

Penalty Games: Reducing IRS Penalties
by

ROBERT E. McKENZIE, EA, ATTORNEY

**ARNSTEIN & LEHR
SUITE 1200
120 SOUTH RIVERSIDE PLAZA
CHICAGO, ILLINOIS 60606
(312) 876-7100**

REMCKENZIE@ARNSTEIN.COM
<http://www.mckenzielaw.com>

Penalty Games: Reducing IRS Penalties

TABLE OF CONTENTS

INTRODUCTION		1
1. FAILURE TO FILE TAX RETURN OR PAY TAX.....		1
1.10 Failure to File and Failure to Pay Penalties		1
1.20 Common Features.....		1
1.30 Coordination Between FTF and FTP Penalty Rates.....		1
1.40 Who Asserts		2
1.50 Extension of Time to File.....		2
1.60 Received Date, IRC Section 7502		3
1.70 Definition of Month		4
1.80 Net Tax Due		4
1.90 Minimum Failure to File		5
1.95 Penalty for Failure to File Income Tax Return Increased		5
1.100 Failure to File a Tax Return IRC Section 6651(a)(1)		5
1.110 Penalty Computation		5
1.120 Penalty Period		5
1.130 Penalty Rate.....		6
1.140 Tax (FTP) IRC Section 6651(a)(2).....		6
1.150 Penalty Period		6
1.160 Penalty Rate.....		6
1.170 Failure to Pay Tax IRC Section 6651(a)(3).....		7
1.180 Net Amount Due		7
1.190 IRC Section 6651(d) Increase in the FTP.....		7
1.200 Failure to Pay Penalty When Paying in Installments Decreased		8
1.210 Penalty Calculations		8
2. FRAUDULENT FAILURE TO FILE		9
2.10 Fraudulent Failure to File IRC Section 6651(f).....		9
2.20 Penalty Rate.....		9
2.30 Estimated Tax Penalties, Overview		9
2.40 Penalty Rate.....		9
3. FAILURE TO DEPOSIT		10
3.10 Failure-to-Deposit Penalty Overview and General		10
3.20 Failure to Deposit Penalty Rate		10
3.30 Time Sensitive Portion of the FTD Penalty		10
3.40 Correction of Cascading Failure to Deposit Penalty		11
4. REASONABLE CAUSE.....		11
4.10 Reasonable Cause		11

4.20 Standards.....	12
4.30 Ordinary Business Care and Prudence.....	12
4.40 Ignorance of the Law	13
4.50 Mistake was Made	14
4.60 Forgetfulness	14
4.70 Death, Serious Illness, or Unavoidable Absence	15
4.80 Unable to Obtain Records	16
4.90 Statutory Exceptions & Administrative Waivers	16
4.100 Administrative Waiver	17
4.110 Undue Hardship	18
4.120 Advice	19
4.130 Written Advice from the Service	20
4.140 Oral Advice from the Service	20
4.150 Advice from a Tax Advisor	21
4.160 Fire, Casualty, Natural Disaster, or Other Disturbance	21
4.170 Official Disaster Area	22
4.180 Service Error.....	22
5. ACCURACY PENALTIES.....	22
5.10 OBRA 89 Consolidated and Renumbered the Following Penalty Code Sections	22
5.20 Common Features: Accuracy-Related and Civil Fraud Penalties	23
5.30 Negligence or Disregard of Rules and Regulations	23
5.40 Negligence Penalty Assertion.....	23
5.50 Penalty Relief.....	24
5.60 IRC Section 6662(d): Substantial Understatement.....	25
5.70 Substantial Authority Exception	25
5.80 Adequate Disclosure Exception	28
6. HISTORY AND REQUIREMENTS.....	28
6.10 History and Requirements of Abatement of Interest Claims	28
6.20	29
6.30	29
6.40	29
6.50 Jurisdiction.....	29
6.60 Suspension of Interest	29
6.70 Abatement of Interest in Presidentially Declared Disaster Areas	30
6.80 Notice of Interest Charges	30
Exhibit	31-36

Penalty Games: Reducing IRS Penalties

Robert E McKenzie, Attorney

INTRODUCTION

Procedural Requirements for Imposition of Penalties and Additions to Tax

The Internal Revenue Service Restructuring Act requires that each notice imposing a penalty include the name of the penalty, the Code section imposing the penalty, and a computation of the penalty. The Act also requires the specific approval of IRS management to assess all non-computer generated penalties unless excepted. This provision does not apply to failure to file penalties, failure to pay penalties, or to penalties for failure to pay estimated tax. **The provision is effective with respect to notices issued, and penalties assessed, after December 31, 2000. [Act '3306] [IRC '6751]**

1. FAILURE TO FILE TAX RETURN OR PAY TAX

1.10 The Failure to File and Failure to Pay Penalties are:

- IRC Section 6651(a) Failure to File a Return
- IRC Section 6651(a)(1) Failure to File a Tax Return
- IRC Section 6651(a)(2) Failure to Pay a Tax
- IRC Section 6651(a)(3) Failure to Pay a Tax within 10 days of Notice and Demand
- IRC Section 6651(d) Increase in the Penalty for Failure to Pay in Certain Cases
- IRC Section 6651(f) Increase in the Penalty for Fraudulent Failure to File
- IRC Section 6698 Failure to File a Partnership Return

1.20 Common Features

Generally, a failure to file (FTF) and/or failure to pay (FTP) penalty discussed in this chapter is based on the amount of tax required to be shown on a late-filed or late paid return, reduced by any portion of the tax paid on or before the prescribed due date of the return. An exception to this general rule is the Failure to File a Partnership return, IRC section 6698, which is based on a penalty of \$50 per month, per partner for each month the return is late.

1.30 Coordination between FTF and FTP Penalty Rates

1. If both the FTF (under IRC section 6651(a)(1)) and FTP (under IRC section 6651(a)(2)) penalties apply, the FTP penalty amount is allowed as an offset against the FTF penalty for any month in which both apply. When this occurs, the combined penalty rate for the month will not exceed five percent.
2. For example; if the FTP penalty rate of one-half of one percent (.005) is applicable, the FTF penalty would be assessed at 4.5 (.045) percent.

3. When both the FTP penalty and minimum failure to file penalty apply (income tax returns only), the minimum failure to file penalty is not reduced by the amount of the FTP penalty.

1.40 Who Asserts

Generally, all areas of the Service may assert or assess the penalty, based on the circumstances at the time the return is received. On a delinquent tax return mailed to the Service after the due date of the return:

1. Master File assesses any appropriate FTF and/or FTP penalty at the time the tax is assessed and the taxpayer will be sent a balance due notice.
2. Additions to tax (penalty and interest) will accrue.

1.50 Extension of Time to File

1. General Rule: IRC section 6081 and the related regulations provide for a reasonable extension of time to file a return.
2. That "reasonable extension" is not to exceed 6 months (unless the taxpayer is overseas).
 - A. If the taxpayer has a valid extension of time for filing a return, that taxpayer is not liable for the FTF penalty for the duration of the extension period. The computation of the FTF penalty begins immediately after the extended due date.
 - B. However, an extension of time to file is not an extension of time to pay. Generally, once the signed return is received, the FTP penalty will be computed from the original due date of the return to the date the tax is paid.
 - C. Individuals are granted the automatic four month extension of time to file if the following conditions are satisfied: (Treas. Regs. 1.6081-1 and 1.6081-4 and 4T)
 - (1) The individual must have completed Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return.
 - (2) Signed the request as required in IRC section 6061, Signing of returns and other documents by individuals.
 - (3) Filed the application on or before the due date of the return.
 - (4) Effective for tax year 1991 and prior: (1) the application must have shown the amount of tax properly estimated to be due; and (2) the amount properly estimated to be due, must have been paid with the application.
 - (5) Effective for the tax year 1992 and subsequent, Notice 93-22, 1993-1 C.B.

305, issued April 7, 1993, granted individuals a four month extension of time to file **even if they are unable to pay the amount of tax properly estimated to be due**. They must however: (1) complete and file the Form 4868 prior to the original due date of the return; (2) sign the request; and (3) properly estimate the amount of tax due.

1.60 Received Date, IRC Section 7502

1. A return is considered timely, if received prior to, or on, the due date or extended due date of the return.
2. U.S. Postal Service. Consider a return timely-filed if postmarked by the U.S. Postal Service by the original or extended due date.
 - A. A postmark with a date after the prescribed due date is late.
 - B. When more than one United States Postal Service postmark date appears on an envelope, consider the earlier postmark date as the date the return was mailed.
3. Privately Metered Mail. In general, consider a return timely filed if it contains a postal meter stamp that:
 - A. Bears the date on or before the last date (or last day of the period) prescribed for filing the return, and
 - B. The return is received not later than the time the return would normally have been received if it had been mailed on the last date (or last day of the period) prescribed for filing the return.
4. If the return is received after the normal time , the taxpayer must prove the factors in IRC section 301.7502-1(c)(iii)(b) which in general states:
 - A. The document must show a postmarked date that is on or before the last day of the period prescribed for filing the document.
 - B. The document must be received by the Service not later than the time the document would have been received if it were postmarked at the same point of origin by the United States Post Office.
 - C. In addition, the person who is required to file the document must show: the document was deposited before the last collection of the mail (from the place of deposit) on or before the last day prescribed for filing the document, any delay in receiving the document was due to a delay in the transmission of the mail, and caused the document to be received after the due date of the document.
5. Designated Private Delivery Services. Section 1210 of the Taxpayer Bill of Rights 2

TBOR 2), Pub. L. No. 104-168, 110 Stat. 1452, added subsection (f) to IRC section 7502. This provision authorizes the Service to expand the "timely mailing as timely filing/paying" rule to certain private delivery services.

