MLI #6 Failure to File Penalty Under IRC § 6651(a)(1), Failure to Pay an Amount Shown as Tax on Return Under IRC § 6651(a)(2), and Failure to Pay Estimated Tax Penalty Under IRC § 6654

SUMMARY

We reviewed 86 decisions issued by federal courts from June 1, 2012, to May 31, 2013, regarding the additions to tax for:

- Failure to file a tax return by the due date under Internal Revenue Code (IRC) § 6651(a)(1);
- Failure to pay an amount shown as tax on a return under IRC § 6651(a)(2);
- Failure to pay estimated tax under IRC § 6654; or
- Some combination of the three.[1]

The phrase "addition to tax" is commonly referred to as a penalty, so we will refer to these additions to tax as the failure to file penalty, the failure to pay penalty, and the estimated tax penalty. Nineteen cases involved the imposition of the estimated tax penalty in conjunction with the failure to file and failure to pay penalties, 14 involved both the failure to file and failure to pay penalties, one case involved only the estimated tax penalty, three cases involved only the failure to pay penalty, and 39 cases involved only the failure to file penalty.

The failure to file and failure to pay penalties are imposed unless the taxpayer can demonstrate that the failure is due to reasonable cause and not willful neglect.[2] The estimated tax penalty is imposed unless the taxpayer can meet one of the statutory exceptions.[3] In 71 out of the 86 cases, taxpayers were unable to avoid a penalty.

PRESENT LAW

Under IRC § 6651(a)(1), a taxpayer who fails to file a return on or before its due date (including extensions) will be subject to a penalty of five percent of the tax due (minus any credit the taxpayer is entitled to receive and payments made by the due date) for each month or partial month the return is late, up to a maximum of 25 percent, unless the failure is due to reasonable cause and not willful neglect.[4] To establish reasonable cause, the taxpayer must show that he or she exercised ordinary business care and prudence but was still unable to file by the due date.[5] The failure to file penalty applies to income, estate, gift, employment and self-employment, and certain excise tax returns.[6]

1 IRC § 6651(a)(3) imposes an addition to tax for failure to pay a tax liability not shown on a return. However, because only a small number of cases involved this penalty, we did not include it in our analysis.

2 IRC § 6651(a)(1), (a)(2).

3 IRC § 6654(e).

4 IRC § 6651(a)(1), (b)(1). The penalty increases to 15 percent per month up to a maximum of 75 percent if the failure to file is fraudulent. IRC § 6651(f).

5 Treas. Reg. § 301.6651-1(c)(1).

6 IRC § 6651(a)(1).

The failure to pay penalty applies to a taxpayer who fails to pay an amount shown as tax on his or her return. The penalty accrues at a rate of 0.5 percent per month on the unpaid balance for as long as the balance due remains unpaid, up to a maximum of 25 percent of the amount due.[7] When both the failure to file and failure to pay penalties are imposed for the same month, the amount of the failure to pay penalty reduces the amount of the failure to file penalty by 0.5 percent for each month.[8]

The failure to pay penalty applies to income, estate, gift, employment and self-employment, and certain excise tax returns.[9] The taxpayer will not be held liable if he or she can establish reasonable cause, *i.e.*, the taxpayer must show that he or she exercised ordinary business care and prudence but still could not pay by the due date, or that payment on the due date would have caused undue hardship.[10] Courts will consider "all the facts and circumstances of the taxpayer's financial situation" to determine whether the taxpayer exercised ordinary business care and prudence.[11] In addition, "consideration will be given to the nature of the tax which the taxpayer has failed to pay."[12]

IRC § 6654 imposes a penalty on any underpayment of estimated tax by an individual or by certain estates or trusts.[13] The law requires four installments per taxable year, each generally 25 percent of the annual payment.[14] The required annual payment is generally the lesser of 90 percent of the tax shown on the return for the current taxable year or 100 percent of the tax shown on the return for the previous year.[15] The IRS will determine the amount of the penalty by applying the underpayment rate according to IRC § 6621 to the amount of the underpayment for the applicable period.[16]

To avoid the penalty, the taxpayer has the burden of proving that one of the following exceptions applies:

- The tax due (after taking into account any federal income tax withheld) is less than $1,000;[17]
- The preceding taxable year was a full 12 months, the taxpayer had no liability for the preceding taxable year, and the taxpayer was a U.S. citizen or resident throughout that year;[18]
- The IRS determines that because of casualty, disaster, or other unusual circumstances, the imposition of the penalty would be against equity and good conscience;[19] or

7 IRC § 6651(a)(2). Note that if the taxpayer timely files the return (including extensions) but an installment agreement is in place, the penalty will continue accruing at the lower rate of 0.25 percent rather than 0.5 percent of the tax shown. IRC § 6651(h).

