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 63 decisions issued by federal courts from June 1, 2014, to May 31, 2015, 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); or
- Failure to pay installments of the estimated tax under IRC § 6654.[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. Eighteen cases involved the imposition of the estimated tax penalty in conjunction with the failure to file and failure to pay penalties; 44 involved the failure to file or failure to pay penalties; one case involved only the estimated tax penalty.

The IRS imposes the failure to file and failure to pay penalties unless the taxpayer can demonstrate 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] Taxpayers were unable to avoid a penalty in 59 of the 63 cases.

TAXPAYER RIGHTS IMPACTED[4]

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to a Fair and Just Tax System*

PRESENT LAW

Under IRC § 6651(a)(1), a taxpayer who fails to file a return on or before the due date (including extensions) will be subject to a failure to file 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. This penalty will accrue up to a maximum of 25 percent, unless the failure is due to reasonable cause and not willful neglect.[5] To establish reasonable cause, the taxpayer must show he or she

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 See Taxpayer Bill of Rights *available at* www.TaxpayerAdvocate.irs.gov/taxpayer-rights.

5 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).

exercised ordinary business care and prudence but was still unable to file by the due date.[6] The failure to file penalty applies to income, estate, gift, employment, self-employment, and certain excise tax returns.[7]

The failure to pay penalty, IRC § 6651(a)(2), applies to a taxpayer who fails to pay an amount shown as tax on the return. The penalty accrues at a rate of 0.5 percent per month on the unpaid balance for as long as it remains unpaid, up to a maximum of 25 percent of the amount due.[8] When IRS imposes both the failure to file and failure to pay penalties for the same month, it reduces the failure to file penalty by the amount of the failure to pay penalty (0.5 percent for each month).[9]

The failure to pay penalty applies to income, estate, gift, employment, self-employment, and certain excise tax returns.[10] The taxpayer will not be held liable if he or she can establish reasonable cause, *i.e.*, the taxpayer must show he or she has exercised ordinary business care and prudence but was still unable to pay by the due date, or that payment on that date would have caused undue hardship.[11] 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.[12] In addition, "consideration will be given to the nature of the tax which the taxpayer has failed to pay."[13]

IRC § 6654 imposes a penalty on any underpayment of estimated tax by an individual or by certain estates or trusts.[14] The law requires four installments per taxable year, each generally 25 percent of the required annual payment.[15] 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 for the previous taxable year.[16] 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.[17]

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;[18]
- 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 the preceding taxable year;[19]

---

6 Treas. Reg. § 301.6651-1(c)(1).

7 IRC § 6651(a)(1).

8 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).

9 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 maximum limitation.

10 IRC § 6651(a)(2).

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

12 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).

13 Treas. Reg. § 301.6651-1(c)(2).

14 IRC §§ 6654(a), (l).

15 IRC §§ 6654(c)(1), (d)(1)(A).

16 IRC § 6654(d)(1)(B).

17 IRC § 6654(a).

18 IRC § 6654(e)(1).

19 IRC § 6654(e)(2).

- The IRS determines that because of casualty, disaster, or other unusual circumstances, the imposition of the penalty would be against equity and good conscience;[20] or
- 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.[21]

In any court proceeding, the IRS has the burden of producing sufficient evidence that it imposed the failure to file, failure to pay, or estimated tax penalties appropriately.[22]

ANALYSIS OF LITIGATED CASES

We analyzed 63 opinions issued between June 1, 2014, and May 31, 2015, where the failure to file penalty, failure to pay penalty, or estimated tax penalty was in dispute. All but 14 of these cases were litigated in the United States Tax Court. A detailed list appears in Table 6 in Appendix 3. Twenty-three cases involved individual taxpayers and 40 involved businesses (including individuals engaged in self-employment or partnerships). Last year, individual filers outnumbered businesses nearly two to one.

Of the 41 cases in which taxpayers appeared *pro se* (without counsel), taxpayers prevailed in full in one case, and six resulted in split decisions. Of the 22 cases in which taxpayers had representation, taxpayers prevailed in full in three cases, and one was a split decision.

