On appeal, the taxpayers asserted that the *Boyle* rule should not apply because filing a return electronically was fundamentally different than mailing a paper return. The Government asserted that *Boyle* should extend to e-filing. The Fifth Circuit concluded that it did not need to decide the issue because, unlike the taxpayers' agent in *Boyle*, who clearly was negligent in not timely filing his client's return, it was not clear whether the preparer in the present case was negligent. The court explained that whether it was reasonable for the preparer to assume, based on the IRS's silence, that it had accepted the return or whether ordinary business care and prudence would demand that he personally contact the IRS to ensure acceptance, was a genuine question of material fact for a jury to decide. The Fifth Circuit further explained that because the preparer was the taxpayers' agent, if a jury determined that his actions met the reasonable cause standard, it also had to find that the taxpayers met the standard absent any determination of independent negligence on their part.[2386]

In *Oosterwijk v. United States*,[2387] the taxpayers relied on their accountant to electronically file a timely 2017 extension and cause the estimated balance due of $1.8 million to be automatically debited from their bank account. The taxpayers later discovered that the accountant had not e-filed the extension and he advised them erroneously that if they immediately filed the extension, it would extend the due date until October 15. The taxpayers mailed a paper extension and a check and eventually filed the return in September 2018. The IRS later asserted late filing and late payment penalties. The taxpayers argued that *Boyle* did not apply to electronic filing because a taxpayer could not personally confirm that an accountant had e-filed as promised. The district court, noting that *Boyle's* applicability to e-filing has not been squarely addressed by appellate courts, agreed with the government that *Boyle* controlled and the taxpayers thus could not assert reliance on their accountant to e-file the extension request to excuse the penalties. The court observed that the taxpayers were free to file their own extension request on paper and that specialized technology and professionals-only availability of e-filing was no barrier to the filing of the extension request.

A minor child's reliance on his parents to file returns on his behalf does not constitute reasonable cause even if the parents are legally obligated to file as guardians unless the parents themselves can demonstrate that their failure was due to reasonable cause.[2388]

Even where all information is provided to the advisor, the taxpayer still has a duty to review the tax return to make sure that all income items are included.[2389] The taxpayer does not have to duplicate the work of his tax return preparer, but he must at least confirm that items reported on information returns have been included.[2390] Moreover, advice that no penalty will be incurred if a return is not filed because no deficiency exists, however, is not the same as advice that no return is required, and does not constitute reasonable cause.[2391]

In *Estate of Thouron v. United States*,[2392] the Third Circuit held that *United States v. Boyle*,[2393] which was a failure to file case, also applied to failure to pay cases. The Third Circuit held that the district court erred in failing to apply different standards for relying on a tax professional to fulfill administrative acts and relying on a tax professional for substantive tax advice. Although the Supreme Court in *Boyle* identified three separate categories of reliance on a tax professional, the Third Circuit noted that the Supreme Court only reached a conclusion about the taxpayer's dependence on a tax professional for

not found in reliance on professional accountants that filed return late where same accountants repeatedly filed returns late in past years); *Harrison v. Commissioner*, T.C. Memo 1998-417 (accountant's timely filing of extension forms containing estimated tax liability constituted advice as to estimated tax liability as well as filing obligation); *McMahan v. United States*, 114 F.3d 366 (2d Cir. 1997) (taxpayer has nondelegable duty to file timely return or seek timely extension; reliance on advisor to merely complete and mail extension request does not fall within "substantive advice" exception of *Boyle*); *Denenburg v. United States*, 920 F.2d 301 (5th Cir. 1991) (where taxpayer knew return was due and procrastinated in giving CPA information necessary to prepare return, CPA's refusal to file incomplete return was not reasonable cause), *cert. denied*, 502 U.S. 809 (1991); *Walter v. Commissioner*, 753 F.2d 35 (6th Cir. 1985) (taxpayer did not have reasonable cause for late filing where he placed total reliance on his secretary to obtain and correctly complete tax return).

[2385] 760 Fed. App'x. 324, 2019 BL 28542 (5th Cir. 2019).

[2386] *Haynes v. United States*, 760 Fed. App'x. 324, 2019 BL 28542 (5th Cir. 2019). In a footnote, the Fifth Circuit noted that, in addition to neither the taxpayer nor their preparer taking any further action to confirm that the IRS had actually received the return or acknowledged its acceptance for processing, the taxpayers, although aware that the return reflected an unpaid balance of more than $40,000, made no payment at any time before receiving the IRS's nonpayment notice.

[2387] No. CCB-21-1151, 2022 BL 28469 (D. Md. Jan. 27, 2022).

[2388] *See Bassett v. Commissioner*, 100 T.C. 650 (1993), aff'd, 67 F.3d 29 (2d Cir. 1995) (although §6651 imposes liability on taxpayer, its application is not limited to failure to file by taxpayer).

[2389] *See, e.g., Woodsum v. Commissioner*, 136 T.C. 585 (2011) (penalty imposed where advisor omitted $3,400,000 of income that was reported on one of more than 160 Form 1099s received by taxpayer, which represented approximately 10% of the taxpayer's AGI). *See also Magill v. Commissioner*, 70 T.C. 465 (1978), aff'd, 651 F.2d 1233 (6th Cir. 1981) (court distinguished *Thrane v. Commissioner*, T.C. Memo 2006-269, where erroneous income figure was set forth only on worksheet to schedule).

[2390] *Walton v. Commissioner*, T.C. Memo 2021-40 (taxpayer failed to provide preparer with all information returns, then did not identify any errors during post-filing return review despite 30% difference in income estimated by taxpayer and income listed on return; no reasonable cause).

[2391] *Jackson v. Commissioner*, 86 T.C. 492 (1986), aff'd, 864 F.2d 1521 (10th Cir. 1989); *Estate of Plotkin v. Commissioner*, T.C. Memo 1972-202.

[2392] 752 F.3d 311 (3d Cir. 2014).

[2393] 469 U.S. 241 (1985).

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administrative acts. According to the Third Circuit, the taxpayer's reliance on substantive advice from a tax attorney may be reasonable cause for failing to timely pay the taxes due if the taxpayer can also show either an inability to pay or undue hardship from paying at the deadline.[2394]

The IRS would limit penalty relief based on reliance on a tax advisor to technical and complicated issues. According to the IRS, the taxpayer's responsibility to file a tax return, pay a tax or make a deposit generally cannot be excused by reliance on the advice of a tax advisor.[2395]

The courts are split as to whether a taxpayer's reliance on erroneous legal advice with respect to the need for filing a tax return or its due date can constitute reasonable cause for failing to timely file the return. The Tax Court has consistently held that it can.[2396] Some other courts agree.[2397] These courts distinguish such affirmative advice from an impermissible delegation of a duty to file. Accordingly, the taxpayer should be able to reasonably rely on his tax advisor. Advice must take the form of a communication that sets forth the advisor's analysis or conclusion.[2398]

Other courts disagree.[2399] They hold that each taxpayer has a personal, nondelegable duty to timely file his tax returns. Reliance on the mistaken advice of counsel is not sufficient to constitute reasonable cause for failing to fulfill that duty. According to one court, the taxpayer's remedy for being misled is to recover from his tax advisor.[2400] The advisor should not be advantaged by affirmatively misleading the taxpayer, which would occur if a taxpayer who had been affirmatively misled could escape liability for a penalty, while a taxpayer who was passively negligent could not. The statute should not be enforced so as to encourage advisors who are merely negligent to compound their error by active deception of their clients so as to avoid liability.

Addressing the question when legal advice about the due date of a return constitutes reasonable cause, the Federal Circuit Court of Appeals applied a standard of objective reasonableness.[2401] Under this standard, both the advisor's qualifications and the substance of the advice are important. The court focused on whether the advice had a legally reasonable basis. It is unreasonable for a taxpayer to rely on advice that rested on an assumption that is not itself legally reasonable. The court analogized from Reg. §1.6664-4(c) (interpreting "reasonable cause" for purposes of the underpayment penalty) that, in order for a taxpayer's reliance on the advice of a tax professional to constitute reasonable cause for late filing, the advice must not be based on unreasonable factual or legal assumptions. Even if all factual assumptions are correct, a defense of reliance on professional advice will fail if the advice depends on legal assumptions that are unreasonable.

For a taxpayer to reasonably rely on advice, the advice must directly address the issue. Merely reporting a position on the tax return is not sufficient.[2402] The mere fact that an advisor has prepared a tax return does not mean that she has opined on any or all of the items reported on such return.[2403] A taxpayer cannot rely on informal advice,[2404] and cannot pick and choose from conflicting advice without good reason.[2405] Moreover, the advice must be obtained timely, generally before the return is filed, and cannot be relied on after the advice is withdrawn.[2406]

Without actual legal advice to rely on, it could be argued that the reasonable cause discussion is unnecessary. For example, in *West v. Koskinen*,[2407] the taxpayer asked the attorney "what legal follow-ups are needed in the short term," for settling an estate tax matter. The taxpayer claimed that the attorney's e-mail response that the estate tax process could take "as long as two years" constituted legal advice for the required estate tax deadlines. Thus, the taxpayer argued he could reasonably rely on it, and therefore established "reasonable cause" for the late return and taxes payment. The court held that the e-mail was not legal advice, based on the following facts: (1) the taxpayer failed to ask for a deadline date before the e-mail response; (2) the taxpayer told the attorney before his e-mail that an accountant would be handling the estate taxes; (3) the e-mail did not contain the typical language for deadline advice (e.g., "pay by," "due on," or "file within"); and (4) the referenced two-year period lacked a start date to calculate an exact deadline.

Given that no legal advice was provided, the court could have concluded its analysis at that point without a reasonable

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[2394] *Estate of Thouron v. United States*, 752 F.3d 311 (3d Cir. 2014).

[2395] IRM 20.1.1.3.3.4.3(3) (11-21-17).

[2396] *See, e.g.*, *Estate of La Meres v. Commissioner*, 98 T.C. 294 (1992); *Zabolotny v. Commissioner*, 97 T.C. 385 (1991), aff'd in part and rev'd in part, 7 F.3d 774 (8th Cir. 1993), nonacq., 1994-1 C.B. 1; *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986); *Aiken Indus., Inc. v. Commissioner*, 56 T.C. 925 (1971), acq., 1972-2 C.B. 1; *Estate of Buring v. Commissioner*, T.C. Memo 1985-610; *Estate of Bradley v. Commissioner*, T.C. Memo 1974-17, aff'd, 511 F.2d 527 (6th Cir. 1975); *Estate of Kwang Lee v. Commissioner*, T.C. Memo 2009-84.

[2397] *See, e.g.*, *Commissioner v. Am. Ass'n of Eng'rs Empl., Inc.*, 204 F.2d 19 (7th Cir. 1953); *Burton Swartz Land Corp. v. Commissioner*, 198 F.2d 558 (5th Cir. 1952); *Haywood Lumber & Mining Co. v. Commissioner*, 178 F.2d 769 (2d Cir. 1950); *Girard Inv. Co. v. Commissioner*, 122 F.2d 843 (3d Cir. 1941), cert. denied, 314 U.S. 699 (1942); *Estate of Hake v. United States*, 234 F. Supp. 3d 626 (M.D. Pa. 2017).

[2398] Reg. §1.6664-4(c)(2).

[2399] *See, e.g.*, *Boeving v. United States*, 650 F.2d 493 (8th Cir. 1981); *Estate of Lillehei v. Commissioner*, 638 F.2d 65 (8th Cir. 1981); *Estate of Kerber v. United States*, 717 F.2d 454 (8th Cir. 1983); *Smith v. United States*, 702 F.2d 741 (8th Cir. 1983) *Baer v. United States*, 150 Fed. Cl. 761, 2020 BL 429926 (Fed. Cl. 2020); *Sarto v. United States*, 563 F. Supp. 476 (N.D. Cal. 1983); *Quality Homes, Inc. v. United States*, 2002-1 USTC ¶50,301 (W.D. La. 2002).

[2400] *Sarto v. United States*, 563 F. Supp. 476 (N.D. Cal. 1983).

[2401] *Liftin v. United States*, 754 F.3d 975 (Fed. Cir. 2014).

[2402] *See, e.g.*, *Russian Recovery Fund Ltd. v. United States*, 122 Fed. Cl. 600 (2015), aff'd, 851 F.3d 1253 (Fed. Cir. 2017); *Richardson v. Commissioner*, 125 F.3d 551 (7th Cir. 1997); *Minchem Int'l, Inc. v. Commissioner*, T.C. Memo 2015-56, aff'd sub nom, *Sun v. Commissioner*, 880 F.3d 173 (5th Cir. 2018); *RB-1 Inv. Partners v. Commissioner*, T.C. Memo 2018-64.

[2403] *Neonatology Assocs., P.A. v. Commissioner*, 115 T.C. 43 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002).

[2404] *See, e.g.*, *Peak v. Commissioner*, T.C. Memo 2021-128 (holding that it is unfortunate that taxpayer may have received incorrect legal advice from IRS employee but that advice does not have force of law and cannot bind IRS or court); *Richmond v. Commissioner*, T.C. Memo. 2009-207 (same); *Dwinnell & Co. v. Commissioner*, 33 T.C. 827 (1960), *acq.*, 1960-2 C.B. 4; *Woodward v. Commissioner*, T.C. Summ. Op. 2009-150.

[2405] *Condor Int'l., Inc. v. Commissioner*, 78 F.3d 1355 (9th Cir. 1996).

[2406] *Stevens Bros. Found. Inc. v. Commissioner*, 39 T.C. 93 (1962), aff'd in part and rev'd in part, 324 F.2d 633 (8th Cir. 1963), cert. denied, 376 U.S. 969 (1964), acq., 1965-2 C.B. 6; *Estate of Curie v. Commissioner*, 4 T.C. 1175 (1945), nonacq., 1945 C.B. 8.

[2407] 141 F. Supp. 3d 498 (E.D. Va. 2015) ("reasonable cause" required taxpayer to show: (1) exercise of ordinary business care and prudence and, despite exercise of that care; (2) inability to file by deadline, inability to pay tax due by deadline, or undue hardship resulting from timely payment).

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cause discussion. However, it nevertheless applied the same facts to determine that the taxpayer failed to establish the first element of reasonable cause because no reasonable person exercising ordinary business care and prudence would rely on that e-mail as legal advice. Consequently, the *West* court held that the reasonable cause defense did not apply to the case.

c. Reasonable Reliance

(1) In General

To qualify for relief from a penalty based on the erroneous advice of a tax advisor, the taxpayer must show that each of the following requirements were met:[2408]

- The advisor was a competent tax professional who had sufficient expertise to justify reliance;
- The taxpayer accurately provided all the necessary information to the advisor;
- The taxpayer actually and reasonably relied in good faith on the advice received from the advisor;
- The advisor must be a person other than the taxpayer;[2409] and
- The advisor must actually render advice, i.e., the advisor must communicate his analysis or conclusion to the taxpayer.[2410]

The determination is made on a case-by-case basis, taking into account all pertinent facts and circumstances.[2411]

The tax advisor must be competent with respect to the specific tax matter.[2412] Generally, the advisor need not be a specialist in the particular area.[2413] However, more complicated issues may require more knowledgeable advisors.[2414] The taxpayer needs to know his advisor, as well as his qualifications.

The taxpayer must furnish the advisor with all necessary and relevant information to make a determination.[2415] The professional advice must be based on all pertinent facts and circumstances.[2416] Accordingly, a taxpayer may not rely on a generic opinion because it would not have been prepared for him and would not necessarily focus on facts peculiar to him.[2417] However, a taxpayer is not required to share details that a reasonably prudent taxpayer would not know, or that the taxpayer would neither know nor reasonably should know are relevant.[2418]

Whether a taxpayer reasonably relied on the advice in good faith is made on a case by case basis, taking into account all the facts and circumstances.[2419] Generally, the most impor-

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[2408] *Neonatalogy Assocs., P.A. v. Commissioner*, 115 T.C. 43 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002); *Higbee v. Commissioner*, 116 T.C. 438 (2001). *See also* Reg. §1.6664-4(c)(1); *McNeill v. United States*, No. 2:14-cv-00172, 2017 BL 67179 (D. Wyo. Feb. 24, 2017) (taxpayer relied in good faith on tax professionals in distressed asset debt (DAD) tax shelter transaction; despite taxpayer's high level of education, he was not knowledgeable or sophisticated in complex DAD transaction).

[2409] Reg. §1.6664-4(c)(2). Thus, for example, a corporation cannot avoid an accuracy-related penalty by relying on an in-house tax professional. *See Seven W. Enters., Inc. v. Commissioner*, 136 T.C. 539 (2011), vac'd on another issue rem'd, 723 F.3d 857 (7th Cir. 2013).

[2410] Reg. §1.6664-4(c)(2). *See Caylor Land & Dev., Inc. v. Commissioner*, T.C. Memo 2021-30 (no advice given where taxpayer and preparer never discussed tax treatment of consulting payments and preparer "simply copied information handed to him on a general ledger onto a tax return"). The advice does not need to be in any particular form. Reg. §1.6664-4(c)(2). Merely omitting an item from a tax return without any analysis does not constitute advice. *Woodsum v. Commissioner*, 136 T.C. 585 (2011).

[2411] Reg. §1.6664-4(b)(1). *See also Clary Hood, Inc. v. Commissioner*, 69 F.4th 168 (4th Cir. 2023) (vacating substantial understatement penalties on deduction of excessive bonus compensation as taxpayer reasonably relied on accountant and acted in good faith), *aff'g in part, vacating in part* T.C. Memo 2022-15.

[2412] *See, e.g.*, Reg. §1.6664-4(c)(1); *Freytag v. Commissioner*, 89 T.C. 849 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990), aff'd, 501 U.S. 868 (1991); *Mayflower Inv. Co. v. Commissioner*, 24 T.C. 729 (1955), aff'd, 239 F.2d 624 (5th Cir. 1956); *Hermax Co. v. Commissioner*, 11 T.C. 442 (1948), aff'd per curiam, 175 F.2d 776 (3d Cir. 1949); *Keenan v. Commissioner*, T.C. Memo 2018-60; Rev. Rul. 72-27.

[2413] *See, e.g., Grecian Magnesite Mining, Indus. & Shipping Co. v. Commissioner*, 149 T.C. 63 (2017) (licensed attorney and CPA who spent nearly 40 years preparing tax returns had sufficient expertise to justify reliance, even though he did not specialize in international tax law or have an LL.M.); *Miller v. Commissioner*, 237 F.2d 830 (5th Cir. 1956) (taxpayer has reasonable cause to act in accordance with the instructions of a certified public accountant, where he was not put on notice of any facts to cause him to doubt the accountant's skill); *Mayflower Inv. Co. v. Commissioner*, 239 F.2d 624 (5th Cir. 1956) (it is not a requirement that a lawyer or accountant must in fact be shown to be a "tax expert" before reliance on his advice is reasonable; however, the taxpayer did not show it relied on the advice).

[2414] *See, e.g., G. Kierstead Fam. Holdings Tr. v. Commissioner*, T.C. Memo 2007-158, aff'd, 330 Fed. App'x 126 (9th Cir. 2009) (taxpayer's CPA who was "comfortable" with area was not sufficient absent proof of his qualifications as tax expert); *Wright v. Commissioner*, T.C. Memo 2014-175 (one reason for denying reasonable cause was that the lawyer lacked the requisite expertise to justify the taxpayers reliance), *rev'd on another issue and rem'd*, 809 F.3d 877 (6th Cir. 2016); *Woodward v. Commissioner*, T.C. Summ. Op. 2009-150 (taxpayer cannot rely on information found on unspecified website written by unidentified individuals).

[2415] *Brinkley v. Commissioner*, 808 F.3d 657 (5th Cir. 2015) (taxpayer failed to provide pertinent facts to essential advisers, such as amount of stock owned, determined value of such stock, and executed consent and merger agreement, rendering reliance on advice unreasonable); *Given v. Commissioner*, 238 F.2d 579 (8th Cir. 1956); *Haywood Lumber & Mining Co. v. Commissioner*, 178 F.2d 769 (2d Cir. 1950); *Hatfried, Inc. v. Commissioner*, 162 F.2d 628 (3d Cir. 1947); *Yale Ave. Corp. v. Commissioner*, 58 T.C. 1062 (1972); *Stevens Bros. Found., Inc. v. Commissioner*, 39 T.C. 93 (1962), *acq.*, 1965-2 C.B. 6 *aff'd in part and rev'd in part*, 324 F.2d 633 (8th Cir. 1963); *Fourth & R.R. Realty Co. v. Commissioner*, 25 T.C. 458 (1955); *Walton v. Commissioner*, T.C. Memo 2021-40 (no reasonable cause where taxpayer failed to provide preparer with all information returns; taxpayer reviewed return after filing and did not identify any errors despite 30% difference in estimated income and income listed on return); *Walker v. Commissioner*, T.C. Memo. 2016-159; *Slavin v. Commissioner*, T.C. Summ. Op. 2016-28 (2016) (taxpayer claiming mortgage interest expense deduction did not furnish CPA tax return preparer with mortgage modification agreements or interest rate modification agreement when he prepared returns); *InterTan v. Commissioner*, T.C. Memo 2004-1; *Wright v. Commissioner*, T.C. Memo 2014-175 (accuracy-related penalty under §6662(a) upheld where taxpayer relied on opinion of tax advisor but did not provide advisor with signed investor representations, without which advisor stipulated that taxpayer could not rely on opinion); Rev. Rul. 72-27.

[2416] *See, e.g.*, Reg. §1.6664-4(c)(1)(i); *Alpha I, L.P. v. United States*, 93 Fed. Cl. 280 (2010).

[2417] *See, e.g., Palm Canyon X Invs., LLC v. Commissioner*, T.C. Memo 2009-288, aff'd per curiam, No. 16-1334, 2018 BL 54378 (D.C. Cir. Feb. 16, 2018).

[2418] *See CNT Invs., LLC v. Commissioner*, 144 T.C. 161 (2015).

[2419] *See* Reg. §1.6664-4(b)(1), §1.6664-4(c)(1); §6694(a). *See, e.g., Hussey v. Commissioner*, 156 T.C. 170 (2021) (given that taxpayer had no background in tax, he took extensive steps to ensure he was receiving adequate professional advice; taxpayer reasonably believed attorney could help him and thus he relied on attorney's advice in good faith); *Estate of Morgan v. Commissioner*, T.C. Memo 2021-104 (even though taxpayer was well-educated and sophisticated businessman, reliance on advice was deemed reasonable where advisor had prepared taxpayer's returns for over 10 years); *Babu v. Commissioner*, T.C. Memo 2020-121 (despite testimony that taxpayer received advice from tax professional that represented taxpayer in previous tax matters, such reliance is not

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tant factor is the taxpayer's efforts to comply with his tax obligations.[2420] Accordingly, the inquiry focuses on what the taxpayer knew or should have known at the time he obtained the advice.[2421]

The taxpayer's education, sophistication and business experience must be taken into account in determining his need for the advice, as well as whether the taxpayer disclosed all relevant facts and whether the taxpayer's reliance on the advice is reasonable.[2422] For example, in *West v. Koskinen*,[2423] because the attorney's statement that an estate tax process could take "as long as two years" was not considered legal advice for estate tax deadlines, the court held that the taxpayer's reliance on such was unreasonable. Furthermore, the court emphasized that a reasonable person would have sought clarification of the deadlines, which the taxpayer could have done at several instances but chose not to.

In *Whitsett v. Commissioner*,[2424] the preparer advised the improper year to report the taxpayer's stock sale proceeds. The court highlighted the following facts supporting that the taxpayer actually relied in good faith on the adviser's judgment. First, the taxpayer accepted advice that was contrary to her economic interest, which constituted proof positive that she relied in good faith. Second, the stock redemption documentation provided to the taxpayer listed several dates that would confuse any lay person in determining the correct year to report such gain. Third, the taxpayer had retained the preparer's services for many years and none of her prior returns had prompted a serious IRS challenge.

Comment: As a general principle, the taxpayer is not required to challenge an independent and competent advisor, confirm for himself that the advice is correct or seek a second opinion.[2425] Most taxpayers are not competent to do so. That was the reason for obtaining the advice in the first place.[2426]

The advice must be based on all relevant facts and circumstances, and apply the law to those facts and circumstances.[2427] The advice cannot be based on unreasonable factual or legal assumptions.[2428] Nor can a taxpayer rely on a return preparer where a review of the return would reveal errors.[2429]

Comment: A taxpayer should recognize if advice is based on an unreasonable factual assumption. But would the taxpayer know if it was based on an unreasonable legal assumption?

Where a tax benefit depends on nontax factors, the taxpayer also has a duty to investigate such underlying factors.[2430] The taxpayer cannot simply rely on statements by another person, such as a promoter. Moreover, if the tax advisor is not versed in these nontax factors, mere reliance on the tax advisor does not suffice.[2431]

Whether reliance is in good faith depends on the taxpayer's own information and knowledge.[2432] For example, a partnership's substantial authority defense was dismissed due to improper reliance on the tax advisor's opinion.[2433] The court found that the tax opinion was based on improper authorities as applied to transactions lacking economic substance; therefore, the partnership could not rely on the opinion. Additionally, where an estate filed its tax return four months after the IRS denied a second request for an extension of the time to file, the estate's initially reasonable reliance on its preparer's representation that he could obtain a second extension to file the return became unreasonable once the IRS denied the request.[2434] Moreover, the taxpayer cannot rely on advice that is obviously incorrect.[2435] On the other hand, the more complex the issue, the more likely such reliance will be accepted.[2436]

In addition, a taxpayer may be able to rely on a tax advisor where the taxpayer cannot comply with the requirements without the advisor's assistance and the advisor has reasonable cause for his failure. In *Brown v. United States*,[2437] the executor, because of his age, poor health and lack of experience, could not have filed the estate tax return without his attorney's assis-

reasonable where taxpayer is tax professional with years of experience in tax field).

[2420] *See, e.g.*, Reg. §1.6664-4(b)(1); *Prudhomme v. Commissioner*, 345 Fed. App'x 6 (5th Cir. 2009); *Stanford v. Commissioner*, 152 F.3d 450 (5th Cir. 1998); *Jelle v. Commissioner*, 116 T.C. 63 (2001).

[2421] *Am. Boat Co., LLC v. United States*, 583 F.3d 471 (7th Cir. 2009).

[2422] *See, e.g.*, Reg. §1.6664-4(c)(1); *Prudhomme v. Commissioner*, 345 Fed. App'x 6 (5th Cir. 2009); *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000); *Bachmann v. Commissioner*, T.C. Memo 2009-51.

[2423] 141 F. Supp. 3d 498 (E.D. Va. 2015).

[2424] T.C. Memo 2017-100.

[2425] *United States v. Boyle*, 469 U.S. 241, 251 (1985).

[2426] *United States v. Boyle*, 469 U.S. 241, 251 (1985).

[2427] *See, e.g.*, Reg. §1.6664-4(c)(1)(i).

[2428] *See, e.g.*, Reg. §1.6664-4(c)(1)(ii); *Stobie Creek Invs., LLC v. United States*, 82 Fed. Cl. 636 (2008), aff'd, 608 F.3d 1366 (Fed. Cir. 2010); *Long Term Cap. Holdings v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004), aff'd, 150 Fed. App'x 40 (2d Cir. 2005); *Santa Monica Pictures, LLC v. Commissioner*, T.C. Memo 2005-104; *Ocmulgee Fields, Inc. v. Commissioner*, 132 T.C. 105 (2009), aff'd, 613 F.3d 1360 (11th Cir. 2010); *Liftin v. United States*, 754 F.3d 975 (Fed. Cir. 2014).

[2429] *See, e.g.*, *Metra Chem. Corp. v. Commissioner*, 88 T.C. 654 (1987); *Yapp v. Commissioner*, T.C. Memo 2018-147.

[2430] *Novinger v. Commissioner*, T.C. Memo 1991-289; *Rogers v. Commissioner*, T.C. Memo 1990-619; *Everett v. Commissioner*, T.C. Memo 1990-65.

[2431] *See Conway v. United States*, 326 F.3d 1268 (Fed. Cir. 2003) (where taxpayer made plastics recycling investment following tip by attorney who was neither taxpayer's investment advisor nor expert in business, taxpayer could not avoid negligence penalty based on claimed reliance on attorney); *Addington v. Commissioner*, 205 F.3d 54 (2d Cir. 2000) (former §6653 negligence penalty upheld against taxpayer-attorneys who did not perform their own investigations and who unreasonably relied on attorney whose efforts to learn about partnerships were inadequate to compensate for his lack of experience); *Gilmore & Wilson Constr. Co. v. Commissioner*, 166 F.3d 1221 (10th Cir. 1999) (unpub. op.) (negligence penalty upheld where reliance by educated businessmen on advice of long-time CPA who had no expertise in plastics recycling and who failed to properly investigate investment was not reasonable and justifiable); *Wright v. Commissioner*, T.C. Memo 2014-175 (accuracy-related penalty under §6662(a) upheld where taxpayer relied on opinion of tax advisor that did not have expertise relating to taxation of foreign currency options), *rev'd on another issue and rem'd*, 809 F.3d 877 (6th Cir. 2016).