8 IRC § 6651(c)(1). When both the failure to file and failure to pay penalties are accruing simultaneously, the failure to file will max out at 22.5 percent and the failure to pay will max out at 2.5 percent, thereby abiding by the 25 percent limitation.

9 IRC § 6651(a)(2).

10 Treas. Reg. § 301.6651-1(c)(1). Even when a taxpayer shows undue hardship, the regulations require him or her to prove reasonable cause.

11 Treas. Reg. § 301.6651-1(c)(1). *See, e.g., East Wind Indus., Inc. v. U.S.*, 196 F.3d 499, 507 (3d Cir. 1999).

12 Treas. Reg. § 301.6651-1(c)(2).

13 IRC § 6654(a), (l).

14 IRC § 6654(c)(1), (d)(1)(A).

15 IRC § 6654(d)(1)(B).

16 IRC § 6654(a).

17 IRC § 6654(e)(1).

18 IRC § 6654(e)(2).

19 IRC § 6654(e)(3)(A).

- The taxpayer retired after reaching age 62 or became disabled in the taxable year for which estimated payments were required or in the taxable year preceding that year, and the underpayment was due to reasonable cause and not willful neglect.[20]

In any court proceeding, the IRS has the burden of producing sufficient evidence that it appropriately imposed the failure to file, failure to pay, or estimated tax penalties.[21]

ANALYSIS OF LITIGATED CASES

We analyzed 86 opinions issued between June 1, 2012, and May 31, 2013, where the failure to file penalty, failure to pay penalty, or estimated tax penalty was in dispute. All but seven of these cases were litigated in the United States Tax Court. A detailed list appears in Table 6 in Appendix III. Fifty-one cases involved individual taxpayers and 35 involved businesses (including individuals engaged in self-employment or partnerships). Of the 53 cases in which taxpayers appeared *pro se* (without counsel), taxpayers prevailed in full in one case, and six resulted in split decisions. Of the 32 cases in which taxpayers appeared with representation, taxpayers prevailed in full in two cases, and six were split decisions.[22]

Failure to File Penalty

A common basis for the courts' ruling against taxpayers on the failure to file penalty was that the taxpayer could not establish that the failure was due to reasonable cause. Among the 63 cases where the court considered whether there was evidence to establish reasonable cause, taxpayers showed reasonable cause in only four cases. The most common arguments raised by taxpayers for reasonable cause included the following.

Medical Illness

Depending on the facts and circumstances, a medical illness may establish reasonable cause for failing to file, if the taxpayer can show incapacitation to such a degree that he or she could not file a return on time.[23] When considering whether the severity of the illness suffices to establish reasonable cause, the court will analyze a taxpayer's management of his or her business affairs during the period of illness.[24] In *Hardin v. Commissioner*, the taxpayer's mental disorders (attention deficit and hyperactive disorder, bipolar disorder, and post-traumatic stress disorder) did not rise to the level of reasonable cause because the taxpayer was able to continue his business affairs.[25] Specifically, during the time the return was due, the taxpayer managed two rental properties and worked full time for the Department of Defense as an engineer, performing complex analyses of military equipment. In light of the taxpayer's management of

20 IRC § 6654(e)(3)(B).

21 *Higbee v. Comm'r*, 116 T.C. 438, 446 (2001) (quoting IRC § 7491(c)). An exception to this rule relieves the IRS of this burden where the taxpayer's petition fails to state a claim for relief from the penalty (and therefore is deemed to concede the penalty), such as where the taxpayer only makes frivolous arguments. *Funk v. Comm'r*, 123 T.C. 213 (2004).