Failure to File Penalty

One recurring basis for taxpayer success in IRC § 6651 litigation is IRS failure to meet its burden of production. For example, in *Crawford v. Commissioner*, the IRS and the taxpayer stipulated that the taxpayer's return was timely filed.[23] Despite this agreed upon stipulated fact, at the time of the trial, the IRS argued that the taxpayer failed to file his return timely. However, the court noted that stipulations are treated as conclusive admissions by the parties.[24] The court went on to note that it can relieve parties of a stipulation that is contrary to the record or if justice requires.[25] The court did not ignore the stipulated fact in this case because it determined that it may have the effect of prejudicing the *pro se* taxpayer. Because the IRS previously stipulated that the taxpayer filed his return timely, the IRS had not met its burden of production regarding the appropriateness of the failure to file penalty. Consequently, the court held that the taxpayer was not liable for the failure to file penalty.

In most of the cases reviewed, taxpayers could not successfully establish that the failures to file were due to reasonable cause. Circumstances suggesting reasonable cause are typically outside the taxpayer's control.[26] Frequent reasonable cause claims included medical illness and reliance on an agent.

---

20 IRC § 6654(e)(3)(A).

21 IRC § 6654(e)(3)(B).

22 *Higbee v. Comm'r*, 116 T.C. 438, 446 (2001) (applying 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). *Funk v. Comm'r*, 123 T.C. 213 (2004).

23 T.C. Memo. 2014-156.

24 *Crawford v. Comm'r*, T.C. Memo. 2014-156 (citing U.S. Tax Court Rules of Practice and Procedure, Rule 91(e), and *Chapman Glen Ltd. v. Comm'r*, 140 T.C. 294, 317 (2013)).

25 U.S. Tax Court Rules of Practice and Procedure (as Amended Through July 6, 2012), Rule 91(e): "Binding Effect: A stipulation shall be treated, to the extent of its terms, as a conclusive admission by the parties to the stipulation, unless otherwise permitted by the Court or agreed upon by those parties. The Court will not permit a party to a stipulation to qualify, change, or contradict a stipulation in whole or in part, except that it may do so where justice requires."

26 *McMahan v. Comm'r*, 114 F.3d 366, 369 (2d Cir. 1997), *aff'g* T.C. Memo.1995–547.

Medical Illness

Depending on the facts and circumstances, a medical illness may establish reasonable cause for failure to file, if the taxpayer can show incapacitation to such a degree that he or she could not file a return on time.[27] 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 illness.[28]

In *Estate of Stuller v. United States*, the IRS assessed a failure to file penalty for the late filing of the taxpayers' (Mr. and Mrs. Stuller) 2003 individual income tax return.[29] On August 27, 2009, Mrs. Stuller (in her capacity individually as well as the executor of Mr. Stuller's estate) fully paid the assessed failure to file penalty. Mrs. Stuller then timely filed a claim for refund for the failure to file penalty.[30] After Mrs. Stuller did not hear from the IRS within six months from the time the claim for refund was filed, she filed a refund suit claiming that the failure to file penalty should be refunded because the failure was due to reasonable cause.[31]

Mrs. Stuller claimed that she was prevented from filing timely tax returns by her inability to locate documents needed to file the 2003 return (*i.e.*, bank statements). She claimed that this inability was due to her being disorganized as a result of extenuating circumstances. More specifically, in early 2003, Mr. Stuller died in a fire, and Mrs. Stuller was hospitalized with pneumonia for several weeks. Some tax records were lost in the fire while others were deposited in storage in unmarked boxes. Mrs. Stuller testified that she experienced stress, depression, and chronic bronchitis following the fire. The granddaughter they cared for also had health and behavioral problems following the death of Mr. Stuller that required additional care. Further, the death of Mr. Stuller created additional work for Mrs. Stuller as trustee.

However, the court pointed out that Mrs. Stuller's 2002 tax return was timely filed in the year of the fire. She actively ran a restaurant business during 2003, firing one director of operations and hiring another. The new director testified that Mrs. Stuller was attentive to the necessary issues of the business and addressed any problems in a timely manner. Additionally, Mrs. Stuller was involved in the reconstruction of her home and competed in several horse shows, which required a significant investment of time for training.