[2432] *Am. Boat Co., LLC v. United States*, 583 F.3d 471 (7th Cir. 2009).

[2433] *NPR Invs., LLC v. United States*, 740 F.3d 998 (5th Cir. 2014).

[2434] *Estate of Maltaman v. Commissioner*, T.C. Memo 1997-110. *See Roco v. Commissioner*, 121 T.C. 160 (2003) (asserted reliance by taxpayer, accountant who claimed that his qui tam payment was not taxable, on advice of spouse, also accountant, was undermined by spouse's filing separately for year in issue, unlike prior joint filings).

[2435] *United States v. Archer*, 174 F.2d 353 (1st Cir. 1949); *LaVerne v. Commissioner*, 94 T.C. 637 (1990), aff'd without op., 956 F.2d 274 (9th Cir. 1992); *Horn v. Commissioner*, 90 T.C. 908 (1988); *Paula Constr. Co. v. Commissioner*, 58 T.C. 1055 (1972), aff'd by unpub. op., 474 F.2d 1345 (5th Cir. 1973); *Rogers v. Commissioner*, T.C. Memo 1990-619; *Chupack v. Commissioner*, T.C. Memo 1989-548.

[2436] *See, e.g.*, *Haywood Lumber & Mining Co. v. Commissioner*, 178 F.2d 769 (2d Cir. 1950); *Gross v. Commissioner*, 7 T.C. 837 (1946), acq., 1946-2 C.B. 2.

[2437] 630 F. Supp. 57 (M.D. Tenn. 1985). This case was decided after *Boyle*.

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tance. The attorney was unable to file the return on time because of an unexpected illness. As a result, the court found reasonable cause existed for the late filing of the return and late payment of the tax.

(2) Conflict of Interest

A taxpayer generally may not rely on the advice of a tax advisor who has an inherent conflict of interest which the taxpayer knows or should have known about.[2438] For example, it is unreasonable to rely on the advice of a founder or "promoter" of a tax shelter, or their offering materials.[2439] The advisor's significant financial interest in the transaction proceeding taints his objectivity, making it improper for the taxpayer to rely on any advice the advisor may provide.

The definition of a promoter is not entirely clear. For example, The Tax Court has stated that a promoter is someone who participated in the structuring of a tax shelter transaction that is offered to numerous clients or otherwise has a financial interest in or profits from the transaction.[2440] Such a prohibited financial interest may include a fee based on the tax saving from the transaction,[2441] or an exorbitant fixed fee.[2442] However, the court recognized that an advisor is not a promoter if he:[2443]

- Has a continual long-term relationship with the client;
- Does not render unsolicited advice with respect to a tax shelter;
- Advises the client only within his field of expertise (and not because of his involvement in the tax shelter); and
- Has no stake in the transaction beyond his hourly rate.

There is no bright line test for promoter status. In determining whether the advisor is a promoter, the court must also consider that the taxpayer has the right to structure his affairs in a way that minimizes his tax, and may seek tax advice to accomplish that.[2444] As a result, the taxpayer had reasonable cause in relying on his long-time accountant, who customized a transaction to fit the taxpayer's need, repeated assuring the taxpayer after the taxpayer told the accountant that he did not want to engage in any type of transaction that would subject him to IRS scrutiny, and the taxpayer believed that the accountant would protect his interest.[2445] In addition, a taxpayer may rely on the advice of a promoter if he does not know (and has no reason to know) of the relationship.[2446]

The IRS tried to argue that, as a matter of law, a taxpayer could not rely on his own counsel's opinion with respect to a transaction because the taxpayer paid a significant fee to the law firm to structure the transaction. The court correctly declined to adopt a strict per se rule, and based on the facts, rejected the argument.[2447] As the court noted: "To accept the government's argument would mean that a taxpayer may *never* rely upon the legal advice of the same advisor who counsels the individual on restructuring."[2448]

(3) Too Good to be True

A reasonably prudent taxpayer is also put on notice that something may be awry where the proposed tax benefits are "too good to be true."[2449] Generally, in determining whether a taxpayer acted reasonably and in good faith, the most important factor is the extent of the taxpayer's efforts to determine its correct tax liability.[2450] Negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion which would seem to a reasonable and prudent person to be "too good to be true" under the circumstances.[2451] Where the tax benefits far exceed the cost, the taxpayer must ask additional questions.[2452] For example, in *Candyce Martin 1999 Irrevocable Trust*,[2453] the court

[2438] *Am. Boat Co., LLC v. United States*, 583 F.3d 471 (7th Cir. 2009); *106 Ltd. v. Commissioner*, 136 T.C. 67 (2011), aff'd, 684 F.3d 84 (D.C. Cir. 2012); *RB-1 Inv. Partners v. Commissioner*, T.C. Memo 2018-64.

[2439] *See, e.g., Cowles v. Commissioner*, 949 F.2d 401 (10th Cir. 1991); *Goldman v. Commissioner*, 39 F.3d 402 (2d Cir. 1994); *Pasternak v. Commissioner*, 990 F.2d 893 (6th Cir. 1993); *LaVerne v. Commissioner*, 94 T.C. 637 (1990), aff'd without op., 956 F.2d 274 (9th Cir. 1992); *Chamberlain v. Commissioner*, 66 F.3d 729 (5th Cir. 1995); *Neonatology Assocs., P.A. v. Commissioner*, 115 T.C. 43 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002); *Zenkel v. Commissioner*, T.C. Memo 1996-398; *Stobie Creek Invs., LLC v. United States*, 82 Fed. Cl. 636 (2008), aff'd, 608 F.3d 1366 (Fed. Cir. 2010); *Paschall v. Commissioner*, 137 T.C. 8 (2011); *Blum v. Commissioner*, 737 F.3d 1303 (10th Cir. 2013); *Curtis Inv. Co. v. Commissioner*, T.C. Memo 2017-150, aff'd, 909 F.3d 1339 (11th Cir. 2018), aff'd sub nom, 910 F.3d 150 (4th Cir. 2018).

[2440] *106 Ltd. v. Commissioner*, 136 T.C. 67 (2001), aff'd, 684 F.3d 84 (D.C. Cir. 2012); *Tigers Eye Trading, LLC v. Commissioner*, T.C. Memo 2009-121 aff'd in part, rev'd in part and rem'd, 616 Fed. App'x 426 (D.C. Cir. 2015); *SAS Inv. Partners v. Commissioner*, T.C. Memo 2012-159.

[2441] *See, e.g., Stobie Creek Invs., LLC v. United States*, 82 Fed. Cl. 636 (2008) aff'd, 608 F.3d 1366 (Fed. Cir. 2010).

[2442] *Canal Corp. & Subsidiaries v. Commissioner*, 135 T.C. 199 (2010).

[2443] *106 Ltd. v. Commissioner*, 136 T.C. 67 (2001) (citing *Countryside Ltd. P'ship v. Commissioner*, 132 T.C. 347 (2009)), *aff'd*, 684 F.3d 84 (D.C. Cir. 2012); *Rawls Trading, L.P. v. Commissioner*, T.C. Memo 2012-340 (citing *Countryside*); *Am. Boat Co., LLC v. United States*, 583 F.3d 471 (7th Cir. 2009).

[2444] *Tucker v. Commissioner*, T.C. Memo 2017-183 (citing *Gregory v. Helvering*, 293 U.S. 465 (1935)); *Neonatology Assoc., P.A. v. Commissioner*, 299 F.3d 221 (3d Cir. 2002) (citing *Gregory*).

[2445] *See, e.g., Tucker v. Commissioner*, T.C. Memo 2017-183; *McNeill v. United States*, 237 F. Supp. 3d 1171 (D. Wyo. 2017).

[2446] *Ervin v. United States*, 276 F. Supp. 3d 727 (W.D. Ky. 2017).

[2447] *Am. Boat Co., LLC v. United States*, 583 F.3d 471 (7th Cir. 2009). There, the taxpayer paid his counsel a flat fee for his services, which included significant restructuring work as well as in connection with a Son of BOSS tax shelter. The compensation was not based on a percentage of the tax benefits from the transaction. The client did not approach his counsel seeking a tax shelter.

[2448] *Am. Boat Co., LLC v. United States*, 583 F.3d 471, 483 (7th Cir. 2009) (emphasis in original).

[2449] *See, e.g., Stobie Creek Invs., LLC v. United States*, 82 Fed. Cl. 636 (2008), aff'd, 608 F.3d 1366 (Fed. Cir. 2010); *Jade Trading, LLC v. United States*, 80 Fed. Cl. 11 (2007), aff'd in part, vac'd in part, and rev'd in part on other grounds, 598 F.3d 1372 (Fed. Cir. 2010); *Peete v. Commissioner*, T.C. Memo 2004-31; *Santa Monica Pictures, LLC. v. Commissioner*, T.C. Memo 2005-104; *Smith v. Commissioner*, T.C. Memo 1997-503, aff'd, 182 F.3d 927; (9th Cir. 1999); *Provizer v. Commissioner*, T.C. Memo 1992-177, aff'd without op., 996 F.2d 1216 (6th Cir. 1993); *Kerman v. Commissioner*, T.C. Memo 2011-54, aff'd, 713 F.3d 849 (6th Cir. 2013), cert. denied, 571 U.S. 1126 (2014); *Salem Fin. Inc. v. United States*, 112 Fed. Cl. 543 (2013), aff'd in part and rev'd in part, 786 F.3d 932 (Fed. Cir. 2015), cert. denied, 136 S. Ct. 1366 (2016); *Hristov v. Commissioner*, T.C. Memo 2012-147. See discussion at IV.H.1., above.

[2450] Reg. §1.6664-4(b)(1).

[2451] Reg. §1.6662-3(b)(1)(ii).

[2452] *Stevens Bros. Found., Inc. v. Commissioner*, 39 T.C. 93 (1962), *acq.*, 1965-2 C.B. 6, *aff'd in part and rev'd in part*, 324 F.2d 633 (8th Cir. 1963); *Estate of Curie v. Commissioner*, 4 T.C. 1175 (1945), *nonacq.*, 1945 C.B. 8. See discussion at IV.H.1., above.

[2453] *Candyce Martin 1999 Irrevocable Tr. v. United States*, 822 F. Supp. 2d 968 (N.D. Cal. 2011), aff'd in part and rev'd in part, 739 F.3d 1204 (9th Cir. 2014).

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allowed the taxpayer to rely his tax lawyer in connection with having a business purpose with respect to a complicated transaction. However, the court found that such reliance was not in good faith. Even if the business purpose was too complicated for the taxpayer to assess or comprehend, the taxpayer should have known that the transaction which generated $315,700,000 of tax basis for $900,000 of offsetting option cost was "too good to be true."

On the other hand, sizable tax savings do not automatically create a "too good to be true" situation.[2454] A taxpayer should recognize if advice is based on an unreasonable factual assumption. Taxpayers lawfully may arrange their affairs to keep their taxes as low as possible.[2455] Moreover, taxpayers may reasonable rely on their advisor's in good faith, even if such advice is ultimately incorrect.

Comment: Good faith reliance on a competent tax advisor after disclosing all relevant information should trump the "too good to be true" argument, especially in complex transactions. Many transactions that seemed too good to be true have been upheld by the courts. For example, in *Cottage Savings*,[2456] the U.S. Supreme Court allowed the taxpayer to recognize a loss on a swap of virtually identical mortgage pools. In *Gitlitz v. Commissioner*,[2457] the Supreme Court gave an S corporation shareholder a step-up in basis for tax-exempt cancellation of indebtedness income. In *Woods Inv. Co.*,[2458] the Tax Court allowed the taxpayer to deduct the same loss twice based on a literal reading of the regulations. The potential tax benefit in these transactions far exceed the cost. Each of these situations required an amendment to the Code to correct what might otherwise have been described as "too go to be true." In other cases, different transactions with the same economic outcome may be taxed differently.[2459] Even sophisticated businessmen are generally not sufficiently adept in the tax law to know what is and is not possible. Of course, if the taxpayer wins on the merits, there is no penalty, even though the benefits may have seeded too good to be true. The same should be true where the taxpayer relies on advice from a competent tax expert who has all of the relevant fact and does not have a conflict of interest. The tax law has become so complicated, an expert is generally required. In such cases, the taxpayer should be able to rely on the affirmative advice of that expert.

d. Tax Preparation Software

Use of tax preparation software generally does not constitute reasonable cause to avoid penalty.[2460] Tax preparation software is only as good as the information the taxpayer inputs into it. Moreover, the taxpayer cannot shift his responsibility to file an accurate return to the preparer.[2461]

2. Death, Serious Illness, or Unavoidable Absence

The death, serious illness, or unavoidable absence of the taxpayer or the death or serious illness of a member of the taxpayer's family may constitute reasonable cause for late filing, payment, or deposit.[2462] Relevant factors include:[2463]

- The relationship of the incapacitated person to the taxpayer;
- The date and duration of the incapacity;
- How the incapacity prevented compliance;
- Whether other business obligations were impaired; and
- Whether the taxpayer's tax duties were attended to promptly after the incapacity passed or within a reasonable

[2454] *McNeill v. United States*, 237 F. Supp. 3d 1171 (D. Wyo. 2017) (court rejected the government's "too good to be true argument" and found that the taxpayer reasonably relied on an opinion from his advisors with respect to a distressed asset/debt ("DAD") transaction designed to generate $20,000,000 of loss from an $300,000 investment, where professional fees were based on a percentage of the anticipated loss, and where the opinion relied on the taxpayer's representations that he had a substantial business purpose for the transaction, that he had an opportunity to make a return on his investment without regard to tax benefits and that his decision to do the DAD transaction was made solely on the economics of the DAD transaction; the court acknowledged that the representations were not true, but found that, although it was a close call, the taxpayer could rely on his advisors who told him the transaction was legal and failed to disclose any concern about the transaction, since they had a fiduciary duty to do so); *CNT Investors, LLC v. Commissioner*, 144 T.C. 161 (2015) (court rejected government's arguments that the transaction was "too good to be true" and that the taxpayer was aware of the government's position based on Notices since the taxpayer reasonably relied on an opinion of counsel that reached a contrary conclusion); *Am. Boat Co., LLC v. United States*, 583.F.3d 471 (7th Cir. 2009) (taxpayer did not know the transaction held no profit potential); *Rawls Trading, L.P. v. Commissioner*, T.C. Memo 2012-340 (reasonable to rely on accountant). *See* Richard M. Lipton, *The New Penalty Standard: Too Good to Be True (Unless You Win on the Merits)*, 116 J. Tax'n 151 (Mar. 2012), criticizing the imposition of a penalty in *Candyce Martin 1999 Irrevocable Tr. v. United States*).

[2455] *Gregory v. Helvering*, 293 U.S. 465 (1935).

[2456] *Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554 (1991).

[2457] 531 U.S. 206 (2001).

[2458] *Woods Inv. Co. v. Commissioner*, 85 T.C. 274 (1985), *acq.*, 1986-2 C.B. 1.

[2459] *See, e.g.*, §368(a) (different types of reorganizations may have different requirements to be tax free, even though the final ownership is identical); *Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1988), aff'd without op., 886 F.2d 1318 (7th Cir. 1989) (as long as there are no extra steps, the order of the steps used by the taxpayer is respected).

[2460] *See, e.g.*, *Bunney v. Commissioner*, 114 T.C. 259 (2000); *Au v. Commissioner*, T.C. Memo 2010-247, aff'd, 482 Fed. App'x 289 (9th Cir. 2012); *Lam v. Commissioner*, T.C. Memo 2010-82; *Haynes v. United States*, 2017 BL 237583 (W.D. Tex. June 15, 2017); *Bulakites v. Commissioner*, T.C. Memo 2017-79. *But see Thompson v. Commissioner*, T.C. Memo 2007-174 (where, on entire record, court found that taxpayer behaved reasonably in obtaining software to aid in preparation of his return); *Olsen v. Commissioner*, T.C. Summ. Op. 2011-131 (taxpayer made isolated error in transcribing information from wife's Schedule K-1 while using tax prep software; mistake was isolated as taxpayer correctly reported source of income and did not repeat any similar error in preparing his return).

[2461] *United States v. Boyle*, 469 U.S. 241 (1985). See discussion at XI.D.1.b., above.

[2462] IRM 20.1.1.3.2.2.1 (11-25-11). *But see Lindsay v. United States*, No. 20-50994, 2021 BL 259051 (5th Cir. July 7, 2021) (delegation to third party through power of attorney due to incarceration not reasonable cause to avoid late filing penalties where attorney in fact failed to file; incarceration is not considered unavoidable absence sufficient for reasonable cause where taxpayer hired CPA to conduct other business affairs); *Carlson v. United States*, 126 F.3d 915 (7th Cir. 1997) (son's mental illness not reasonable cause due to substantial income after medical expenses and second home); *Thrower v. Commissioner*, T.C. Memo 2003-139 (mere fact that petitioner was incarcerated when his return was due is not reasonable cause for his failure to timely file); *George v. Commissioner*, 821 Fed. App'x. 76, 2020 BL 355484 (3d Cir. 2020) (same); *Stine v. United States*, 106 Fed. Cl. 586 (2012) ("selective incapacity" when conducting other complex transactions, financial arrangements and contracts but failing to timely file gift tax return); *Gonzales v. United States*, 115 Fed. Cl. 779 (2014) (taxpayer filing income tax return during same period diminishes claim of incapacity for excise return due in same filing period absent proof of debilitation).

[2463] IRM 20.1.1.3.2.2.1(3) (11-21-17).

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period after a death or absence. In the case of an entity, the incapacity must relate to the individual having the sole authority to take the required action or to a member of his family.[2464]

In making the determination as to whether a taxpayer's illness constitutes reasonable cause, the courts focus on the severity and duration of the illness. The incapacity must be so severe that the taxpayer cannot function during the period, and so sudden that he could not reasonably have planned for it.[2465] Accordingly, a court has waived the failure to file penalty imposed against a taxpayer whose sudden and continuing paralysis confined him to bed and required multiple blood transfusions.[2466] Similarly, a taxpayer who was rendered a quadriplegic as a result of a 1984 diving accident was found to have reasonable cause for his failure to file returns from 1986 through 1989 because his disability necessitated his reliance on a preparer to perform the physical act of preparing and filing the returns, and despite his best efforts, the preparer failed to act.[2467] On the other hand, where the taxpayer continues to work or take care of other normal business matters during his incapacity, reasonable cause generally does not exist.[2468]

Incarceration, however, does not constitute reasonable cause for failing to timely file a return.[2469]

Since a joint return involves two taxpayers, courts apply the test separately to each.[2470] Of course, the effect of one taxpayer's illness on his spouse, as well as the spouse's knowledge and experience, can be taken into account in making this determination.[2471]

3. Records Unavailable

The unavailability of records is generally not considered reasonable cause for a taxpayer's failure to file a return.[2472] Rather, the taxpayer must estimate his tax liability based on the best information available and, where necessary, obtain an extension of time to file.[2473]

The inability to obtain records may constitute reasonable cause in some circumstances. Reasonable cause may be established if the taxpayer exercised ordinary business care and prudence, but due to circumstances beyond the taxpayer's control, the taxpayer was unable to comply.[2474] The IRS will consider the following:[2475]

- Why the records were needed to comply;
- Why the records were unavailable and what steps were taken to secure the records;
- When and how the taxpayer became aware that he did not have the necessary records;
- Whether other means were explored to secure needed information;
- Why the taxpayer did not estimate the information;

[2464] IRM 20.1.1.3.2.2.1(3) (11-21-17). *See All Stacked Up Masonry, Inc. v. United States*, 150 Fed. Cl. 540, 2020 BL 409025 (Fed. Cl. 2020) (injury of corporation's owner insufficient to establish corporation's disability where tax filings indicated business's continuing viability following its owner's injury).

[2465] *See In re Sykes & Sons, Inc.*, 188 B.R. 507 (Bankr. E.D. Pa. 1995) (family-owned corporation failed to exercise ordinary business care in allowing its terminally ill principal to continue at helm, ignoring corporation's duty to file, pay, and deposit employment taxes); *Torres v. Commissioner*, T.C. Memo 2021-66 (taxpayer credibly testified that he was not capable of handling his business because of his illness, not being able to read, and relying on others; his illness affected his ability to file a timely tax return; but once he became aware of his problems, he hired new tax preparer, thus, showing reasonable cause and was not liable for addition to tax under §6651(a)(1)); *Poppe v. Commissioner*, T.C. Memo 2015-205 (taxpayer's autistic spectrum disorder previously known as Asperger's Syndrome was not found to constitute reasonable cause for late filing of a return and late payment of tax).

[2466] *United States v. Isaac*, 91-2 USTC ¶50,314 (E.D. Ky. 1991), aff'd by unpub. op., No. 91-5830 (6th Cir. July 10, 1992).

[2467] *See Erickson v. Commissioner*, 172 B.R. 900 (Bankr. D. Minn. 1994). *See also Meyer v. Commissioner*, T.C. Memo 2003-12 (penalty not imposed on petitioner whose severe health problems and mental condition incapacitated him during years in issue).

[2468] *Hoefle v. Commissioner*, 114 F.2d 713 (6th Cir. 1940); *Stephen J. Sebesta & Assocs. v. United States*, No. 1:98 CV 1580 (N.D. Ohio Jan. 26, 2000); *BoStar Foods, Inc. v. United States*, 97-1 USTC ¶50,285 (W.D. Ky. 1997); *Estate of Stuller v. United States*, 55 F. Supp. 3d 1091 (C.D. Ill. 2014), aff'd, 811 F.3d 890 (7th Cir. 2016); *Ward v. United States*, 58-2 USTC ¶9922 (E.D. Tenn. 1958); *Hernandez v. Commissioner*, 72 T.C. 1234 (1979); *Williams v. Commissioner*, 16 T.C. 893 (1951), acq., 1951-2 C.B. 4; *Fambrough v. Commissioner*, T.C. Memo 1990-104; *Dickerson v. Commissioner*, T.C. Memo 1990-577; *Estate of Plotkin v. Commissioner*, T.C. Memo 1972-202; *Hardin v. Commissioner*, T.C. Memo 2012-162.

[2469] *See, e.g., Llorente v. Commissioner*, 74 T.C. 260 (1980), aff'd in part and rev'd in part on other grounds and rem'd, 649 F.2d 152 (2d Cir. 1981), acq., 1981-2 C.B. 1; *Mendes v. Commissioner*, 121 T.C. 308 (2003); *George v. Commissioner*, T.C. Memo 2019-128 (court suggested that since incarcerated taxpayer had family, family members could have assisted taxpayer in assembling documents necessary to file), *aff'd*, 821 Fed. App'x. 76, 2020 BL 355484 (3d Cir. 2020).

[2470] *Sanders v. Commissioner*, 21 T.C. 1012 (1954), aff'd, 225 F.2d 629 (10th Cir. 1955), cert. denied, 350 U.S. 967 (1956); *Williams v. Commissioner*, 16 T.C. 893 (1951), *acq.*, 1951-2 C.B. 4; *Labato v. Commissioner*, T.C. Memo 2001-243.

[2471] *See Ruckman v. Commissioner*, T.C. Memo 1998-83 (reasonable cause defense to negligence penalty imposed for not reporting self-employment income was allowed where husband understood little of finances and wife who handled family's finances underwent surgery and cancer treatments); *Wesley v. United States*, 369 F. Supp. 2d 1328 (N.D. Fla. 2005) (normally, incapacity of one party to joint return does not excuse failure to file return if incapacity does not affect other party; court finds in present case, however, that husband's health problems were severe enough to require wife to largely abandon her other work-related responsibilities, which, if true, indicated that responding to husband's illness may have impaired her ability to exercise ordinary business care and prudence).

[2472] *Crocker v. Commissioner*, 92 T.C. 899 (1989); *Elec. & Neon, Inc. v. Commissioner*, 56 T.C. 1324 (1971), acq., 1973-2 C.B. 1, aff'd by unpub. op., 496 F.2d 876 (5th Cir. 1974); *Llorente v. Commissioner*, 74 T.C. 260 (1980), aff'd in part and rev'd in part on other grounds, 649 F.2d 152 (2d Cir. 1981), acq., 1981-2 C.B. 1; *Estate of Vriniotis v. Commissioner*, 79 T.C. 298 (1982); *Fluet v. Commissioner*, T.C. Memo 1986-555; *Hackett v. Commissioner*, T.C. Memo 1970-17; *Kalinoski v. Commissioner*, T.C. Summ. Op. 2010-30.

[2473] *George v. Commissioner*, T.C. Memo 2019-128 (incarcerated taxpayer's failure to have family members assist in assembling documents necessary to file, to file for extension, or to estimate deductions in order to itemize shows lack of ordinary business care and prudence), *aff'd*, 821 Fed. App'x. 76, 2020 BL 355484 (3d Cir. 2020).

[2474] IRM 20.1.1.3.2.2.3(3) (12-11-09). *See also In re Refco Public Commodity Pool, L.P.*, 554 B.R. 736 (Bankr. D. Del. 2016) (reasonable cause and absence of willful neglect found where fund in which taxpayer invested did not provide taxpayer essential information via Schedules K-1 for several years; court found that taxpayer acted responsibly before and after failure to file occurred, noting risk of accuracy-related penalties taxpayer if taxpayer knowingly filed inaccurate returns, and court found significant mitigating factors in taxpayer's established filing history and absence of prior penalties).

[2475] IRM 20.1.1.3.2.2.3(4) (12-11-09). *See Gilbert v. Commissioner*, T.C. Summ. Op. 2016-17 (nonreceipt of Form W-2 and reliance on H&R Block return preparer did not constitute reasonable cause); *See also*, *LFAM Corp. v. United States*, 42 Fed. Cl. 698 (1999) (reasonable cause for late filing not shown, because partner who passively awaited K-1, which arrived after filing due date, did not exercise ordinary business care and prudence); *Connor v. Commissioner*, T.C. Memo 1982-302.

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• Whether the taxpayer contacted the IRS for guidance; and

• Whether the taxpayer promptly complied once the missing information was received.

The taxpayer may be unable to access his records because he has suffered from a fire, casualty, natural disaster or other disturbance. In the case of a disaster affecting numerous taxpayers or a significant fire, the IRS generally provides special guidance for penalty relief.[2476]

In a community property state, where a spouse is taxed on half the income earned by the other spouse, the inability to obtain information from the other spouse — despite reasonable efforts — constitutes reasonable cause.[2477] The inability to obtain information from a spouse, however, is not reasonable cause for failing to file a joint return.[2478] In the case of a joint return, both parties are responsible for filing the return. Moreover, the couple has the option of filing separately based solely on their own information.

4. Inability to Pay

a. In General

The mere inability of the taxpayer to pay the tax does not ordinarily provide a basis for granting penalty relief.[2479] Ordinary business care and prudence requires a taxpayer to provide for his tax obligations. In determining whether the taxpayer was unable to pay the tax, in spite of the exercise of ordinary business care and prudence, consideration will be given to all the facts and circumstances of the taxpayer's financial situation. This includes the amount and nature of the taxpayer's expenditures in light of the income or other amounts he could, at the time of those expenditures, reasonably expect to receive before the tax payment deadline.[2480] Accordingly, a taxpayer who incurs lavish or extravagant living expenses in an amount such that the remainder of his 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.[2481] Similarly, a taxpayer who invests in speculative or illiquid assets has not exercised ordinary business care and prudence in providing for the payment of his tax, unless at the time of the investment, the taxpayer has (or reasonably expects to have) sufficient liquid assets to pay his tax.[2482] On the other hand, the taxpayer is 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.[2483] An undue hardship may provide a basis for granting an extension of time for paying a tax or deficiency.[2484] The taxpayer must demonstrate, however, that he would sustain a substantial financial loss if he were forced to pay a tax or deficiency on the due date.[2485] For this purpose, having to sell property at its current market price does not ordinarily constitute undue hardship.[2486]

b. Employment Tax Withholding

Where the failure to pay or make a deposit penalty relates to taxes required to be withheld from an employee, there is a split among the circuits regarding the effect of the taxpayer's inability to pay. In the Sixth Circuit, financial difficulty is never reasonable cause for such failure.[2487] The Second, Third, Seventh and Ninth Circuits, however, reject the bright line approach in favor of a facts and circumstances test based on Reg. §301.6651-1 and §1.6161-1(b).[2488] Such courts generally look to see whether the taxpayer favored other creditors over the government, and the taxpayer's efforts to decrease its expenses so it would be able to pay the tax.[2489]

[2476] §7508A, amended by the Filing Relief for Natural Disasters Act, Pub. L. No. 119-29, §2, effective for disasters declared after July 24, 2025. IRM 20.1.1.3.3.6. *See* discussion at XI.D.12., below.

[2477] *Fleming v. Commissioner*, T.C. Memo 1984-130; *Connor v. Commissioner*, T.C. Memo 1982-302.

[2478] *Belk v. Commissioner*, 93 T.C. 434 (1989).