1.70 Definition of Month

1. If the date prescribed for filing a return is the last day of a calendar month, each succeeding calendar month or (fraction thereof) during which the failure to file or pay continues is a month for the purposes of the FTF/FTP penalty. For example, when a return is due January 31, 1989, the first month ended on February 28, and the succeeding months ended on March 31, April 30, etc.
2. If the date prescribed for filing the return or paying the tax is other than the last day of the calendar month, the period ends with the corresponding day in the following month.
3. If there is no corresponding day, consider the last day of the following month as the ending date.
4. Example: The failure to pay due date falls on January 30, 1992,
 - A. 1992 is a leap year. February has no corresponding due date.
 - B. The period from January 30th through the last day of the following month (February 29, 1992) shall be considered a month for the purposes of the FTF and FTP penalty.
 - C. If the tax remains unpaid, the FTP penalty due date will fall on the 30th day of each succeeding month.
5. If a return is not timely filed or the tax is not timely paid, the fact that the date prescribed for filing the return or paying the tax, or the corresponding date in any succeeding calendar month, falls on a Saturday, Sunday, or a legal holiday is immaterial in determining the number of months for the FTF/FTP penalty. Treas. Reg. 301.6651-1(b)(3).

1.80 Net Tax Due

1. The net tax amount is the amount of tax required to be shown on the return less allowable credits, such as general business credits, foreign income tax credits, SIC and fuel tax credits. This amount is reduced by payments made on or before the prescribed due date of the return (excluding extensions), such as withholding credits, tax deposits, estimated tax payments, overpayments from prior periods, or other payments made on or before the prescribed due date of the return.
2. The penalty applies not only to tax shown on a taxpayer's original return, but also to

any additional tax later found due on the return.

3. The net tax amount required to be shown on the return includes all income taxes as well as employment taxes. For example, the uncollected employee FICA tax on tips is a tax required to be shown on Form 1040, Individual Tax Return; thus, this uncollected FICA tax on tips should be included in the net tax amount.
4. When computing the net tax amount, the IRS will not consider amounts which were paid after the due date of the return, but before the date of filing.

1.90 Minimum Failure to File

For late returns a minimum FTF penalty applies to all individual and corporate income tax returns delinquent for more than 60 days. The minimum FTF penalty shall not be less than the lesser of: \$135.00 or 100 percent of the amount required to be shown as tax on the return.

1.95 Penalty for Failure to File Income Tax Return Increased

If you do not file your return by the due date (including extensions) you may have to pay a failure-to-file penalty. For income tax returns required to be filed after 2008, the failure-to-file penalty for returns filed more than 60 days after the due date (including extensions) is increased. In this situation, the minimum penalty is the smaller of \$135 or 100% of the unpaid tax.

1.100 Failure to File a Tax Return IRC Section 6651(a)(1)

IRC section 6651(a)(1) imposes a penalty for failure to file (FTF) a tax return, by the date prescribed (taking into consideration any extension of time for filing), unless it is shown that the failure is due to reasonable cause and not due to willful neglect.

1.110 Penalty Computation

To calculate the penalty:

1. determine the penalty period (number of months including a part of a month)
2. determine the penalty rate (4 1/2 or 5 percent);
3. determine the net tax due for each month (including a part of a month) the penalty is applicable; and
4. Multiply the number of months (including a part of a month) the return is past due, times the penalty rate, times the net tax due.

1.120 Penalty Period

The penalty period extends from the prescribed due date, including valid extensions, to the date the Service receives the return.

1. The prescribed due date is the date taxpayers are required to file their returns.

2. If the due date falls on a Saturday, Sunday, or legal holiday, and the return is filed by the next business day, consider it filed on the due date.
3. If the taxpayer has a valid extension of time for filing a return, he/she is not liable for the FTF penalty for the duration of the extension period.

1.130 Penalty Rate

1. Generally, the FTF penalty is 5 percent of the amount of the tax required to be shown on the return for each month, or fraction thereof, that the failure continues, not to exceed 25 percent of the tax.
2. When the FTP penalty under IRC section 6651(a)(2) also applies, the FTF penalty of 5 percent (.05) is reduced by 1/2 of 1 percent per month to 4 1/2 (.045) percent for each month or part of a month that the FTF and FTP both apply.
3. Be aware, that both the FTF and the FTP penalties may apply at the full rate, for the same amount of money, but for different periods in time.

1.140 Tax (FTP) IRC Section 6651(a)(2)

1. IRC section 6651(a)(2) imposes a FTP penalty if the tax shown on any return, other than an information return, is not paid by the due date of that return. The FTP penalty under this provision applies to original and amended returns filed by the taxpayer. This penalty applies to the following returns:
 - A. Income tax returns;
 - B. Employment tax returns;
 - C. Excise tax returns;
 - D. Gift tax returns;
 - E. Estate tax returns;
2. It does not apply to:
 - A. Information returns required under Chapter 61, Subchapter A, Part III;
 - B. Payments of estimated tax;
 - C. Partnership returns.

1.150 Penalty Period

The period for computing the IRC Section 6651(a)(2) penalty, which applies to original returns, is from the due date of the return until the tax is paid.

1.160 Penalty Rate

IRC section 6651(a)(2) provides that the FTP penalty be assessed at one-half of 1 percent (.005) of the unpaid tax for the first month the penalty applies and an additional one-half of

1 percent (.005) for each additional month or fraction of the month the tax is unpaid, not to exceed 25 percent of the tax.

1.170 Failure to Pay Tax IRC Section 6651(a)(3)

1. IRC section 6651(a)(3) imposes a FTP penalty on any tax required to be reported on a return, other than information returns, but was not reported on the return.
2. The FTF penalty is not reduced by the FTP penalty imposed under IRC section 6651(a)(3).
 - A. The FTF penalty will be computed from the original due date of the return for up to five months.
 - B. The FTP penalty imposed under IRC section 6651(a)(3) begins with the assessment (23C) date and continues until the additional tax is paid, not to exceed 25 percent of the tax.
 - C. Therefore, the FTF and FTP penalties may be assessed on the same amount of unpaid tax, but for different periods of time.
3. For the first notice and demand (first balance due notice) made:
 - A. Prior to January 1, 1997, the FTP penalty, under IRC section 6651(a)(3), was assessed when payment was not made within 10 days of notice and demand.
 - B. After December 31, 1996, the FTP penalty, under IRC section 6651(a)(3), is assessed if payment is not made within 21 calendar days (or 10 business days if the balance due amount equals or exceeds \$100,000) of notice and demand.

1.180 Net Amount Due

Net amount due as it relates to IRC section 6651(a)(3) is the amount of tax stated in the balance due notice. For purposes of computing the FTP penalty, the net amount due may be reduced by any payments made after the balance due notice but prior to the beginning of the following month.

1.190 IRC Section 6651(d) Increase in the FTP

1. IRC section 6651(d) increases the FTP penalty under IRC section 6651(a)(2) or (3) on any tax required to be reported on a return, from one-half of one percent (.005) to one percent (.01) of the tax after either:
 - A. The day, 10 days after the date notice of intent to levy (IRC section 6331(d)), or
 - B. The day on which notice and demand for immediate payment is given (IRC section 6631(a)).

2. The increased penalty rate (1 percent) applies to all subsequent assessments on that module. However, once a module is fully paid, a later assessment will accrue at the one-half of one percent rate until notice of intent to levy is sent.

1.200 Failure to Pay Penalty When Paying in Installments Decreased

Taxpayers who make '6159 installment payments under an agreement with IRS are now subject to a '6651(a) .0025 percent a month penalty instead of .0050 percent a month penalty for failure to pay taxes if the individual filed the tax return in a timely manner, including extensions (Act '3303; new Code '6651(h); effective for purposes of determining additions to the tax for months beginning after December 31, 1999).

1.210 Penalty Calculations

Example: Failure to File and Failure to Pay Form 1040

Return Due Date (041599) – Tax year 1998

Code	Date Received	Amount	Comments
TC150	122699	\$1,753.00	Amount of tax on return
TC610	112199	\$953.00	Payment received with the return
TC660	061798	\$800.00	Estimated tax payment

The tax is received seven months and 5 days after the due date of the return. For the purpose of computing the failure to file and failure to pay penalties, this equals eight months. Because both the failure to file and failure to pay penalty apply, the FTF will be computed at .045 for the first five months after the due date of the return.

$$\begin{array}{r}
 \$ 953.00 \\
 \times .045 \\
 \hline
 \$ 42.89 \text{ amount per month} \\
 \times 5 \text{ number of months} \\
 \hline
 \$214.45 \text{ Failure to file penalty}
 \end{array}$$

The failure to pay penalty continues to apply for the entire eight months and is computed at one half of one percent (.005).