Moreover, Mrs. Stuller had not specified which tax records she could not locate when the search for them began or the length of time she looked. The court remarked that because bank statements were the primary record used, Mrs. Stuller could have requested duplicate bank records but did not.[32] The court found it had no basis on which to conclude that the taxpayer could not produce the necessary records in time to file the return and therefore held the taxpayer liable for the late filing of the 2003 return. However, the court left open an avenue for an appeal, which Mrs. Stuller subsequently filed, by suggesting

---

27 *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).

28 *Judge v. Comm'r*, 88 T.C. 1175, 1189-91 (1987).

29 55 F. Supp. 3d 1091 (C.D. Ill. 2014), *appeal docketed*, No. 15-1545 (7th Cir. Mar. 13, 2015).

30 Under IRC § 6511(a), a taxpayer generally has within three years from the time the return was filed or two years from the time the tax was paid, whichever period expires the later, to file a claim for refund.

31 IRC § 6532(a)(1). If a taxpayer has not received a response from the IRS regarding a claim for refund within six months from the time the refund claim was filed, the taxpayer can file a suit for refund in a United States District Court or the United States Court of Federal Claims.

32 *Estate of Stuller*, 55 F.Supp.3d at 1091, *appeal docketed*, No. 15-1545 (7th Cir. Mar. 13, 2015).

that evidence of a futile search for the records for weeks or months prior to the tax filing deadline might be sufficient for reasonable cause, in conjunction with the other circumstances.[33]

Reliance on Agent

The U.S. Supreme Court, in *United States v. Boyle*, held that taxpayers have a non-delegable duty to file a return on time.[34] The Court noted that "[i]t requires no special training or effort to ascertain a deadline and make sure that it is met."[35] Therefore, a taxpayer's reliance on an agent to file a return does not excuse any failure to comply with a known filing requirement.

For example, in *Specht v. United States*, Mrs. Specht (a co-fiduciary of the Escher estate), sought to recover penalties and interest in the amount of $1,198,261.38 imposed for failing to timely file the estate tax return and pay estate taxes.[36] Mrs. Specht, a 73-year-old high school-educated homemaker and the cousin of the deceased, was asked to be executor of the estate and formally accepted this role in February 2009. She hired Ms. Escher's former attorney, Mary Backsman, who had over 50 years of experience in estate planning, to represent the estate. Unknown to Mrs. Specht, Ms. Backsman was fighting brain cancer.

Ms. Backsman informed Mrs. Specht that the federal estate tax return was due by September 30, 2009, though she did not file it by that date. Additionally, Ms. Backsman failed to arrange for an agreed upon sale of stock to pay off the estate tax and lied to Mrs. Specht about it. She failed to file a first accounting of assets for the estate, missed probate deadlines, lied to Mrs. Specht about filing an extension, failed to file state estate tax returns, and failed to file the federal estate tax return. Ms. Backsman lied repeatedly about her handling of the situation. After discovering that Ms. Backsman had failed to request sale of the stock, Mrs. Specht fired her and hired another attorney on November 1, 2010. The estate filed a malpractice suit against Ms. Backsman that was settled.

Despite the above failures on the part of Ms. Backsman, the court determined that Mrs. Specht's reliance on her was unjustified. First, Mrs. Specht could not confirm if she had timely completed her listed obligations as a fiduciary and showed no concern about that duty. She stated in testimony that she was unsurprised Ms. Backsman had missed the filing deadline. She took no steps to proceed with the sale of stock before the deadline and received numerous warnings that Ms. Backsman was missing filing dates. Mrs. Specht did not attend probate hearings prior to the filing deadline. She received four notices from the probate court before the deadline, warning that Ms. Backsman was not performing her duties and that she had missed deadlines. After the deadline for filing the federal estate tax return had passed, Mrs. Specht received two more notices and was contacted in July and September 2010 by another client of Ms. Backsman, who warned her that Ms. Backsman was incompetent. In August 2010, she received a letter from the Ohio Department of Taxation alerting her that Ms. Backsman had not responded to their inquiries, and it could impose penalties. Lastly, in September 2010, she contacted an attorney who told her she needed to replace Ms. Backsman.