[2479] Reg. §301.6651-1(c). *See Jones v. Commissioner*, 25 T.C. 1100 (1956), rev'd in part on other grounds, 259 F.2d 300 (5th Cir. 1958), *acq.*, 1958-2 C.B. 6; *Sanders v. Commissioner*, 21 T.C. 1012 (1954), aff'd, 225 F.2d 629 (10th Cir. 1955), cert. denied, 350 U.S. 967 (1956); *Langston v. Commissioner*, T.C. Memo 1977-421; *Fitch v. Commissioner*, T.C. Memo 1975-36; IRM 20.1.1.3.3.3(3) (08-05-14). *See also Downing v. Commissioner*, 118 T.C. 22 (2002) (in §6330(d) review of IRS's determination to proceed with collection of §6651(a)(2) addition to tax, reasonable cause for failing to pay income tax not established by taxpayer's belief that offer in compromise that did not meet minimum requirements was fair or by delayed attempt to get second trust on home to pay taxes). See discussion at III.D.5., above.

[2480] Reg. §301.6651-1(c)(1). *See, e.g.*, *West v. Koskinen*, 141 F. Supp. 3d 498 (E.D. Va. 2015) (facts foreclosed any "inability to pay" argument: (1) over $5 million total estate value, of which over $4 million was from stocks and money market account, assets presumably easily liquidated; (2) total estate asset value more than sufficient to pay assessed tax and penalties; and (3) payments readily made, which unsurprising given estate's relative liquidity).

[2481] *In re Cent. La. Home Healthcare, LLC*, 617 B.R. 263, 2020 BL 123392 (Bankr. W.D. La. 2020) (reasonable cause for failure to deposit payroll taxes does not exist where taxpayer corporation continued to pay owner high salary, made charitable donations, expanded operations by creating a new affiliate and reopened a previously closed office).

[2482] Reg. §301.6651-1(c)(1).

[2483] Reg. §301.6651-1(c)(1). *See In re Cent. La. Home Healthcare, LLC*, 617 B.R. 263, 2020 BL 123392 (Bankr. W.D. La. 2020) (although vendors withheld taxpayer corporation's expected revenue, reasonable cause for failure to deposit payroll taxes does not exist where taxpayer corporation continued to pay owner high salary, made charitable donations, expanded operations by creating a new affiliate and reopened a previously closed office).

[2484] Reg. §1.6161-1(b). An extension of time to pay does not provide the taxpayer with an extension of time to file. IRM 20.1.1.3.3.3 (08-05-14). Also, if the extension pertains to one installment payment of tax, it does not apply to subsequent installments. Reg. §1.6161-1(d). *See Fran Corp. v. United States*, 164 F.3d 814 (2d Cir. 1999).

[2485] *See In re Hillard Dev. Corp.*, 2007 BL 264880 (Bankr. S.D. Fla. Apr. 19, 2007) (taxpayer's late payments were due to reasonable cause and financial hardship caused by "malicious" actions of outside party in withholding funding, without which taxpayer was unable to pay both taxes and necessary food and other expenses of its nursing home residents).

[2486] Reg. §1.6161-1(b).

[2487] *Brewery, Inc. v. United States*, 33 F.3d 589 (6th Cir. 1994). The court also applied the same rule to the employer portion of the employment taxes.

[2488] *Fran Corp. v. United States*, 164 F.3d 814 (2d Cir. 1999), aff'g 998 F. Supp. 296 (S.D.N.Y. 1998); *E. Wind Indus., Inc. v. United States*, 196 F.3d 499 (3d Cir. 1999), rev'g 33 F. Supp. 2d 339 (D.N.J. 1999); *Diamond Plating Co. v. United States*, 390 F.3d 1035 (7th Cir. 2004); *Van Camp & Bennion v. United States*, 251 F.3d 862 (9th Cir. 2001). The Tax Court in a case appealable to another circuit, and the Court of Federal Claims, followed these cases. *Custom Stairs & Trim, Ltd. v. Commissioner*, T.C. Memo 2011-155; *Q.E.D., Inc. v. United States*, 55 Fed. Cl. 140 (2003).

[2489] *See, e.g., Staff IT, Inc. v. United States*, 482 F.3d 792 (5th Cir. 2007) (no reasonable cause under either the bright line test or the multi-factor test), *cert. denied*, 552 U.S. 892 (2007); *Valteau v. Commissioner*, T.C. Memo 2014-144.

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5. Ignorance of the Law

Ignorance of the law, in and of itself, does not constitute reasonable cause.[2490] This includes, for example, a taxpayer's erroneous belief (not based on advice of counsel) that no return is required to be filed; a lack of knowledge as to the correct due date; and an erroneous belief that the proceeds were not taxable. Ordinary business care and prudence requires taxpayers to make reasonable efforts to determine their tax obligations.[2491]

On the other hand, the taxpayer may have reasonable cause for noncompliance if the taxpayer was unaware of a requirement and could not reasonably be expected to know of it.[2492] Accordingly, ignorance of the law in conjunction with other facts and circumstances, such as:

- The taxpayer's education;
- If the taxpayer was not previously subject to the tax or penalized;
- If there was a recent change in the tax law or forms which the taxpayer could not reasonably be expected to know; or
- The level of complexity of the tax or compliance issue,

may constitute reasonable cause.[2493] For example, where the IRS has not provided any guidance as to difficult and complex issues, reasonable cause may exist for a reasonable position taken in good faith. A taxpayer's mistake of law can constitute reasonable cause if: (1) the law was unclear, (2) the taxpayer made a reasonable good faith effort to comply with the law, and (3) under all the facts and circumstances, it would be unfair to penalize the taxpayer for an honest mistake.[2494] Accordingly, a taxpayer may have reasonable cause if the failure is a result of a recent change in the tax law or forms of which the taxpayer could not reasonably be expected to know.

6. Mistake or Forgetfulness

Generally, a taxpayer's mistake, forgetfulness, or carelessness does not constitute ordinary business care and prudence and therefore is not a basis for reasonable cause.[2495] Absent the affirmative advice of counsel, even a good faith but mistaken belief does not relieve the taxpayer from the penalty.[2496] The Tax Court has expressly rejected any notion that a good faith dispute as to the proper treatment of a particular item constitutes reasonable cause for any failure to file a return[2497] (unless the failure is based on the advice of competent counsel as discussed at XI.D.1., above).

The reason for the mistake, however, may be a supporting factor if additional facts and circumstances support a determination that the taxpayer exercised ordinary business care and prudence.[2498]

7. Misfeasance by Employee or Agent

The neglect or misfeasance by the taxpayer's employee or agent is not reasonable cause.[2499] In instances where the taxpayer's employee has failed to file timely tax returns or pay taxes, the courts have held that the taxpayer still has a duty to file, pay, and deposit taxes and cannot avoid responsibility by simply relying on the employee to comply with the statutes. Under such circumstances, a taxpayer can establish reasonable cause only if they can demonstrate that they were "disabled" from timely complying with the statutes.[2500] While a taxpayer cannot

[2490] *Estate of Lammerts v. Commissioner*, 456 F.2d 681 (2d Cir. 1972); *Niedringhaus v. Commissioner*, 99 T.C. 202 (1992); *P. Dougherty Co. v. Commissioner*, 5 T.C. 791 (1945), acq., 1946-1 C.B. 3, aff'd, 159 F.2d 269 (4th Cir. 1946), cert. denied per curiam, 331 U.S. 838 (1947); *Heller v. Commissioner*, T.C. Memo 1980-417; *Crawford v. Commissioner*, T.C. Memo 1961-224; *Ebner v. Commissioner*, T.C. Memo 1958-108. *See* IRM 20.1.1.3.2.2.6 (11-25-11).

[2491] IRM 20.1.1.3.2.2.6(1) (11-25-11).

[2492] IRM 20.1.1.3.2.2.6(4) (11-25-11).

[2493] IRM 20.1.1.3.2.2.6(2) (11-25-11).

[2494] *In re Canada*, 2016 BL 183100 (Bankr. N.D. Tex. June 7, 2016); *Ochsner v. Commissioner*, T.C. Memo 2010-122.

[2495] *Logan Lumber Co. v. United States*, 365 F.2d 846 (5th Cir. 1966); *Beck Chem. Equip. Corp. v. Commissioner*, 27 T.C. 840 (1957), acq., 1957-2 C.B. 3; *Calvert Iron Works, Inc. v. Commissioner*, 26 T.C. 770 (1956); *Hornsby v. Commissioner*, 26 B.T.A. 591 (1932); *Ruiz v. Commissioner*, T.C. Memo 1984-213; *Deese v. Commissioner*, T.C. Memo 1958-89; IRM 20.1.1.3.2.2.4(1) (12-11-09); IRM 20.1.1.3.2.2.7(1) (08-05-14).

[2496] *Fides v. Commissioner*, 137 F.2d 731 (4th Cir. 1943), cert. denied, 320 U.S. 797 (1943); *Shomaker v. Commissioner*, 38 T.C. 192 (1962); *Beck Chem. Equip. Corp. v. Commissioner*, 27 T.C. 840 (1957), acq., 1957-2 C.B. 3; *P. Dougherty Co. v. Commissioner*, 5 T.C. 791 (1945), acq., 1946-1 C.B. 3, aff'd, 159 F.2d 269 (4th Cir. 1946); *W. Side Tennis Club v. Commissioner*, 39 B.T.A. 149 (1939), aff'd, 111 F.2d 6 (2d Cir. 1940), cert. denied, 311 U.S. 674 (1940).

[2497] *Stevens Bros. Found., Inc. v. Commissioner*, 39 T.C. 93 (1962), aff'd in part and rev'd in part on other grounds, 324 F.2d 633 (8th Cir. 1963), cert. denied, 376 U.S. 969 (1964), acq., 1965-2 C.B. 6; *Saigh v. Commissioner*, 36 T.C. 395 (1961), acq., 1962-2 C.B. 4, 5, 6; *A.C. Monk & Co. v. Commissioner*, 10 T.C. 77 (1948); *Southeastern Finance Co. v. Commissioner*, 4 T.C. 1069 (1945), acq., 1945 C.B. 6, aff'd, 153 F.2d 205 (5th Cir. 1946); *Fides v. Commissioner*, 47 B.T.A. 280 (1942), aff'd, 137 F.2d 731 (4th Cir. 1943), cert. denied, 320 U.S. 797 (1943). But see *Palm Beach Tr. Co. v. Commissioner*, 174 F.2d 527 (D.C. Cir. 1949), cert. denied, 338 U.S. 825 (1949); *Economy Sav. & Loan Co. v. Commissioner*, 158 F.2d 472 (6th Cir. 1946).

[2498] IRM 20.1.1.3.2.2.4(2) (12-11-09).

[2499] *United States v. Boyle*, 469 U.S. 241 (1985); *Valen Mfg. Co. v. United States*, 90 F.3d 1190 (6th Cir. 1996); *Conklin Bros. of Santa Rosa, Inc. v. United States*, 986 F.2d 315 (9th Cir. 1993) (corporate controller's misconduct not "reasonable cause"); *Berlin v. Commissioner*, 59 F.2d 996 (2d Cir. 1932); *Atlas Therapy, Inc. v. United States*, 66 F. Supp. 2d 1203 (N.D. Ala. 1999) (no abatement from penalties for failure to file payroll taxes, even though employee in charge of payroll actively concealed his failure to file returns and pay taxes); *San Diego Drywall, Inc. v. United States*, 93-2 USTC ¶50,548 (S.D. Cal. 1993), aff'd by unpub. op., 56 F.3d 73 (9th Cir. 1995); *Padda v. Commissioner*, T.C. Memo 2020-154 (reasonable cause not found in reliance on professional accountants as agent that filed return late where same accountants repeatedly filed returns late in past years); *Pioneer Auto. Serv. Co. v. Commissioner*, 36 B.T.A. 213 (1937). *See Henry v. United States*, 73 F. Supp. 2d 1303 (N.D. Fla. 1999) (reasonable cause not established where failure to timely file was due to employee misunderstanding instructions).

[2500] *Compare In re Am. Biomaterials Corp.*, 954 F.2d 919 (3d Cir. 1992) (reasonable cause existed where corporate officers — who controlled corporation and were in charge of filing and paying taxes — embezzled funds, thereby "incapacitating" corporation and leaving it unable to comply with tax laws) *with Valen Mfg. Co. v. United States*, 90 F.3d 1190 (6th Cir. 1996) (taxpayer lacked reasonable cause despite responsible employee's circumvention of institutional controls); *Conklin Bros. of Santa Rosa, Inc. v. United States*, 986 F.2d 315 (9th Cir. 1993) (taxpayer lacked reasonable cause despite embezzlement and failure of comptroller to file returns and make deposits since such conduct remains largely within corporation's control); *Universal Concrete Prods. Corp. v. United States*, 90-2 USTC ¶50,440 (E.D. Pa. 1990) aff'd by unpub. op., 941 F.2d 1204 (3d Cir. 1991), (taxpayer's failure to establish adequate internal controls constituted lack of ordinary business care and prudence, since basic procedures would have detected comptroller's embezzlement); *All Stacked Up Masonry, Inc. v. United States*, 150 Fed. Cl. 540, 2020 BL 409025 (Fed. Cl. 2020) (no reasonable cause where corporation's disabled owner delegated tax preparation responsibilities to employee who could not properly operate tax preparation software); *Huffman, Carter & Hunt, Inc. v. United States*, 317 F. Supp. 2d 816 (S.D. Ohio 2004) (prudence in selecting and monitoring outside accountant as he performed payroll and employment tax services was insufficient to warrant abatement of failure to file/pay penalties imposed after accountant embezzled funds); *Dogwood Forest Rest Home, Inc. v. United States*, 181 F. Supp.

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delegate their responsibility to timely file and pay their taxes, the underlying cause for such delegation may provide reasonable cause.[2501]

8. Erroneous Advice From the IRS

a. Written Advice

The portion of any penalty attributable to erroneous advice furnished to the taxpayer, in writing, by an IRS employee acting in his official capacity is waived if:[2502]

- The advice is reasonably relied on by the taxpayer;
- The advice is issued in response to a specific written request for advice by the taxpayer; and
- The taxpayer has provided adequate and accurate information in connection with the request.

A taxpayer is not considered to have reasonably relied on advice that he receives after the return or act to which it relates is filed or undertaken.[2503] Moreover, reasonable reliance cannot continue after the taxpayer is put on notice that the advice no longer represents the IRS's position.[2504] The taxpayer is considered to be put on notice that the written advice is no longer valid upon the subsequent:[2505]

- Receipt by the taxpayer of correspondence from the IRS that the advice no longer represents the IRS's position; or
- Enactment of legislation, ratification of a treaty, issuance of a decision by the Supreme Court, issuance of final or temporary regulations, or issuance of a revenue ruling, revenue procedure or other statement published in the Internal Revenue Bulletin that sets forth a position that is inconsistent with the advice.

In cases involving erroneous IRS advice, the request for abatement is made by filing Form 843 (Claim for Refund and Request for Abatement), with the words "Abatement of penalty or addition to tax pursuant to §6404(f)" written at the top, with the IRS service center where the taxpayer filed the return.[2506] The request must include a copy of the taxpayer's written request for advice, a copy of the erroneous written advice furnished by the IRS, any IRS adjustment report that identifies the penalty, and a statement of whether the penalty was paid.[2507] The taxpayer must file the claim within the period in which the IRS can collect the penalty, or if the penalty has been paid, the period allowed for claiming a refund or credit of the penalty.[2508]

A taxpayer who does not meet the criteria for statutory relief described above may still qualify for other penalty relief (e.g., the IRS determines that the taxpayer exercised ordinary business care and prudence in relying on the IRS's written advice).[2509]

b. Oral Advice

The IRS has administratively extended the relief for reliance on erroneous written advice to include erroneous oral advice when appropriate.[2510] In addition to the criteria described above for abating a penalty based on erroneous written advice the IRS will consider:[2511]

- Whether the taxpayer exercised ordinary business care and prudence in relying on the advice;
- Whether there was a clear relationship between the taxpayer's situation, the advice provided, and the penalty assessed;
- The taxpayer's prior tax history and experience with tax requirements;
- Whether the IRS provided correct information through other means (e.g., tax forms or publications); and
- What supporting documentation is available, including the question presented, the advice provided, the IRS office and method by which the advice was provided, the date the

2d 554 (M.D.N.C. 2001) (reasonable cause not established for corporations' failure to meet filing and deposit obligations, as corporation is not disabled from complying with tax deadlines because it retained control over accountant/agent responsible for tax liabilities); *San Diego Drywall v. United States*, 93-2 USTC ¶50,548 (S.D. Cal. 1993) (disability involves something more than misconduct on part of employee; taxpayer lacked reasonable cause despite fact that its failure to timely file and pay employment taxes was due to comptroller's embezzlement), *aff'd by unpub. op.*, 56 F.3d 73 (9th Cir. 1995). *See also Mason Motors Co. v. United States*, 8 F. Supp. 2d 1177 (D. Minn. 1998) (second request for abatement denied because business not disabled where office manager with history of depression again failed to deposit and pay taxes and to file returns then concealed inaction); *BoStar Foods, Inc. v. United States*, 97-1 USTC ¶50,285 (W.D. Ky. 1997) (responsible person's stress and personal problems do not constitute reasonable cause — reasonable cause contemplates severe illness and incapacity). *Cf. Nesse v. IRS*, 305 B.R. 645 (D. Md. 2004) (rejecting trustee's contention that reasonable cause existed because lender was responsible for filing, depositing, and paying debtor's employment taxes and maintained total control over debtor's funds).

[2501] *Valen Mfg. Co. v. United States*, 90 F.3d 1190 (6th Cir. 1996). Using ordinary business care and prudence in selecting and dealing with a financial agent does not absolve a taxpayer from the statutory duty to make sure taxes are properly filed and paid. A taxpayer faces penalties, not from relying on an agent's advice, but because that taxpayer relies on an agent to complete and file his taxes. *See Vaughn v. United States*, 635 Fed. App'x 216 (6th Cir. 2015) (disability is something beyond the taxpayer's control and oversight, not something that occurs under the taxpayer's authorization and subject to his control; the taxpayer's own immediate failure to exercise any oversight led to agent's ability to embezzle funds). In CCA 201637012, the taxpayer had granted a durable power of attorney to a third party authorizing them to prepare, file and sign income tax returns, make estimated tax payments, and make and file gift tax returns. The third party failed to do so. The failure of the POA holder is not a reasonable cause, because the taxpayer is ultimately responsible for those acting on their behalf. However, the power of attorney had been executed because the taxpayer was ostensibly becoming mentally incapacitated with dementia and was becoming unable to handle their own financial affairs. Depending upon the facts and timing of the taxpayer's incapacitation, a reasonable cause analysis could provide a different basis for abatement of the penalties.

[2502] §6404(f); Reg. §301.6404-3(a), §301.6404-3(b). For this purpose, a penalty is a liability imposed under Chapter 68, Subchapter A or B (§6651–§6725) or §6038(b), §6038(c), §6038A(d), §6038B(c), §6039E(c) or §6332(d)(2), or any other Code section that the IRS has designated a penalty for purposes of §6404(f), and any interest imposed with respect thereto. Reg. §301.6404-3(c)(2).

[2503] Reg. §301.6404-3(b)(2)(ii). If, however, the taxpayer files an amended return that conforms to the written advice, the taxpayer is considered to have reasonably relied on the advice. Reg. §301.6404-3(b)(2)(iii).

[2504] Reg. §301.6404-3(b)(2)(v).

[2505] Reg. §301.6404-3(b)(2)(v).

[2506] Reg. §301.6404-3(d).

[2507] Reg. §301.6404-3(d).

[2508] Reg. §301.6404-3(e).

[2509] IRM 20.1.1.3.2.2.5 (11-21-17), IRM 20.1.1.3.3.4.1 (11-25-11).

[2510] IRM 20.1.1.3.2.2.5 (11-21-17), IRM 20.1.1.3.3.4.2 (12-11-09).

[2511] IRM 20.1.1.3.3.4.2(2)–(3) (12-11-09). See discussion at XI.D.8.a., above.

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advice was provided, and the name of the IRS employee providing the information.

9. Time and Business Pressures

The taxpayer's heavy workload does not constitute reasonable cause for his failure to perform a required act.[2512] A person exercising ordinary business care and prudence does not take on assignments that would prohibit him from fulfilling his own legal obligations within the prescribed time. Similarly, the time pressures of the taxpayer's agents cannot excuse his failure to file a return.[2513]

10. Invalid Extension

A return that is filed within the period of an invalid extension of time to file is still late. As discussed earlier, even an automatic extension can be voided, for example, if the taxpayer fails to estimate his tax properly.[2514] A voided automatic extension is not reasonable cause for failing to file a timely return.[2515]

Similarly, filing within an extension period that is requested but not granted does not constitute reasonable cause.[2516] A taxpayer cannot presume that his request for an extension of time will be granted. Accordingly, the mere request for an extension does not eliminate the penalty.

11. Service in Combat Zone or Contingency Operation

Section 7508 postpones specified acts for an individual serving in the Armed Forces of the United States, or serving in support of such Armed Services, in an area designated by the President of the United States as a "combat zone," or when deployed outside the United States away from the individual's permanent duty station while participating in an operation designated by the Secretary of Defense as a contingency operation (or that became a contingency operation by operation of law). The individual has until 180 days after the "period of combatant activities," period of such contingency operation, or period of continuous "qualified hospitalization" attributable to an injury received while serving in such combat zone or contingency operation, to perform the acts specified in the statute, which includes filing a return and paying tax due.[2517] The extension also applies to the taxpayer's spouse.[2518]

For discussion of postponement of the time for the IRS to certify a seriously delinquent debt if a taxpayer is either serving in a combat zone or a contingency operation, see discussion at XIII., below.

12. Fire, Casualty, Natural Disaster or Other Disturbance

A fire, casualty, natural disaster, or other disturbance may be grounds for relief from a penalty for the failure to file a return or pay a tax.[2519] For taxpayers not subject to §7508A, the taxpayer must show he exercised ordinary business care and prudence but, due to circumstances beyond the taxpayer's control, the taxpayer was nevertheless unable to comply with the law.[2520] The determination is based on all the facts and circumstances in the particular case.[2521] Factors the IRS considers include:[2522]

- Timing;
- The effect on the taxpayer's business;
- The steps the taxpayer took to comply; and
- Whether the taxpayer complied when it became possible to do so.

When a significant disaster occurs affecting a wide area of taxpayers, the IRS often issues special instructions to facilitate evaluating requests for penalty relief.[2523]

The IRS has the authority to postpone certain deadlines for taxpayers that are affected by a "federally declared disaster" (defined in §165(i)(5)), a significant fire,[2524] or a "terroristic or military action" (defined in §692(c)(2)) for a period of up to one year.[2525] If a tax-related deadline is postponed, the IRS will publish guidance describing the acts postponed, the postponement period, and the geographic area covered. The postponement of the deadline does not extend the due date of the act but merely allows the IRS to disregard up to one year for performance of the act. The IRS also has the authority under §7508A to suspend interest, penalties and additional amounts that would normally accrue during the time the tax-related act is postponed.

[2512] *Crocker v. Commissioner*, 92 T.C. 899 (1989); *Odend'hal v. Commissioner*, 80 T.C. 588 (1983), aff'd, 748 F.2d 908 (4th Cir. 1984), cert. denied, 471 U.S. 1143 (1985); *Dustin v. Commissioner*, 53 T.C. 491 (1969), aff'd, 467 F.2d 47 (9th Cir. 1972); *Bogatin v. Commissioner*, T.C. Memo 1981-538; *Estate of Plotkin v. Commissioner*, T.C. Memo 1972-202.

[2513] *Nosek v. Commissioner*, T.C. Memo 1989-622; *Dritz v. Commissioner*, T.C. Memo 1969-175, aff'd, 427 F.2d 1176 (5th Cir. 1970).

[2514] *See* II.B.2., above.

[2515] *Crocker v. Commissioner*, 92 T.C. 899 (1989); *Pflug v. Commissioner*, T.C. Memo 1989-615; *Bacon v. Commissioner*, T.C. Memo 1989-90.

[2516] *Belk v. Commissioner*, 93 T.C. 434 (1989); *Johnston v. Commissioner*, T.C. Memo 1984-374; *Heller v. Commissioner*, T.C. Memo 1980-417; *Fitch v. Commissioner*, T.C. Memo 1975-36.

[2517] §7508(a); Reg. §301.7508-1. See Tables, Charts and Lists (Federal) > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions*, for an updated list of acts whose deadlines are postponed under §7508 For the portion of the first tax year ending after June 9, 2015, which begins on such date, and any subsequent tax year beginning before 2026, a qualified hazardous duty area is treated as if it were a combat zone. The Sinai Peninsula of Egypt is a qualified hazardous duty area. Pub. L. No. 115-97, §11026.

[2518] §7508(c).

[2519] IRM 20.1.1.3.2.2.2. *See Brown v. Commissioner*, T.C. Memo 1997-418 (taxpayers not liable for §6662(a) penalty where failure to substantiate deductions at trial was due to loss of records in house fire; court found that taxpayers had substantiation when return was filed).

[2520] IRM 20.1.1.3.2.2.2(3). *See Estate of Stuller v. United States*, 55 F. Supp. 3d 1091 (C.D. Ill. 2014), aff'd, 811 F.3d 890 (7th Cir. 2016) (fire at taxpayer's home was not reasonable cause for late filing where taxpayer could have gotten copies of records from bank). *Compare* Reg. §301.6651-1(c). Section 7508A is discussed below.

[2521] IRM 20.1.1.3.2.2.2(5).

[2522] IRM 20.1.1.3.2.2.2(4). *See Photographic Assistance Corp. v. United States*, 99-2 USTC ¶50,773 (N.D. Ga. 1999) (no reasonable cause for failure to pay tax shown when due date passed before fire destroyed business).

[2523] IRM 20.1.1.3.3.6(1).

[2524] §7508A(f), redesignated and amended by the Filing Relief for Natural Disasters Act, Pub. L. No. 119-29, §2(a), effective for disasters declared after July 24, 2025.

[2525] A mandatory 120-day postponement may also apply to qualified taxpayers in disaster areas. §7508A(e), redesignated and amended by the Filing Relief for Natural Disasters Act, Pub. L. No. 119-29, §2(a), effective for disasters declared after July 24, 2025. Former §7508A (60-day mandatory period for disasters declared after November 15, 2021, and before July 25, 2025).

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The IRS provided a list of time-sensitive acts whose deadlines may be postponed under §7508 and §7508A.[2526] For taxpayers to be entitled to a postponement of any act listed in the revenue procedure, the IRS and other government agencies (e.g., EBSA, PBGC) generally publish a notice or other guidance (including IRS News Releases) providing relief.[2527] The postponement period under §7508A runs concurrently with extensions of time to file and pay, if any, under other Code sections. When the original due date precedes the first day of the postponement period and the extended due date falls within the postponement the following rules apply:

- If an affected taxpayer received an extension of time to file, filing will be considered timely if it is made on or before the last day of the postponement period, and the taxpayer is eligible for relief from penalties and additions to tax related to the failure to file during the postponement period; and

- If an affected taxpayer received an extension of time to pay, payment will be considered timely if it is made on or before the last day of the postponement period and the taxpayer is eligible for relief from interest, penalties and additional amounts related to the failure to pay during the postponement period.

For a further discussion of §7508 and §7508A, see 627 T.M., *Limitations Periods, Interest on Underpayments and Overpayments, and Mitigation.*

13. Complexity

Taxpayers have asserted reasonable cause based on both the complexity of the law and the complexity of the facts. Complexity by itself is not sufficient to avoid a failure to file or failure to pay penalty.[2528] With respect to other penalties, however, the level of complexity is a factor which may mitigate the penalty.[2529]

14. Prohibition Against Communicating with Accountant

In *Hoeffner v. Commissioner*,[2530] a criminal court order which prohibited the taxpayers from communicating with their accountant did not amount to reasonable cause for the failure to timely pay a return and timely pay taxes. According to the court, the taxpayers could have requested that a modification of the order prohibiting communication, but failed to do so until the time for filing the return and paying the tax had passed.

15. Constitutional Objections

a. In General

There is no Constitutional right not to file a tax return.[2531] Constitutional challenges to the federal income tax have long been rejected. The whole purpose of the Sixteenth Amendment was to approve of the income tax.[2532]

Religious beliefs are not valid reasons for failing to file a return or failing to pay the required tax.[2533] Thus, citing a compelling governmental interest in maintaining uniform, mandatory participation in the federal income tax system, courts have held that the Religious Freedom Restoration Act of 1993[2534] is not a basis for exempting taxpayers from filing and payment requirements.[2535]

b. Privilege Against Self-Incrimination Under Fifth Amendment

An IRS criminal investigation cannot excuse the taxpayer from filing a tax return.[2536] The Fifth Amendment privilege against self-incrimination extends only to a taxpayer's refusal to answer specific questions in the return, and does not constitute reasonable cause sufficient to justify a taxpayer's complete refusal to file any return at all.[2537] Similarly, reasonable cause may not exist even if the taxpayer's failure to file is based solely on the erroneous advice of an accountant or attorney not to file the return due to Fifth Amendment concerns.[2538]

[2526] See Tables, Charts and Lists (Federal) > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions*, discussing Rev. Proc. 2018-58, for an updated list of acts whose deadlines may be postponed.

