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 60 decisions issued by federal courts from June 1, 2016, to May 31, 2017, regarding the additions to tax for:

i. Failure to file a tax return by the due date under Internal Revenue Code (IRC) § 6651(a)(1);

ii. Failure to pay an amount shown on a tax return under IRC § 6651(a)(2);

iii. Failure to pay installments of the estimated tax under IRC § 6654; or

iv. 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. Eight cases involved the imposition of the estimated tax penalty in conjunction with the failure to file and failure to pay penalties; six cases involved the estimated tax penalty and either the failure to file penalty or the failure to pay penalty; 46 cases involved the failure to file or failure to pay penalties without the estimated tax penalty; there were no cases involving the estimated tax penalty as the only issue.

A taxpayer can avoid the failure to file and failure to pay penalties by demonstrating the failure is due to reasonable cause and not willful neglect.[2] The estimated tax penalty is imposed unless the taxpayer falls within one of the statutory exceptions.[3] Taxpayers were unable to avoid a penalty in 57 of the 60 cases.

TAXPAYER RIGHTS IMPACTED[4]

- *The Right to a Fair and Just Tax System*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Appeal an IRS Decision in an Independent Forum*

PRESENT LAW

Under IRC § 6651(a)(1), a taxpayer who fails to file a return on or before the due date (including extensions of time for filing) 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. This penalty will accrue up to a maximum of 25 percent, unless the failure is due to

1 Internal Revenue Code (IRC) § 6651(a)(3) imposes an addition to tax if the tax required to be shown on a return, but which is not shown, is not paid within 21 calendar days from the date of notice and demand for payment. We did not identify any cases where this addition to tax was at issue, so we have not included any analysis.

2 IRC § 6651(a)(1), (a)(2).

3 IRC § 6654(e).

4 *See* Taxpayer Bill of Rights (TBOR), https://TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the IRC. *See* Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a), 129 Stat. 2242, 3117 (2015) (codified at IRC § 7803(a)(3)).

reasonable cause and not willful neglect.[5] For the taxpayer to avoid the penalty by showing there was a reasonable cause, the taxpayer must have exercised ordinary business care and prudence.[6] The failure to file penalty applies to income, estate, gift, employment, self-employment, and certain excise tax returns.[7]

When an income tax return is filed more than 60 days after the due date (including extensions), the penalty shall not be less than the lesser of two amounts — 100 percent of the tax required to be shown on the return that the taxpayer didn't pay on time, or a specific dollar amount, which is adjusted annually for inflation.[8] The specific dollar amounts are as follows:

- $210 for returns due on or after 1/1/2018;
- $205 for returns due between 1/1/2016 and 12/31/2017;
- $135 for returns due between 1/1/2009 and 12/31/2015; and
- $100 for returns due before 1/1/2009.

The failure to pay penalty, IRC § 6651(a)(2), applies to a taxpayer who fails to pay an amount shown or required to be shown as tax on the return. The penalty accrues at a rate of half a percent (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.[9] When the 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).[10] The taxpayer can avoid the penalty by establishing the failure was due to reasonable cause; in other words, the taxpayer must have exercised ordinary business care and prudence but nonetheless was unable to pay by the due date, or that paying on the due date would have caused undue hardship.[11] The failure to pay penalty applies to income, estate, gift, employment, self-employment, and certain excise tax returns.[12]

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.[13] In addition, "consideration will be given to the nature of the tax which the taxpayer has failed to pay."[14]

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

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).

6 Treas. Reg. § 301.6651-1(c)(1).

7 IRC § 6651(a)(1).

8 IRC § 6651(a). Rev. Proc. 2016-55, 2016-45 I.R.B. 707, contains the most recent inflation amount.

9 IRC § 6651(a)(2). Note that if the taxpayer timely files the tax 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).

10 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.

11 Treas. Reg. § 301.6651-1(c)(1). Even when a taxpayer shows undue hardship, the regulations require proof of the exercise of ordinary business care and prudence.