22 In *Cryer v. Comm'r*, T.C. Memo. 2013-69, the taxpayer died before the court hearing and no substitution of any personal representative was ever made; therefore, this case is neither marked as *pro se* or not *pro se* and constitutes the 86th case in our total case review.

23 *Williams v. Comm'r*, 16 T.C. 893, 905-06 (1951) (interpreting § 291 of the 1939 Code, a predecessor to IRC § 6651), *acq.*, 1951-2 C.B. 1. *See, e.g., Harbour v. Comm'r*, T.C. Memo. 1991-532 (finding reasonable cause for failing to timely file because the taxpayer was in a coma the month before the due date of his tax return).

24 *Judge v. Comm'r*, 88 T.C. 1175, 1189–1191, 1987 WL 49322 (1987).

25 T.C. Memo. 2012-162.

these activities, the court held the disorders were not severe enough to establish reasonable cause and the penalty was properly assessed.

Conversely, in *Wright v. Commissioner*, the court held that a stay in a hospital and a rehabilitation center for an injured leg during the time that the taxpayer's 2006 return was due, in conjunction with the fact that her financial documents were not easily accessible, was enough to establish reasonable cause.[26] The IRS argued that the taxpayer's ability to carry on negotiations with her insurance company[27] during this time negated reasonable cause, but the court was not persuaded. These cases illustrate how a reasonable cause determination can easily turn on the specific facts of the taxpayer's situation.

Reliance on Agent

The U.S. Supreme Court, in *United States v. Boyle*,[28] held that taxpayers have a nondelegable duty to file a return on time, and a taxpayer's reliance on an agent to file that return does not excuse a failure to comply with a known filing requirement. In *Tesoriero v. Commissioner*,[29] the taxpayer relied on his accountant to file a request for an extension, but the IRS never received it. The court held that filing an extension request is tantamount to filing a return and a taxpayer's reliance on an agent to file the request does not establish reasonable cause for the delay.[30]

A taxpayer may establish reasonable cause for a failure to file if he or she can prove reasonable reliance on a professional tax advisor's advice or that the taxpayer made a good-faith effort to ascertain return filing requirements.[31] In order to reasonably rely on the advice of a tax professional, the taxpayer must present evidence of the professional's expertise and show that he or she provided the practitioner with all necessary and accurate information.[32] In *Thousand Oaks Residential Care Home I, Inc. v. Commissioner*,[33] the court held the taxpayer reasonably relied on advice from its accountant regarding the reasonableness of certain compensation payments, making the payments deductible, and rendering the filing of Form 5330, *Return of Excise Taxes Related to Employee Benefit Plans,* and the payment of the amount due unnecessary.[34] Since the advisor was an accountant, the court determined that reliance on the accountant's advice after consultation was reasonable and the taxpayer was not liable for IRC § 6651(a)(1) or (2) penalties for failure to file Form 5330 and pay the associated tax.

26 T.C. Memo. 2013-129.

27 The taxpayer had filed a claim for reimbursement from her insurance company due to water damage to her apartment and personal belongings.

28 469 U.S. 241 (1985).

29 T.C. Memo. 2012-261.

30 *Tesoriero v. Comm'r*, T.C. Memo. 2012-261.

31 *Estate of La Meres v. Comm'r*, 98 T.C. 294, 315-17 (1992) (citations omitted).

32 *Id*.

33 T.C. Memo. 2013-10.

34 IRC § 162(a)(1) permits a deduction for ordinary and necessary business expenses, including "a reasonable allowance for salaries or other compensation for personal services actually rendered." The deductibility of compensation is determined through a two-prong test: the amount of compensation must be reasonable, and the payment must be purely for services rendered. In *Thousand Oaks Residential Care Home I, Inc. v. Comm'r*, the court held that the compensation payments were not reasonable and, therefore, not deductible.

"Zero Return" Filers and Other Frivolous Arguments

Under the longstanding four-part test articulated in *Beard v. Commissioner*,[35] a valid return must:

1. Contain sufficient data to calculate the tax liability;
2. Purport to be a return;
3. Represent an honest and reasonable attempt to satisfy the requirements of the tax laws; and
4. Be signed under penalties of perjury.