\$ 953.00	
X .005	
\$ 4.77	amount per month
x 8	number of months
\$ 38.16	failure to pay penalty
\$214.45	FTF
+ 38.16	FTP
\$252.62	total penalty
\$252.61	total penalty

In this example the failure to pay penalty will continue for three months after the failure to file penalty reached the maximum amount.

2. FRAUDULENT FAILURE TO FILE

2.10 Fraudulent Failure to File IRC section 6651(f)

1. For returns due after December 31, 1989 (determined without regard to extensions), the civil fraud penalty, IRC section 6663, can only apply to situations when a return has been filed. This restriction was legislated in IRC section 6664(b) by OBRA 89.
2. OBRA 89 enacted IRC section 6651(f), Increase in Penalty for Fraudulent Failure to File (FFTF). This penalty generally has an impact equal to the severity of the civil fraud penalty.
3. The burden of proof is on the government to establish FFTF.

2.20 Penalty Rate

The FFTF penalty is 15 percent per month of the net amount due for each month the return is delinquent, up to a maximum of five months or 75 percent.

2.30 Estimated Tax Penalties, Overview

1. IRC section 6654 provides for a penalty when individuals, estates and most trusts underpay any required installment(s) of estimated income tax liabilities reportable on Forms 1040 (U.S. Individual Income Tax Return) and Forms 1041 (U.S. Fiduciary Income Tax Return).
2. For taxable years beginning before January 1, 1998, taxpayers will not be subject to estimated tax penalties if the tax shown on their return (or, if no return is filed, their tax liability), minus tax amounts withheld from wages during the year, is less than \$500. The Taxpayer Relief Act of 1997 increased the \$500 threshold to \$1,000 for taxable years beginning after December 31, 1997.

2.40 Penalty Rate

Although the estimated tax penalty is not interest, it is computed in the same manner as

interest, except it is NOT COMPOUNDED DAILY. Use the debit interest rate in effect for the appropriate time period. A. In accordance with IRC section 6621, the debit interest rate is determined quarterly. This means that the penalty on a \$1000 underpayment for one quarterly tax period may be different from the penalty on a \$1000 underpayment for a different quarterly tax period. B. Interest rates can be found in the Internal Revenue Bulletin (IRB), News Releases, TAX NEWS, Taxpayer Service Electronic Bulletin Board (TEBB) and Notice 433, Yearly Interest and Certain Penalty Rates.

3. FAILURE TO DEPOSIT

3.10 Failure To Deposit Penalty, Overview And General

1. The Internal Revenue Code (IRC) section 6656 provides for a Failure To Deposit (FTD) Penalty if a taxpayer does not deposit tax in the correct amount, within the prescribed time period, and/or in the required manner.
2. The obligation to deposit employment/excise taxes is ongoing and requires that the taxpayer continues to follow the requirements as long as the taxpayer is incurring these taxes. For example, as long as an employer has employees and is issuing a payroll, that employer must deposit as required.

3.20 Failure-to-Deposit Penalty Rate

The FTD Penalty is charged for any failure to deposit correctly. The three components of a correct deposit are that it is made timely, in the correct amount, and in the correct manner.

- A. A failure to comply with any of these components will subject the deposit to an FTD Penalty.
- B. Because there may be multiple deposits (with each individual deposit subject to scrutiny for compliance) on any one account, the FTD Penalty that is assessed on the account will be a sum of the "time-sensitive" penalty(ies) and/or the "avoidance" penalty(ies).

3.30 Time Sensitive Portion of the FTD Penalty

For deposits required after December 31, 1989, there is a four tier penalty system. The penalty rate assessed depends on the number of days a deposit is late, as shown below:

- percent for deposits 1--5 days late,
- 5 percent for deposits 6--15 days late,
- 10 percent for all direct payments and those deposits made more than 15 days late, but paid on or before the 10th day following notice and demand.
- 15 percent (actually, a 5 percent addition to the 10 percent for late payment in (c) above) for all un-deposited taxes still unpaid after the 10th day following the first balance due notice or the day on which notice and demand for immediate payment is given.

3.40 Correction of Cascading Failure to Deposit Penalty

Under prior law, deposits of payroll taxes were allocated to the earliest period for which a deposit was due. If the business makes an insufficient or no deposit, later deposits were first applied to the earlier period and the remainder is applied to the current period. Cascading penalties usually resulted that could have been avoided if later deposits were applied first to the current period. Now businesses can designate the period to which each deposit is applied during the 90-day period beginning on the date of a related IRS penalty notice. Also, the IRS now has the authorization to waive the failure to deposit penalty to the first deposit the business is required to change the frequency of the taxpayers deposits (e.g., from monthly to semi-weekly). (Act '3304; Code '6656; applicable to deposits required to be made more than 180 days after July 22, 1998. A deposit required to be made after December 31, 2001, must be applied to the most recent period or periods within the tax period to which the deposit relates unless the person making the deposit designates otherwise.)

4. REASONABLE CAUSE

4.10 Reasonable Cause

1. Reasonable cause is based on all the facts and circumstances in each situation and allows the Service to provide relief from a penalty that would otherwise be assessed. Reasonable cause relief is generally granted when the taxpayer exercises ordinary business care and prudence in determining their tax obligations but is unable to comply with those obligations.
2. In the interest of equitable treatment of the taxpayer and effective tax administration, the nonassertion or abatement of civil penalties based on reasonable cause or other relief provisions provided in this IRM must be made in a consistent manner and should conform with the considerations specified in the Internal Revenue Code (IRC), Regulations (Treas. Regs.), Policy Statements, and Part 20.1.
3. Reasonable cause relief is not available for all penalties; however, other exceptions may apply.
 - A. For those penalties where reasonable cause can be considered, any reason which establishes that the taxpayer exercised ordinary business care and prudence, but was unable to comply with a prescribed duty within the prescribed time, will be considered.
 - B. If a reasonable cause provision applies only to a specific Code section, that reasonable cause provision will be discussed in the IRM 20.1 chapter relating to that IRC section.

C. Remember that an acceptable explanation is not limited to those given in IRM 20.1.

4. The wording used to describe reasonable cause provisions varies. Some IRC penalty sections also require evidence that the taxpayer acted in good faith or that the taxpayer's failure to comply with the law was not due to willful neglect. See specific IRM sections for the rules that apply to a specific Code section.
5. Taxpayers have reasonable cause when their conduct justifies the nonassertion or abatement of a penalty. Each case must be judged individually based on the facts and circumstances at hand. Consider the following in conjunction with specific criteria identified in the remainder of IRM 1.3.
 - (1) What happened and when did it happen?
 - (2) During the period of time the taxpayer was non-compliant, what facts and circumstances prevented the taxpayer from filing a return, paying a tax, or otherwise complying with the law?
 - (3) How did the facts and circumstances prevent the taxpayer from complying?
 - (4) How did the taxpayer handle the remainder of their affairs during this time?
 - (5) Once the facts and circumstances changed, what attempt did the taxpayer make to comply?
6. 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.[IRM 20.1.1.3.1]

4.20 Standards

1. Any reason that establishes a taxpayer exercised ordinary business care and prudence but was unable to comply with the tax law may be considered for penalty relief.
2. The following regulations contain examples of circumstances that may be helpful in determining if a taxpayer has established reasonable cause:
 - A. Accuracy-Related Penalty: 1.6664-4
 - B. Failure to Pay Penalty: 301.6651-1(c)
 - C. Failure to File: 301.6651-1(c)
 - D. Failure to Deposit Penalty: 301.6656-1(b); 301.6656-2(c)
 - E. Information Returns Penalty: 301.6723-1A(d); 301.6724-1

4.30 Ordinary Business Care and Prudence

1. Ordinary business care and prudence includes making provision for business obligations to be met when reasonably foreseeable events occur. A taxpayer may

establish reasonable cause by providing facts and circumstances showing the taxpayer exercised ordinary business care and prudence (taking that degree of care that a reasonably prudent person would exercise), but nevertheless was unable to comply with the law.

2. In determining if the taxpayer exercised ordinary business care and prudence, review available information including the following:
 - A. Taxpayer's Reason. The taxpayer's reason should address the penalty imposed. To show reasonable cause, the dates and explanations should clearly correspond with events on which the penalties are based. If the dates and explanations do not correspond to the events on which the penalties are based, request additional information from the taxpayer that may clarify the explanation (See IRM 20.1.1.3.1).
 - B. Compliance History. Check the preceding tax years (at least 2) for payment patterns and the taxpayer's overall compliance history. The same penalty, previously assessed or abated, may indicate that the taxpayer is not exercising ordinary business care. If this is the taxpayer's first incident of noncompliant behavior, weigh this factor with other reasons the taxpayer gives for reasonable cause, since a first time failure to comply does not by itself establish reasonable cause.
 - C. Length of Time. Consider the length of time between the event cited as a reason for the noncompliance and subsequent compliance. See IRM 20.1.1.3.1. Consider: (1) when the act was required by law, (2) the period of time during which the taxpayer was unable to comply with the law due to circumstances beyond the taxpayer's control, and (3) when the taxpayer complied with the law.
 - D. Circumstances Beyond the Taxpayer's Control. Consider whether or not the taxpayer could have anticipated the event that caused the noncompliance. Reasonable cause is generally established when the taxpayer exercises ordinary business care and prudence but, due to circumstances beyond the taxpayer's control, the taxpayer was unable to timely meet the tax obligation. 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 meet the requirements, even though late.