[2527] FEMA provides an updated list of federally declared disasters at: https://www.fema.gov/disasters.

[2528] *See, e.g., Ellwest Stereo Theatres of Memphis, Inc. v. Commissioner*, T.C. Memo 1995-610; *West v. Commissioner*, T.C. Memo 2016-134 (with respect to complexity of law); and *Hoeffner v. Commissioner*, 587 Fed. App'x 147 (5th Cir. 2014); *In re Craddock*, 149 F.3d 1249 (10th Cir. 1998); *Edgar v. Commissioner*, 56 T.C. 717 (1971); *Estate of Ridenour v. United States*, 468 F. Supp. 2d 941 (S.D. Ohio 2006) (with respect to complexity of facts). *But see Estate of Proske v. United States*, 2010-1 USTC ¶60,594 (D.N.J. 2010) (penalty does not apply because extension of time to file should have been granted due to the complexity of the estate).

[2529] *See, e.g., Kraus v. Commissioner*, T.C. Memo 2003-10, and *Liu v. Commissioner*, T.C. Summ. Op. 2009-137 (with respect to §6662 penalty) Reg. §1.6694-2(e)(1); IRM 20.1.1.3.2.2.6(2) (11-25-11).

[2530] 587 Fed. App'x 147 (5th Cir. 2014).

[2531] *California v. Byers*, 402 U.S. 424 (1971).

[2532] *See, e.g., Brushaber v. Union Pac. R.R. Co.*, 240 U.S. 1 (1916); *Stanton v. Baltic Mining Co.*, 240 U.S. 103 (1916).

[2533] *United States v. Lee*, 455 U.S. 252 (1982); *Autenrieth v. Cullen*, 418 F.2d 586 (9th Cir. 1969), cert. denied, 397 U.S. 1036 (1970); *Muste v. Commissioner*, 35 T.C. 913 (1961), acq., 1961-2 C.B. 5; *Greenberg v. Commissioner*, 73 T.C. 806 (1980); *Robertson v. Commissioner*, T.C. Memo 1984-222.

[2534] 42 U.S.C. §2000bb *et seq.*

[2535] *See Adams v. Commissioner*, 110 T.C. 137 (1998) (Quaker not exempt from filing returns and paying taxes despite sincere religious opposition to use of taxes to fund military costs), *aff'd*, 170 F.3d 173 (3d Cir. 1999), cert. denied, 528 U.S. 1117 (2000). *Cf. Steckler v. United States*, 98-1 USTC ¶50,219 (E.D. La. 1998) (withholding under §3406 held least restrictive means of furthering government's interest in tracking taxable income).

[2536] *United States v. Josephberg*, 562 F.3d 478 (2d Cir. 2009), cert. denied, 558 U.S. 965 (2009); *United States v. Poschwatta*, 829 F.2d 1477 (9th Cir. 1987), cert. denied, 484 U.S. 1064 (1988); *Garner v. United States*, 424 U.S. 648 (1976); *United States v. Sullivan*, 274 U.S. 259 (1927); *Heligman v. United States*, 407 F.2d 448 (8th Cir. 1969), cert. denied, 395 U.S. 977 (1969); *Cupp v. Commissioner*, 65 T.C. 68 (1975), aff'd by unpub. op., 559 F.2d 1207 (3d Cir. 1977).

[2537] *See, e.g., United States v. Sullivan*, 274 U.S. 259 (1927); *Garner v. United States*, 424 U.S. 648 (1976); *United States v. Edelson*, 604 F.2d 232 (3d Cir. 1979); *United States v. Egan*, 459 F.2d 997 (2d Cir. 1972), cert. denied, 409 U.S. 875 (1972); *United States v. Sturman*, 951 F.2d 1466 (6th Cir. 1991), cert. denied, 504 U.S. 985 (1992); *Cooper v. United States*, 834 F. Supp. 669 (D.N.J. 1993), aff'd without op., 9 F.3d 1539 (3d Cir. 1993); *Lee v. United States*, 2017 BL 50101 (D. Nev. Feb. 17, 2017).

[2538] *See Cooper v. United States*, 834 F. Supp. 669 (D.N.J. 1993), aff'd without op., 9 F.3d 1539 (3d Cir. 1993) (reliance on attorney's erroneous advice not to file return until conclusion of IRS investigation was unreasonable since taxpayers made no effort to secure extension, but merely accepted unquestioningly the advice that they need not file for an indefinite period of time).

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c. Double Jeopardy Under Fifth Amendment

The Fifth Amendment of the Constitution provides, in part, that no person shall be put in jeopardy of life or limb twice for the same offense. Additions to tax are not punishments for purposes of the Double Jeopardy Clause. Rather, the sanctions are remedial in nature. They are provided primarily as a safeguard for the protection of tax revenues and to reimburse the government for the heavy expense of investigation and the loss resulting from the taxpayer's action.[2539]

In addition, the Double Jeopardy Clause applies only if a person is put in jeopardy twice from the same conduct. Conduct is considered to be different for this purpose if the two proceedings require proof of different facts.[2540] The criminal tax penalties are different from the civil tax penalties. In addition, the failure to file a tax return or pay a tax under §6651(a) and the accuracy-related penalty under §6662 do not punish the same conduct.[2541]

d. Excessive Fine Under the Eighth Amendment

Taxpayers have unsuccessfully tried to attack civil tax penalties as violating the Eighth Amendment of the Constitution, which prohibits the imposition of excessive fines. Such a violation requires that the penalty constitute punishment for an offense, and that such punishment is grossly disproportional to the gravity of the offense.[2542] The courts have consistently held that the purpose of the civil tax penalties is to encourage voluntary compliance, and not to punish.[2543] Imposing a financial penalty to safeguard the fisc and reimburse the government for its costs of investigation and losses resulting from the taxpayer's actions is remedial, and therefore does not violate the Eighth Amendment.[2544] Moreover, the courts have found that the civil tax penalties were not grossly disproportional to the offense.[2545] Similarly, FBAR penalties under the Bank Secrecy Act generally have not been were considered by the courts to be excessive.[2546]

16. Taxpayers with Disabilities

The IRS's policy is to take the necessary steps to ensure that taxpayers with disabilities have an equal opportunity to participate in all IRS programs, activities and services. A taxpayer that is unable to read certain post-filing notices issued in standard print may request that the IRS provide an accessible copy of a notice in an alternative format.[2547]

Taxpayers with disabilities generally are subject to the same reasonable cause standards of ordinary business care and prudence discussed above.[2548] Nevertheless, a disabled taxpayer may request penalty relief if a notice in a standard print format was received requiring action, but the taxpayer did not timely respond because they could not access the notice.

In evaluating whether the taxpayer has established reasonable cause, in addition to the factors discussed above, the IRS will also consider the following:

- Was a description of the issue that prevented the taxpayer from reading the standard print notice provided?
- When was the notice received and when did the taxpayer first become aware of the issue stated in the standard print notice?
- What was the taxpayer's degree of knowledge concerning the tax, interest, or penalty owed before issuance of the inaccessible notice?
- When did the IRS become aware that the taxpayer needs accessible format notices?
- Did the taxpayer promptly respond to the notice once a copy of the notice in accessible format was received?

[2539] *See, e.g., Helvering v. Mitchell*, 303 U.S. 391 (1938) (with respect to fraud penalty under predecessor to §6663); *United States v. Alt*, 83 F.3d 779 (6th Cir. 1996) (with respect to accuracy-related penalties under the predecessors to §6662), *cert. denied*, 519 U.S. 872 (1996); *Dillon v. Commissioner*, T.C. Memo 1981-583 (with respect to failure to file penalty under §6651(a)); *Healey v. Commissioner*, T.C. Memo 1996-260 (with respect to failure to file penalty under §6651(a) and accuracy-related penalty under §6662); *Louis v. Commissioner*, T.C. Memo 1996-257, aff'd per curiam, 170 F.3d 1223 (9th Cir. 1999), cert. denied, 528 U.S. 145 (2000) (with respect to fraud penalty under predecessor of §6663).

[2540] *Blockburger v. United States*, 284 U.S. 299 (1932); *Brown v. Ohio*, 432 U.S. 161 (1977); *Iannelli v. United States*, 420 U.S. 770 (1975); *Hudson v. United States*, 522 U.S. 93 (1997).

[2541] *Healey v. Commissioner*, T.C. Memo 1996-260.

[2542] *United States v. Bajakajian*, 524 U.S. 321 (1998).

[2543] *See, e.g., Gorra v. Commissioner*, T.C. Memo 2013-254 (with respect to the 40% penalty under §6662(h)); *Ackers v. Commissioner*, 26 T.C. 107 (1956) (with respect to the failure to file penalty under the predecessor to §6651(a) and the estimated tax penalty under the predecessor to §6654), *aff'd in part and rev'd in part*, 258 F.2d 568 (6th Cir. 1958), aff'd, 361 U.S. 87 (1959); *Little v. Commissioner*, 106 F.3d 1445 (9th Cir. 1997) (with respect to negligence penalty or substantial understatement penalty under the predecessors to §6662); *Wilson v. Commissioner*, T.C. Memo 2002-234 (with respect to the 75% fraud penalty under §6663); *Thompson v. Commissioner*, 148 T.C. 59 (Feb. 2, 2017) (with respect to the 30% penalty under §6662A). *See also Hudson v. United States*, 522 U.S. 93 (1997) (whether punishment is criminal or civil requires: statutory construction to determine if Congress indicated preference for one label; and evaluation of whether purpose or effect of statutory scheme is so punitive as to transform civil sanction into criminal penalty); *United States v. Dunkel*, 182 F.3d 923 (7th Cir. 1999) (with respect to negligence, failure-to-pay, and accuracy-related penalties); *Louis v. Commissioner*, 170 F.3d 1232 (9th Cir. 1999) (with respect to fraud penalty); *Bickham Lincoln-Mercury, Inc. v. United States*, 168 F.3d 790 (5th Cir. 1999) (with respect to failure-to-file penalty); *United States v. Alt*, 83 F.3d 779 (6th Cir. 1996) (with respect to fraud, understatement, and negligence penalties); *Ianniello v. Commissioner*, 98 T.C. 165 (1992) (with respect to fraud penalty). Double jeopardy is discussed at XI.D.15.c., below.

[2544] *Helvering v. Mitchell*, 303 U.S. 391 (1938); *Ackers v. Commissioner*, 26 T.C. 107 (1956), aff'd in part and rev'd in part, 258 F.2d 568 (6th Cir. 1958), aff'd, 361 U.S. 87; *Little v. Commissioner*, 106 F.3d 1445 (9th Cir. 1997).

[2545] *See, e.g., Thompson v. Commissioner*, 148 T.C. 59 (Feb. 3 2017). *See also R S B C O v. United States*, No. 3:21-CV-01192, 2022 BL 99518 (W.D. La. Mar. 23, 2022) (motion for judgment on pleadings denied, regarding claim that §6721(a) penalty amount was grossly disproportionate to taxpayer's failure to file correct information returns, given that pleadings did not state what taxpayer did or failed to do warranting such penalty and how assessment was determined).

[2546] *See, e.g., United States v. Bussell*, 2015 BL 454171 (C.D. Cal. Dec. 8, 2015), aff'd by unpub. op., 699 Fed. App'x 695 (9th Cir. 2017), cert. denied, 138 S. Ct. 1697 (2018) (FBAR penalty was reduced from $1,221,806 to $1,120,513, and then upheld as not being excessive).

[2547] *See* IRM 1.18.4.4.3 (09-18-24) (noting that taxpayers may choose to receive their IRS tax notices in Braille, large print, audio or electronic formats upon completion and submission of Form 9000, *Alternative Media Preference*); *see also* Policy Statement 1-47, printed in IRM 1.2.1.2.12 (10-19-92).

[2548] *See* IRM 20.1.1.3.2.2.8 (03-29-23). *See also* Policy Statement 1-47, printed in IRM 1.2.1.2.12 (10-19-92).

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Example: A taxpayer filed their 2021 Form 1040 showing a tax amount due and made no payment. When the return was processed, a notice (CP 14) was issued to explain that the Form 1040 was filed with an amount owed and gives the balance due information. In this case, the taxpayer had knowledge of the unpaid tax before issuance of the notice and would not qualify for relief.

17. IRS Frequently Asked Questions (FAQs)

The IRS has increasingly used FAQs to quickly communicate guidance with taxpayers.[2549] Practitioners have raised concerns regarding the increased use of FAQs. Among those concerns are the failure to solicit public comments, availability of reasonable cause relief for penalties where taxpayers relied on the material, and the availability of archived FAQs.[2550] In addition to practitioner concerns, the National Taxpayer Advocate (NTA)[2551] and Government Accountability Office (GAO)[2552] have raised concerns regarding the use of FAQs. In the Fiscal Year 2021 Objectives Report to Congress, the National Taxpayer Advocate (NTA) included FAQ recommendations which attempted to balance the needs of the IRS to quickly issue guidance on certain topics while also protecting taxpayers who rely on FAQs.[2553]

On October 15, 2021, the IRS updated its process for FAQs.[2554] According to the IRS, for any "significant" FAQs on new legislation, including later updates or revisions to those FAQs, it will announce the FAQs in a news release and Fact Sheet. The IRS will date the material and maintain a database of prior FAQ Fact Sheets.

In IR-2021-202[2555] the IRS also clarified that where a taxpayer reasonably relies, based on the facts and circumstances, on an FAQ in good faith, the IRS will consider this in a reasonable cause defense for penalties that provide "a reasonable cause standard for relief, including a negligence penalty or other accuracy-related penalty, to the extent that reliance results in an underpayment of tax." This applies even if the FAQ is subsequently updated or modified. If the FAQs are published in an FAQ Fact Sheet linked to a news release, these are authority for the substantial authority exception to the accuracy-related penalties.

In CC-2022-006,[2556] the Chief Counsel announced FAQ review and posting procedures. The procedures apply to FAQs for newly enacted legislation and in other contexts, such as emerging issues where no pre-existing Internal Revenue Bulletin guidance, including regulations, has been issued. Fact Sheet FAQs will include standard disclaimer language and a link to guidance on the issue of reliance on Fact Sheet FAQs. The Chief Counsel Office of Executive Counsel will coordinate review, clearance and issuance of Fact Sheet FAQs. After review, the IRS will issue the Fact Sheet FAQs as an IRS Fact Sheet linked to an IRS News Release. The Fact Sheet FAQs and IRS News Release are numbered, dated, and archived in a searchable record on the IRS website.

For a discussion of the precedential value of FAQs, see 100 T.M., *Legal Authorities in U.S. Federal Tax Matters — Research and Interpretation.*

Practice Tip: Even though the IRS stated it will maintain a database of FAQ Fact Sheets, it is a good practice keep copies of FAQs relied on in performing work for clients.

E. First-Time Penalty Abatement Program

The IRS maintains a first-time penalty abatement policy (FTA) under which a taxpayer who has incurred a failure to file (§6651(a)(1), §6698(a)(1), or §6699(a)(1)), failure to pay (§6651(a)(2) or §6651(a)(3)), or failure to deposit penalty (§6656) may have the penalty administratively waived if:[2557]

- the taxpayer has filed the same return as the penalized return for the three years preceding the penalized tax period, unless there is no filing requirement for the applicable tax period or the tax modules for the same return are not in TDI Status 02, 03 (BMF), or 04 (IMF);
- if required to file the same return during the preceding years, the taxpayer has no unreversed penalties (except an estimated tax penalty) and no notice was issued showing the assessed penalty or penalties; and
- if required to file the same return during the preceding three years, the taxpayer has no penalties manually suppressed or reversed with Penalty Reason Code 018, 020, or 021.

The following additional criteria apply in the case of business (BMF) taxpayers:[2558]

[2549] *See* National Taxpayer Advocate (NTA) Blog: *Protecting the Rights of Taxpayers Who Rely on IRS "Frequently Asked Questions" (FAQs)* (July 7, 2020). As of July 7, 2020, the posting date of the NTA blog, NTA had counted that the IRS posted almost 500 COVID-19 related FAQs. National Taxpayer Advocate (NTA) Blog: *Protecting the Rights of Taxpayers Who Rely on IRS "Frequently Asked Questions" (FAQs)* (July 7, 2020).

[2550] *See* Procedurally Taxing, *FAQ Disclaimers: Balancing the Need for Guidance and Taxpayer Reliance on FAQs* (July 10, 2020), https://proceduralltaxing.com/faq-disclaimers-balancing-the-need-for-guidance-and-taxpayer-reliance-on-faqs/; Procedurally Taxing, *NTA Blog Post On "Protecting the Rights of Taxpayers Who Rely on FAQs" Is Timely and Welcome, But Doesn't Go Far Enough* (July 9, 2020), https://procedurallytaxing.com/nta-blog-post-on-protecting-the-rights-of-taxpayers-who-rely-on-faqs-is-timely-and-welcome-but-doesnt-go-far-enough/; Procedurally Taxing, *The Proper Role of FAQs* (May 8, 2020), https://procedurallytaxing.com/the-proper-role-of-faqs/.

[2551] *See e.g.*, National Taxpayer Advocate (NTA) Blog: *IRS Frequently Asked Questions Can Be a Trap for the Unwary* (July 26, 2017), https://www.taxpayeradvocate.irs.gov/news/ntablog-irs-frequently-asked-questions-can-be-a-trap-for-the-unwary/.

[2552] *See* GAO Report, *VIRTUAL CURRENCIES: Additional Information Reporting and Clarified Guidance Could Improve Tax Compliance*, GAO-20-188, pg. 17–22 (Feb. 2020).

[2553] NTA Objectives Report to Congress Fiscal Year 2021, pg. 36 (June 29, 2021).

[2554] IRS News Release IR-2021-202 (Oct. 15, 2021); IRS Fact Sheets, Reliance Page, *General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs*, https://www.irs.gov/newsroom/general-overview-of-taxpayer-reliance-on-guidance-published-in-the-internal-revenue-bulletin-and-faqs.

[2555] IR-2021-202 also applies to FAQs released before October 15, 2021 (release date of the news release).

[2556] To be incorporated in the IRM as CCDM 32.5.1.

[2557] IRM 20.1.1.3.3.2.1(4) (03-29-23). *See* PMTA 2018-02 (Chief Counsel's Office advised that IRS has authority both to waive penalties under first-time abatement policy and to automate execution of abatement policy; automation of abatement policy does not affect IRS's exercise of enforcement discretion).

[2558] IRM 20.1.1.3.3.2.1(6) (03-29-23).

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• An FTA waiver is not available for any portion of a failure to deposit penalty relating to a failure to use EFTPS.

• An FTA waiver is not available if there are four or more failure to deposit waiver codes present in the taxpayer's three year penalty history with respect to the tax account under review.

• An FTA waiver is not available for a Form 1120 or Form 1120-S penalty if, in the prior three years, at least one return was filed late but not penalized.

• An FTA waiver is not available if the penalty is charged for an incomplete S-corporation return (Form 1120-S) or partnership return (Form 1065).

A taxpayer need not specifically apply for the FTA. If the criteria are met, the IRS should abate the penalty.[2559] If the FTA criteria are met, the FTA waiver applies before reasonable cause.[2560]

Comment: This ordering rule can hurt a taxpayer who would otherwise qualify for a reasonable cause exception, since the taxpayer would not be eligible for another FTA exception for three more years. The National Taxpayer Advocate would reverse the ordering rule.[2561]

The FTA can only apply to a single tax period for a given account. Furthermore, penalty relief under the FTA waiver only applies to a tax period for which the qualifying criteria have been met. In addition, the FTA waiver is not applicable based solely on a taxpayer's first request for penalty relief.[2562] The FTA waiver does not apply to, among other things:[2563]

• Returns with an event-based filing requirement, generally returns filed once or infrequently (e.g., estate and gift tax returns);

• The Daily Delinquency Penalty (DDP) (e.g., §6652(c)(2)(A)) and Employee Plans and Exempt Organization Penalties (e.g., IRM 20.1.8 (11-15-24)); and

• Information return reporting that depends on another filing (e.g., where other forms are attached).

[2559] IRM 20.1.1.3.3.2.1(16) (03-29-23). As a general matter, the IRS Chief Counsel's Office recommends that an FTA waiver be considered before assessment of failure-to-deposit penalties. CCA 201414017. If it is determined that a penalty was asserted in error, the IRS will take corrective action to reverse the penalty. IRM 20.1.1.3(1) (10-19-20). *See* IRM 20.1.1.3.4 (08-05-14).

[2560] IRM 20.1.1.3.3.2.1(12) (03-29-23).

[2561] NTA Blog: *The Systemic First Time Abatement Policy Currently Under Consideration by IRS Would Override Reasonable Cause Relief and Jeopardize Fundamental Taxpayer Rights* (Aug. 29, 2018). *See Kopstad v. Commissioner*, T.C. Memo 2018-139.

[2562] IRM 20.1.1.3.3.2.1(10) (03-29-23).

[2563] IRM 20.1.1.3.3.2.1(7) (03-29-23).

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XII. Assessment and Collection

A. In General

1. Limitations on Assessment

a. In General

Civil tax penalties imposed under Chapter 68 of the Code (§6651–§6751) are due and payable upon notice and demand from the IRS, and are generally assessed, collected, and paid in the same manner as taxes.[2564] The notice of penalty, however, must include the name of the penalty, the Code section under which it is imposed, and a computation of the penalty.[2565]

Under §6751(b) and Reg. §301.6751(b)-1,[2566] a penalty[2567] is not valid unless the initial determination of the assessment is personally approved in writing[2568] by the immediate supervisor[2569] of the the individual who first proposed the penalty (i.e., the individual making the determination)[2570] or such higher level official[2571] as the IRS may determine.[2572] Reg. §301.6751(b)-1, discussed in XII.A.1.b., below, provides standards for applying the supervisory approval requirement.

Supervisory approval is not required for any penalty under §6651, §6654, §6655, or §6662 (only for additions by reason of §6662(b)(9) or §6662(b)(10)), or a penalty that is automatically calculated through electronic means, as discussed further in XII.A.1.d., below.[2573] Additionally, §6673 penalties have been excluded from the supervisory approval requirement.[2574]

Assuming the procedural requirements are met, the IRS can collect by levy any tax or penalty due if the taxpayer fails to make prompt payment.[2575] Alternatively, the IRS may choose to pursue collection of any tax or penalty through the filing of a suit in a federal district court.[2576]

The type of penalty determines the method for assessment. It also affects the means and timing of any appeal.[2577]

Generally, restitution in a criminal tax case does not preclude the IRS from assessing tax, interest, and penalties for the same acts or omissions.[2578] However, in certain cases, the terms of the taxpayer's plea agreement with the government in the criminal case may impact the tax liability.[2579]

b. Initial Penalty Determination and Timing

Under the §6751(b) regulations, if a penalty was included in a pre-assessment notice that is subject to Tax Court review, then supervisory approval of the penalty must be obtained on or before the date the notice is mailed.[2580] If the penalty was raised by the IRS in an answer, amended answer, or amendment to the answer to a Tax Court petition, then supervisory approval must be obtained no later than the date the IRS requests the court to determine the penalty.[2581] If the penalty was assessed without prior opportunity for review by the Tax Court, then supervisory approval must be obtained before the penalty is assessed.[2582]

The regulations provide examples illustrating the operation of the rules.[2583]

Example 1 — Penalty Assessed in Cover Memo to Appeals: In the course of an audit regarding a penalty not sub-

[2564] §6665(a), §6671(a). As with taxpayer-related deadlines, in determining whether the IRS assessed, gave notice or demand for payment of, or administratively or judicially sought to collect a tax, penalty, additional amount, or addition to tax in a timely manner, the deadline for performing these actions may be postponed in instances in which the taxpayer is serving in, or in support of, the U.S. Armed Forces in an area designated as a combat zone or qualifying deployment in a contingency operation, or the taxpayer is affected by a federally declared disaster, significant fire, or terroristic or military action. §7508(a); §7508A(a); Reg. §301.7508-1, §301.7508A-1. See Tables, Charts & Lists, *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions*, for an updated list of acts whose deadlines may be postponed.

[2565] §6751(a). Where the IRS uses boilerplate accuracy penalty language, the Tax Court has interpreted this to "assert all of the specified grounds as alternative bases for the penalty, unless other portions of the communication explicitly limit the penalty determination to a subset of those grounds." The Tax Court has declined to review extrinsic evidence in this determination. *Oropeza v. Commissioner*, 155 T.C. 132 (2020) (citing *Estate of Ronning v. Commissioner*, T.C. Memo 2019-38, and *Ocampo v. Commissioner*, T.C. Memo 2015-150).

[2566] Reg. §301.6751(b)-1, T.D. 10017, 89 Fed. Reg. 104,419 (Dec. 23, 2024). Reg. §301.6751(b)-1(f) applies to penalties assessed on or after December 23, 2024. Reg. §301.6751(b)-1(f).

[2567] See Reg. §301.6751(b)-1(a)(3)(i) for the definition of "penalty."

[2568] See Reg. §301.6751(b)-1(a)(3)(v) for the definition of "personally approved in writing."

[2569] The term "immediate supervisor" means any individual with responsibility to review another individual's proposal of penalties, without the proposal being subject to an intermediary's approval. Reg. §301.6751(b)-1(a)(3)(iii). The immediate supervisor definition under the final regulations changed the proposed regulations definition by substituting "responsibility to approve" with "responsibility to review." *Cf.* Prop. Reg. §301.6751(b)-1(a)(3)(iii).

[2570] See Reg. §301.6751(b)-1(a)(3)(ii) for the definition of "individual who first proposed the penalty."

[2571] See Reg. §301.6751(b)-1(a)(3)(iv), §301.6751(b)-1(a)(4) (definitions of "higher level official").

[2572] *See* IRM 20.1.1.2.3 (10-19-20) *et seq.*

[2573] §6751(b)(2), Reg. §301.6751(b)-1(a)(2). The IRS takes the position that the exception for §6651 penalties does not apply to the §6651(f) penalty for a fraudulent failure to file, i.e., supervisory approval is needed. IRM 20.1.1.2.3(4) (10-19-20), IRM 4.24.25.5.14(3) (11-23-21).

[2574] Reg. §301.6751(b)-1(a)(2)(i). For discussion of the §6673 exception to §6751(b)(1), see XII.A.1.e., below.

[2575] §6331.

[2576] §7403. For detailed discussion of collection procedures, see 637 T.M., *Federal Tax Collection Procedure — Liens, Levies, Suits, and Third-Party Liability*.

[2577] For a discussion of assessment, see 638 T.M., *Federal Tax Collection Procedure — Defensive Measures*. For a further discussion of appeals, see 623 T.M., *IRS Procedures: Examinations and Appeals. See also* 1660, *Collection Appeal Rights*, 594, *The IRS Collection Process*.

[2578] *See, e.g.*, *Helvering v. Mitchell*, 303 U.S. 391 (1938); *Morse v. Commissioner*, 419 F.3d 829 (8th Cir. 2005); *Cantrell v. Commissioner*, T.C. Memo 2017-170. For a discussion of restitution, see 638 T.M., *Federal Tax Collection Procedure — Defensive Measures*, and 636 T.M., *Tax Crimes*.

[2579] *See, e.g.*, *Creel v. United States*, 419 F.3d 1135 (11th Cir. 2005) (IRS cannot pursue civil penalties where government, as part of criminal proceedings, included taxpayer's tax, interest and penalties as part of restitution order, and following payment, U.S. attorney released tax lien). In CC-2007-008 (Feb. 27, 2007), the Chief Counsel's Office indicated that it believes that the Eleventh Circuit misconstrued the facts in *Creel* in concluding that civil liability was compromised by satisfaction of a criminal restitution obligation and that, in future cases arising in the Eleventh Circuit, the IRS would seek to distinguish *Creel* on its facts. In addition, in other circuits, the IRS would argue that the case was wrongly decided.

[2580] Reg. §301.6751(b)-1(c).

[2581] Reg. §301.6751(b)-1(d).

[2582] Reg. §301.6751(b)-1(b).

[2583] *See* Reg. §301.6751(b)-1(e)(1)–Reg. §301.6751(b)-1(e)(6).