The court noted the precedent of *United States v. Boyle*, which established a distinction between relying on an attorney for legal advice and relying on an attorney to file tax returns, a non-delegable duty which

33 *Estate of Stuller v. U.S.*, *appeal docketed*, No. 15-1545 (7th Cir. Mar. 13, 2015).
34 *U.S. v. Boyle*, 469 U.S. 241 (1985).
35 *Id.* at 252.
36 *Specht v. U.S.*, 115 A.F.T.R.2d (RIA) 357 (S.D. Ohio 2015), *appeal docketed*, No. 15-3095 (6th Cir. Feb. 6, 2015).

requires no particular expertise.[37] "'Ordinary care and prudence' requires more than mere delegation."[38] The court also cited *Valen Mfg. Co. v. United States*, where a corporation's reliance on a bookkeeper who actively concealed a failure to file, did not establish reasonable cause.[39] This court clearly felt constrained by precedent, noting that while Ohio had refunded the estate tax penalties after the malpractice suit, it was "truly unfortunate that the United States did not follow the State of Ohio's lead."[40]

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 substantive legal advice.[41] To reasonably rely on the advice of a tax professional, the taxpayer must present evidence of the professional's expertise and show he or she provided the professional with all necessary and accurate information.[42]

In *Cavallaro v. Commissioner*, the IRS issued a notice of deficiency to Mr. and Mrs. Cavallaro, determining a liability for the addition to tax under IRC § 6651(a)(1) in the amount of $29.6 million for the failure to file gift tax returns.[43] The court held that the IRS showed the additions to tax were applicable but sustained the Cavallaros' defenses of "reasonable cause."

Mr. and Mrs. Cavallaro had little to no advanced education, including no formal accounting, legal, or business education. They hired *advisers* who were competent professionals with sufficient expertise to justify reliance. They engaged professionals from a well-known accounting firm and a well-known law firm to structure the tax-free merger of their S corporation, Knight Tool Co., with their sons' S corporation, Camelot Systems, Inc. The merger transaction was eventually structured according to the advice given by the Cavallaros' attorney. Under this advice, it was determined that rights to technology developed by Knight Tool Co. (*i.e.*, a computer-controlled liquid dispensing machine known as CAM/ALOT) were previously transferred to Camelot Systems, Inc. prior to the merger and therefore could not be gifted to Camelot Systems, Inc. at the time of the merger.

The court found that taxpayers had reasonably relied upon their advisors. They had no formal legal, accounting, or business education and had hired competent professionals. Those professionals had

37 *Specht v. U.S.*, 115 A.F.T.R.2d (RIA) 357 (S.D. Ohio 2015) (citing *U.S. v. Boyle*, 469 U.S. 241 (1985)).

38 *Id.* (quoting *In re Carlson*, 126 F.3d 915, 922 (7th Cir.1997)).

39 *Id.* (S.D. Ohio 2015) (citing *Valen Mfg. Co. v. U.S.*, 90 F.3d 1190 (6th Cir.1996)).

40 *Id*. 115 A.F.T.R.2d (RIA) 357 (S.D. Ohio 2015), *appeal docketed*, No. 15-3095 (6th Cir. Feb. 6, 2015).