4.40 Ignorance of the Law

1. In some instances taxpayers may not be aware of specific obligations to file and/or pay taxes. The ordinary business care and prudence standard requires that taxpayers make reasonable efforts to determine their tax obligations. Reasonable cause may be established if the taxpayer shows ignorance of the law in conjunction with other facts and circumstances.

2. For example, consider:
 - A. The taxpayer's education,
 - B. If the taxpayer has been subject to the tax,
 - C. If the taxpayer has been penalized, or
 - D. If there were recent changes in the tax forms or law which a taxpayer could not reasonably be expected to know.
3. The level of complexity of a tax or compliance issue is another factor that should be considered in evaluating reasonable cause because of ignorance of the law.
4. Reasonable cause should never be presumed, even in cases where ignorance of the law is claimed.
5. The taxpayer may have reasonable cause for noncompliance if:
 - A. A reasonable and good faith effort was made to comply with the law, or
 - B. The taxpayer was unaware of a requirement and could not reasonably be expected to know of the requirement. [IRM 20.1.1.3.1.2.1]

4.50 Mistake was Made

The taxpayer may try to establish reasonable cause by claiming that a mistake was made.

1. Generally, this is not in keeping with the ordinary business care and prudence standard and does not provide a basis for reasonable cause.
2. However, the reason for the mistake may be a supporting factor if additional facts and circumstances support the determination that the taxpayer exercised ordinary business care and prudence.[IRM 20.1.1.3.1.2.2]

4.60 Forgetfulness

1. The taxpayer may try to establish reasonable cause by claiming forgetfulness or an oversight by the taxpayer or another party caused the noncompliance. Generally, this is not in keeping with ordinary business care and prudence standard and does not provide a basis for reasonable cause.
 - A. Relying on another person to perform a required act is generally not sufficient for establishing reasonable cause.
 - B. It is the taxpayer's responsibility to file a timely and accurate return and to make

timely deposits or payments. This responsibility cannot be delegated.

2. Information to consider when evaluating a request for an abatement or non-assertion of a penalty based on a mistake or a claim of ignorance of the law includes, but is not limited to:
 - A. When and how the taxpayer became aware of the mistake.
 - B. The extent to which the taxpayer corrected the mistake.
 - C. The relationship between the taxpayer and the subordinate.
 - D. If the taxpayer took timely steps to correct the failure after it was discovered.
 - E. The supporting documentation.[IRM 20.1]..3.1.2.3]

4.70 Death, Serious Illness, or Unavoidable Absence

1. Death, serious illness or unavoidable absence of the taxpayer may establish reasonable cause for late filing, payment, or deposit for the following:
 - A. An individual: If there was a death, serious illness, or unavoidable absence of the taxpayer or a death or serious illness in the taxpayer's immediate family (i.e. spouse, sibling, parents, grandparents, children).
 - B. A corporation, estate, trust, etc.: If there was a death, serious illness, or other unavoidable absence of the taxpayer (or a member of such taxpayer's immediate family), and that taxpayer had sole authority to execute the return, make the deposit, or pay the tax (person responsible).
2. If someone, other than the taxpayer or the person responsible, is authorized to meet the obligation, consider the reasons why that person did not meet the obligation when evaluating the request for relief. In the case of a business, if only one person was authorized, determine whether this was in keeping with ordinary business care and prudence.
3. Information to consider when evaluating a request for penalty relief based on reasonable cause due to death, serious illness, or unavoidable absence includes, but is not limited to, the following:
 - A. The relationship of the taxpayer to the other parties involved.
 - B. The date of death.
 - C. The dates, duration, and severity of illness.
 - D. The dates and reasons for absence.
 - E. How the event prevented compliance.

- F. If other business obligations were impaired, and
- G. If tax duties were attended to promptly when the illness passed, or within a reasonable period of time after a death or absence.[IRM 20.1.1.3.1.2.4]

4.80 Unable to Obtain Records

1. Explanations relating to the inability to obtain the necessary records may constitute reasonable cause in some instances, but may not in others.
2. Consider the facts and circumstances relevant to each case and evaluate the request for penalty relief.
3. If the taxpayer was unable to obtain records necessary to comply with a tax obligation, the taxpayer may or may not be able to establish reasonable cause. Reasonable cause may be established if the taxpayer exercised ordinary business care and prudence, but due to circumstances beyond the taxpayer's control they were unable to comply.
4. Information to consider when evaluating such a request includes, but is not limited to an explanation as to:
 - A. Why the records were needed to comply.
 - B. Why the records were unavailable and what steps were taken to secure the records
 - C. When and how the taxpayer became aware that they did not have the necessary records.
 - D. If other means were explored to secure needed information.
 - E. Why the taxpayer did not estimate the information.
 - F. If the taxpayer contacted the Service for instructions on what to do about missing information.
 - G. If the taxpayer promptly complied once the missing information was received; and
 - H. Supporting documentation such as copies of letters written and responses received in an effort to get the needed information. .[IRM 20.1.1.3.1.2.5]

4.90 Statutory Exceptions & Administrative Waivers

1. These two very separate categories are placed together because in many instances an Administrative Waiver is an extension of rules that were provided for by statute.

Tax legislation (Internal Revenue Code (IRC)) may provide an exception to a penalty. Specific statutory exceptions can be found in either the penalty-related IRC section or the accompanying regulations. For example:

- A. IRC section 6654(e)(1), (2), or (3), Estimated Tax Penalties for Individuals (IRM

20.1.3).

- B. IRC section 7502(a) and 7502(e), Timely Mailing Treated as Timely Filing and Paying (IRM 20.1.2).
 - C. IRC section 6724(a) or 6724(c), Waiver; Definitions and Special Rules, Information Return Penalties (IRM 20.1.7).
 - D. IRC section 6404(f), Abatement of Penalty or Addition to Tax Attributable to Written Advice of the Internal Revenue Service (see IRM 20.1.1).
 - E. IRC section 7508, Time for performing certain Acts Postponed by Reason of Service in Combat Zone. This provision applies only in a Presidentially-declared "Combat Zone."
2. Legislation with retroactive provisions may provide guidance on associated penalties. As a result of that retroactive provision, the Service may issue a News Release or other guidance with instructions for the disposition of the related penalties.
 3. Some Statutory Exceptions are assigned their own Penalty Reason Code (see the specific topic). However, many are not.

4.100 Administrative Waiver

1. The Service may formally interpret or clarify a provision to provide administrative relief from a penalty that would otherwise be assessed. An administrative waiver may be addressed in either a Policy Statement, News Release, or other formal communication stating that the policy of the Service is to provide relief from a penalty under specific conditions.
2. An administrative waiver may be necessary when there is a delay by the Service in:
 - A. Printing or mailing of forms
 - B. Publishing guidance, writing of regulations, or
 - C. Other conditions.
3. An example of an administrative waiver is Notice 93-22, 1993-1 C.B. 305. This allowed individuals who requested an automatic 4-month extension of time to file an income tax return, an extension of time without remitting the unpaid amount of any tax properly estimated to be due. [IRM 20.1.1.3.2.2]

4.110 Undue Hardship

1. An undue hardship may support the granting of an extension of time for paying a tax or deficiency. Treas. Reg. 1.6161-1(b), provides that an undue hardship must be more than an inconvenience to the taxpayer. The taxpayer must show that they would sustain a substantial financial loss if forced to pay a tax or deficiency on the due date.
2. The extension of time to pay does not provide the taxpayer with an extension of time to file. Nor does the extension of time to pay relieve the taxpayer of any appropriate penalties.
3. Undue hardship generally does not affect a person's ability to file and therefore would not provide a basis for penalty relief in a failure to file situation. However, each request must be considered on a case-by-case basis. Undue hardship may establish reasonable cause for failure to file on magnetic media, under Treas. Reg. 301.6724-1.
4. Undue hardship may also support relief from the addition to tax for failure to pay tax if, the explanation for the noncompliance supports such a determination. However, the mere inability to pay does not ordinarily provide the basis for granting penalty relief. Under Treas. Reg. 301.6651-1(e), the taxpayer must also show that they exercised ordinary business care and prudence in providing for the payment of the tax liability.
 - A. The taxpayer may claim that enough funds were on hand but, as a result of unanticipated events, the taxpayer was unable to pay the taxes.
 - B. Consider an individual taxpayer's inability to pay a factor when considering penalty relief if the taxpayer shows that, had the payment been made on the payment due date, undue hardship (as defined in Treas. Reg. 1.6161-1(b)) would have resulted. In the case where a taxpayer files bankruptcy, consider inability to pay a factor if the insolvency occurred before the tax payment date.
5. If a payroll was met, taxes were withheld and should be available for deposit. Employers must reserve money withheld from employees' wages in trust until deposited. The employer should not use the money for any other purpose. Undue hardship does not support relief from the IRC section 6672, Failure to Collect and Pay Over Tax, or attempt to Evade or Defeat Tax (Trust Fund Recovery Program).
6. Information to consider when evaluating a request for penalty relief includes, but is not limited to, the following:
 - A. When did the taxpayer know they could not pay?
 - B. Why was the taxpayer unable to pay?
 - C. Did the taxpayer explore other means to secure the necessary funds?