12 IRC § 6651(a)(2).

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

14 Treas. Reg. § 301.6651-1(c)(2).

15 IRC § 6654(a), (l).

required annual payment.[16] The required annual payment is generally the lesser of 90 percent of the tax shown on the return for the current tax year or 100 percent of the tax for the previous tax year.[17]

The amount of the penalty is determined by applying:

- The underpayment rate established under IRC § 6621;
- To the amount of the underpayment;
- For the period of the underpayment.[18]

The amount of the underpayment is the excess of the required payment over the amount paid by the due date. 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;[19]
- The preceding tax year was a full 12 months, the taxpayer had no liability for the preceding tax year, and the taxpayer was a U.S. citizen or resident throughout the preceding tax year;[20]
- The IRS determines that because of casualty, disaster, or other unusual circumstances, the imposition of the penalty would be against equity and good conscience;[21] or
- The taxpayer retired after reaching age 62, or became disabled, in the tax year for which estimated payments were required, or in the tax year preceding that year, and the underpayment was due to reasonable cause and not willful neglect.[22]

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.[23]

ANALYSIS OF LITIGATED CASES

We analyzed 60 opinions issued between June 1, 2016, and May 31, 2017, where the failure to file penalty, failure to pay penalty, or estimated tax penalty was in dispute. All but eight of these cases were either litigated in the United States Tax Court, or an appeal of a Tax Court decision. A detailed list appears in Table 6 in Appendix 3. Twenty-eight cases involved individual taxpayers and 32 involved businesses (including individuals engaged in self-employment or partnerships).

Of the 39 cases in which taxpayers appeared *pro se* (without counsel), the outcomes generally favored the IRS. In six cases, the court granted partial relief to taxpayers, and in the other 33 the taxpayers did not prevail. Taxpayers represented by counsel fared slightly better; of the 21 cases in which taxpayers had

16 IRC § 6654(c)(1), (d)(1)(A).

17 IRC § 6654(d)(1)(B). If the adjusted gross income shown on the return of the individual for the preceding taxable year exceeds $150,000, the required annual payment increases to an amount 110 percent of the tax shown on the return of the individual for the preceding taxable year (if preceding tax year was 2002 or after). IRC § 6654(d)(1)(C)(i).

18 IRC § 6654(a).

19 IRC § 6654(e)(1).

20 IRC § 6654(e)(2).

21 IRC § 6654(e)(3)(A).

22 IRC § 6654(e)(3)(B).

23 *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, 218 (2004).

representation, taxpayers prevailed in full in three cases, in part in three cases, and were denied relief in the remaining 15.

Failure to File Penalty

In 51 out of the 55 cases reviewed where the failure to file penalty was at issue, the taxpayers could not prove that the failures to file were due to reasonable cause.[24] Taxpayers provided reasons such as physical injury or mental illness and reliance on an agent as a basis for reasonable cause. Circumstances suggesting reasonable cause are typically outside the taxpayer's control.[25]

Physical Injury or Mental Illness Defense

A physical injury or mental illness may provide a basis for a taxpayer to establish reasonable cause for not filing, if the condition impacted the taxpayer to such a degree that he or she could not file a tax return on time. When determining whether the condition establishes reasonable cause, the court analyzes how the taxpayer conducted his or her business affairs during the illness.

In *Brodmerkle v. Commissioner*, the taxpayers testified that they both suffered from various medical conditions during the years in which the IRS assessed failure to file penalties.[26] The court found that "while these medical conditions have been compounded and exacerbated over the years, they did not at the time prevent [the taxpayers] from timely filing their 2007 and 2008 tax returns."[27] Since the taxpayers were unable to persuade the court that their failure to file was due to a reasonable cause, the Tax Court determined the taxpayers were liable for the additions to tax under section 6651(a)(1) for tax years 2007 and 2008.

In *Leslie v. Commissioner*, the taxpayer argued that she had reasonable cause for failing to file her tax return because of her ongoing psychological problems.[28] The taxpayer suffered from bouts of depression as the result of a recent divorce, was diagnosed with several serious mental disorders, and was subsequently the victim of an African diamond scam. The court acknowledged that the applicable standard was difficult to meet, requiring that the taxpayer show that her mental illness and depression "rendered [her] incapable of exercising ordinary business care and prudence during the period in which the failure to file continued."[29] During the same period, the taxpayer supported herself with the income from eight rental properties which required her active management. Since the taxpayer's mental illness did not render her incapable of managing the rental properties, the court found that she was able to "carry on normal activities" and thus did not excuse the late filing.[30]

In contrast, the court in *Rogers v. Commissioner* found that given her dire circumstances, the taxpayer exercised ordinary business care and prudence despite failing to file a tax return in 2009.[31] Prior to 2009, she correctly handled her filing and payment obligations. In 2007, the taxpayer lost her apartment in a fire and received an insurance settlement in 2009 for less than full value, which entitled her to claim

24 Taxpayers avoided the failure to file penalty by proving reasonable cause in three cases, and in one case by proving the IRS granted an automatic six-month extension of the filing deadline. *See* IRC § 6081.

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

26 *Brodmerkle v. Comm'r*, T.C. Memo. 2017-8.

27 *Id*.