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

42 *Id.* In her Annual Reports to Congress, the National Taxpayer Advocate has emphasized the need for minimum competency standards for paid unenrolled return preparers. *See* National Taxpayer Advocate 2013 Annual Report to Congress 61-74 (Most Serious Problem: *Regulation of Return Preparers: Taxpayers and Tax Administration Remain Vulnerable to Incompetent and Unscrupulous Return Preparers While the IRS Is Enjoined From Continuing Its Efforts to Effectively Regulate Unenrolled Preparers*); National Taxpayer Advocate 2009 Annual Report to Congress 41-69 (Most Serious Problem: *The IRS Lacks a Servicewide Return Preparer Strategy*); National Taxpayer Advocate 2008 Annual Report to Congress 504-12 (Most Litigated Issue: *Accuracy-Related Penalty Under Internal Revenue Code Sections 6662(b)(1) and (2)*). In June 2014, the IRS announced that it would be offering a new voluntary program designed to encourage education and filing season readiness for such preparers. This program allows unenrolled return preparers to obtain a record of completion when they voluntarily complete a required amount of continuing education, including a course in basic tax return filing issues and updates, ethics, and other federal tax law courses. Tax return preparers who elect to participate in the program and receive a record of completion from the IRS are included in a database on irs.gov to help taxpayers determine return preparer qualifications. *See* IRS Press Release, *New IRS Filing Season Program Unveiled for Tax Return Preparers*, IR-2014-75 (June 26, 2014); Rev. Proc. 2014-42, 2014-29 I.R.B. 192. The American Institute of Certified Public Accountants (AICPA) filed suit in the District Court for the District of Columbia, alleging that the IRS lacks the authority to implement the voluntary program. The government subsequently filed a motion to dismiss. On October 27, 2014, the District Court for the District of Columbia granted the IRS's motion to dismiss. On December 16, 2014, the AICPA filed an appeal with the Court of Appeals for the District of Columbia that has not yet been decided. *AICPA v. IRS*, 114 A.F.T.R.2d (RIA) 6451 (D.D.C. 2014), *appeal docketed*, No. 14-5309 (D.C. Cir. Dec. 16, 2014).

43 *Cavallaro v. Comm'r*, T.C. Memo. 2014-189, *appeal docketed*, No. 15-1368 (1st Cir. Mar. 24, 2015).

explicitly considered the relevant issue. Citing *Boyle*, the court noted that taxpayers are not required to challenge an attorney's tax advice to satisfy ordinary business care and prudence.[44] The court found the Cavallaros had provided accurate and necessary information to their advisors. They had relied sufficiently upon the advisors, and their tax positions were not attributable to themselves but to their advisors. The court concluded that the Cavallaros had reasonable cause for not filing a gift tax return and were not liable for the failure to file penalty.

"Zero Return" Filers and Other Frivolous Arguments

Under the longstanding four-part test articulated in *Beard v. Commissioner*,[45] 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 that were accurately reported on a Form W-2. A "zero" return does not constitute a tax return under the *Beard* test because it is devoid of financial data and lacks sufficient information to calculate the tax liability.[46] Thus, when the taxpayers in *Waltner v. Commissioner* filed a return containing zeros for taxable income and total tax, the court upheld the failure to file penalty against the husband and wife.[47]

Failure to Pay an Amount Shown Penalty

A taxpayer can file a return by the due date and still be liable for a penalty under IRC § 6651(a)(2) if the amount shown on the return is not timely paid. In cases where individual taxpayers disputed that they were subject to the failure to pay penalty, many of their arguments for reasonable cause were similar to those used for the failure to file penalty under IRC § 6651(a)(1). The taxpayers often unsuccessfully argued medical illness or reliance on an agent or failed to make a separate and distinct argument relevant to the failure to pay.[48]

However, a taxpayer can prevail on the failure to pay penalty when the IRS cannot meet its burden of production under IRC § 7491(c). Specifically, the IRC § 6651(a)(2) penalty applies only when the taxpayer's filed return shows an amount due.[49] If the taxpayer did not file a return, the IRS can only assess the penalty if it has introduced a Substitute for Return (SFR) that satisfies the requirements of IRC § 6020(b). If the IRS cannot produce the SFR, it fails to meet its burden of production under IRC § 7491.[50]

44 *Cavallaro v. Comm'r*, T.C. Memo. 2014-189 (citing *U.S. v. Boyle*, 469 U.S. 241 (1985)).

45 82 T.C. 766, 777 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986).

46 *See Cabirac v. Comm'r*, 120 T.C. 163 (2003). *See also U.S. v. Moore*, 627 F.2d 830, 835-36 (7th Cir.1980); *Turner v. Comm'r*, T.C. Memo. 2004-251.

47 *Waltner v. Comm'r*, T.C. Memo. 2014-133.