- D. What did the taxpayer supply in the way of supporting documentation, such as copies of bank statements?
- E. Did the taxpayer pay when the funds became available?

4.120 Advice

1. This section discusses three basic types of advice: written and/or oral advice provided by the Service, and advice provided by a tax professional.
2. Information to consider when evaluating a request for abatement or nonassertion of a penalty due to reliance or advice, includes, but is not limited to, the following:
 - A. Was the advice in response to a specific request and was the advice received related to the facts contained in that request?
 - B. Did the taxpayer reasonably rely on the advice?
3. The following examples address situations where a taxpayer relies on written advice from the Service regarding an item on a filed return.
 - A. The taxpayer did not reasonably rely on the advice regarding an item included on a return if the advice was received after the date the return was filed;
 - B. A taxpayer may be considered to have reasonably relied on advice received after the return was filed if they then filed an amended return that conformed with such written advice;
 - C. A taxpayer may not be considered to have reasonably relied on written advice unrelated to an item included on a return, such as advice on the payment of estimated taxes, if the advice is received after the estimated tax payment was due.
4. Did the taxpayer provide the Service or the tax professional with adequate and accurate information?
5. The taxpayer is entitled to penalty relief for the period during which they relied on the advice. The period continues until the taxpayer is placed on notice that the advice is no longer correct or no longer represents the Service's position.
6. The taxpayer is placed on notice as the result of any of the following events that present a contrary position and occur after the issuance of the written advice:
 - A. Written correspondence from the Service that its advice is no longer correct or no longer represents the Service's position;
 - B. Enactment of legislation or ratification of a tax treaty;

- C. A U.S. Supreme Court decision;
 - D. The issuance of temporary or final regulations; or
 - E. The publication of a revenue ruling, revenue procedure, or other statement in the Internal Revenue Bulletin.
7. Taxpayers should submit the necessary supporting information and documentation with Form 843, Claim. However, if the information provided demonstrates that abatement of the penalty is warranted, the penalty should be abated, whether or not a Form 843 is provided..[IRM 20.1.1.3.2.4]

4.130 Written Advice from the Service

1. The Service is required by IRC section 6404(f) and Treas. Reg. 301.6404-3 to abate any portion of any penalty attributable to erroneous written advice furnished by an officer or employee of the Service acting in their official capacity.
2. If the taxpayer does not meet the criteria for penalty relief under IRC section 6404, the taxpayer may qualify for other penalty relief. For instance, taxpayers who fail to meet all of the above criteria may still qualify for relief under reasonable cause if the Service determines that the taxpayer exercised ordinary business care and prudence in relying on the Service's written advice.

4.140 Oral Advice from the Service

1. The Service may provide penalty relief based on a taxpayer's reliance on erroneous oral advice from the Service. The Service is required by IRC section 6404(f) and Treas. Reg. 301.6404-3 to abate any portion of any penalty attributable to erroneously written advice furnished by an employee acting in their official capacity. Administratively, the Service has extended this relief to include erroneous oral advice when appropriate.
2. In addition to considering the criteria provided in above, consider the following:
 - A. Did the taxpayer exercise ordinary business care and prudence in relying on that advice?
 - B. Was there a clear relationship between the taxpayer's situation, the advice provided, and the penalty assessed?
 - C. What is the taxpayer's prior tax history and prior experience with the tax requirements?
 - D. Did the Service provide correct information by other means (such as tax forms

and publications)?

E. What type of supporting documentation is available?

3. The following are types of supporting documentation:

A. A notation of the taxpayer's question to the Service;

B. Documentation regarding the advice provided by the Service;

C. Information regarding the office and method by which the advice was obtained;

D. The date the advice was provided, and

E. The name of the employee who provided the information. [IRM 20.1.1.3.2.4.2]

4.150 Advice from a Tax Advisor

1. Reliance on the advice of a tax advisor generally relates to the reasonable cause exception in IRC section 6664(c) for the accuracy-related penalty under IRC section 6662. See IRM 20.1.5, Preparer Promoter Penalty, and Treas. Reg. 1.6664-4(c).

2. However, in very limited instances, reliance on the advice of a tax advisor may apply to other penalties when the tax advisor provides advice on a substantive tax issue.

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

4. Reliance on the advice of a tax advisor is limited to issues generally considered technical or complicated. The taxpayer's responsibility to file, pay or deposit taxes cannot be excused by reliance on the advice of a tax advisor.[IRM 20.1.1.3.2.4.3]

4.160 Fire, Casualty, Natural Disaster, or Other Disturbance

1. Relief from a penalty may be requested if there was a failure to timely comply with a requirement to file a return or pay a tax as the result of a fire, casualty, natural disaster, or other disturbance.

2. Relief from a penalty because the taxpayer suffered from a fire, casualty, natural disaster, or other disturbance should be identified by the use of the appropriate PRC. It could be that as a result of the fire the taxpayer was unable to access their records

3. Fire, casualty, natural disaster, or other disturbance are factors to consider. One of these circumstances by itself does not necessarily provide penalty relief.
4. Penalty relief may be appropriate if the taxpayer exercised ordinary business care and prudence, but due to circumstances beyond the taxpayer's control they were unable to comply with the law.
5. Factors to consider include:
 - A. Timing.
 - B. Effect on the taxpayer's business.
 - C. Steps taken to attempt to comply.
 - D. If the taxpayer complied when it became possible.
6. The determination to grant relief from each penalty must be based on the facts and circumstances surrounding each individual case.[IRM 20.1.1.3.2.5]

4.170 Official Disaster Area

When a significant disaster occurs affecting a wide area of taxpayers, the Service often issues special instructions to facilitate evaluating the request for penalty relief. [IRM 20.1.1.3.2.6]

4.180 Service Error

A Service error can be any error made by the Service in computing or assessing tax, crediting accounts, etc. [IRM 20.1.1.3.3].

5. ACCURACY PENALTIES

5.10 OBRA 89 Consolidated And Renumbered The Following Penalty Code Sections:

1. The accuracy-related penalty rate is 20 percent of the underpayment attributable to any adjustments on the above. The penalty increases to 40 percent when there is a gross valuation misstatement as defined in IRC section 6662(h).
2. OBRA 89 changed the civil fraud penalty from IRC section 6653(b) to 6663. The penalty rate is 75 percent of the underpayment attributable to fraud.
3. OBRA 89 added IRC section 6664 to provide definitions and special rules that apply to both the accuracy-related penalties and the civil fraud penalty.

5.20 Common Features: Accuracy-Related and Civil Fraud Penalties

1. All accuracy-related and civil fraud penalties are associated with the examination of a tax return. See Treas. Reg. 1.6662-2(a). Penalty review, abatement, and reconsideration follow guidelines established for the examination of the return.
2. Return Filing Requirement: The accuracy-related penalty and the civil fraud penalty apply when a return has been filed, either timely or late. The accuracy-related penalties under IRC section 6662 and the civil fraud penalty under IRC section 6663 cannot be asserted on a substitute-for-return filed under IRC section 6020(b). See IRC section 6664(b).
3. Uniform Definition of Underpayment: IRC section 6664(a) provides a common definition of underpayment. The accuracy-related and civil fraud penalties are calculated only on the underpayment (or portion of the underpayment) of tax attributable to the misconduct or fraud, as applicable. See IRC sections 6662(a) and 6663(a).
4. Coordination of Accuracy-Related and Civil Fraud Penalties: The accuracy-related and civil fraud penalties cannot be asserted on the same portion of the same underpayment. However, the accuracy-related penalty and the civil fraud penalty may be asserted on the same return when civil fraud applies to one portion of the underpayment and the accuracy-related penalty applies to another portion of the underpayment. See IRC section 6662(b).

5.30 Negligence or Disregard of Rules and Regulations

OBRA 89 redesignated the negligence penalty from IRC section 6653(a) to). IRC section 6662(b)(1) applies to returns due after December 31, 1989 (without regard to extensions). 2.6662(b)(1) creates a negligence penalty of 20 percent of the underpayment attributable to negligence or disregard of rules or regulations.

5.40 Negligence Penalty Assertion

1. Negligence includes any failure to make a reasonable attempt to comply with the provisions of the tax law, exercise ordinary and reasonable care in tax return preparation, or keep adequate books and records. (See Treas. Reg. 1.6662-3(b).)
2. The regulations also provide that negligence is strongly indicated when a taxpayer fails to report income shown on an information return, fails to make a reasonable inquiry into the correctness of a deduction, credit, or exclusion on a tax return that seems "too good to be true," or when the returns of partners or S corporation shareholders are clearly inconsistent with the tax returns of their respective entities.