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ject to preassessment review in the Tax Court, Revenue Agent A concludes that a taxpayer should be subject to the penalty under §6707A for failure to disclose a reportable transaction. Revenue Agent A sends the taxpayer a letter giving the taxpayer the option to agree to the penalty; submit additional information to A about why the penalty should not apply; or request within 30 days that the matter be sent to the Independent Office of Appeals (Appeals) for consideration. After the taxpayer requests that Appeals consider the case, A prepares the file for transmission, and B (who is A's immediate supervisor) signs a cover memorandum informing Appeals of the proposed penalty and asks Appeals to consider it. The Appeals Officer upholds the penalty, and it is assessed. The requirements of §6751(b)(1) are satisfied because B's signature on the cover memorandum is B's personal written assent to the penalty proposed by A and was given before the penalty was assessed.[2584]

Example 2 — Penalty Assessed in Audit Report: In the course of an audit, Revenue Agent A concludes that a taxpayer should be subject to an accuracy-related penalty for substantial understatement of income tax under §6662(b)(2). Revenue Agent A sends the taxpayer a Letter 915, Examination Report Transmittal, along with an examination report that includes the penalty. The Letter 915 gives the taxpayer the option to agree to the examination report; provide additional information to be considered; discuss the report with A or B (who is A's immediate supervisor); or request a conference with an Appeals Officer. The taxpayer agrees to assessment of the penalty and signs the examination report to consent to the immediate assessment and collection of the amounts shown on the report. B provides written supervisory approval of the penalty after the taxpayer signs the examination report, but before the penalty is assessed. Reg. §301.6751(b)-1(b) applies because T's agreement to assessment of the penalty excepts it from pre-assessment review in the Tax Court. Because B provided written supervisory approval before assessment of the penalty, the requirements of §6751(b)(1) are satisfied.[2585]

Example 3 — Penalty Assessed in Notice of Proposed Adjustment: In the course of an audit of Taxpayer T by a team of revenue agents, Revenue Agent A concludes that a taxpayer should be subject to an accuracy-related penalty for negligence under §6662(b)(1) and §6662(c). Supervisor B is the issue manager and is assigned the duty to review the Notice of Proposed Adjustment for any penalty A would propose. Revenue Agent A reports to B, but B is not responsible for the overall management of the audit of the taxpayer. C is the case manager of the team auditing the taxpayer and is responsible for the overall management of the audit of. C may assign tasks to A and other team members, and has responsibility for approving any examination report presented to the taxpayer:

(i) Alternative Outcome 1: Only B approves the penalty in writing before the mailing to T of a notice of deficiency that includes the penalty. Under Reg. §301.6751(b)-1(a)(3)(iii), B qualifies as the immediate supervisor of A with respect to A's penalty proposal, and the requirements of §6751(b)(1) are met.

(ii) Alternative Outcome 2: Only C approves the penalty in writing before the mailing to T of a notice of deficiency that includes the penalty. Because C has responsibility to approve A's proposal of the penalty as part of approving the examination report, C qualifies as a higher level official designated under Reg. §301.6751(b)-1(a)(4) to approve the penalty proposed by A, and the requirements of §6751(b)(1) are met.[2586]

Example 4 — Penalty Assessed in Answer: In the course of an audit, Revenue Agent A concludes that a taxpayer should be subject to a penalty for negligence under §6662(c). Revenue Agent A recommends the penalty to her immediate supervisor B, who thinks more factual development is needed to support the penalty but must close the audit immediately due to the limitations period on assessment expiring soon. The IRS issues a statutory notice of deficiency without the penalty, and the taxpayer files a petition in the Tax Court. In reviewing the case file and conducting discovery, IRS Chief Counsel Attorney C concludes that the facts support imposing a negligence penalty under §6662(c). Attorney C proposes to her immediate supervisor, D, that the penalty should apply and should be raised in an Answer pursuant to §6214(a). D agrees and signs the Answer that includes the penalty before it is filed. The §6662(c) penalty at issue is subject to pre-assessment review in the Tax Court and was raised in the Tax Court after a petition was filed under Reg. §301.6751(b)-1(d). Therefore, written supervisory approval under Reg. §301.6751(b)-1(d) was required prior to filing the written pleading that includes the penalty. Attorney C is the individual who first proposed the penalty for purposes of §6751(b)(1), Reg. §301.6751(b)-1(d), and Reg. §301.6751(b)-1(a)(3)(ii), and she secured timely written supervisory approval from D, the immediate supervisor, as defined in Reg. §301.6751(b)-1(a)(3)(iii). As a result, the requirements of §6751(b)(1) are met. Revenue Agent A did not make the initial determination of the penalty assessment because any assessment would not be attributable to A's proposal but would be based on the independent proposal of Attorney C raised pursuant to §6214(a).[2587]

Example 5 — Penalty Assessed in Report to Taxpayer: In the course of an audit, Revenue Agent A concludes that a taxpayer is subject to a penalty for negligence under §6662(c). Revenue Agent A includes the penalty in a draft

[2584] Reg. §301.6751(b)-1(e)(1).
[2585] Reg. §301.6751(b)-1(e)(2).
[2586] Reg. §301.6751(b)-1(e)(3).
[2587] Reg. §301.6751(b)-1(e)(4).

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report that she sends for review to her immediate supervisor B. B reviews A's recommendation and notices that A did not consider whether a penalty for a substantial understatement of income tax under §6662(d) should apply in the alternative. B sends an email to A telling her to add a §6662(d) penalty "if the math checks out." Revenue Agent A reviews the facts, determines that the imposition of the §6662(d) penalty is warranted, and adds the penalty to a report she issues to the taxpayer. Revenue Agent A is the individual who first proposed both of the penalties for purposes of §6751(b)(1), Reg. §301.6751(b)-1(d) and Reg. §301.6751(b)-1(a)(3)(iii) because she is the individual who first proposed the penalty to the taxpayer. Supervisor B did not make the initial determination of the §6662(d) penalty because, even though she first thought of and suggested it, she did not propose it to the taxpayer or her supervisor (or designated higher level official).[2588]

Example 6 — Penalty Proposed in CP2000 Notice: The IRS's Automated Underreporter (AUR) program detects a discrepancy between the information received from a third party and the information contained on a taxpayer's return, and AUR automatically generates a CP2000, *Notice of Underreported Income*, that includes an adjustment based on the unreported income and a proposed penalty under §6662(d) that is mailed to T. The CP2000 gives the taxpayer 30 days to respond to contest the proposed adjustments and the penalty. The taxpayer submits a response to the CP2000, asking only for more time to respond. More time is granted but no further response is received from the taxpayer, and a statutory notice of deficiency that includes the adjustments and the penalty is automatically generated and issued to the taxpayer. The §6662(d) penalty at issue is automatically calculated through electronic means under paragraphs Reg. §301.6751(b)-1(a)(2)(ii) and Reg. §301.6751(b)-1(a)(3)(vi). The penalty was proposed by the AUR computer program, which generated a notice to the taxpayer that proposed the penalty. Although the taxpayer submitted a response to the CP2000, the response did not challenge the proposed penalty, or the amount of tax to which the proposed penalty is attributable. Therefore, the penalty was automatically calculated through electronic means, and written supervisory approval was not required.[2589]

For further discussion of the §6751(b) regulations, see the Worksheets, below. The following discussion provides the varying approaches the IRS and the courts have taken in applying §6751(b).

(1) Timing Issues

When must the penalty approval occur? As discussed further below, the courts have not been in uniform agreement on the timing issue. Thus, taxpayers and their counsel should be extremely cognizant of when a penalty is first communicated with respect to an assessment and should seek any and all relevant documents that purport to contain the written assertion of the penalty and the written supervisory approval.[2590]

Taxes and penalties are imposed by the Code and can be assessed. One can determine whether the tax was computed correctly, and if not, whether to make an assessment. But assessments are not determined, and there cannot be an initial determination of an assessment. An assessment is essentially a bookkeeping entry, i.e., it merely refers to the formal recording of the taxpayer's liability on the IRS's records. It is akin to recording a judgment, which empowers the IRS to use administrative tools to start collection.[2591]

The first case to consider the issue was *Graev v. Commissioner*.[2592] The taxpayer claimed a charitable contribution deduction for a facade easement. The IRS revenue agent determined to disallow the deduction and impose a 40% gross valuation misstatement penalty under §6662(h), which was approved in writing by his immediate supervisor. The revenue agent prepared a draft of notice of deficiency that included the 40% penalty. The IRS Chief Counsel attorney who reviewed the notice through a memorandum that was approved by his supervisor, advised that a 20% substantial valuation misstatement under §6662(e) should be added to the notice of deficiency as an alternative. The notice of deficiency was revised to include both penalties and was issued without any further approval by the revenue agent's supervisor. Subsequently, the IRS dropped its assertion of the 40% penalty, and the Tax Court disallowed the deduction.[2593] The taxpayer challenged the 20% penalty on the grounds that the IRS revenue agent did not obtain supervisory approval to assess the 20% penalty.

In a strongly contested, reviewed decision,[2594] the Tax Court initially held that any argument that the IRS failed to comply with the supervisor approval requirement was premature. Section 6751(b) only requires supervisor approval before assessment. Before a deficiency can be assessed, the IRS must first determine a deficiency and issue a notice of deficiency announcing its intention to assess that deficiency.[2595] In the case at bar, as the taxpayer timely petitioned the Tax Court, assessment of the penalty could not occur until after the Tax Court decision became final and nonappealable.[2596] Accordingly, since the Tax Court had not yet decided whether the imposition of the penalty was proper, the court held that the challenge under §6751(b) was not ripe for review. The majority flatly rejected the taxpayer's argument that supervisor approval had to be obtained at the time of the initial determination by the revenue agent. The majority also declined to hold the IRS to its stated administrative practice — that the supervisor's ap-

[2588] Reg. §301.6751(b)-1(e)(5).

[2589] Reg. §301.6751(b)-1(e)(6).

[2590] *See, e.g.*, *Lakepoint Land II, LLC v. Commissioner*, T.C. Memo 2023-111, in which the Tax Court reversed an order granting summary judgment to the government on the issue of the timing of the §6751(b) supervisory approval after learning that the revenue agent's "lead sheet" that first proposed penalties before the assessment date later had been backdated by her supervisor after the assessment date.

[2591] §6203; *Baltic v. Commissioner*, 129 T.C. 178 (2007); *Liang v. United States*, 423 U.S. 161 (1976).

[2592] 147 T.C. 460 (2016) (*Graev II*).

[2593] 140 T.C. 377 (2013) (*Graev I*).

[2594] *Graev II* was reviewed by the entire Tax Court and decided by a 9-5 majority. Three judges concurred with the majority, but did not address the statutory construction issue.

[2595] §6201(a), §6212(a).

[2596] §6213(a), §6665(a), §7485.

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proval had to be noted on the form reflecting the agent's assertion of the penalty — as reflected in the then applicable Internal Revenue Manual provision,[2597] because the manual did not have the force or effect of law. The court also found support for its holding in the effective date provision for §6751(b), which applied to notices issued and penalties assessed after December 31, 2000, concluding that the statute focused on the time of assessment regardless of when the initial determination was made.

However, in *Chai v. Commissioner*,[2598] the Second Circuit rejected the Tax Court opinion, adopting and extending the reasoning of the *Graev II* dissent. In Chai, during the Tax Court proceeding, the IRS asserted an additional deficiency and a penalty by amended answer, which was not approved by a supervisor. Whereas the Tax Court believed the statutory language of §6751(b) was clear, the Second Circuit found the phrase "initial determination of such assessment" to be ambiguous. Therefore, the Second Circuit looked for guidance to the legislative history, which explained that the provision was added to prevent the IRS from improperly imposing a penalty as a bargaining chip to improve settlements.[2599] Accordingly, the Second Circuit reasoned that if supervisory approval was required, such approval must be meaningful — i.e., it must be obtained while the supervisor has the discretion to give or withhold such approval. This could only occur at or before the time when the notice of deficiency was issued, or in the case of a new claim, at the time of the answer or amended answer. Once the notice of deficiency is issued, the IRS had no further discretion. If the taxpayer failed to timely file a petition to the Tax Court, the deficiency had to be assessed.[2600] If the taxpayer timely filed a petition, the deficiency was assessed after the Tax Court decision became final and binding.[2601] The court also found this to be consistent with the meaning of the word "initial" and the position taken by the IRS itself in the IRM.

On rehearing, the Tax Court followed the Second Circuit in Chai and withdrew its conflicting decision in *Graev II*, which was appealable to the Second Circuit.[2602] In reaching its conclusion, the Tax Court rejected the taxpayer's argument that an initial determination could not be made by a Chief Counsel attorney who reviewed the proposed notice of deficiency. Subsequently, the Tax Court continued to follow Chai, even in cases appealable to other circuits.[2603]

Comment: In a concurring opinion in *Graev III*, Tax Court Judge Holmes raised some significant questions relating to the application of *Chai*.[2604] Some have been answered in the cases described herein. Others still await answers. Additionally, other questions may arise:

- What is the "initial determination" of a penalty? Can there be more than one initial determination? For example, what happens if the revenue agent raises a penalty, but his supervisor disagrees? If a revenue agent who determined a penalty retires before submitting it for approval, can the successor revenue agent assert the same penalty with his supervisor's approval?

- What does *Chai* mean that compliance with §6751(b) is part of the IRS's "burden of production *and proof*" (emphasis added) in a deficiency case in which a penalty is asserted? Section 7491(c) deals only with the burden of production — which party bears the obligation to come forward with evidence. Burden of proof, on the other hand, describes which party loses if the evidence is balanced.

Comment: To Judge Holmes, placing the burden of proof on the IRS was untenable. For example, the IRS should not be required to prove that the taxpayer did not have reasonable cause. It appears Judge Holmes was correct and the Second Circuit was just sloppy in its choice of language:

- Was Congress really focused on the 3% of proposed assessment cases that end up in Tax Court when it enacted §6751? Judge Holmes did not think so. Rather, he would apply §6751(b) to penalties determined and assessed by the IRS without Tax Court review, and would apply the more specific rules of §6214 and §6673 to the penalties determined by the Tax Court, which are assessed under §6215.

- Which penalties have to be separately asserted and approved? For example, does the negligence penalty include the penalty for intentional disregard of rules and regulations since both are imposed by §6662(b)(1)? Does a determination of a 40% gross valuation misstatement penalty under §6662(h)(1) (which applies where the claimed value is at least four times the actual value) include a determination of a 20% substantial valuation misstatement penalty under §6662(b)(3) and §6662(e) (which applies where the claimed value is at least twice the actual value), since the requirements by definition are also met?[2605]

In subsequent decisions, some (but not all) courts have held that the supervisor must approve the penalty no later than the earlier of a notice of deficiency or other formal communication sent to the taxpayer that advises penalties were deter-

[2597] Former IRM 20.1.5.6(4) (7-1-08).

[2598] 851 F.3d 190 (2d Cir. 2017), aff'g in part, rev'g in part T.C. Memo 2015-42.

[2599] S. Rep. No. 105-174, at 65 (1998).

[2600] §6213(c).

[2601] §6213(a). There were exceptions for mathematical or clerical errors, termination assessments and jeopardy assessments. §6213(b).

[2602] 149 T.C. 485 (2017) (*Graev III*). Because *Graev III* was appealable to the Second Circuit, the Tax Court was bound to follow *Chai*. *Golsen v. Commissioner*, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971).

[2603] *See, e.g.*, *Becnel v. Commissioner* , T.C. Memo 2018-120; *Ayissi-Etoh v. Commissioner*, T.C. Memo 2018-107; *Azam v. Commissioner*, T.C. Memo 2018-72; *Povolny Grp., Inc. v. Commissioner*, T.C. Memo 2018-37; *Platts v. Commissioner*, T.C. Memo 2018-31; *Ford v. Commissioner*, T.C. Memo 2018-8.

[2604] *Graev v. Commissioner*, 149 T.C. 485 (2017).

[2605] *See Oropeza v. Commissioner*, 155 T.C. 132 (2020) (§6662(i) steps up rate of §6662(b)(6) penalty; where §6662(b)(6) did not have timely supervisor approval, a stepped up rate cannot apply); *Palmolive Bldg. Investors, LLC v. Commissioner*, 152 T.C. 75 (2019) (§6662(a) and §6662(h) are distinct penalties and require separate supervisory approvals). *See also McCarthy v. Commissioner*, T.C. Memo 2020-74; *Campbell v. Commissioner*, T.C. Memo 2020-41 and *Rogers v. Commissioner*, T.C. Memo 2019-61 (all following *Palmolive*).

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mined and provides an opportunity to appeal.[2606] At that time, the penalty issue is officially on the table.[2607]

However, in *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*,[2608] the Ninth Circuit, reversing and remanding to the Tax Court for further proceedings, held that the penalty for failure to include reportable transaction information (§6707A) can be approved by a supervisor anytime before assessment. Before obtaining supervisory approval, the revenue agent had sent the taxpayer a letter stating that the IRS would impose the penalty unless the taxpayer appealed within 30 days. Thus, the letter included threatening language that overstated the IRS's position. The taxpayer appealed, and before the revenue agent transferred the case to Appeals, the supervisor approved the proposed penalty. The Tax Court had ruled that §6751(b) requires supervisory approval before the IRS formally communicates a proposed penalty to a taxpayer.

The Ninth Circuit reversed, holding that §6751(b) requires written supervisory approval before assessment of the penalty or, if earlier, before the relevant supervisor loses discretion as to whether to approve the penalty assessment. In this case, the Ninth Circuit concluded that a 30-day IRS letter in which the taxpayer was threatened with a §6707A penalty was not an "initial determination" that required supervisory approval. The court reasoned that §6751(b) does not contain an express requirement that the written approval be obtained at any particular time before assessment. It pointed out that the statute does not make any reference to the communication of a proposed penalty to the taxpayer, much less a "formal" communication.

The Eleventh Circuit in *Kroner v. Commissioner*[2609] agreed with the Ninth Circuit in *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*, holding that §6751(b) is satisfied so long as written supervisor approval of the initial determination of a penalty assessment is obtained before that penalty is assessed. The Eleventh Circuit rejected the Tax Court's interpretation that §6751(b) requires supervisor approval before any penalty is communicated to the taxpayer. The Eleventh Circuit highlighted that §6751(b) specifically refers to an "assessment" (a formal recording of an obligation on the IRS's books) and not just a "communication" when requiring prior approval from a supervisor. Furthermore, the court's understanding of §6751(b) supports the statute's purpose: (1) to avoid inappropriate penalties from being used as bargaining chips and (2) to ensure appropriate penalties are assessed and collected.[2610] Likewise, the Tenth Circuit held that the approval requirement under §6751(b)(1) is met as long as written supervisory approval of an initial determination of an assessment is obtained on or before the date the IRS issues a notice of deficiency.[2611]

Kraske v. Commissioner[2612] further highlighted the tension between the Tax Court and the U.S. courts of appeal — as well as the potential for inconsistent tax treatment among the U.S. courts of appeal — due to the Tax Court's deference.[2613] The Tax Court noted that the supervisory approval deadline under §6751(b) is before the assessment of the penalty or, if earlier, before the relevant supervisor loses discretion whether to approve the penalty assessment, deferring to the Ninth Circuit Court of Appeals' precedent[2614] because an appeal would lie with that court.[2615] Citing *Lardas v. Commissioner*,[2616] the Tax Court cautioned that as a court of national jurisdiction, it "should be careful to apply the *Golsen* doctrine of deference only under circumstances where the holding of the Court of Appeals is squarely on point," and then found *Laidlaw's* was squarely on point.[2617] Because Ninth Circuit precedent requires written supervisory approval before the supervisor loses discretion to approve the penalty assessment, and in this case super-

[2606] *Beland v. Commissioner*, 156 T.C. 80 (2021) (Form 4549 presented at closing conference constituted initial determination where meeting was formal and revenue agent stated failing to sign would cause IRS to issue notice of deficiency; initial determination communication not limited to mail); *Clay v. Commissioner*, 152 T.C. 223 (2019), aff'd, 990 F.3d 1296 (11th Cir. 2021), cert. denied, No. 21-237, 142 S.Ct. 342 (U.S. 2021) (revenue agent report sent with 30-day letter was initial determination; supervisor approval occurred after). *See Sugarloaf Fund, LLC v. Commissioner*, T.C. Memo 2018-181, aff'd, 953 F.3d 439 (7th Cir. 2020); *Roth v. Commissioner*, 922 F.3d 1126 (10th Cir. 2019) (§6751(b) does not restrict meaning of initial determination; not limited to notice of deficiency), aff'g T.C. Memo 2017-248; *Chadwick v. Commissioner*, 154 T.C. 84 (2020) (initial determination of §6672 penalty was in Letter 1153; supervisor approval timely obtained on Form 4183 electronically signed before Letter 1153 was mailed); *Excelsior Aggregates, LLC v. Commissioner*, T.C. Memo 2021-125 (faxed IRS agenda was not initial determination as it did not clearly inform taxpayer that IRS completed its examination and was asserting determinable penalties, rather agenda highlighted IRS's "current findings" which were subject to change pending completion of examination); *Estate of Morgan v. Commissioner*, T.C. Memo 2021-104 (although Form 4549-A was produced before supervisory approval was secured, Form 4549-A was not mailed to taxpayers until after penalty was approved; approval was timely under §6751(b)); *Kroner v. Commissioner*, T.C. Memo 2020-73 (Letter 915 was first formal communication advising taxpayer of proposed penalties and provided opportunity to file protest with Appeals Office); *Endeavor Partners Fund, LLC v. Commissioner*, T.C. Memo 2018-96 (cannot cure failure to obtain supervisor approval by reasserting penalty in amended pleading approved by supervisor), aff'd on other grounds, 943 F.3d 464 (D.C. Cir. 2019).

[2607] *Palmolive Bldg. Invs., LLC v. Commissioner*, 152 T.C. 75 (2019).

[2608] 29 F.4th 1066 (9th Cir. 2022).

[2609] 48 F.4th 1272 (11th Cir. 2022).

[2610] The Eleventh Circuit disagreed with the taxpayer's and by extension the Tax Court's reliance on *Chai v. Commissioner*, 851 F.3d 190, 218–20 (2d Cir. 2017), which required supervisor approval by the date the IRS issued a notice of deficiency, based on the interpretation that §6751(b)'s purpose is only to prevent penalties from being used as bargaining chips during negotiations.

[2611] *See Minemyer v. Commissioner*, No. 21-9006, 2023 BL 16752 (10th Cir. Jan. 19, 2023) (supervisory approval not required before proposed penalties communicated to taxpayer).

[2612] 161 T.C. No. 7 (2023).

[2613] The taxpayer challenged a §6662 penalty assessment on the basis that Letter 692 (15-day letter) was issued on June 2, 2014, but supervisory approval was not granted until July 21, 2014. Under the Tax Court's standard, supervisory approval would appear to be beyond the cutoff. However, under the Ninth Circuit's precedent, supervisory approval was timely because it was granted before the case was transferred to Appeals, i.e., before the supervisor lost discretion to approve the penalty assessment. Because the taxpayer did not raise reasonable cause and good faith as affirmative defenses, the court deemed them to be waived and entered its decision against the taxpayer.

[2614] *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*, 29 F.4th 1066 (9th Cir. 2022).

[2615] *Kraske v. Commissioner*, 161 T.C. No. 7 (2023) (citing *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970) ("better judicial administration … requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone"), aff'd, 445 F.2d 985 (10th Cir. 1971)).

[2616] 99 T.C. 490 (1992).

[2617] Referring to *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*, 29 F.4th 1066 (9th Cir. 2022), the Tax Court reasoned that, "[b]y its terms, the holding is not confined to assessable penalties, and the Ninth Circuit's discussion makes clear that it had in mind penalties subject to deficiency procedures when it added the qualifier that a supervisor must have had discretion to approve when acting to do so. Thus, nothing in the Ninth Circuit's holding or analysis suggests that it might think a timing rule different from its 'retention of discretion' rule would apply in the case of penalties subject to deficiency procedures."

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visor approval occurred before the transfer to Appeals, the Tax Court upheld penalties against the taxpayer.[2618]

Furthermore, the Tax Court has ruled that where the penalty approval forms include the supervisor's signature and a signature date indicating timely supervisory approval, the absence of a digital time stamp on the forms or metadata authenticating when the approval forms were transmitted, doesn't raise a factual issue as to whether supervisory approval was timely. Absent clear evidence to the contrary, the Tax Court presumes that public officials properly discharge their official duties.[2619]

Can different penalties can be asserted at different times by different individuals, including by the Chief Counsel in an answer? Section 6751(b) requires only that the initial determination of each penalty be approved by the immediate supervisor of the individual making the determination.[2620] In *Oropeza v. Commissioner*,[2621] the Tax Court determined that where a penalty steps up a lower penalty amount (§6662(i) steps up penalty rate of §6662(b)(6)) the penalties are not distinct, thus timely supervisor approval cannot occur for the stepped up penalty where the lower penalty was not timely approved.

(2) Type of Form and Review Required for Supervisory Approval

What type of review must the IRS perform? The IRS is not required to show the depth or comprehensiveness of the review.[2622] In addition, the hearing officer is not required to analyze the thought process of the supervisor.[2623] However, the hearing officer must confirm that the §6751(b) requirements were met and a failure to do so is considered an abuse of discretion.[2624]

There is no particular form required for supervisor approval.[2625] A handwritten or digital signature for supervisory approval is sufficient,[2626] as is a rubber stamp signature.[2627] A note or e-mail written by the immediate supervisor also may be sufficient.[2628] An acting manager with approved designation to act is considered an immediate supervisor for this purpose.[2629]

The IRS has provided guidance regarding the documentation of penalty determinations as follows:[2630]

- The employee initially proposing the penalty should indicate the name of the penalty, the Code section, and the amount of the penalty on the examination report. The penalty computation should also be documented in the case file.
- Written supervisory approval must cover all tax years and penalties in the statutory notice of deficiency, including alternative penalties.
- On correspondence examination automation support (CEAS) cases, the supervisor will indicate their approval by leaving a CEAS nonaction note specifically stating which penalty is approved. In a deficiency case, the CEAS nonaction note must be input before issuing any written communication of penalties that offers the taxpayer an opportunity to sign an agreement, or consent to assessment or proposal of the penalty.
- Supervisory approval may be documented in the form of an e-mail, memo to file, or on a penalty approval form (e.g., Lead Sheet 300, Civil Penalty Approval Form, SAIN 011 Lead Sheet, Form 4700, signed comment on Form 5464, Form 8278, Form 5701).
- For SB/SE field and office examination cases, written supervisory approval and nonassertions should be documented on the 300 — Civil Penalty Approval Form lead sheet.
- For LB&I cases, supervisory approval and nonassertions should be documented on the penalty lead sheets. The LB&I information management system (IMS) provides lead sheets based on the standard audit index number (SAIN) entry for the penalty issue. SAIN 011 is used to approve penalties in LB&I. IMS generated forms may apply the ink signatures.
- For W&I and SB/SE campus cases, written supervisory approval is required if the taxpayer challenges the penalty

[2618] *Kraske v. Commissioner*, 161 T.C. No. 7 (2023).

[2619] *Rock Cliff Rsrv., LLC v. Commissioner*, No. 12472-20, 2023 BL 233540 (T.C. July 10, 2023).

[2620] *Palmolive Bldg. Invs., LLC v. Commissioner*, 152 T.C. 75 (2019); *Roth v. Commissioner*, 922 F.3d 1126 (10th Cir. 2019), aff'g T.C. Memo 2017-248; *Koh v. Commissioner*, T.C. Memo 2020-77 (Chief Counsel has authority to make initial determination in answer). *See Excelsior Aggregates, LLC v. Commissioner*, T.C. Memo 2021-125 (IRS's assertion of valuation misstatement penalties against appraiser was not initial determination for same penalties against taxpayer for relying on appraisal; §6751(b) requirement applies to each taxpayer separately and such requirement must be met for each applicable penalty asserted).

[2621] 155 T.C. 132 (2020) (§6662(i) is akin to aggravating factor in criminal law and is not separate offense).

[2622] *Belair Woods, LLC v. Commissioner*, 154 T.C. 1 (2020). *See Oropeza v. Commissioner*, T.C. Memo 2020-111; *McNely v. Commissioner*, T.C. Memo 2019-39; *Brown v. Commissioner*, T.C. Memo 2019-30, aff'd, No. 19-12653, 806 Fed. App'x 842 (11th Cir. 2020); *Dasent v. Commissioner*, T.C. Memo 2018-202; *Giunta v. Commissioner*, T.C. Memo 2018-180; *Berry v. Commissioner*, T.C. Memo 2018-143; *Raifman v. Commissioner*, T.C. Memo 2018-101.

[2623] *Blackburn v. Commissioner*, 150 T.C. 218 (2018).

[2624] *See, e.g., ATL & Sons Holdings, Inc. v. Commissioner*, 152 T.C. 138 (2019); *Rosendale v. Commissioner*, T.C. Memo 2018-99.

[2625] *See Palmolive Bldg. Investors, LLC v. Commissioner*, 152 T.C. 75 (2019) (Form 5701 and Form 5402-C satisfy §6751 requirements). Note that in this case, although penalties were asserted at different times during the partnership audit process, they had supervisory approval before the 30-day letter and 60-day letter were issued to the taxpayer. *See also Oropeza v. Commissioner*, T.C. Memo 2020-111 (Civil Penalty Approval Form satisfied requirement even though signature was on first page and penalty was listed on second page; citing *Frost v. Commissioner*, 154 T.C. 23 (2020); *Sellers v. Commissioner*, T.C. Memo. 2020-84; *Novoselsky v. Commissioner*, T.C. Memo. 2020-68). *Cf. McCarthy v. Commissioner*, T.C. Memo 2020-74 (document IRS provided to Tax Court did not expressly show supervisor approval; document lacked sufficient detail, contained contradictory information, and lacked information on employees involved).

[2626] *PBBM-Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 2018); *Chadwick v. Commissioner*, 154 T.C. 84 (2020) (electronically signed approval was sufficient); *Mohamed v. Commissioner*, T.C. Summ. Op. 2017-69; IRM 20.1.5.2.3.1 (08-31-21) *et seq.*, IRM 20.1.1.2.3 (10-19-20); CC-2018-006.