48 See, *e.g.*, *Central Motorplex, Inc. v. Comm'r*, T.C. Memo. 2014-207 (reliance on agent); *Akey v. Comm'r*, T.C. Memo. 2014-211 (medical illness); *U.S. v. Chelsea Brewing Co., LLC*, 114 A.F.T.R.2d (RIA) 5348 (S.D.N.Y. 2014) (financial hardship); *Villegas v. Comm'r,* T.C. Memo. 2015-33 (taxpayer offered "same excuses" for failure to pay as for failure to file); *Sodipo v. Comm'r*, T.C. Memo. 2015-3 (inability to file a tax return not reasonable cause for failure to pay), appeal docketed, No. 15-2089 (4th Cir. Sept. 16, 2015).

49 IRC §§ 6651(a)(2), (g)(2).

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

For example, in *El v. Commissioner*, the taxpayer failed to file a return and pay taxes for 2009.[51] The IRS determined a deficiency and imposed penalties under IRC §§ 6651(a)(1) and (2) for failure to file and failure to pay.

To impose the failure to pay penalty in the case, the IRS was required to introduce an SFR, because the taxpayer did not file an original return for 2009.[52] The IRS conceded that it failed to meet its burden of production, as an SFR had not been introduced into evidence. On that basis, the court held the taxpayer not liable for the IRC § 6651(a)(2) failure to pay penalty.

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;
- Made no estimated tax payments for that year; and
- Offered no evidence to refute the IRS.

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).

For example, in *Muncy v. Commissioner*, the taxpayer, who worked at a tire store, failed to file income tax returns and pay estimated taxes for tax years 2000 through 2005.[53] He insisted on halting his tax withholding and claimed the status of independent contractor though no aspect of his job was altered. A third-party entity would receive his wages and disburse them to the taxpayer's trusts or nominee accounts. The entity receiving his wages did not issue him Forms W-2, 1099, or any other forms for the income distributions, at his instruction. In 2010, he pleaded guilty to one criminal count of willfully attempting to evade income taxes for 2004. The taxpayer was placed on probation by the court and was required to file income tax returns as a condition of his probation.[54] In 2011, the IRS sent a notice of deficiency for tax years 2000 through 2005, which included estimated tax penalties under IRC § 6654.

In regard to the estimated tax penalty imposed, the court noted that the IRS burden of production requires evidence that there was a "required annual payment" under IRC § 6654(d)(1)(B). The required annual payment is the lesser of: (1) 90 percent of the reported tax for that year (or the tax due, if no return is filed), or (2) 100 percent of the tax shown on the return for the immediately preceding taxable year.[55] In situations where there was no return filed for the preceding year, the second clause is ignored.[56] Thus, the taxpayer's required payment in this case was 90 percent of the tax due, as determined by the IRS, for each of the tax years 2001 through 2005. For 2000, the IRS was obligated to introduce the tax return filed in 1999 so that the court could calculate the required annual payment from the lesser of the

51 *El v. Comm'r*, 144 T.C. No. 9 (2015).

52 *See* IRC §§ 6651(g), 6020(b); *Cabirac v. Comm'r*, 120 T.C. 163, 170 (2003).

53 *Muncy v. Comm'r*, T.C. Memo. 2014-251, *appeal docketed*, No. 15-1626 (8th Cir. Mar. 26, 2015).

54 *U.S. v. Muncy*, No. 4:10-cr-00018-BSM (E.D. Ark. filed Jan. 8, 2010).

55 IRC § 6654(d)(1)(B).

56 *Id*.

two amounts under IRC § 6654(d)(1)(B).[57] As that return was not provided, the court was unable to conclude that there was a required annual payment for 2000. It held the taxpayer liable for the failure to pay estimated tax penalty for the years 2001 through 2005, but not for 2000.