3. Some indications of negligence follow:

- A. Unreported or understated income,
- B. Deductions or credits significantly overstated,
- C. Careless, improper, or exaggerated deductions,
- D. Misrepresenting or miscategorizing deductions in such a manner as to conceal the true nature of the deduction,
- E. Unexplainable 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 another taxing agency),
- H. Substantial errors on an issue that had been adjusted in a prior year,
- I. Giving the preparer incorrect or incomplete information to prepare the returns.

5.50 Penalty Relief

1. Reasonable Cause. The penalty does not apply if the taxpayer has reasonable cause and acted in good faith, i.e., if an error was due to an honest misunderstanding of the facts or the law and the taxpayer took reasonable steps to comply with the law.
2. Adequate Disclosure. Disclosure is adequate if: A. It is made with the return, or on a qualified amended return, and B. Unless otherwise prescribed by the Commissioner, a completed Form 8275, Disclosure Statement, is filed with the original return or qualified amended return. Form 8275-R, Regulations Disclosure Statement, is necessary for disclosing a position contrary to a regulation. C. Treas. Regs. 1.6662-3(c), 1.6662-4(e) and (f) define adequate methods of disclosure for returns due after December 31, 1991, the effective date of the regulations. D.
3. When disclosure is not adequate. The exception for adequate disclosure will not apply if: A. The item on the return is attributable to a tax shelter, B. The taxpayer has not kept adequate books and records, or fails to substantiate items on the return, C. For returns due (without regard to extension) before January 1, 1994, the item or position on the return is frivolous (i.e., patently improper), or D. For returns due (without regard to extension) after December 31, 1993, the item or position on the return does not have a reasonable basis. (Applies to disregard of rules and regulations only.)
4. Adequate Disclosure Determination. The applicability of the disclosure exception is determined for each item or group of similar items separately. When the adequate disclosure exception is met (except in the case of a tax shelter), the tax attributable to the disclosed item is not included in the calculation of the underpayment for penalty purposes.

5. Negligence and Adequate Disclosure: A. For returns due after December 31, 1989 and before January 1, 1994 the adequate disclosure exception does not apply if the item is frivolous. See Notice 90-20, 1990-1 C.B. 328. B. For returns due after December 31, 1993, adequate disclosure does not apply. Whenever the taxpayer has a reasonable basis for an item or position taken, negligence by definition does not apply.
6. Disregard of Rules or Regulations and Adequate Disclosure: A. Adequate disclosure is an exception to the penalty attributable to disregard of rules or regulations. Since the penalty attributable to negligence (for returns due after December 31, 1993) is not subject to a disclosure exception, the distinction between negligence and disregard of rules and regulations will sometimes have to be made. B. The penalties attributable to negligence and disregard of rules or regulations often overlap, seem to apply equally to any given case, and are often difficult to distinguish. (See Treas. Reg. 1.6662-3(b)(1) and (2) for the definitions of negligence and disregard.) C. For returns due after December 31, 1991 (without regard to extensions) and before January 1, 1994, the disclosure exception is met for disregard of rules or regulations only when the required form is filed by the taxpayer (Form 8275 or 8275-R), and the item or position on the return has a realistic possibility of being sustained on its merits. D. For returns due after December 31, 1993 (without regard to extensions), the disclosure exception is available if the position taken on the return has a reasonable basis. E. The penalty for disregard usually applies if an item on the return is contrary to the Internal Revenue Code, temporary or final regulations issued under the Internal Revenue Code, or a revenue ruling or notice (other than notices of proposed rule making) published in the Internal Revenue Bulletin. However, the penalty does not apply to a position contrary to a revenue ruling or notice if the item has a realistic possibility of being sustained on its merits.

5.60 IRC Section 6662(d): Substantial Understatement

1. OBRA 89 repealed IRC section 6661, Substantial Understatement of Liability, and replaced it with the accuracy-related penalties in IRC section 6662(d).
2. The penalty is 20 percent of the underpayment of income tax when there is a substantial understatement of income tax. An understatement is substantial when it exceeds the greater of 10 percent of the tax required to be shown on the return for a taxable year, or \$5,000 (\$10,000 for C-corporations).

5.70 Substantial Authority Exception

1. The penalty under IRC section 6662(d) will not be asserted if there is substantial authority for the tax treatment of an item or return position. When the taxpayer's authority for the item or return position is substantial with respect to the authority against it, the penalty will not be asserted. Authorities relevant to both sides of the tax treatment of an item are taken into account.

2. Substantial authority is an objective standard involving an analysis and application of the law to the relevant facts. It is not determined with reference to what the taxpayer actually believed to be the correct treatment of the item. Every item must be separately evaluated to determine whether there is substantial authority for the tax treatment of an item.
 - A. The substantial authority standard is less rigid than the "more likely than not" standard. The "more likely than not" standard is met when there is more than a 50 percent likelihood that the position would be sustained.
 - B. The substantial authority standard is more rigid than the reasonable basis standard. The reasonable basis standard has not been defined by regulation, but per the committee reports associated with section 13251 of the Uruguay Round Agreement Act, P.L. 103-465 dated December 8, 1994, is the same standard that precludes the assertion of the penalty for negligence and disregard of rules and regulations. A position having a reasonable basis is a position that is arguable but fairly unlikely to prevail in court.
 - C. Therefore, the substantial authority exception can be met when the taxpayer has less than a 50 percent, but more than a one-in-three likelihood of being sustained on the issue.
3. "Authority" under Treas. Reg. 1.6662-4(d)(3)(iii) is established by reference to:
 - A. The Internal Revenue Code and other statutory provisions;
 - B. Proposed, temporary and final regulations;
 - C. Revenue rulings and revenue procedures;
 - D. Tax treaties, the regulations thereunder, and Treasury Department and other official explanations of such treaties;
 - E. Court cases;
 - F. Congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statement made prior to enactment by one of a bill's managers;
 - G. General Explanations of tax legislation prepared by the Joint Committee on Taxation (the "Blue Book");
 - H. Private letter rulings and technical advice memoranda issued after October 31, 1976;

- I. Actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin);
 - J. IRS information releases and press releases;
 - K. Notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin.
4. Taxpayers automatically meet the substantial authority standard if:
- A. They have been named in a technical advice memorandum,
 - B. Have been issued a district director's determination letter,
 - C. Have been issued a private letter ruling, or
 - D. Received a revenue agent's report for a prior taxable year with an affirmative statement on the same item.
- E. Taxpayers do not automatically meet the substantial authority standard if a private letter ruling is revoked or is inconsistent with:
- (1) Subsequent proposed regulations
 - (2) Subsequent revenue rulings, or
 - (3) Other administrative pronouncements published in the Internal Revenue Bulletin.
 - (4) See Treas. Reg. 1.6662-4(d)(3)(ii).
 - (5) The term "authority" does not include treatises, legal periodicals, legal opinions or opinions rendered by other tax professionals.
 - (6) An authority does not continue to be an authority if it is overruled or modified, implicitly or explicitly, by a body having the power to overrule or modify an earlier authority such as a U.S. Court of Appeals overruling a district court which originally issued the authority used by the taxpayer.
 - (7) A Tax Court opinion is not considered to be overruled or modified by a court of appeals to which a taxpayer does not have a right of appeal, unless the Tax Court adopts the holding of the court of appeals.

(8) Substantial authority is determined as of the date of filing or the last day of the taxable year. (See Treas. Reg. 1.6662-4(d)(3)(iv)(C).)

(9) For determining the weight of various "authorities" see Treas. Regs. 1.6662-4(d)(3)(ii).

5.80 Adequate Disclosure Exception

1. When the adequate disclosure exception is met, the tax attributable to the disclose item or return position is not included in the calculation of the understatement for penalty purposes.
2. Generally, the accuracy-related penalty attributable to substantial understatement will not be asserted on the underpayment attributable to an item that is adequately disclosed. However, even when the item is adequately disclosed the penalty will still be asserted if:
 - A. For returns due after January 31, 1991, but before January 1, 1994--the disclosed item is frivolous, i.e., patently improper (see former Treas. Regs. 1.6662-3(b)(3)),
 - B. For returns due after December 31, 1993--the disclosed item does not meet the reasonable basis standard,
 - C. The taxpayer failed to keep adequate books and records or failed to substantiate the disclosed item. (IRM 4271, Inadequate Records Cases), or
 - D. The item is attributable to a tax shelter as defined in IRC section 6662(d)(2)(C)(iii) and Treas. Reg. 1.6662-4(g)(2).
3. Disclosure is adequate if it is made in a statement attached to a return, i.e., Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement. A. Disclosure is considered adequate for tax return line item entries identified in and disclosed according to the annual revenue procedure that applies for the year of the return. B. If the revenue procedure does not expressly provide that disclosure of an item on the return is sufficient, disclosure should be made on Form 8275.
4. The definition of adequate disclosure provided by the following revenue procedures only pertains to the accuracy-related penalty attributable to a substantial understatement.

6. HISTORY AND REQUIREMENTS

6.10 History And Requirements Of Abatement Of Interest Claims

IRC 6404(e)(1) was added by the Tax Reform Act of 1986 to provide for abatement of

interest on deficiencies or payments attributable to errors or delays in the performance of ministerial acts by the Service. A ministerial act is a procedural, mechanical, processing-type act that does not involve the exercise of judgment, and that occurs after all prerequisites to the act have taken place. See Revenue Procedure 87-42 and regulation section 301.6404-2T for additional guidance.