[2627] *Deyo v. United States*, 296 Fed. App'x. 157 (2d Cir. 2008); CC-2018-006.

[2628] CC-2018-006. *See Cannon Corp. v. Commissioner*, No. 12466-16, 2020 BL 132666 (T.C. Apr. 2, 2020) (order) (where IRS claimed privilege, not clear whether blacked out email communications between manager and revenue agent regarding draft Form 886-A provided supervisory approval).

[2629] CC-2018-006; *Thompson v. Commissioner*, 155 T.C. 87 (2020) (acting immediate supervisor's signature satisfied supervisor approval requirements).

[2630] *See* IRM 20.1.5.2.3.1 (08-31-21), IRM 4.19.13.7 (04-06-22) *et seq.*, IRM 20.1.1.2.3 (10-19-20) *et seq.*, IRM 20.1.8.2 (08-12-24) (referencing Form 8278, *Assessment and Abatement of Miscellaneous Civil Penalties*).

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or the liability to which it relates. Written supervisory approval and nonassertions may be documented on Form 4700.

• For TE/GE, supervisory approval may be documented in the form of an e-mail, memo to file or signed comment on Form 5464, Case Chronology Record (CCR).

(3) Other Issues

The following cases and IRS guidance have also addressed other issues under §6751(b)(1), including who is an "immediate supervisor," which the Tax Court has held is the individual who directly supervises the examining agent's work in an examination.[2631]

Penalties requiring supervisory approval under §6751(b) must be approved by the immediate supervisor of the individual making the determination before issuing any written communication of penalties that offers a taxpayer an opportunity to sign an agreement, consent to assessment, or proposal of the penalty.[2632] Similarly, if a penalty assessed under §6751(b) or relevant IRS policy required written supervisory approval, then written supervisory approval is required for penalty abatement unless the abatement is purely computational.[2633] However, a taxpayer waives the §6751(b) supervisory approval requirement when consenting to the assessment of a penalty by signing a closing agreement.[2634]

In *Thompson v. Commissioner*[2635] the Tax Court rejected the taxpayers' argument to apply the rule of lenity to §6751(b). According to the Tax Court, ambiguity in the statute is not enough to trigger the rule of lenity. Here, as the court explained, it can apply logical conclusions to determine the meaning of the words in the statute and does not have to guess at Congress's intent.[2636]

Supervisory approval is not required for a tentative proposal, including a general penalty settlement offer for an abusive transaction.[2637] According to the Tax Court in Belair Woods, LLC v. Commissioner, an initial determination is more formal and definite.[2638] However, it is not necessary that the notification grant appeal rights in order to qualify as an initial determination.[2639] Furthermore, IRS public guidance advising taxpayers of the risk of penalty for certain transactions does not constitute "the first formal communication to the taxpayer of penalties."[2640] Although, an initial determination is made if the penalty is described in the examiner's report, even if it is posed as an alternative position, and therefore was not included in the computation of the taxpayer's liability.[2641]

The Eighth Circuit held in *Wells Fargo & Co. v. United States*,[2642] that §6751(b) does not apply to offset defenses in refund litigation because there is no assessment.

In *Grajales v. Commissioner*,[2643] the Tax Court held that for purposes of §6751(b), §72(t) is a tax, not a penalty, addition to tax, or additional amount, and, therefore, the supervisory approval requirements do not apply to §72(t). Citing *Nat'l Fed'n of Indep. Bus. v. Sebelius*,[2644] the Tax Court explained that "an exaction may be a 'tax' for one purpose and a 'penalty' for another purpose, depending on the context." The Second Circuit affirmed.[2645]

In *Chadwick v. Commissioner*,[2646] the Tax Court held that the §6751(b) supervisor approval requirements apply to the §6672 trust fund recovery penalty. Previously the Southern District of New York, in a case the Second Circuit declined to affirm on those grounds, held that §6672 is considered a shift-

[2631] *See Sand Investment Co., LLC v. Commissioner*, 157 T.C. No. 11 (Nov. 23, 2021), in which the revenue agent switched supervisors during the examination but was allowed to continue the exam under the original supervisor. Although the new supervisor signed the agent's timecards, the original manager and the agent signed off on penalties the day before sending to the taxpayer and the new manager signed the penalty form two days later. The taxpayer asserted that the new manager was the agent's supervisor and was required to sign the penalty approval form before the initial determination of the penalty was sent. The Tax Court held that, as the individual who oversaw the agent's work throughout the case, the original manager was the agent's "immediate supervisor," and because the original manager timely approved the agent's penalty determinations, the IRS satisfied the requirements of §6751(b)(1). The court observed that the person who actually supervises the agent's work during the examination — including "the development of all penalty issues" — is the person to whom Congress is most logically viewed as having entrusted this responsibility. *See Duffy v. Commissioner*, T.C. Memo Worksheets (IRS failed to prove that penalty approver was immediate supervisor of agent who made initial determination; approver was supervisor of some agents involved in audit, but not all).

[2632] IRM 20.1.1.2.3.1 (10-19-20); SBSE-04-1024-0053 (Oct. 22, 2024) (interim guidance for IRM 4.10.6).

[2633] SBSE-04-1024-0061 (Oct. 22, 2024) (interim guidance for IRM 4.10.6). Written supervisory approval should be obtained before the issuance of any report reflecting the penalty abatement.

[2634] *Rockafellor v. Commissioner*, T.C. Memo 2019-160; *McAvey v. Commissioner*, T.C. Memo 2018-142.

[2635] 155 T.C. 87 (2020).

[2636] *Thompson v. Commissioner*, 155 T.C. 87 (2020) (citing *Muscarello v. United States*, 524 U.S. 125 (1998), and *Rand v. Commissioner*, 141 T.C. 376 (2013)). For a discussion of the rule of lenity, see 100 T.M., *Legal Authorities in U.S. Federal Tax Matters — Research and Interpretation.*

[2637] *Thompson v. Commissioner*, 155 T.C. 87 (2020) (penalty settlement offer for abusive transaction based on IRS guidance, not completed audit; letter stated if offer was not accepted that IRS would continue audit and impose "applicable penalties" without stating specific penalties; no supervisor approval of penalties necessary at that point).

[2638] 154 T.C. 1 (2020) (60-day letter constituted initial determination; Letter 1807 inviting partners to conference to discuss proposed adjustments was not initial determination because penalty was tentative during fact-gathering process). *See Kestin v. Commissioner*, 153 T.C. 14 (2019) (Letter 3176C requesting taxpayer correct frivolous filing or face penalty was not initial determination); *Oxbow Bend, LLC v. Commissioner*, T.C. Memo 2022-23 (status call that mentioned possible penalties was not initial determination); *Tribune Media Co. v. Commissioner*, T.C. Memo 2020-2 ("determination is not a synonym for a mere suggestion, proposal, or initial informal mention of the possibility of the assertion of a penalty").

[2639] *Carter v. Commissioner*, T.C. Memo 2020-21 (Letter 5153 and RAR examination report were initial determinations; citing *Belair Woods, LLC v. Commissioner*, 154 T.C. 1 (2020) and *Rose v. Commissioner*, T.C. Memo 2019-73). *See Oropeza v. Commissioner*, 155 T.C. 132 (2020);*Oropeza v. Commissioner*, T.C. Memo 2020-111 (both following *Carter*).

[2640] *Pickens Decorative Stone, LLC v. Commissioner*, T.C. Memo 2022-22 (citing *Frost v. Commissioner*, 154 T.C. 23, 32 (2020)).

[2641] *Legg v. Commissioner*, 145 T.C. 344 (2015).

[2642] 957 F.3d 840, 2020 BL 152882 (8th Cir. 2020) (citing *Lewis v. Reynolds*, 284 U.S. 281 (1932)). For a further discussion of offsets in refund litigation, see 631 T.M., *Refund Litigation.*

[2643] 156 T.C. 55 (Jan. 25, 2021) (citing *Williams v. Commissioner*, 151 T.C. 1 (2018)).

[2644] 567 U.S. 519 (2012).

[2645] *See Grajales v. Commissioner*, 47 F.4th 58 (2d Cir. 2022).

[2646] 154 T.C. 84 (2020).

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ing of tax liability and not a penalty, thus, the requirement for supervisor approval does not apply.[2647]

Comment: Since §6751 only applies to penalties, it should not apply to increased taxes, such as those imposed by §409A(a)(1)(B)(i)(II), or other penalties imposed by a court, including penalties under §6673(a)(2), §6673(b) and §7482(c)(4).[2648]

c. Burden of Production

Under §7491(c), the IRS has the burden of production with respect to a penalty in any court proceeding with respect to the liability of an individual. That burden includes producing evidence of supervisor approval under §6751(b)(1), unless such approval is not required because the penalty is under §6651, §6654 or §6655, or §6662 (only for additions by reason of §6662(b)(9)), or the penalty is automatically calculated through electronic means.[2649] The IRS must show not only approval of the auditor's determination to impose the penalty, but that the approving party was the auditor's immediate supervisor (or designated higher level official) at the relevant time. The showing needs to be made in existing cases as well as new ones.[2650] The IRS is not required, as part of its initial burden, to prove a negative — that there was no prior formal communication.[2651]

If the IRS meets its burden of production, the burden shifts to the taxpayer to produce contrary evidence. According to the Tax Court, the taxpayer would have access to any evidence of prior formal communication.[2652]

In *Smith v. Commissioner*,[2653] the IRS met its burden under §6751(b) for three out of the four penalties by providing a completed Form 8278 with a corresponding statement that the form was signed by the immediate supervisor of the individual making the initial determination. However, the IRS failed to adequately show that the fourth penalty was in fact approved by the immediate supervisor because when the fourth Form 8278 was signed, there were three possible immediate supervisors and only one of them approved that penalty. In *Berry v. Commissioner*,[2654] the IRS failed to meet its burden under §6751(b)(1), despite arguing that the immediate supervisor's electronic signature on the 30-day letters was enough for procedural purposes. The court explained that because the IRS admitted in the stipulation of facts that the supervisor signed the penalty form after the accuracy-related penalties were assessed against the taxpayers and generally a stipulation of fact is binding, the IRS was not in compliance with §6751(b)(1), and therefore, the taxpayers were not liable for those penalties.

Where the IRS does not prove compliance with §6751(b)(1) when required, it cannot sustain the penalty.[2655] However, unless the requirement is brought up by the court of its own accord, failure by the taxpayer to raise the issue in the Tax Court proceeding results in a waiver.[2656]

Comment: In addition, it may be possible that the IRS could still prevail based on the presumption of regularity that absent evidence to the contrary, public officers are presumed to properly discharge their duties.[2657] In *Kestin*,[2658] the Tax Court asked whether this presumption applies to §6751(b)(1) and directed the parties to address the issue. The presumption was not raised in §6751(b)(1) cases before *Kestin*. Subsequently, the Tax Court applied the presumption to find that the IRS officer who signed the penalty approval as group manager was the immediate supervisor of the agent who made the initial determination.[2659] However, the Tax Court refused to apply the presumption to reopen the record to admit a penalty memorandum signed by the revenue agent that was initialed by an unknown person.[2660]

Comment: Applying the presumption of regularity to assume compliance with §6751(b) would shift the burden of proof from the IRS to the taxpayer, which appears to be contrary to the statute and *Graev III*.

It does not appear that the IRS will raise the presumption of regularity in §6751(b) cases. The IRS Chief Counsel has advised its attorneys to submit evidence of compliance with §6751(b)(1) unless an exception applies, even if the taxpayer does not raise the issue, and, to concede the issue at the earliest opportunity if the attorney cannot find evidence to establish compliance.[2661]

The IRS does not bear the burden of production under §7491(c) with respect to penalties assessed against a corpora-

[2647] *United States v. Rozbruch*, 28 F. Supp. 3d 256 (S.D.N.Y. 2014). *See* CC-2018-006 (pre-*Chadwick* advice to Chief Counsel attorneys instructing them to argue §6751(b) does not apply to §6672).

[2648] The exception to the §6751(b) requirement for §6673 penalties is discussed in XII.A.1.e., below.

[2649] *Graev v. Commissioner*, 149 T.C. 485 (2017), vacating and rem'g in part, aff'g in part and rev'g in part 147 T.C. 460 (2016). Penalties calculated by electronic means are discussed at XII.A.1.d., below.

[2650] *Becker v. Commissioner*, T.C. Memo 2018-69. *Chai* and *Graev III* did not create new law; §6751(b)(1) has been part of the Code since 1998. Note that the Tax Court has permitted the IRS to reopen the record in cases where the record was closed before *Graev*, *Chai*, and *Belair Woods* were decided. *See Kroner v. Commissioner*, T.C. Memo 2020-73. *Cf. Azam v. Commissioner*, T.C. Memo 2018-72.

[2651] *Frost v. Commissioner*, 154 T.C. 23 (2020). *Cf. Minemyer v. Commissioner*, T.C. Memo 2020-99 (where IRS had issued Form 4549 which was then withdrawn, IRS needed to produce Form 4549 to show there was no formal communication of penalty), *rev'd and rem'd on other grounds*, *Minemyer v. Commissioner*, No. 21-9006, 2023 BL 16752 (10th Cir. Jan. 19, 2023).

[2652] *Frost v. Commissioner*, 154 T.C. 23 (2020) (citing *Wheeler v. Commissioner*, 127 T.C. 200 (2006) and *Higbee v. Commissioner*, 116 T.C. 438 (2001)).

[2653] T.C. Memo 2021-29, aff'd by unpub. op., No. 22-70051, 2023 BL 233655 (9th Cir. July 10, 2023).

[2654] T.C. Memo 2021-42.

[2655] *See, e.g.*, *Kurdziel v. Commissioner*, T.C. Memo 2019-20; *Becker v. Commissioner*, T.C. Memo 2018-69; *Azam v. Commissioner*, T.C. Memo 2018-72; *Martin v. Commissioner*, T.C. Memo 2018-109.

[2656] *Kaufman v. Commissioner*, 784 F.3d 56 (1st Cir. 2015); *Mellow Partners v. Commissioner*, 890 F.3d 1070 (D.C. Cir. 2018); *Nix v. United States*, 339 F. Supp. 3d 580 (E.D. Tex. 2018). The court raised the IRS's failure to comply with §6751(b) in *Becker v. Commissioner*, T.C. Memo 2018-69. *See Ginsburg v. United States*, No. 19-11836, 2021 BL 410347 (11th Cir. Oct. 26, 2021) (district court correctly refused to consider §6751(b) argument where taxpayer failed to raise issue in claim for refund before IRS and exhaust administrative remedies), *aff'g* No. 6:17-cv-1666-Orl-41DCI, 2019 BL 138918 (M.D. Fla. Mar. 11, 2019).

[2657] *See, e.g.*, *United States v. Ahrens*, 530 F.2d 781 (8th Cir. 1976); *United States v. Chem. Found. Inc.*, 272 U.S. 1 (1926); *Walker v. Commissioner*, T.C. Memo 2018-22.

[2658] *Kestin v. Commissioner*, No. 18254-17L, 2018 BL 507342 (T.C. May 7, 2018) (Order).

[2659] *Yaryan v. Commissioner*, T.C. Memo 2018-129.

[2660] *Azam v. Commissioner*, T.C. Memo 2018-72.

[2661] CC-2018-006.

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tion.[2662] By its terms, §7491(c) only applies with respect to tax liabilities of an individual.[2663]

d. Penalty Automatically Calculated Through Electronic Means

Supervisory approval is not required if the penalty is automatically calculated through electronic means.[2664] Although the statutes or legislative history do not explain what is meant by automatically calculating the penalty by electronic means, the IRS issued rules defining the statement.

In Reg. §301.6751(b)-1(a)(3)(vi), a penalty[2665] is "automatically calculated through electronic means" if an IRS computer program automatically generates a notice to the taxpayer that proposes the penalty. If a taxpayer responds in writing or otherwise to the automatically-generated notice and challenges the proposed penalty, or the amount of tax to which the proposed penalty is attributable, and an IRS employee considers the response before assessment (or the issuance of a notice of deficiency that includes the penalty), then the penalty is no longer considered automatically calculated through electronic means.[2666]

Similarly, in SCA 200211040, a penalty is considered to be automatically calculated through electronic means if it is assessed free of any independent determination by an IRS employee as to whether the penalty should be imposed.[2667] That would include, for example, a negligence penalty or substantial understatement penalty under §6662 that is assessed under the Automated Underreporter Program (AUP) without any analysis by an IRS agent. The AUP compares the information shown on the taxpayer's return to the items and amounts furnished with respect to the taxpayer on information returns by third parties, and requests the taxpayer to explain any deficiency. If the taxpayer fails to respond or if the taxpayer fails to report income shown on a third party information return for a second year, the deficiency and negligence penalty are automatically assessed.[2668] The analysis is similar with respect to the substantial understatement penalty — in that the penalty is automatically assessed if the criteria are met and the taxpayer fails to provide an explanation.[2669] If the taxpayer responds either to the initial letter proposing the §6662 penalty or to the notice of deficiency that the AUP automatically issues, an IRS employee must consider whether the response provides a basis upon which the taxpayer may avoid the penalty. If the IRS employee determines not to fully abate the penalty, written supervisor approval of the remaining penalty being asserted is needed at that time.[2670]

In *Piper Trucking & Leasing LLC v. Commissioner*,[2671] the Tax Court determined that a §6721(e) penalty assessed for failures to file Form W-2, *Wage and Tax Statement*, and Form W-3, *Transmittal of Wage and Tax Statement*, was not subject to the supervisory approval requirement because the penalty was "automatically calculated through electronic means" under §6751(b)(2)(B). Piper Trucking & Leasing LLP, a single-member limited liability company (LLC), failed to file Form W-2 and Form W-3 with the Social Security Administration (SSA). Following the LLC's failure to respond to correspondence from the SSA, the SSA notified the IRS, and the IRS's combined annual wage reporting (CAWR) computer program automatically sent the LLC a letter, which the LLC also failed to respond to, asserting a §6721(e) penalty. The Tax Court held that the §6721(e) penalty determined by the CAWR computer program was not subject to the §6751(b)(1) supervisory approval requirement because the penalty did not involve human intervention and was automatically calculated through electronic means.[2672]

In *ATL & Sons Holdings, Inc. v. Commissioner*,[2673] in determining whether a §6699 penalty for failure to file a S corporation return was an "other penalty automatically calculated through electronic means" under the §6751(b)(2)(B) exception, the Tax Court focused on the word "other". The court held that to be automatically calculated, the penalties excluded from the approval requirement because they were calculated through electronic means had to be comparable to one of the explicitly excluded penalties under §6751(b)(2)(A). It then found the §6699 penalty was comparable to the penalty under §6651, even though the penalty under §6699 is a fixed amount per shareholder and not a percentage of the tax due. Accordingly, since the penalty was determined mathematically by a computer program without the involvement of a human IRS agent, the penalty did not require supervisor approval. In addition, supervisor approval was not required for a substantial understatement of tax penalty under §6662(b)(2) and §6662(d) that was asserted through the IRS Automated Correspondence Exam system based on computer matching of third party information without human involvement.[2674] In addition, the penalties for failure to file an S corporation return under §6699[2675] or for a substantial understatement of tax under §6662(d)[2676] are excluded if the penalty is mathematically determined by a computer program without the involvement of a human IRS agent.

Comment: Similarly, a penalty for failure to file a partnership return under §6698 should not require supervisor approval if it is determined automatically without the involvement of an IRS agent.

[2662] *NT Inc. v. Commissioner*, 126 T.C. 191 (2006); *Dynamo Holdings, LP v. Commissioner*, 150 T.C. 224 (2018); *Povolny Group Inc. v. Commissioner*, T.C. Memo 2018-37.

[2663] For a discussion of §7491(c) with respect to partnerships, see XII.A.2.a., below.

[2664] §6751(b)(2)(B).

[2665] The term "penalty" means any penalty, addition to tax, or additional amount under the Code. Reg. §301.6751(b)-1(a)(3)(i).

[2666] *See* Reg. §301.6751(b)-1(e)(5). For further discussion of the §6751(b) regulations, see the Worksheets, below.

[2667] IRM 4.24.25.5.14(4) (11-23-21), IRM 20.1.1.2.3(3) (10-19-20).

[2668] SCA 200211040; CC-2018-006; IRM 4.19.3.22.1.4(2), (3) (11-29-23). It could also include a §6702 frivolous submission penalty. CC-2014-004; PMTA 2014-02, *revoking* CC-2011-004, which had initially concluded that a §6702 penalty could not be automatically calculated through electronic means.

[2669] SCA 200211040. *See Walquist v. Commissioner*, 152 T.C. 61 (2019) (accuracy-related penalty issued without human intervention through IRS's Correspondence Examination Automated Support computer program was automatically calculated through electronic means).

[2670] SCA 200211040; IRM 20.1.1.2.3.2(2) (10-19-20), IRM 4.19.3.22.1.4 (11-29-23).

[2671] 161 T.C. No. 3 (Sept. 14, 2023).

[2672] *Piper Trucking & Leasing LLC v. Commissioner*, *citing Walquist v. Commissioner*, 152 T.C. 61 (2019).

[2673] 152 T.C. 138 (2019).

[2674] *Walquist v. Commissioner*, 152 T.C. 61 (2019).

[2675] *ATL & Sons Holdings, Inc. v. Commissioner*, 152 T.C. 138 (2019).

[2676] *Walquist v. Commissioner*, 152 T.C. 61 (2019).

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e. Exception for Penalties Under §6673

In Reg. §301.6751(b)-1(a)(2), the IRS expanded on the list of penalties that do not require supervisory approval to include sanctions and costs awarded by courts under §6673.[2677] The penalties are imposed at the discretion of the court and are designed to deter bad behavior in litigation and conserve judicial resources. Section 6673 penalties are not determined by the Commissioner, and the applicable federal court can impose them regardless of whether the Commissioner moves for their imposition.[2678] The regulation excepts §6673 penalties from the supervisory requirement because §6751(b)(1) was not created to restrict the federal courts.[2679]

Reg. §301.6751(b)-1(a)(2) is consistent with the Tax Court's holding in *Williams v. Commissioner*,[2680] where the IRS prepared a substitute for return for a taxpayer who failed to file, determined a deficiency, and assessed a late filing and late payment penalty. The taxpayer filed a petition to the Tax Court which contained frivolous arguments, and continued to make frivolous arguments in pre-trial motions. IRS counsel twice warned the taxpayer that his arguments were frivolous, and that if he persisted, the IRS would move the court to impose a penalty. After additional frivolous arguments by the taxpayer, IRS counsel asked the court to impose a penalty. Despite an additional warning from the court, the taxpayer continued raising frivolous arguments. The court then imposed a $2,000 penalty under §6673(a)(1). The taxpayer contested the penalty on the grounds that it was not approved in writing by IRS counsel's immediate supervisor.

In *Williams*, the Tax Court upheld its imposition of the penalty, finding that §6751(b)(1) supervisory approval does not apply to §6673(a)(1) penalties. Even though the IRS requested the penalty, the penalty may be imposed only in the discretion of the Tax Court. It is not a penalty determined by the IRS. Moreover, the provisions serve different purposes, and are not in conflict. The intent of §6751(b)(1) is to prevent the IRS from imposing a penalty as a bargaining chip. On the other hand, §6673(a)(1) was enacted as a positive tool for the Tax Court to combat frivolous litigation that waste the time and resources of the court. Section 6751(b)(1) was not intended as a mechanism to restrain the Tax Court.

Comment: As a result, the Tax Court did not distinguish between §6673(a)(1) penalties requested by the IRS and those imposed by the Tax Court on its own.

Comment: The same analysis should apply to penalties imposed by the Tax Court on an attorney or other person admitted to practice before the Tax Court under §6673(a)(2) (where such person has unreasonably and frivolously multiplied the proceedings), penalties imposed on a taxpayer by another court under §6673(b)(1) (where the taxpayer's position in the proceeding is frivolous or groundless), or penalties imposed on a taxpayer by a Court of Appeals or the Supreme Court under §7482(c)(4) (penalty where the court affirms the Tax Court decision and the appeal was instituted or maintained primarily for delay or the taxpayer's position in the appeal was frivolous or groundless).[2681]

Comment: Before the decision in *Williams*, Chief Counsel advised that, even though §6751(b)(1) arguably does not apply to a §6673 penalty, its attorneys who move the Tax Court to impose a §6673 penalty should have their immediate supervisor approve such motion in writing at the earliest convenient time.[2682] The IRS has not changed its guidelines.

2. Special Rule for Partnerships

a. TEFRA Partnership Rules

The Bipartisan Budget Act of 2015 ("2015 BBA")[2683] repealed the TEFRA partnership audit provisions (§6221–§6234), effective for partnership tax years beginning after 2017, and replaced them with new partnership audit provisions. Partnerships may elect to apply the amended partnership audit provisions to any partnership return filed for partnership tax years beginning after November 2, 2015 and before 2018.[2684] The discussion in this section relates to the TEFRA audit rules as in effect before the amendments made by the 2015 BBA. The effect of the new partnership audit rules is discussed at XII.A.2.b., below.

The partnership audit and assessment procedures are described in detail in 624 T.M., *Audit Procedures for Pass-Through Entities*.

Penalties relating to partnership items are determined at the partnership level.[2685] Partnership-level determinations include all legal and factual determinations that underlie the determination of the penalty, other than partner level defenses.[2686] With respect to partnerships, the IRS's alleged noncompliance with §6751(b) is a partnership-level defense. A partner may not raise §6751(b) noncompliance as a defense at the partner level for penalties previously determined at the partnership level.[2687]

Partner-level defenses to a penalty that relate to an adjustment to a partnership item, however, may only be asserted at a separate partner-level refund case following assessment and payment.[2688] Partner-level defenses are limited to those that are personal to the partner or are dependent upon the partner's separate return and cannot be determined at the partnership level.[2689] Examples of partner-level items include the amount of a partner's underpayment of tax and whether it meets an applicable threshold or whether the partner has a reasonable cause and acted in good faith, subject to partnership-level determinations.[2690]

[2677] For further discussion of the §6751(b) regulations, see the Worksheets, below.

[2678] For discussion of §6673 penalties, see VIII.C.2.a., above.

[2679] *See* Preamble to REG-121709-19, 88 Fed. Reg. 21,564 (Apr. 11, 2023). For further discussion of the §6751(b) regulations, see the Worksheets, below.

[2680] 151 T.C. 1 (2018).

[2681] See discussion at VIII.C.2.a., above.

[2682] CC-2018-006.

[2683] Pub. L. No. 114-74, §1101.

[2684] Pub. L. No. 114-74, §1101(g)(4).

[2685] Former §6221; former §6226(f).

[2686] Reg. §301.6221-1(c).

[2687] *See, e.g., Ginsburg v. United States*, No. 19-11836, 2021 BL 410347 (11th Cir. Oct. 26, 2021), *aff'g* No. 6:17-cv-1666-Orl-41DCI, 2019 BL 138918 (M.D. Fla. Mar. 11, 2019); *Rogers v. Commissioner*, T.C. Memo 2019-61; *Nix v. United States*, 339 F. Supp. 3d 580 (E.D. Tex. 2018).

[2688] Reg. §301.6221-1(c), §301.6221-1(d).

[2689] Reg. §301.6221-1(d).

[2690] Reg. §301.6221-1(d); *Tigers Eye Trading, LLC v. Commissioner*, 138 T.C. 67 (2012) aff'd in part, rev'd in part and rem'd by *Logan Trust v. Commissioner*, 616 Fed. App'x 426 (D.C. Cir. 2015).

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Under former §6226(f), the court has jurisdiction in a partnership-level proceeding to determine all partnership items, as well as the applicability of a penalty that relates to an adjustment to a partnership item. The statute and regulations regarding the tax treatment of partnership items apply to an entity that filed a partnership return, even if it is determined not to be an entity.[2691] The Tax Court has jurisdiction to make the determinations that the entity is not a partnership or that the entity does not exist, and determinations with respect to all items that would be partnership items if the entity were a partnership.[2692]

In *United States v. Woods*,[2693] the Supreme Court resolved that although a partner's outside basis is not a partnership item and needs to be resolved in a partner-level proceeding, where the partnership is disregarded as a sham, the partner by definition has a zero basis. According to the Supreme Court, the court in the partnership-level proceeding can determine whether the adjustments it made, including the economic substance determination, had the potential to trigger a penalty. That each partner's outside basis must be adjusted at the partner level does not prevent the partnership-level court's provisional consideration of whether the economic-substance determination is legally capable of triggering the penalty. As a result, the court in the partnership level determination may announce that a penalty has been triggered based on the presumption that the outside basis in a sham partnership is zero, but it cannot formally adjust a partner's outside basis at that time.[2694] In addition, the partner may raise personal defenses to the penalty in a separate partner-level proceeding.[2695] This applies even if it is the managing partner, who acts for the partnership and whose good faith (or lack thereof) was tested at the partnership-level proceeding.[2696] See discussion at XI.B.2., above.