Each year, some taxpayers claim they have no obligation to pay taxes by filing returns reporting zero income when they have earned substantial wages accurately reported on a Form W-2.[36] A "zero" return does not constitute a tax return under the *Beard* test because it is devoid of financial data and does not provide sufficient information to calculate the tax liability.[37] Thus, when the taxpayer in *Nelson v. Commissioner* filed returns containing zeros for taxable income, the Tax Court sustained the failure to file penalty.[38]

Failure to Pay an Amount Shown Penalty

A taxpayer can file his or her return by the applicable due date and still be liable for a penalty if the amount shown on the return is not paid. In cases where taxpayers disputed that they were subject to the failure to pay penalty, many of the justifications were similar to those used for the failure to file penalty under IRC § 6651(a)(1). To refute the failure to pay penalty, individual taxpayers often unsuccessfully argued medical illness or reliance on an agent.[39]

However, taxpayers succeeded in disputing the penalty when the IRS was unable to meet its burden of production under IRC § 7491(c).[40] Specifically, the IRC § 6651(a)(2) penalty applies only when the return filed by the taxpayer shows the amount due.[41] If the taxpayer did not file a return, the IRS can only assess the penalty if it has prepared a substitute for return (SFR) that satisfies the requirements of IRC § 6020(b). If the IRS cannot produce the SFR, it falls short of satisfying its burden of production under IRC § 7491.[42] For example, in *Gardner v. Commissioner*, the IRS stated it prepared a valid SFR for the taxpayers for each year in issue. However, no SFRs were introduced into evidence, and the parties did not stipulate that valid SFRs were prepared.[43] Instead, the IRS relied upon account transcripts, which stated "substitute tax return prepared by IRS" and listed a corresponding date. Despite the transcripts, the court held that the IRS did not meet its burden of production under IRC § 7491(c), because the transcripts did not adequately prove the SFRs had been created.

35 82 T.C. 766, 777 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986).

36 *See, e.g., Parker v. Comm'r*, T.C. Memo. 2012-66 (concluding that there was no evidence of reasonable cause presented when the taxpayer reported all "zeros" on his return and offered only frivolous arguments).

37 *See Turner v. Comm'r*, T.C. Memo. 2004-251, and the numerous cases cited therein.

38 *Nelson v. Comm'r*, T.C. Memo. 2012-232.

39 *See, e.g., Kuretski v. Comm'r*, T.C. Memo. 2012-262 (illness); *Knappe v. U.S.*, 713 F.3d 1164 (9th Cir. 2013), *petition for cert. filed*, *aff'g* 2013-1 U.S.T.C. (CCH) ¶ 60,662 (C.D. Cal. 2010) (agent).

40 *See, e.g., Arroyo v. Comm'r*, T.C. Memo. 2013-112; *Jenkins v. Comm'r*, T.C. Memo. 2012-181.

41 IRC § 6651(a)(2), (g)(2).

42 *See Wheeler v. Comm'r*, 127 T.C. 200, 210, (2006), *aff'd*, 521 F.3d 1289 (10th Cir. 2008).

43 *Gardner v. Comm'r*, T.C. Memo. 2013-67.

Estimated Tax Penalty

Courts routinely found taxpayers liable for the IRC § 6654 estimated tax penalty when the IRS proved the taxpayer had a tax liability, had no withholding credits, and made no estimated tax payments for that year, and the taxpayer offered no evidence to refute the IRS.[44]

The IRS has the burden of production under IRC § 7491(c) to produce evidence that a taxpayer was required to make an annual payment under IRC § 6654(d)(1)(B). We found six cases where the taxpayer prevailed regarding the estimated tax penalty because of the IRS's failure to put forth evidence that the penalty was appropriate. In *Kuretski v. Commissioner*, the IRS did not produce any evidence the taxpayers (husband and wife) did not file a return or that they had a tax liability for 2006.[45] Without the 2006 return, and without knowing if the taxpayers had a liability for that year, the court was unable to calculate the taxpayers' estimated annual payment for 2007, if any. Therefore, the IRS did not meet its burden of production of information showing that the taxpayers had a required payment under IRC § 6654.