6.20 As originally enacted, IRC Section 6404(e)(1) allows the Service to abate interest when an IRS employee fails to perform a ministerial act in a timely manner or makes an error in the performance of that act. Interest attributable to the delay may be abated provided no significant aspect of the delay is attributable to the taxpayer. Only delays in the performance of a ministerial act that would be "widely perceived as grossly unfair" (Committee Reports) will merit abatement. (For purposes of this provision, Chief Counsel employees will be treated as employees of the IRS.)

6.30 On July 30, 1996, the Taxpayer Bill of Rights 2, was enacted amending IRC section 6404(e)(1) to add "unreasonable" before each reference to "error" in the statute and to replace each reference to performing a "ministerial act" with a reference to performing a "ministerial or managerial act." P.L. 104-168, 110 Stat. 1452. These changes to IRC section 6404(e) are effective with respect to deficiencies or payments for taxable years beginning after July 30, 1996. Therefore, each reference in this discussion to an "error or delay" refers to "an error of delay in performing a ministerial act" for taxable years beginning on or before July 30, 1996, and "unreasonable error or delay in performing a ministerial or managerial act" for taxable years beginning after July 30, 1996.

6.40 The Service has the authority to abate only the amount of interest that accrued during the period attributable to an error or delay in performing the ministerial or managerial act. Section 6404(e)(1) applies only to an error or delay that occurs after the date the Service contacts the taxpayer in writing with respect to the deficiency or payment. Accordingly, there is no abatement of interest applicable from the return due date to the date the Service first contacts the taxpayer in writing, except as noted in paragraph 6.80.

6.50 Jurisdiction

The Tax Court has jurisdiction to review the Commissioner's failure to abate interest only when each of the following requirements has been met: a) The taxpayer filed a request for abatement of interest (generally via Form 843) with the Service after July 30, 1996, or the Service did not deny the request prior to July 31, 1996; b) the IRS mailed the taxpayer a notice of Final Determination not to abate interest; c) the taxpayer filed a petition for review with the Tax Court within 180 days of the mailing of the Final Determination notice; and d) the taxpayer meets the net worth requirements of I.R.C. ' 7430(c)(4)(A)(ii).

6.60 Suspension of Interest

The Internal Revenue Service Restructuring Act suspends the accrual of certain penalties and interest after eighteen (18) months if the IRS has not sent the taxpayer a notice specifically stating the taxpayer's liability for additional taxes (and the basis for the liability) within eighteen (18) months following the date that is the later of (1) the original due date of the return or (2) the date on which the individual taxpayer timely filed the return. The

suspension only applies to individuals who file a timely tax return and does not apply to the failure to pay penalty, in the case of fraud, or with respect to criminal penalties. The provision is effective for taxable years ending after the date of enactment. With respect to taxable years beginning before January 1, 2004, the eighteen (18) month period is decreased to twelve (12) months. Interest and penalties resume 21 days after the IRS sends a notice to the taxpayer specifically stating the taxpayer's liability and the basis for the liability. The provision is applied separately with respect to each item or adjustment. [Act '3305] [IRC '6404(g)]

6.70 Abatement of Interest in Presidentially Declared Disaster Areas

The Internal Revenue Service Restructuring Act provides that taxpayers located in a Presidentially declared disaster area do not have to pay interest on taxes due for the length of any extension for filing their tax returns granted by the Secretary of the Treasury, effective for disasters declared after December 31, 1997, with respect to taxable years beginning after December 31, 1997. The provision is designated as emergency legislation under Section 252(e) of the Balanced Budget and Emergency Deficit Control Act. [Act '3309] [IRC '6404(h)]

6.80 Notice of Interest Charges

The Act requires every IRS notice that includes an amount of interest required to be paid by the taxpayer that is sent to an individual taxpayer to include a detailed computation of the interest charged and a citation to the Code section under which such interest is imposed, effective for notices issued after December 31, 2000. ['3308] [IRC '6631]

EXHIBITS

March 9, 2009

Via Facsimile: 563-328-4452

Mr. John H. Officer
Internal Revenue Service
101 W. 2nd Street, 6th Floor
Davenport, IA 52801

Re: Nursing Home Supportive Living Center, LLC

FEIN: 36-0000000

Request for Abatement of Penalties 941, 2nd, 3rd, 4th Quarter 2006

Request for Abatement of Penalties 941, 1st, 2nd, 3rd Quarter, 2007

Request for Abatement of Penalties 941, 1st, 2nd, 3rd Quarter, 2008

Request for Abatement of Penalties 940, 2006, 2007

Dear Mr. Mills:

We have received your correspondence of February 26, 2009 containing the balances of tax, interest and penalties due for Nursing Home Living Center, LLC. (copy of letter attached). We believe that Nursing Home Supportive Living Center, LLC, (hereinafter "Nursing Home") had reasonable cause for having failed to file and to pay its taxes on a timely basis. We request that you abate the federal tax deposit penalties, failure to file, failure to pay penalties, and late filing penalties and the interest assessed on these penalties in connection with its 941 and 940 tax liabilities for tax periods listed above on the basis of reasonable cause.

Facts*

Nursing Home Supportive Living Center, LLC operates a facility which converted to a supportive living facility during 2004 and 2005. Nursing Home has a resident population of beds occupied primarily by recipients of Medicaid. Nursing Home's business suffered substantially over the course of the economic downturn in Illinois over the last several years and in the United States recession. Specifically, during the periods at issue, the facility had serious cash flow difficulties and as a result it was unable to pay its bills.

In January, 2008, when Bank of America bought LaSalle Bank, the new bank refused to extend Nursing Home's line of credit, called its loan and offset the cash in Nursing Home's bank accounts against LaSalle's balance due on its loan, causing cash flow difficulties for the business during the first 3 quarters of 2008. It has taken Nursing Home until March, 2009 to locate another lender who might be willing replace Bank of America/LaSalle Bank. The United States economy is in a serious recession if not in a depression, and the government of the State of Illinois is in disarray with the impeachment of our governor.

The State of Illinois is extremely delinquent in reimbursement of its payments to Illinois providers. Nursing Home failed to pay certain employment taxes because the State of Illinois Medicaid reimbursement cut reimbursements to provider facilities and because the State of Illinois has lagged in payment to provider facilities from 150 days during 2002 and later years, to its current lag time of 30 to 90 days. Nursing Home has an Illinois statutory duty to provide medical and residential care to its Medicaid recipients. Please see portions of T. LeBlang, W. Basanta, R. Kane, The Law of Medical Practice in Illinois, (update), at 2003 update pages 53, 54 (for Page 130, footnote 50) (1996, 2003) attached as Exhibit A.

It was not foreseeable to Nursing Home that the State of Illinois would cut the rates of reimbursement the State of Illinois paid to its Medicaid Recipients, and at the same time the State of Illinois would delay payment to the providers of services to the State of Illinois Medicaid recipients by such lengthy time periods. Nursing Home had no control over the actions of the State of Illinois with respect to the reductions of reimbursement instituted by the State of Illinois Public Aid/Medicaid reimbursement program, or over the slow payment of its bills by the State of Illinois.

Nursing Home could not increase rates to its residents covered by State Medicaid to cover the reduction in State of Illinois reimbursements. The Illinois Public Aid Code provides that it is a business offense, carrying a fine of between \$5,000 and \$25,000 for a nursing home or other facility to charge Medicaid residents any additional amounts for covered services beyond the rates established by the IDPA. 305 ILCS 5/8A-11 and LeBlang, supra 2003 (update) at 484. During the period of change from a nursing home to a supportive living center, the City of Nursing Home refused to allow new patients to enter the facility, and the facility's income dropped even further as its bed count reduced through attrition.

Nursing Home could not ask its Public Aid/Medicaid residents to move or to find other supportive living housing because the reimbursements to Nursing Home had been cut by the Illinois Department of Public Aid/Medicaid programs. One Hundred Fourteen Nursing Home residents have no where else to live. Under the Illinois Public Aid Code, such an action is also a business offense with fines from \$500 to \$5,000. See LeBlang, supra, 2003 (update) at 484.

Nursing Home could not cover the shortfall created by the State of Illinois's reduction in reimbursements and the State of Illinois's lagging revenue payments by cutting Nursing Home's payroll, or its costs for supplies. Nursing Home, by State of Illinois mandate, could not reduce the medical, nursing and skilled care to be provided to its supportive living center residents or reduce the standard of living (medicines, medical supplies, semi-skilled care, food, electricity, heat, clothing, etc.) provided to its supportive living center residents, despite the reduction in payment on behalf of those residents by the State of Illinois. To do so could have resulted in the suspension of its Illinois operating license, its certifications to participate in the Medicaid programs, and possibly subject the licensee and its employees to criminal charges. LeBlang, supra, 2003 (update), 467, 474, 476, and 477. The employees of Nursing Home and the vendors who provided medicines, medical supplies,

food, electricity, heat, and clothing to the Nursing Home facility would have refused to provide continued services to Nursing Home if their salaries and accounts were not paid or partially paid.