Based on the foregoing, the deficiency procedures do not apply to penalties that relate to adjustments to partnership items.[2697] The exclusion, however, does not apply to a §6662 negligence penalty that was imposed on a partner solely because the partner reported inconsistently with the partnership, since there were no adjustments to partnership items.[2698] Special rules apply where the spouse of a partner asserts innocent spouse relief under §6015.[2699]

As mentioned above, by its terms, §7491(c) only applies with respect to tax liabilities of an individual. In a case of first impression, the Tax Court held that §7491(c) does not apply in a TEFRA partnership-level proceeding where at least some of the partners are individuals.[2700] According to the Tax Court, TEFRA partnership-level proceedings are not with respect to the tax liabilities of an individual. Rather, they determine the treatment of partnership level items and the applicability of a penalty at the partnership level. Once a partnership-level determination is made, the liability of a partner is made in a separate partner-level proceeding.[2701] Moreover, partnership-level proceedings are not proceedings with respect to individuals. Defenses that are unique to any partner — individual or otherwise — are not part of the partnership-level proceeding. The court also found that Congress intended to narrowly define the scope of §7491(c), and did not intend it to apply to partnership-level proceedings.[2702]

Notwithstanding the fact that the IRS does not bear the burden of proof under §7491(c) in a TEFRA partnership case, §6751(b)(1) still applies,[2703] and IRS Chief Counsel directs its attorneys to submit proof of compliance with §6751(b)(1) in the partnership level proceeding.[2704]

Comment: The Tax Court Dynamo Holdings case was decided under the TEFRA audit rules. It does not appear that the BBA partnership audit rules require a different result as the underlying principles regarding penalties remains the same.[2705] Generally, under the BBA partnership audit rules, absent an election out or a push out election, the penalty is determined at the partnership level and the partnership is liable for the penalty.[2706] In such case, the partnership is treated more like a corpo-

[2691] Reg. §301.6233-1(a), §301.6233-1(b).

[2692] Reg. §301.6233-1(a).

[2693] 571 U.S. 31 (2013). The Court dismissed *amici* warnings that the holding bodes an odd procedural result — that the IRS will be able to assess the 40% penalty directly, but will have to use deficiency proceedings to assess the underpayment of tax upon which the penalty is based, stating that the criticism assumes that the underpayment would not be exempt from deficiency proceedings because it rests on outside basis, which is an affected item other than a penalty. *See* pre-2015 BBA §6230(a)(2)(A)(i). However, an underpayment from an affected item is exempt from deficiency proceedings if it does not require a partner-level determination. *United States v. Woods*, 571 U.S. 31, 42 (2013). *See Bush v. United States*, 655 F.3d 1323 (Fed. Cir. 2011). It is not readily apparent why a partner-level proceeding would be required to adjust outside basis where the partnership is regarded as a sham. *United States v. Woods*, 571 U.S. at 42 n.2 (2013).

[2694] *See, e.g., Logan Tr. v. Commissioner*, 616 Fed. App'x 426 (D.C. D.C. Cir. 2015).

[2695] *United States v. Woods*, 571 U.S. 31 (2013).

[2696] *McNeill v. United States*, 836 F.3d 1282 (10th Cir. 2016).

[2697] Former §6230(a)(1), former §6230(2)(A)(i).

[2698] *Malone v. Commissioner*, 148 T.C. 372 (2017).

[2699] Former §6230(a)(3).

[2700] *Dynamo Holdings, LP v. Commissioner*, 150 T.C. 224 (2018). *See Carter v. Commissioner*, T.C. Memo 2020-21 (declining to extend *Dynamo Holdings* to partnerships subject to TEFRA small partnership exception). Although the Tax Court examined the issue in earlier cases, *Dynamo Holdings* is the first case to decide the issue. *See, e.g., Palmer Ranch Holdings, Ltd. v. Commissioner*, T.C. Memo 2014-79, aff'd in part, rev'd in part and remanded, 812 F.3d 982 (11th Cir. 2016); *Santa Monica Pictures, LLC v. Commissioner*, T.C. Memo 2005-104. In addition, the Tax Court recognized that it may have assumed the IRS's burden in certain cases. *See, e.g., RERI Holdings I, LLC v. Commissioner*, 149 T.C. 1 (2017), aff'd sub. nom. *Blau v. Commissioner*, 924 F.3d 1261 (D.C. Cir. 2019); *Curtis Inv. Co. v. Commissioner*, T.C. Memo 2017-150, aff'd on other issues, 909 F.3d 1339 (11th Cir. 2018), aff'd sub nom. on other issues, 910 F.3d 150 (4th Cir. 2018). The Eleventh Circuit, in the partnership's appeal, cited §7491(c) for the proposition that the IRS has the burden of production and implied that burden was met, and analyzed whether the taxpayer had supported its reasonable cause defense. In *Dynamo Holdings*, the Tax Court held that to the extent such cases state that the IRS bears the burden of production with respect to penalties in partnership proceedings, they are not followed. 150 T.C. 224 (2018). The Tax Court followed its *Dynamo Holdings* decision in *RB-1 Invs. Partners v. Commissioner*, T.C. Memo 2018-64.

[2701] See discussion at XII.A.2., below.

[2702] For example, §7430, which allows costs and fees to be awarded to a prevailing party, looks to the partners as the parties; but §7491(c)does not focus on parties, only on the nature of the proceeding. Moreover, in contrast to §7491(c), which refers to any individual, §7491(a) refers to the taxpayer, which includes a partnership (see §7701(a)(14), §7701(a)(1)), and §7491(a)(2)(C) expressly includes a partnership.

[2703] *Dynamo Holdings, LP v. Commissioner*, 150 T.C. 224 (2018).

[2704] CC-2018-006.

[2705] The partnership audit rules are discussed in 624 T.M., *Audit Procedures for Pass-Through Entities.*

[2706] §6225(a), §6233. Reg. §301.6221(a)-1 generally provides that, except as otherwise required, in the case of an adjustment to a partnership-related item, and any income tax attributable thereto, the applicability of any penalty that

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ration and the IRS should not bear the burden of production in a partnership-level proceeding. Even if the partnership elects to push out the liability and make the reviewed year partners liable, under the regulations, partner-level defenses continue to be allowed to be raised in separate partner-level proceedings. The only difference now is that the partner would have to pay the penalty and claim a refund.[2707] In addition, the other reasons raised by the Tax Court, including the distinction between an individual and a partnership, still apply.

b. Post-2015 Bipartisan Budget Act Rules

The 2015 BBA revised the partnership audit rules for partnership tax years beginning after 2017.[2708] The partnership audit rules are described in detail in 624 T.M., *Audit Procedures for Pass-Through Entities.* Under the new partnership audit rules, unless the partnership is an eligible partnership which elects out of the new rules,[2709] the adjustment for partnership-related items is determined at the partnership level,[2710] and unless the partnership elects to push out the adjustment to the partners in the reviewed year,[2711] the partnership itself is liable for any tax, interest and penalty.[2712]

Even if the partnership elects to push out the adjustment to the partners, the applicability of any penalty that relates to an adjustment is determined at the partnership level, by treating the imputed underpayment as an underpayment of tax.[2713] Any defense to a penalty is raised by the partnership in the partnership-level proceeding.[2714] Partner-level defenses are limited to those that are personal to the reviewed year partner.[2715]

The amount of the imputed underpayment is adjusted to the extent a partner files an amended return for the reviewed year and any other affected taxable year taking into account the adjustments allocable to such partner and pays the tax due.[2716] The regulations also require payment of any interest, additions to tax and penalties.[2717] Alternatively, a direct or indirect partner is treated as satisfying such provisions if in lieu of filing an amended return, the partner provides the same information to the IRS in the form and manner required, takes into account the adjustments (including adjustments to tax attributes) allocable to him, and pays the tax.[2718] As in the case for other amended returns, the IRS may also require the taxpayer to pay any interest, additions to tax and penalties.[2719] The applicability of the penalty is determined at the partnership level, but the amount a relevant partner must pay is based on the underpayment or understatement of tax, if any, reflected on the partner's amended return.[2720]

If the partnership fails to pay an imputed underpayment to which §6225 applies, or any interest, addition to tax or penalty with respect to such amount, within 10 days after notice and demand by the IRS, the interest rate increases by 200 basis points, and the IRS may assess each partner for his proportionate share.[2721] Such liability may be assessed and collected without regard to the deficiency procedures, generally at any time within two years after such notice and demand.[2722]

Note: Absent authority under §7508A, PMTA 2020-007[2723] authorizes the IRS to deem that notice and demand letters that were mailed out late due to the temporary closure of IRS printing services during the COVID-19 pandemic were sent out on a date later than the date shown on the notice in order to grant relief from penalties and interest.

The IRS may also impose a penalty with respect to a failure to pay an imputed underpayment.[2724]

3. Burden of Proof

In any court proceeding, the IRS has the burden of proof with respect to a factual issue, including the facts relating to the imposition of a penalty, if the taxpayer introduces credible evidence with respect to the factual issue relevant to ascertaining the taxpayer's tax liability.[2725] The taxpayer has the burden of proving each of the four conditions to the application of this provision to an issue:[2726]

- The taxpayer must comply with the requirements to substantiate the item;
- The taxpayer must maintain records required under the tax law;
- The taxpayer must cooperate with reasonable request by the IRS for meetings, interviews, information and documents, including providing within a reasonably period of time access to and inspection of witnesses, information and documents within the taxpayer's control, as well as providing reasonable assistance to the IRS in obtaining access to and inspection of witnesses, information and documents not within the taxpayer's control, and providing English translations of documents;[2727] and

relates to such adjustment and any consideration necessary to make a determination is made at the partnership level.

[2707] Reg. §301.6226-3(d)(3). Although the applicability of the penalty to a reviewed year partner is determined at the partnership level, the amount of the penalty for the reviewed year partner is based on the characteristics of, and facts and circumstances applicable to, the reviewed year partner. For example, if after taking into account the partnership adjustments, the reviewed year partner does not have an underpayment, no penalty is due from such partner. Reg. §301.6226-3(d)(1), §301.6226-3(d)(2).

[2708] Pub. L. No. 114-74, §1101, as amended by the Consolidated Appropriations Act of 2018, Pub. L. No. 115-141 ("2018 Appropriations Act") §201 *et seq.*, effective as if included in the Bipartisan Budget Act of 2015. Pub. L. No. 115-141 at §207. A partnership may elect to apply the new rules to any partnership return filed for a partnership tax year beginning after November 2, 2015. Pub. L. No. 114-74, §1101(g)(4).

[2709] §6221(b).

[2710] §6221(a).

[2711] §6226(a).

[2712] §6225(a), §6233(a)(1), §6226(c).

[2713] §6221(a), §6233(b)(3), §6226(c)(1).

[2714] Reg. §301.6226-3(d)(1).

[2715] Reg. §301.6226-3(d)(3).

[2716] §6225(c)(2)(A).

[2717] Reg. §301.6225-2(d)(2)(ii)(A).

[2718] §6225(c)(2)(B). This is generally referred to as a "pull-in" election.

[2719] Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the House Amendment to the Senate Amendment to H.R. 1625, JCX-6-18 (Mar. 22, 2018) at 40.

[2720] Reg. §301.6226-3(d).

[2721] §6232(f)(1).

[2722] §6232(f)(6).

[2723] (May 21, 2020).

[2724] Reg. §301.623(b)-1(a).

[2725] §7491(a).

[2726] S. Rep. No. 105-174 at 45 (1998).

[2727] S. Rep. No. 105-174 at 45 (1998). A necessary element of cooperation is that the taxpayer must exhaust its administrative remedies, including any appeal rights provided by the IRS. The taxpayer, however, is not required to agree

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• In the case of a corporation, partnership or trust, the entity's net worth does not exceed $7,000,000.[2728]

What constitutes a "reasonable request" is not defined. Presumably, to be reasonable the IRS's request would have to be calculated to lead to material relevant to the tax liability in dispute, and designed so as not to impose an undue production burden where evidence of comparable probative value is available through less burdensome means.[2729] Nor does the statute define what it means to cooperate. A necessary element of cooperating with the IRS is that the taxpayer must exhaust his administrative remedies, including any appeal rights. However, the taxpayer is not required to extend the statute of limitations. Cooperating also means that the taxpayer establish the applicability of any privilege.[2730]

The burden of proof shifts to the IRS only if the taxpayer first introduces credible evidence with respect to the factual issues relevant to ascertaining the taxpayer's tax liability. Credible evidence is the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness).[2731] A taxpayer has not produced credible evidence for this purpose if the taxpayer merely makes implausible factual assertions, frivolous claims or tax protestor-type arguments. The introduction of evidence will not meet this standard if the court is not convinced that such evidence is worthy of belief. If after evidence from both sides, the court believes that the evidence is equally balanced, the court must find that the IRS has not sustained its burden of proof.[2732]

This provision relating to the shifting of the burden of proof in a court proceeding, however, does not apply to any issue if another provision of the Code provides for a specific burden of proof with respect to the issue.[2733] Moreover, nothing in the provision overrides any substantiation requirement. Taxpayers who fail to substantiate an item in accordance with applicable law has not satisfied the prerequisite to claim such item on his return, and accordingly cannot shift the burden of proof to the IRS.[2734]

In addition, the IRS bears the burden of proof as to a new matter, including a penalty, that is first raised in its answer.[2735]

4. *Suspension of Certain Penalties*

In the case of an individual taxpayer who timely files (including extensions) his income tax return for taxes imposed under subtitle A, the IRS must notify the individual of any adjustments, within 36 months after the later of the date on which the return is filed or the due date of the return, without regard to extensions.[2736] If the individual taxpayer files an amended return showing an additional income tax liability, the 36-month period is computed from the date of the amended return.[2737] The suspension does not apply to an adjustment by the IRS to an amended return that reports a decrease in the taxpayer's income tax.[2738]

The IRS notice of adjustments must be in writing and specifically state the amount of the liability and the basis for the liability.[2739] The notice must provide the taxpayer with sufficient information to identify the items of income, gain, loss, deduction or credit the IRS has adjusted or proposes to adjust, and the reason for the adjustment.[2740] A detailed explanation is not required; nor are citations to any legal authority. Moreover, the information need not be provided in a single document or at the same time.[2741] The notice may be provided by mail (to the last known address) or in person, and to the taxpayer or his representative.[2742] In the case of a TEFRA partnership, notice may be given to the partner or the tax matters partner.[2743]

Comment: Presumably, under the new partnership audit rules under the 2015 Bipartisan Budget Act,[2744] notice could be given to the partnership representative.

If the IRS fails to properly notify the taxpayer, the IRS must suspend the imposition of any addition to tax or penalty with respect to any failure relating to the return that is computed by reference to the period of time the failure continues to exist and which is properly allocable to the suspension period.[2745] For this purpose, the suspension period begins on the day after the end of the 36 month period described above, and ends 21 days after the date on which the required notice is provided by the IRS.[2746] The suspension is computed separately for each item or adjustment.[2747]

The suspension, however, does not apply to:[2748]

• Any penalty for failure to file or failure to pay under §6651;

• Any penalty in a case involving fraud;[2749]

• Any penalty with respect to a tax liability shown on the return;

to extend the statute of limitations. On the other hand, the taxpayer must establish the applicability of any privilege. S. Rep. No. 105-174 at 45 (1998).

[2728] The provision does not apply to a qualified revocable trust. §7491(a)(2) (flush language).

[2729] *Long Term Capital Holdings, LP v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004), aff'd by unpub. op., 150 Fed. App'x 40 (2d Cir. 2005). *See Polone v. Commissioner*, T.C. Memo 2003-339.

[2730] *Long Term Capital Holdings, LP v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004), aff'd by unpub. op., 150 Fed. App'x 40 (2d Cir. 2005); S. Rep. No. 105-174 at 45 (1998).

[2731] S. Rep. No. 105-174 at 45–46 (1998).

[2732] S. Rep. No. 105-174 at 45–46 (1998).

[2733] §7491(a)(3).

[2734] S. Rep. No. 105-174 at 46 (1998).

[2735] Tax Court Rule 142(a); *Shea v. Commissioner*, 112 T.C. 183 (1999).

[2736] §6404(g)(1)(A). The provision also applies to interest. *See* 627 T.M., *Limitation Periods, Interest on Underpayments and Overpayments, and Mitigation.*

[2737] §6404(g)(1) (flush language).

[2738] Reg. §301.6404-4(a)(2)(ii).

[2739] Reg. §301.6404-4(a)(7)(i).

[2740] Reg. §301.6404-4(a)(7)(i).

[2741] Reg. §301.6404-4(a)(7)(i).

[2742] Reg. §301.6404-4(a)(8)(i).

[2743] Reg. §301.6404-4(a)(7)(ii). Notice of a final partnership administrative adjustment must be given to all notice partners. Reg. §301.6404-4(a)(8)(ii).

[2744] Pub. L. No. 114-74.

[2745] §6404(g)(l)(A).

[2746] §6404(g)(3).

[2747] §6404(g)(l)(B).

[2748] §6404(g)(2).

[2749] The suspension does not apply to any case involving a false or fraudulent return. Fraud affecting any item on the return prevents the suspension of any penalty from applying to any item on that return. Reg. §1.6404-4(b)(2).

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• Any penalty with respect to a gross misstatement, including a substantial omission of income under §6501(e) or §6227, gross valuation misstatements under §6662(h) or a misstatement to which a §6702 frivolous tax submission penalty applies;[2750] and

• Any penalty attributable to a reportable transaction if the disclosure requirement of §6664(d)(3)(A) is not met, and any listed transaction.[2751]

According to the IRS, the filing of an amended return may have a significant impact on a §6404(g) suspension of interest and certain penalties, as illustrated by the following examples:[2752]

Example: Taxpayer files an amended return for the tax year within 36 months after the due date of the original return, and before any notice from the IRS relating to any additional tax. The amended return shows an additional tax, but Taxpayer does not pay the additional tax with the amended return. Section 6404(a) does not apply. Interest and time-sensitive penalties accrue from the due date of the original return.[2753]

Example: Taxpayer filed an amended return more than 36 months after the due date of the original return, and before any notice from the IRS relating to any additional tax. The amended return reports an additional tax, which taxpayer pays with the amended return. Section 6404(g) suspends interest and time-sensitive penalties beginning from the day after the 36-month notification period ended through the date on which the amended return was filed and the additional tax was paid.[2754]

Example: Taxpayer files an amended return more than 36 months after the due date of the original return, and before any notice from the IRS relating to any additional tax. The amended return reports an additional tax, but taxpayer does not pay the additional tax with the amended return. Section 6404(g) suspends the accrual of interest and time-sensitive penalties beginning on the day after the 36-month notification period ended through the 21st day after the date on which taxpayer filed the amended return.[2755]

Comment: The validity of Rev. Rul. 2005-4 could be challenged as §6404(g) refers specifically to a notice provided by the IRS and nowhere suggests that a suspension may be eliminated or terminated by the filing of an amended return, as held in the ruling. Moreover, an amended return reporting an additional tax liability will usually be followed by an assessment and if the additional tax is not paid, the IRS will issue a notice and demand under §6155, and this notice might qualify as a notice under §6404(g)(1)(A).

Under the regulations, the general rule of suspension under §6404(g)(1) does not apply to any interest, penalty, addition to tax, or additional amount with respect to any listed transaction as defined in §6707A(c) or any undisclosed reportable transaction. An undisclosed reportable transaction is a reportable transaction described in the regulations under §6011 that is not adequately disclosed under those regulations and that is not a listed transaction. The date that the IRS provides notice to the taxpayer specifically stating the taxpayer's liability regarding a listed transaction or an undisclosed reportable transaction and the basis for that liability is the controlling date for determining whether the transaction is a listed transaction or an undisclosed reportable transaction for purposes of the suspension rules under §6404(g).[2756]

B. Appeals of Penalties

1. Deficiency Procedures

Before an income tax deficiency can be assessed against a taxpayer, the IRS must comply with the deficiency procedures under Chapter 63B.[2757] A deficiency exists if the correct tax exceeds the sum of: (1) the tax shown by the taxpayer on his return and (2) any amounts previously assessed (or collected without assessment) as a deficiency, reduced by (3) the amount of any rebates made.[2758]

Under the deficiency procedures, a taxpayer is entitled to receive a notice of deficiency and to petition the Tax Court for a redetermination before assessment.[2759] The Statement of Procedural Rules also sets forth administrative appeals procedures to which taxpayers are entitled before the IRS can issue notices of deficiency. For example, if the notice of deficiency for a case docketed in Tax Court was not issued by an IRS Appeals office, the case will be referred to Appeals for settlement.

The deficiency procedures also apply to penalties that are based on an income tax deficiency that can only be assessed under the deficiency procedures.[2760] For example, the deficiency procedure must be used to assess an accuracy-related penalty based on an underpayment of income tax. In the case of a failure to file or failure to pay penalty, however, the deficiency procedures apply only to the portion of the tax attributable to a deficiency.[2761]

[2750] Reg. §1.6404-4(b)(4). The substantial understatement of income tax penalty is discussed at IV.C., above. The §6662(h) penalty is discussed at IV.E.2., above. The §6702 penalty is discussed at VIII.C., above.

[2751] The date the IRS provides the required notice is the date for determining whether the transaction is a listed transaction or an undisclosed reportable transaction. Reg. §1.6404-4(b)(5)(i). The §6662A penalty for reportable transactions is discussed in 648 T.M., *Reportable Transactions.*

[2752] Rev. Rul. 2005-4 (which was issued when §6404(g) applied if the IRS did not provide notice within 18 months).

[2753] Rev. Rul. 2005-4, Situation 1.

[2754] Rev. Rul. 2005-4, Situation 2.

[2755] Rev. Rul. 2005-4, Situation 3.

[2756] Reg. §301.6404-4(b)(5)(i).

[2757] §6211–§6216. Exceptions are provided in certain cases, including for mathematical and clerical errors, and cases in which the IRS believes that the assessment or collection of a deficiency will be jeopardized by delay. §6213(b)(l), §6861(c). The deficiency procedures do not apply to employment taxes. The deficiency procedures are discussed further in 630 T.M., *Tax Court Litigation.*

[2758] §6211(a).

[2759] §6211, §6213.

[2760] §6665(b), §6671(a).

[2761] §6665(b)(1). *See Wilson v. Commissioner*, 118 T.C. 537 (2002) (court lacks jurisdiction over §6651(f) additions to tax because such additions are not attributable to a deficiency). *But see Spurlock v. Commissioner*, 118 T.C. 155 (2002) (substitute return under §6020(b) that shows an amount of tax does not affect whether there is a "deficiency" under §6211(a); substitute return is subject to deficiency procedures, which the IRS must follow before making assessment); SCA 199950033 (advising that, because the amount of underlying tax

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Example: A taxpayer files his income tax return late, without having obtained an extension of time to file and without reasonable cause. If the return properly states the tax, there is no deficiency. As a result, the IRS can assess and collect the §6651 penalty without following the deficiency procedures. However, if it is later determined that an income tax deficiency exists (which increases the §6651 penalty), the deficiency procedures apply to the additional penalty.

Example: Executor files a late estate tax return showing a liability, with a balance due. The IRS assesses the liability and a §6651(a)(1) late filing penalty based on the tax reported as due on the return. By notice of deficiency, the IRS determines a deficiency and an additional §6651(a)(1) penalty. The parties resolve the estate tax, but not the §6651 penalty. The settlement results in an estate tax liability that is lower than that reported on the return and thus, an overassessment. Consequently, any §6651(a)(1) penalty that remains relates to only the amount assessed by the IRS before the issuance of the notice of deficiency. Because the estate tax imposed does not exceed the amount of the tax shown on the estate tax return, no deficiency exists,[2762] and the penalty may be assessed.

On the other hand, the deficiency procedures specifically do not apply to the penalties for:

- Underpayment of estimated tax under §6654 or §6654, if no return is filed for the tax year;[2763]
- Furnishing a fraudulent statement or failing to furnish a statement to an employee under §6051 or §6053(b);[2764]
- Failing to file information with respect to certain foreign trusts under §6048;[2765]
- Failing to file returns with respect to the organization, reorganization or acquisition of the stock of a foreign corporation, or returns with respect to a foreign partnership under §6046 or §6046A;[2766]
- Filing false information with respect to withholding under §3402 or §3406;[2767]
- Failing to provide reports on certain tax-favored accounts or annuities under §408(i), §408(l), §220(h), §223(h), §529(d), §529A(d), §529A(d) or §530(h), or for certain designated nondeductible contributions under §408(o)(4);[2768]
- Tax return preparers under §6694 or §6695 or appraisers under §6695A;[2769]
- Failing to file a partnership return under §6031;[2770]
- Failing to file an S corporation return under §6037;[2771]
- Promoting abusive tax shelters under §6700, aiding and abetting the understatement of tax liability under §6701, or filing a frivolous income tax return under §6702;[2772]
- Failing to furnish original issue discount information under §1275(c);[2773] and
- A tax return preparer disclosing or using information.[2774]

Penalties for failure to collect and pay over trust fund taxes are subject to their own procedures.[2775]

Comment: It is not clear why certain penalties are subject to the deficiency procedures and others are not. The distinction is not based on the size of the penalty. Although many of the penalties that are excluded from the deficiency procedures may be small, clearly not all of them are.[2776] Moreover, other small penalties are subject to the deficiency procedures.[2777] Certain failures to file returns are subject to the deficiency procedures,[2778] but others are not.[2779]

2. Post-Assessment Appeal

A taxpayer can generally appeal penalty assessments to IRS Appeals.[2780] The appeal may be made before or after payment, but must be made before a claim for refund is filed.[2781]

The post-assessment appeals procedure applies to all but the following penalties:

- penalties that are not subject to a reasonable cause or reasonable basis determination (e.g., the §6654 and §6655 penalties for failure to make estimated tax payments);
- penalties that are subject to §6211–§6216 deficiency procedures (e.g., §6662, §6662A, and §6663 accuracy-related and fraud penalties), because the taxpayer has the right to appeal such penalties before assessment;
- penalties that are subject to an administratively granted pre-assessment appeal procedure (e.g., the §6694 tax re-

shown on a substitute return under §6020(b) constitutes a deficiency, §6651(a)(2) failure-to-pay penalty is attributable to the deficiency and therefore is subject to §6665 deficiency procedures). The deficiency procedures also apply to the §6654 and §6655 estimated tax penalties where no tax return is filed.

[2762] *See Estate of Forgey v. Commissioner*, 115 T.C. 142 (2000).

[2763] §6665(b)(2). Estimated taxes are described in detail in 581 T.M., *Estimated Tax*.

[2764] §6674.

[2765] §6677(e).

[2766] §6679(b). Section 6679 also imposed the penalty for failing to file under §6035 before the repeal of §6035 (and related amendment of §6679) by Pub. L. No. 108-357, §413(c), effective for tax years of foreign corporations beginning after December 31, 2004, and tax years of U.S. shareholders with or within which such tax years of foreign corporations end.

[2767] §6682(c).

[2768] §6693(d).

[2769] §6696(b).

[2770] §6698(d).

[2771] §6699(d).

[2772] §6703(b).

[2773] §6706(c).

[2774] §6713(d).

[2775] §6672(b). Trust fund penalties are described in 639 T.M., *Responsible Person and Lender Liability for Trust Fund Taxes — Sections 6672 and 3505.*

[2776] *See, e.g.*, §6677(a) (penalty is greater of $10,000 or 35% of gross reportable amount, plus $10,000 for each 30-day period after 90 days after the IRS mails the notice); §6706(b) (penalty is 1% of issue price up to $50,000).

[2777] *See, e.g.*, §6690 (penalty of $50 for each failure).

[2778] *See, e.g.*, §6686, §6716.

[2779] *See, e.g.*, §6679, §6698.

[2780] *See* IRM 20.1.1.4. It is an IRS business decision whether to provide appeal rights with respect to a §6702 penalty abatement request if taxpayer raises nonfrivolous arguments. PMTA 2013-28.

[2781] Reg. §601.106(a)(1)(iv).

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turn preparer penalty), because the taxpayer can protest such penalties before assessment;

• §6700 penalty for promoting abusive tax shelters, because that penalty is subject to special procedural rules under §6703; and

• trust fund recovery penalty imposed by §6672, because the taxpayer has an opportunity to appeal the penalty before assessment.[2782]

Appeals of assessed penalties follow the general pattern of appeals of proposed adjustments.[2783] The taxpayer is notified of the right to appeal assessed penalties, and given 30 days to file a protest with Appeals. If Appeals decides summary abatement is inappropriate, the taxpayer is afforded a conference. If the appeal is rejected, a claim for refund is available after the taxpayer pays the penalty.