A similar issue arose in *United States v. Nichols*, where the taxpayers filed "zero returns."[58] A zero return is filed with the IRS but erroneously lists zero as the amount of tax due. It is not considered a valid return as there was no honest intent to provide the required information.[59] The IRS provided Forms 4340, *Certificate of Assessments, Payments, Other Specified Matters*, instead of SFRs to the court. The court held these as sufficient to impose the failure to file penalties but not for the failure to pay estimated tax penalties. Because the IRS calculates the required annual payment under IRC § 6654 using the tax due as reported by the taxpayer on his return, the estimated payment for the taxpayers' zero returns was zero.[60]

Penalty for Raising Frivolous Arguments

In four cases where the IRS had asserted either the failure to file penalty, failure to pay penalty, estimated tax penalty, or some combination thereof, the courts also imposed the IRC § 6673 penalty for making frivolous arguments.[61] In general, the courts are hesitant to impose this penalty without prior warning and in seven cases this period, the courts warned the taxpayers against making future frivolous arguments.[62]

In *Rader v. Commissioner*, the taxpayer did not report income from his plumbing business and did not file tax returns for five years.[63] The taxpayer argued that he was not legally required to file a return and that SFRs were not valid for purposes of a failure to pay penalty. He also claimed a Fifth Amendment privilege against self-incrimination. The court rejected these claims as meritless. A frivolous position is one contrary to established law and unsupported by a reasoned argument for change in the law.[64] At the conclusion of the trial, the court invoked the IRC § 6673(a)(1) penalty for frivolous arguments and held the taxpayer liable for a $10,000 penalty. Penalties for failure to file, failure to pay, and failure to pay estimated tax were also upheld.

CONCLUSION

The IRS did not prevail in full in 11 of 63 (or 17 percent) of the failure to file, failure to pay, and the estimated tax penalty cases analyzed in this report. Considering the limited resources most taxpayers have when litigating a case against the IRS, and the immense resources possessed by the IRS, a 17 percent success rate seems unexpectedly high. This is similar to the prior year, when the IRS did not prevail in 13 percent of cases.[65] In the cases the IRS lost, the most common problem was the IRS's failure to meet its burden of production.

57 *See Wheeler v. Comm'r*, 127 T.C. 200, 211–12 (2006) (requiring evidence of the prior year's return to determine the required annual payment).

58 *U.S. v. Nichols*, 115 A.F.T.R.2d (RIA) 1971 (E.D. Wash. 2015).

59 *See Cabirac v. Comm'r*, 120 T.C. 163 (2003).

60 *U.S. v. Nichols*, 115 A.F.T.R.2d (RIA) 1971 (E.D. Wash. 2015) (citing *Linmar Prop. Mgmt. Trust v. Comm'r*, T.C. Memo. 2008-219 (2008)).

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

62 *See*, *e.g.*, *Kernan v. Comm'r*, T.C. Memo. 2014-228 (imposing no IRC § 6673 penalty on a taxpayer who believed he was not required to file a return unless personally invited to file), *appeal docketed*, No. 15-70574 (9th Cir. Feb. 25, 2015).

63 *Rader v. Comm'r*, 143 T.C. 376 (2014).

64 *Goff v. Comm'r*, 135 T.C. 231, 237 (2010).

65 National Taxpayer Advocate 2014 Annual Report to Congress 495.

It is critical that IRS employees look closely and thoroughly at the case facts when assessing reasonable cause claims rather than solely relying on the Reasonable Cause Assistant (RCA) software,[66] which is designed to help IRS employees make fair and consistent abatement determinations.[67] The RCA program allows IRS employees to override the results in certain circumstances, but employees must understand the definition of reasonable cause to apply the override.[68] Thus, a close review by an employee is essential to ensure the failure to file penalty or the failure to pay penalty is imposed appropriately. To promote voluntary compliance and to uphold a taxpayer's *right to a fair and just tax system* and the *right to pay no more than the correct amount of tax*, the facts of taxpayers' individual cases must be carefully considered.

66 The Reasonable Cause Assistant can only consider failure to file or failure to pay penalties for certain individual tax returns, and the failure to deposit penalty only for certain business returns.

67 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*). *See also* 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.

68 IRM 20.1.1.3.6.10(3) (Nov. 25, 2011) ("[F]air and consistent application of penalties requires employees to make a final penalty relief determination consistent with the RCA conclusion … [U]nderstanding that the individual facts and circumstances vary for each case and that there may be unique facts and circumstances in certain cases that RCA cannot consider, an 'override (abort)' function is available in RCA.").