Penalty for Raising Frivolous Arguments

In three cases where the IRS had asserted either the failure to file penalty, failure to pay penalty, estimated tax penalty, or some combination, the courts also imposed the IRC § 6673 penalty for making frivolous arguments.[46] Among the frivolous argument cases is one where the taxpayer failed to file a return because he believed neither compensation nor dividends were taxable income.[47] The Tax Court held the taxpayer liable for the failure to file and failure to pay penalties, and imposed a $2,500 penalty under IRC § 6673.

CONCLUSION

The IRS failed to prevail in full in 15 of 86 (or 17 percent) of the failure to file penalty, failure to pay penalty, and the estimated tax penalty cases analyzed in this report. This unsuccessful litigation represents a significant waste of IRS resources, as well as a burden on taxpayers. Typically, the IRS did not meet its burden of production in these cases.

The IRS's incorrect assessment of penalties in these 15 cases, and its failure to appropriately resolve them during the administrative process, may reflect a trend in litigation results because of the IRS's heavy reliance on automatic application of penalties, and its use of the Reasonable Cause Assistant (RCA).[48] The RCA software is designed to help IRS employees make fair and consistent abatement determinations.[49]

44 *See, e.g., Haury v. Comm'r*, T.C. Memo. 2012-215.

45 T.C. Memo. 2012-262.

46 See Most Litigated Issue: *Frivolous Issues Penalty Under IRC § 6673 and Related Appellate-Level Sanctions*, *infra*.

47 *Winslow v. Comm'r*, 139 T.C. 270 (2012).

48 See Most Serious Problem: *Accuracy-Related Penalties: The IRS Assessed Penalties Improperly, Refused to Abate Them, and Continues to Assess Them Automatically, Violating Taxpayer Rights and Reducing Respect for the Law*, *supra*.

49 The Reasonable Cause Assistant can only consider Failure to File or Failure to Pay penalties on certain individual tax returns, and the Failure to Deposit penalty only on certain business returns.

However, as discussed in the National Taxpayer Advocate's 2010 Annual Report to Congress,[50] the IRS's reliance on the RCA has actually eroded the accuracy of abatements.[51]

Further, the cases illustrate how establishing reasonable cause can turn on the very specific facts of the individual case. The cases once again illuminate the importance of the IRS looking closely and thoroughly at the case facts, rather than solely relying on the RCA when assessing reasonable cause claims. A close consideration of the relevant facts for each reasonable cause claim is essential to ensure that the penalty is appropriate. To promote voluntary compliance, it is crucial that taxpayers believe the facts of their individual case have been carefully considered.

As another way to promote voluntary compliance, the National Taxpayer Advocate reiterates her recommendation that Congress implement a one-time abatement of the failure to file penalty for taxpayers who comply with their filing obligations, but in an untimely manner.[52] Further, she urges a repeal of the failure to pay penalty, which could be replaced by a market rate of interest equal to the rate on an unsecured loan.[53]

50 National Taxpayer Advocate 2010 Annual Report to Congress 198 (Most Serious Problem: *The IRS's Over-Reliance on Its "Reasonable Cause Assistant" Leads to Inaccurate Penalty Abatement Determinations*).

51 IRS, Reasonable Cause Assistant (RCA) Usability Test Final Report Summary 4 (May 28, 2010). The test showed that employees using the RCA determined penalty abatement requests correctly in only 45 percent of the cases. An even more disturbing finding was that all of the employees in the study believed they were making correct legal determinations based on reasonable cause.

52 *See* National Taxpayer Advocate 2001 Annual Report to Congress 188. A provision to waive the failure to file penalty for first-time, unintentional, minor errors was included in the House-passed Taxpayer Protection and IRS Accountability Act of 2003. *See* H.R. 1528, 108th Cong. § 106 (2003). Although the IRS has provided for a one-time administrative waiver of the failure to file penalty in IRM 20.1.1.3.6.1 (Nov. 25, 2011), the National Taxpayer Advocate continues to recommend a statutory waiver similar to IRC § 6656(c).

53 *See* National Taxpayer Advocate 2001 Annual Report to Congress 182.