Appeals consideration is not available for administrative determinations based on a frivolous position, which includes any case solely involving the failure or refusal to comply with tax laws because of frivolous moral, religious, political, constitutional, conscientious or similar grounds. Similarly, Appeals consideration is not available related to frivolous positions, or submissions, or providing false information.[2784]

3. Collection Due Process Hearing

Before the IRS can levy on a taxpayer's property, it must give the taxpayer at least 30 days prior written notice of his right to a collection due process hearing ("CDP Hearing") before the IRS Appeals office.[2785] The CDP Hearing gives the taxpayer an opportunity for an independent review to ensure the collection action is warranted and appropriate.[2786] The notice may be combined with the IRS's notice of intention to levy.[2787]

A taxpayer requests a CDP Hearing by filing a Form 12153, *Request for a Collection Due Process or Equivalent Hearing*, within such 30-day period to the IRS office that issued the notice, at the address indicated on the notice.[2788] If the taxpayer does not timely request a CDP Hearing following the first notification, the taxpayer foregoes the right to a CDP Hearing.[2789] The taxpayer may, however, request an equivalent hearing.[2790]

At the CDP Hearing, the taxpayer may raise any relevant issue relating to the unpaid amount or the proposed levy, including challenges to the appropriateness of the collection action.[2791] The taxpayer may also challenge the existence or amount of the underlying liability if he did not receive a notice of deficiency for such liability or did not otherwise have an opportunity to dispute such liability.[2792] Issues raised at a previous administrative or judicial proceeding in which the taxpayer meaningfully participated cannot be reconsidered at the CDP Hearing, unless there has been a change in circumstances with respect to such person that would affect the outcome of the determination.[2793] Specified frivolous positions under §6702(b)(2)(A)(i) or §6702(b)(2)(A)(ii) also may not be raised.[2794] In addition, for returns filed for partnership tax years beginning after 2017, an issue may not be raised at the CDP Hearing if a final determination has been made with respect to that issue in a proceeding brought under subchapter C of chapter 63.[2795] The exceptions, however, do not apply if, after the taxpayer exhausted all administrative remedies, there is a change in circumstances with respect to the taxpayer which affects the determination relating to an issue.[2796]

Generally, a taxpayer is entitled to only one CDP Hearing with respect to the taxable period.[2797] A taxpayer is entitled to a hearing even if the penalty does not relate to a taxable period, such as the penalty under §6673(a)(1) for maintaining a frivo-

[2782] Reg. §601.106(a)(1)(iv). The §6700 penalty is discussed at VIII.A.1., above. *See also* 639 T.M., *Responsible Person and Lender Liability for Trust Fund Taxes — Sections 6672 and 3505.*

[2783] Reg. §601.106. *See also* IRS Pub. 5, *Your Appeal Rights and How to Prepare a Protest If You Don't Agree.* For further discussion, see 623 T.M., *IRS Procedures: Examinations and Appeals.*

[2784] Reg. §301.7803-2(c)(1), §301.7803-2(c)(2), T.D. 10030, 90 Fed. Reg. 3645 (Jan. 15, 2025), applicable to requests for Appeals consideration made after February 13, 2025. *See also* §6702(c); §7803(e)(5)(D); Reg. §601.106(b); Notice 2010-33.

[2785] §6330(a), §6331(d). A notice is not required, however, if collection of the penalty is in jeopardy or with respect to a levy on a state tax refund. §6330(f), §6331(d)(3). In such case, the IRS must issue a notice to the taxpayer within a reasonable time after the levy, and the taxpayer can request a hearing at that time. Reg. §301.6330-1(a)(3) Q-A5. A similar hearing may be required before the IRS can record a federal tax lien against the taxpayer's property. §6320. The CDP provisions are described in detail in 638 T.M., *Federal Tax Collection Procedure — Defensive Measures.*

[2786] IRM 5.1.9.3.1(1) (10-19-23).

[2787] H.R. Conf. Rep. No. 105-599 at 265 (1998). *See* IRM 5.11.1.3.2 (11-24-21).

[2788] Reg. §301.6330-1(c). *See* PMTA 2012-29 (postmark rule under §7502(a)(1) did not apply because taxpayer did not mail request to address listed in instructions, however, request deemed timely where received by service center mailroom before deadline). The request also can be made in another writing signed by the taxpayer or his authorized representative.

[2789] Reg. §301.6330-1(b)(2) Q-B2, §301.6330-1(c)(2) Q-C7, §301.6330-1(i)(1).

[2790] Reg. §301.6330-1(c)(2) Q-C7. Equivalent hearings are discussed at XII.B.4., below.

[2791] §6330(c)(2)(A). *See Loveland v. Commissioner*, 151 T.C. 78 (2018) (collection alternative may be raised at CDP hearing).

[2792] §6330(c)(2)(B). *See, e.g., Iames v. Commissioner*, 850 F.3d 160 (4th Cir. 2017) (pre-assessment hearing before Appeals is opportunity to dispute tax liability, thus taxpayer is barred from disputing underlying liability at a CDP Hearing); *Keller Tank Servs. II, Inc. v. Commissioner*, 854 F.3d 1178 (10th Cir. 2017), *withdrawing and replacing* 848 F.3d 1251 (10th Cir. 2017) (corporation was not entitled to challenge penalty during a CDP Hearing or in the Tax Court because it already challenged the penalty at Appeals).

[2793] §6330(c)(4)(A). *See Loveland v. Commissioner*, 151 T.C. 78 (2018) (collection alternative may be raised at CDP hearing; negotiations with collection officer is not "previous administrative … proceeding" under §6330(c)(4)(A)).

[2794] §6330(c)(4)(B). See discussion at VIII.C.1.b., above.

[2795] §6330(c)(4)(C).

[2796] §6330(c)(4) (flush language).

[2797] §6330(b)(2). Another hearing may be obtained if there is a different type of tax or if the amount of unpaid tax has changed. Reg. §301.6330-1(d)(2) Q-D 1. However, the taxpayer is not entitled to another hearing for the subsequent assessment of accrued interest or penalties. Reg. §301.6330-1(d)(2) Q-D 1. In PMTA 2011-42, the Chief Counsel's Office concluded that a taxpayer who has been issued a CDP notice listing a §6651 failure to file or failure to pay penalty based on the amount shown on the return is entitled to a second CDP notice when a failure to file or failure to pay addition is imposed on the deficiency amount for the same period as the return. Because such penalties are imposed at different times, the means for resolving collection of each of them will differ depending on the taxpayer's circumstances. As a result, the Chief Counsel's Office advised that, although the CDP regulations do not specifically identify the imposition of failure to pay penalty as a circumstance under which a taxpayer may receive more than one hearing (and notice) for a tax period, the regulations should be interpreted to include a failure to pay penalty, as it is sufficiently similar to a failure to file penalty.

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lous position in Tax Court.[2798] In such case, however, the taxpayer cannot challenge the merits of the §6673 penalty at the CDP Hearing, because the taxpayer already had the opportunity to protest the imposition of the penalty in the Tax Court case and to appeal the penalty award. Notwithstanding the foregoing, the IRS acknowledged that the taxpayer can still raise some limited issues at a CDP Hearing, including the appropriateness of the proposed collection action,[2799] eligibility for an installment agreement and whether the proposed collection action balances the need for efficient collection against the taxpayer's concern that any collection action be no more intrusive than necessary.[2800]

There is no mandated time limit within which the Appeals office must conduct the collection due process hearing or render its decision. However, Appeals will attempt to hold the CDP Hearing and issue its notice of determination as expeditiously as possible under the circumstances.[2801] The notice of determination sets forth Appeals' findings and decisions with respect to the issues involved in the hearing, and is sent to the taxpayer by certified or registered mail.[2802]

If the taxpayer disagrees with the IRS Appeals office's determinations from the CDP Hearing, the taxpayer can appeal such determination within 30 days after the date of the notice of determination.[2803] The Tax Court has sole jurisdiction over all appeals of CDP cases.[2804] The Tax Court has jurisdiction under §6330 to review any collection determination, even if it would not have jurisdiction under the deficiency procedure provisions.[2805] However, on appeal, the court can only consider an issue that was properly raised in the taxpayer's CDP Hearing.[2806]

If the taxpayer requests a CDP Hearing, levy actions relating to the tax periods covered by the collection due process notice are suspended during the period in which the hearing and any appeal is pending.[2807] A levy can continue during a judicial appeal if the underlying tax is not at issue and the court determines that the IRS has good cause not to suspend the levy, for example, in jeopardy situations.[2808] Levies relating to other periods are not affected. A timely filed request for a CDP Hearing also suspends the statute of limitations on collection and other suits for the period being appealed.[2809]

4. *Equivalent Hearing*

A taxpayer who fails to make a timely request for a CDP Hearing is not entitled to such a hearing. The taxpayer may nevertheless request an administrative hearing with the IRS Appeals office (an "equivalent hearing").[2810] The request must be made in a writing signed by the taxpayer or his authorized representative, which is dated, and includes the following information: (a) the taxpayer's name, address, daytime telephone number (if any), and taxpayer identification number; (b) the type of tax at issue; (c) the tax period; (d) a request for an equivalent hearing; and (e) the reason the taxpayer disagrees with the levy.[2811] The equivalent hearing generally follows the procedures for a CDP Hearing,[2812] and consider the same issues that would have been considered at a CDP Hearing.[2813]

There are, however, major differences between an equivalent hearing and a CDP Hearing. Appeals' determination following an equivalent hearing is not subject to judicial appeal.[2814] Collection action is not required to be suspended during an equivalent hearing.[2815] Generally, levy action is suspended during such hearing, but may be appropriate, for example, if collection is at risk, the taxpayer raises only frivolous or constitutional issues, or the taxpayer is seeking merely to delay the collection process.[2816] The decision to take collection action during the pendency of an equivalent hearing is determined on a case-by-case basis.[2817] Moreover, requesting an equivalent hearing does not suspend the statute of limitations.[2818]

5. *Taxpayer Assistance Order*

A taxpayer who is suffering or about to suffer a significant hardship as a result of the manner in which the tax laws are being administered by the IRS may obtain a taxpayer assistance order from the Taxpayer Advocate Service ("TAS").[2819] A "significant hardship" is defined as a serious privation caused (or

[2798] CCA 200407019. The penalty for promoting abusive tax shelters under §6700 is another penalty that does not relate to a taxable period.

[2799] §6330(c)(2)(A)(ii); Reg. §301.6330-1(e)(3) Q-E7.

[2800] §6330(c)(3)(C); CCA 200407019.

[2801] Reg. §301.6330-1(e)(3) Q-E9.

[2802] Reg. §301.6330-1(e)(3) Q-E8.

[2803] §6330(d)(l); Reg. §301.6330-1(e)(3) Q-E8, 10. Failure to file a petition to the court within 30 days bars judicial review. The 30-day period is suspended in the case of a taxpayer who is prohibited from filing a petition by reason of a bankruptcy case under Title ll of the U.S. Code. §6330(d)(2). The 30-day period can be extended under §7508A. See Tables, Charts and Lists (Federal) > *Postponements Due to Combat Zone or Contingency Operation Service, Federally Declared Disasters, Significant Fires, or Terroristic or Military Actions*, for an updated list of acts whose deadlines may be postponed.

[2804] §6330(d)(1).

[2805] *McNeill v. Commissioner*, 148 T.C. 481 (2017).

[2806] Reg. §301.6330-1(f)(2) Q-F3.

[2807] §6330(e)(2).

[2808] §6330(e)(2). Levies on state income tax refunds, on federal contractors, and disqualified employment tax levies can also be made. Reg. §301.6330-l(g)(2) Q-G3; IRM 5.1.9.3.5.1 (10-19-23).

[2809] §6330(e)(1). The statute of limitations will not expire before the 90th day after the IRS receives the taxpayer's written withdrawal of its request for a collection due process hearing or the determination resulting from the hearing becomes final (by expiration of the time for seeking judicial review or the exhaustion of any rights to appeal following judicial review). Reg. §301.6330-1(g)(1). The suspension does not apply, however, if collection is in jeopardy or for levies on state tax refunds. *See* Reg. §301.6330-1(g)(2) Q-G3.

[2810] Reg. §301.6330-1(i)(1).

[2811] Reg. §301.6330-l(i)(2) Q-I1(ii). The taxpayer may perfect a timely written request for an equivalent hearing that does not include all of the required information within a reasonable time after a request from the IRS. IRS procedures allow a taxpayer to request an equivalent hearing by (a) checking the equivalent hearing box on Form 12153 *Request for a Collection Due Process Hearing or Equivalent Hearing*, (b) verbally confirming that he wants an untimely CDP Hearing request to be treated as a request for an equivalent hearing, or (c) otherwise indicating in writing that he wishes an equivalent hearing if the CDP Hearing request is untimely. IRM 5.1.9.3.2.2(3) (10-19-23).

[2812] Reg. §301.6330-1(i)(l).

[2813] Reg. §301.6330-1(i)(2) Q-I2.

[2814] Reg. §301.6330-1(i)(2) Q-I6. The determination is set forth in a decision letter. Reg. §301.6330-1(i)(1).

[2815] Reg. §301.6330-1(i)(2) Q-I4.

[2816] IRM 5.1.9.3.5.1(2) (08-30-18).

[2817] Reg. §301.6330-l(i)(2) Q-I4.

[2818] Reg. §301.6330-1(i)(2) Q-I3.

[2819] §7811(a)(1); Reg. §301.7811-1(a). For a further discussion, see 623 T.M., *IRS Procedures: Examinations and Appeals.*

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about to be caused) to the taxpayer as a result of the way the IRS is administering the tax law.[2820] It includes:[2821]

- An immediate threat of adverse action;
- A delay of more than 30 days in resolving taxpayer account problems;
- The incurring by the taxpayer of significant costs (including fees for professional representation) if relief is not granted; or
- Irreparable injury to, or a long-term adverse impact on, the taxpayer if relief is not granted.

Financial distress is not required for a significant hardship.[2822] Moreover, the foregoing factors are not exclusive.[2823]

A Taxpayer Assistance Order ("TAO") may require the IRS to release property of the taxpayer that has been levied upon, or to cease any action, take any action permitted by law, or refrain from taking any action relating to collection of a tax.[2824]

A finding that the taxpayer is suffering or is about to suffer a significant hardship as a result of the manner in which the tax laws are being administered by the IRS does not automatically result in a TAO granting relief. A finding of significant hardship is separate and distinct from a determination that the taxpayer will be granted relief.[2825] The granting of relief requires an examination of the taxpayer's behavior and the action or inaction of the IRS that causes or is about to cause the significant hardship to the taxpayer.[2826] If the IRS is not following applicable published guidance (including the Internal Revenue Manual), the Taxpayer Advocate must construe the factors in the manner most favorable to the taxpayer.[2827] A TAO cannot be used to circumvent the specific provisions of the statute, even if the hardship results from such provisions, or to contest the merits of a tax liability.[2828] Nor is a TAO intended to be a substitute for, or an addition to, any established administrative or judicial review procedure.[2829]

Comment: A TAO is not intended to be a substitute for an established administrative or judicial review procedure, but rather is intended to supplement existing procedures if a taxpayer is about to suffer or is suffering a significant hardship.[2830]

The taxpayer can apply for taxpayer assistance by filing a Form 911, *Request for Taxpayer Advocate Service Assistance (and Application for Taxpayer Assistance Order)*, or a written statement that provides sufficient information for TAS to determine the nature of the harm or the need for assistance.[2831] The IRS also has the power to issue a TAO on its own, without an application.[2832] The taxpayer's application for relief suspends the statute of limitations on collection actions. The statute can be further suspended by the TAO.[2833]

The IRS will comply with a TAO, unless the TAO is appealed and then modified or rescinded.[2834] Only the Taxpayer Advocate, the Commissioner, and the Deputy Commissioner have the power to modify or rescind a TAO.[2835] Any such modification must be accompanied by a written explanation to the National Taxpayer Advocate of the reasons for such modification or rescission.[2836]

6. Collection Appeals Program

Normally, a taxpayer can appeal collection activity under the IRS Collection Appeals Program before or after a levy.[2837] Since penalties have separate appeal procedures, they are excluded from the Collection Appeals Program.[2838] A taxpayer who tries to appeal a penalty under the Collection Appeals Program will be advised of the proper procedure. Collection action is generally suspended while Appeals considers the matter, unless the IRS believes collection is in jeopardy. The decision of the Appeals Office in a Collection Appeals Program appeal is binding on both the IRS and the taxpayer, and is not subject to judicial review.[2839]

7. Refund Claim

Rather than contesting the collection of a penalty, the taxpayer may pay the penalty in full and file a claim for a refund.[2840] If the claim for refund is denied or the IRS does not respond within six months, the taxpayer has two years to file a suit for refund in district court or the Court of Federal Claims.[2841]

C. Persons Responsible for Penalty

1. In General

In the case of the §6672–§6724 penalties, the penalty can also be imposed against a corporate officer or employee (or a member or employee of a partnership) whose duty was to perform the act with respect to which the violation occurred.[2842] A director of a corporation can also be held liable, even if he is

[2820] Reg. §301.7811-1(a)(4)(ii).
[2821] §7811(a)(2).
[2822] H.R. (Conf.) Rep. No. 105-599 at 215–16 (1998).
[2823] Reg. §301.7811-1(a)(4)(ii).
[2824] §7811(b). The TAO can also stop or require action with respect to the taxpayer under Chapter 70B (relating to bankruptcy and receivership), Chapter 78 (relating to discovery of liability and enforcement of title), or any other provision of law that is specifically described by the taxpayer advocate in the TAO.
[2825] Reg. §301.7811-1(a)(5).
[2826] Reg. §301.7811-1(a)(5).
[2827] §7811(a)(3).
[2828] *See* IRM 13.1.20.2 (06-14-23).
[2829] Reg. §301.7811-1(c)(3).
[2830] Reg. §301.7811-1(b).
[2831] Reg. §301.7811-1(b) (promulgated before amendments to §7811).
[2832] Reg. §301.7811-1(a)(3).
[2833] §7811(d).
[2834] Reg. §301.7811-1(c)(2).
[2835] §7811(c)(1).
[2836] §7811(c)(2).
[2837] IRS Pub. 1660, *Collection Appeal Rights*; IRM 8.24.1.3(2) (9-28-21).
[2838] IRM 8.24.1.3.3(1) (9-28-21).
[2839] IRS Pub. 1660, *Collection Appeal Rights*; IRM 8.24.1.3.9(2) (9-28-21).
[2840] §7422(a). Although the payment of a divisible assessment is sufficient, a penalty that accrues monthly is not divisible by months. *Christian Laymen in Partnership Ltd. v. United States*, 90-1 USTC ¶50,042 (W.D. Okla. 1989) (with respect to the penalty for failing to file a partnership tax return). Similarly, the penalty for promoting an abusive tax shelter is not divisible by sale to each investor. *Noske v. United States*, 911 F.2d 133 (8th Cir. 1990), 88-2 USTC ¶9582 (D. Minn. 1988). Accordingly, the entire penalty must be paid to claim a refund. For a detailed discussion of refund claims, see 631 T.M., *Refund Litigation.*
[2841] §6532(a)(1), §6532(a)(2). The two-year period may be extended by agreement.
[2842] §6671(b). For discussion of the §6672 penalty, see 639 T.M., *Responsible Person and Lender Liability for Trust Fund Taxes — Sections 6672 and 3505.*

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not an officer or employee.[2843] Simply holding a corporate office, without more, does not render an officer personally liable for a penalty.[2844]

The liability imposed against any particular corporate officer is separate from any assessment against the corporation itself.[2845] In the case of a partnership, the general partners are personally responsible for liabilities of the partnership, including a liability for a tax penalty. Moreover, if a partner in his individual capacity and the partnership each violate the statute, they may each be subject to separate penalties.[2846]

2. General Partners

Under state law, each general partner is jointly and severally liable for the debts and obligations of the partnership.[2847] A general partner is therefore liable for a penalty assessed against the partnership.[2848] A settlement with a specific general partner does not prevent the IRS from pursuing the other general partners for the balance.[2849]

If the penalty arises because of the partnership's action (or inaction), the Supreme Court held that the penalty does not have to be separately assessed against the individual general partners for the IRS to proceed against them.[2850] Because the penalty in question is first a partnership liability — in the sense that it arose from the partnership's failure to comply with the law — assessment against the partnership is sufficient. Once the tax has been properly assessed, nothing in the Code requires the IRS to duplicate its efforts by separately assessing the same tax against individuals or entities who are not the actual taxpayers but are, by reason of state law, liable for payment of the taxpayer's debt.[2851]

As a result, the IRS concluded that the general partner is liable for the penalty imposed against the partnership, even though the statute of limitations on assessment of the tax against the partnership has expired.[2852] In such situation, however, the general partner is not liable for the tax.

The Supreme Court's decision in did not alter the IRS's position that the IRS may administratively collect a partnership's employment taxes from the general partners, based on their derivative liability under state law,[2853] and the U.S. District Court for the Central District of California agreed.[2854] According to the IRS, after notice and demand for the tax to the partnership under §6303, a federal tax lien attaches to the property of the partnership and each general partner (without the requirement for a separate notice and demand) and the IRS may levy against a general partner's property.[2855] In each case, collection due process notices must be given to the general partners.[2856]

3. Innocent Spouse Relief

Spouses filing a joint return are jointly and severally liable for the income tax with respect to such return.[2857] However, relief from joint and several liability is available in certain cases. If the relief applies, the requesting spouse is not liable for the deficiency, interest or penalty attributable to an understatement of tax attributable to the other spouse, provided that, at the time the return was signed, the requesting spouse did not know or have reason to know of the underpayment.[2858] In addition, an individual who is no longer married to, or is legally separated from, the spouse with whom the individual filed a joint return, or such individual was not a member of the same household of the spouse with whom the joint return was filed at any time during the 12-month period ending on the date the election is filed, the individual's liability for any deficiency assessed with respect to the joint return will not exceed the portion of the deficiency allocable to the individual.[2859] The portion of the deficiency which bears the same ratio to such deficiency as the net amount of items taken into account in computing the deficiency that are allocable to the individual (generally, determined in the same manner as if the spouses filed separate returns) bears to the net amount of all items taken into account in computing the deficiency.[2860] Finally, relief is potentially available when it would be inequitable, under all the facts and circumstances, to hold the requesting spouse liable for the unpaid obligation or understatement of income.[2861]

Any accuracy-related penalty under §6662 or fraud penalty under §6663 is allocable to the spouse whose income generated the penalty.[2862] The methodology is illustrated in *Estate of Capehart*.[2863] In the case of tiered partnerships, the computation is made separately at each tier, starting with the lowest tier.[2864]

> *Example:* Husband and Wife file a joint return showing a tax of $25,000. Erroneous items attributable to Husband, of which Wife had no knowledge, would increase the tax by $5,000. Erroneous items attributable to Wife would increase the tax by $2,000. As a result, Wife is only liable for an accuracy-related penalty of $400 (20% × $2,000 attributable to Wife).

[2843] *United States v. Graham*, 309 F.2d 210 (9th Cir. 1962).

[2844] *Campbell v. Nixon*, 207 F. Supp. 826 (E.D. Mich. 1962).

[2845] *Rosenberg v. United States*, 327 F.2d 362 (2d Cir. 1964).

[2846] See discussion at VIII.A.1.b., above.

[2847] *See* Uniform Partnership Act §306(a) (1997); Uniform Limited Partnership Act §404(a) (2001); Uniform Limited Partnership Act §403(b) (1996).

[2848] *See, e.g.*, *United States ex rel. Perler v. Papandon*, 331 F.3d 52 (2d Cir. 2003); *Remington v. United States*, 210 F.3d 281 (5th Cir. 2000); *Ballard v. United States*, 17 F.3d 116 (5th Cir. 1994); *United States v. Hays*, 877 F.2d 843 (10th Cir. 1989); *Tony Thornton Auction Serv., Inc. v. United States*, 791 F.2d 635 (8th Cir. 1986); *Calvey v. United States*, 448 F.2d 177 (6th Cir. 1971); *Young v. Riddell*, 283 F.2d 909 (9th Cir. 1960).

[2849] CCA 200144002.

[2850] *United States v. Galletti*, 541 U.S. 114 (2004).

[2851] *United States v. Galletti*, 541 U.S. 114 (2004).

[2852] FAA 20042307F.

[2853] Notice CC-2005-003.

[2854] *Pitts v. United States*, 515 B.R. 317 (C.D. Cal. 2014), aff'd, 668 Fed. App'x 774 (9th Cir. 2016).

[2855] Notice CC-2005-003. Chief Counsel advises the IRS to include the name of each general partner on the notice of federal tax lien to avoid any attack that the public was not properly notified.

[2856] Notice CC-2005-003; §6320(a)(1), §6330(a)(1).

[2857] §6013(d)(3).

[2858] §6015(b). For a detailed discussion, see 645 T.M., *Innocent Spouse Relief*.

[2859] §6015(c)(l), §6015(c)(3).

[2860] §6015(d)(l), §6015(d)(3).

[2861] §6015(f).

[2862] Reg. §1.6015-3(d)(4)(iv)(B).

[2863] *Estate of Capehart v. Commissioner*, 125 T.C. 211 (2005).

[2864] *Andrews v. Commissioner*, T.C. Memo 2010-230; *Malsom v. Commissioner*, T.C. Memo 2010-231.

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D. Transferee Liability

The transferee-liability provisions[2865] allow the IRS to collect a tax (and penalties) from a person other than the taxpayer if that person is a transferee of the taxpayer's property at law or in equity. The Code does not define whether a person is a transferee at law or in equity, although §6901 provides that transferees include donees, heirs, devisees, and distributees and certain persons personally liable for estate taxes.[2866] The regulations add a few additional categories, such as shareholders of dissolved corporations.[2867]

Tax and, where applicable, penalties are assessed and collected against a transferee in the same manner as a transferor.[2868] The IRS must send a notice of deficiency, and the transferee can then petition the Tax Court.[2869] Alternatively, the transferee may pay the tax and penalties and file a claim for refund.[2870]

[2865] §6901. For a detailed discussion of the transferee liability provisions, see 628 T.M., *Transferee Liability*.

[2866] §6901(h).

[2867] Reg. §301.6901-1(b).

[2868] §6901(a).

[2869] *See* XII.B.1., above.

[2870] *See* XII.B.7., above.

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XIII. Seriously Delinquent Tax Debt

If the IRS certifies that a taxpayer has a "seriously delinquent tax debt," the Treasury Secretary must transmit the certification to the Secretary of State, who must deny the taxpayer a passport (or renewal of a passport) and must revoke the taxpayer's existing passport.[2871] A seriously delinquent tax debt is an unpaid, legally enforceable[2872] federal tax liability of an individual in excess of $50,000 (adjusted for inflation) that has been assessed and for which either (i) a notice of lien has been filed and administrative rights with respect to the notice of lien have been exhausted or have lapsed, or (ii) a levy is made.[2873] Tax debt is not treated as seriously delinquent if the debt is being paid in a timely manner pursuant to an installment agreement or an offer-in-compromise, or if collection action is suspended for the debt because a collection due process (CDP) hearing or innocent spouse relief has been requested or is pending.[2874] However, the Secretary of State may issue or renew a passport for humanitarian or emergency reasons despite the taxpayer having a seriously delinquent tax debt.[2875]

The IRS must reverse certifications when the certification is erroneous, the debt has been fully satisfied, or the tax debt ceases to be seriously delinquent.[2876] The IRS must notify the taxpayer about the certification, and of any reversal of a certification.[2877] Taxpayers have the right of judicial review in federal district court or the Tax Court to determine the validity of the certification.[2878]

Note: Appeals consideration is unavailable for a certification or issuance of a notice of certification to the State Department under §7345.[2879]

For further discussion, see 637 T.M., *Federal Tax Collection Procedure — Liens, Levies, Suits, and Third-Party Liability*.

[2871] §7345(a).

[2872] *See Garcia v. Commissioner*, No. 27496-22P., 164 T.C. No. 8, 2025 BL 171758 (2025) (whether taxpayer's federal tax liability was "legally enforceable" depended on whether collections limitations period expired).

[2873] §7345(b)(1), §7345(f). The inflation-adjusted amounts for recent years are available in Tables, Charts & Lists, *Revocation or Denial of Passport in Case of Certain Tax Delinquencies*.

[2874] §7345(b)(2).

[2875] Fixing America's Surface Transportation Act, Pub. L. No. 114-94, Div. C, §32101(e)(1)(B).

[2876] §7345(c).

[2877] §7345(d).

[2878] §7345(e). Tax Court Rules 350–354 apply to a certification or a failure to reverse a certification action regarding a passport. CC-2018-005 contains further information regarding the judicial review of certifications and directs Chief Counsel attorneys on how to handle arguments that taxpayers are likely to raise on review, including challenges to underlying liabilities, the period of limitations, and the scope of review.

[2879] Reg. §301.7803-2(c)(12), applicable to requests for consideration by Appeals made after February 13, 2025.

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Working Papers for this Portfolio can be found online at *https://bloombergtax.com.*

Other Resources

• Tables, Charts & Lists, *Penalties.*

• Guide to Most Common Information Returns: Names; What to Report; Amounts to Report; Due Dates from General Instructions for Certain Information Returns:
https://www.irs.gov/pub/irs-pdf/i1099gi.pdf.

• Penalty Relief — Application Chart (Reasonable Cause and Other Relief) — IRM Exhibit 20.1.1-1:
https://www.irs.gov/irm/part20/irm_20-001-001r#idm140198852679328.

• Policy Statements for Submission Processing Activities — IRM 1.2.1.4:
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• Policy Statements for Penalties and Interest Activities — IRM 1.2.1.12:
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• IRS LB&I Process Unit — Erroneous Claim for Refund or Credit Penalty:
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