Nursing Home exercised ordinary business care and prudence in determining its tax obligations but was unable to comply with those obligations. The State of Illinois Public Aid funding cut, and the State of Illinois slow payment, and the fact that almost all of the Nursing Home residents are Public Aid/Medicaid recipients without alternative housing, were circumstances beyond the taxpayer's control. While Nursing Home exercised ordinary care and business prudence, these circumstances prevented Nursing Home from timely meeting its tax obligations.

The State of Illinois announced (on about October 19, 2005) that it would take out a \$1 billion short-term loan to cover some of its outstanding obligations to hospitals, pharmacies and nursing homes, among others. See Chicago Daily Herald, October 19, 2005, at 7, col. 1 to 3, attached as Exhibit B. The State of Illinois still continues to be one to three months behind in payments to nursing homes and other facilities.

Nursing Home provided medical and residential supportive services to its Public Aid Recipient Residents as mandated by Illinois laws, including the Abused and Neglected Long-Term Care Facility Resident Reporting Act, 210 ILCS 30/1 et seq., the Illinois Public Aid Code, 406 ILCS 5/ A-11 et seq., and the Illinois Nursing Home Care Reform Act, 210 ILCS 45/1-101 et seq., during the period when the State of Illinois cut nursing home funding and when the State of Illinois lagged up to six months in its payments to nursing homes. Nursing Home is only now beginning to catch up and recoup some of its losses incurred during these prior periods.

In the exercise of ordinary care and business prudence, Nursing Home now utilizes a payroll company to prepare its payroll and to make EFTPS payroll tax deposits.

Statement of Law

The taxpayer's failure to timely file, deposit and pay the tax due with its returns is due to reasonable cause and not willful neglect. In United States v. Boyle, 469 U.S. 241, 105 S. Ct. 687, 83 L. Ed. 2d 622 (1985), the Court noted:

To escape the penalty, the taxpayer bears the...burden of proving both (1) that the failure did not result from "willful neglect," and (2) that the failure was "due to reasonable cause." 26 U.S.C. 6651 (a) (1).

Section 6724 of the Internal Revenue Code provides that no penalty shall be asserted if such failure to timely file (or pay) was due to reasonable cause and not willful neglect. Although reasonable cause is typically determined on a case by case basis, relief based upon reasonable cause is usually granted when the taxpayer exercises ordinary business care and prudence in determining his or her tax obligations.

The Internal Revenue Service Penalty Handbook provides the following grounds for non-assertion or abatement of penalties:

"20.1.1.3.1 Reasonable Cause

(1) Reasonable cause is based on all the facts and circumstances in each situation and allows the Service to provide relief from a penalty that would otherwise be assessed. Reasonable cause relief is generally granted when the taxpayer exercises ordinary business care and prudence in determining his/her tax obligations but is unable to comply with those obligations.

(2) In the interest of equitable treatment of the taxpayer and effective tax administration, the nonassertion or abatement of civil penalties based on reasonable cause or other relief provisions provided in this IRM must be made in a consistent manner and should conform with the considerations specified in the Internal Revenue Code (IRC), Regulations (Treas Regs), Policy Statements and Part 120.1."

A. Ordinary Business Care and Prudence

The IRM in Section 20.1.1.3.1.2 defines ordinary business care and prudence as:

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

B. Circumstances Beyond Taxpayer's Control

The IRM also provides relief for "circumstances beyond the taxpayer's control":

"Consider whether or not the taxpayer could have anticipated the event that caused the noncompliance. Reasonable cause is generally established when the taxpayer exercises ordinary business care and prudence but, due to circumstances beyond the taxpayer's control, the taxpayer was unable to timely meet the tax obligation. 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 meet the requirements, even though late." (IRM Sec. 20.1.1.3.1.2(d))

In addition, the IRM also states:

(1) "The taxpayer may try to establish reasonable cause by claiming that a mistake was made...." (IRM 20.1.1.3.1.2.2)

"(1) The taxpayer may try to establish reasonable cause by claiming forgetfulness or an oversight by the taxpayer or another party caused the noncompliance." (IRM 20.1.1.3.1.2.3)

Discussion

Nursing Home Supportive Living Center, LLC had reasonable cause for the accrual of its outstanding liabilities during the entire time that it has failed to pay its taxes. As a direct and proximate actions of the State of Illinois and of the LaSalle Bank, and Nursing Home's statutory duty to provide care to its Medicaid resident recipients, Nursing Home was unable pay certain employment taxes. Nursing Home exercised ordinary business care and prudence in determining its tax obligations and paying its taxes, but due to circumstances beyond the taxpayers' control, and in circumstances which would have created undue hardship for its Public Aid/Medicaid Residents in violation of Abused and Neglected Long-Term Care Facility Resident Reporting Act, 210 ILCS 30/1 et seq., the Illinois Public Aid Code, 406 ILCS 5/ A-11 et seq, and the Illinois Nursing Home Care Reform Act, 210 ILCS 45/1-101 et seq, it was unable to comply with those tax obligations and pay all of its taxes.

We therefore request that the Internal Revenue Service abate the failure to deposit penalties, failure to file, failure to pay penalties and paying late penalties and the interest assessed on these penalties in connection with the 941 tax periods for the 2nd, 3rd, 4th Quarter 2006, the 1st, 2nd, 3rd, Quarter, 2007 and the 1st, 2nd and 3rd Quarter, 2008 and the 940 tax periods for 2006 and 2007 assessed against Nursing Home Supportive Living Center, LLC, based on a determination of reasonable cause.

Sincerely,

Robert E. McKenzie

REM/pp
Enclosures

cc: Client

Table 17. Civil Penalties Assessed and Abated, by Type of Tax and Type of Penalty, Fiscal Year 2008

[Money amounts are in thousands of dollars.]

Type of tax and type of penalty	Civil penalties assessed [1]		Civil penalties abated [1, 2]	
	Number	Amount	Number	Amount
	(1)	(2)	(3)	(4)
Civil penalties, total	40,353,465	28,115,371	3,075,159	11,858,696
Individual income tax:				
Civil penalties, total	30,223,315	13,365,745	1,119,922	4,088,235
Accuracy [3]	391,621	904,206	48,326	216,870
Bad check	175,695	21,668	9,324	7,980
Delinquency	3,660,514	4,677,827	779,429	2,091,019
Estimated tax	8,551,575	2,385,319	265,805	286,766
Failure to pay	17,419,367	5,053,053	9,324	1,440,757
Fraud	2,265	165,750	216	16,173
Partnership information [4]	14,847	95,571	2,840	23,602
Other [5]	7,431	62,352	4,658	5,067
Corporation income tax:				
Civil penalties, total [6]	783,864	2,163,750	135,191	1,113,042
Accuracy [3]	3,355	572,514	138	183,068
Bad check	1,453	240	291	2,883
Delinquency	131,450	438,222	22,155	271,404
Estimated tax	301,345	582,773	21,957	307,787
Failure to pay	346,061	555,024	90,257	337,327
Fraud	149	12,401	5	414
Other [5]	51	2,575	388	10,159
Employment taxes:				
Civil penalties, total [7]	8,513,558	4,172,608	1,602,564	3,407,913
Accuracy [3]	2,597	22,601	99	593
Bad check	41,774	3,180	3,079	1,499
Delinquency	1,775,198	1,185,627	285,579	475,293
Estimated tax [8]	4,909	33,082	1,255	19,935
Failure to pay	4,384,202	1,104,878	737,800	276,590
Federal tax deposits	2,304,351	1,814,400	574,721	2,633,260
Fraud	403	6,304	4	16
Other [5]	124	2,535	27	727
Excise taxes:				
Civil penalties, total [9]	417,926	1,259,718	136,566	426,691
Accuracy [3]	950	2,760	d	d
Bad check	4,796	154	262	23
Daily delinquency	92,114	307,142	67,362	241,330
Delinquency	105,510	211,820	12,058	9,364
Estimated tax [10]	13,478	6,049	957	1,691
Failure to pay	168,938	115,436	42,440	9,217
Federal tax deposits	3,806	44,759	1,479	37,757
Fraud	128	1,597	d	d
Other [5]	28,206	570,002	11,963	127,238
Estate and gift tax:				
Civil penalties, total [11]	12,308	2,579,568	6,974	167,167
Accuracy [3]	d	d	6	84
Bad check	132	1,139	74	1,024
Delinquency	3,995	2,494,748	2,447	117,234
Failure to pay	7,931	76,662	4,359	46,485
Fraud	d	d	0	0
Other [5]	185	1,457	88	2,341

Nonreturn penalties [12]

402,494

4,573,982

73,942

2,655,647

**PORTIONS REPRINTED WITH PERMISSION OF
THOMSON WEST, INC. ®**

**FROM
REPRESENTATION BEFORE THE COLLECTION DIVISION OF THE IRS**

**BY
ROBERT E. MCKENZIE
ARNSTEIN & LEHR
120 SOUTH RIVERSIDE PLAZA, SUITE 1200
CHICAGO, ILLINOIS 60656
(312) 876-7100**

**REMCKENZIE@ARNSTEIN.COM
<http://www.mckenzielaw.com>**

2009