28 *Leslie v. Comm'r*, T.C. Memo. 2016-171, *appeal docketed*, No. 17-70450 (9th Cir. Feb. 14, 2017).

29 *Id*. (quoting *Wilkinson v. Comm'r*, T.C. Memo. 1997-410).

30 *Id*., *appeal docketed*, No. 17-70450 (9th Cir. Feb. 14, 2017).

31 *Rogers v. Comm'r*, T.C. Memo. 2016-152.

a casualty loss for the amount not compensated by insurance. The taxpayer misunderstood the casualty loss rules, and believed the loss should be taken in 2009 (the year of the settlement), when it should have been taken in 2007 (the year of the loss).[32] The taxpayer testified that at the time, she believed that since the amount of the casualty loss (over $150,000) was greater than her annual income, she was relieved of her need to file a return in 2009. Following the 2007 fire, the taxpayer was unable to return to her apartment and did not resume the business she had been operating from there. She was forced to live in conditions she found to be dehumanizing at a Young Women's Christian Association. She suffered bouts of depression, and in 2009 fell from a subway platform and sustained a skull fracture. During her hospitalization, she was subject to continuous monitoring and psychiatric examinations. After considering the facts and circumstances surrounding the taxpayer's failure to file her 2009 tax return, the court determined that the taxpayer exercised ordinary business care and prudence under challenging conditions and that her error did not constitute a conscious, intentional failure to file.[33]

Reliance on Agent Defense

When a taxpayer relies on an agent to fulfill a known filing requirement, it does not relieve the taxpayer of the responsibility. Taxpayers have a non-delegable duty to file a tax return on time.[34] In order for reliance on an agent to rise to the standard of reasonable cause for failing to fulfill the filing requirement, the reliance must be reasonable given the facts and circumstances.[35] In other words, merely hiring a tax professional (*e.g.,* accountant or lawyer) to handle tax filing is not enough to establish that the taxpayer used ordinary business care and prudence if there are facts that indicate otherwise.

In *Specht v. United States*, the court considered whether mere good-faith reliance on an agent constitutes reasonable cause.[36] The original action was brought by two co-fiduciaries on behalf of the estate of Virginia L. Esher, which had paid over one million dollars (more than eight percent of the estate's total value) in penalties and interest for its failure to timely file its tax return and pay its tax liability pursuant to IRC § 6651(a)(1) and (2), and filed a claim for refund of the funds in the district court. After the district court granted the government's motion for summary judgment, the executor appealed. The executor of the estate was an unsophisticated seventy-three year old woman, with no formal education beyond high school, and no experience serving as an executor. Witnessing the decedent's will was her first time visiting an attorney's office. After Ms. Esher's passing, the executor hired the very same attorney to represent the estate. The attorney had over fifty years experience in estate planning. The executor relied heavily on the attorney to handle liquidation of assets and compliance with state and federal tax responsibilities. Unbeknownst to the executor, the attorney was suffering from brain cancer and her competency was deteriorating. On several occasions, the executor received written notices indicating the attorney had failed to fulfill filing responsibilities related to the estate. The executor made multiple inquiries to the attorney and "blindly relied" on the attorney's assurances that the filing would be completed on time. Despite receiving multiple warnings regarding the attorney's deficient performance, the executor failed to take any steps to replace her until more than a year after the estate tax return filing deadline. Relying on several well-established precedents, including *Boyle*, the court reaffirmed that that "the duties to file a tax return and pay taxes are non-delegable and mere good-faith

32 IRC § 165(a); Treas. Reg. § 1.165-1(d)(2)(ii), (iii).

33 After applying similar reasonable cause analysis, the court also concluded that the taxpayer was not liable for the failure to pay penalty for tax year 2009.

34 *U.S. v. Boyle*, 469 U.S. 241 (1985). The Court noted that "[i]t requires no special training or effort to ascertain a deadline and make sure that it is met." *Id*. at 252.

35 *See Estate of Hake v. U.S.*, 119 A.F.T.R.2d (RIA) 727 (M.D. Pa. 2017), *appeal docketed*, No. 17-2010 (3d Cir. 2017).

36 *Specht v. U.S.*, 661 F. App'x 357 (6th Cir. 2016), *aff'g* 115 A.F.T.R.2d (RIA) 357 (S.D. Ohio 2015).

reliance does not constitute reasonable cause."[37] The court found "it was the [taxpayer's] complete reliance on an unreliable agent, rather than circumstances beyond her control, that caused the late filing."[38] The executor's dependence on an unreliable agent fell short of ordinary business care and prudence in carrying out the non-delegable duties to pay and file taxes for the estate. Thus, the Court of Appeals for the Sixth Circuit affirmed the district court's summary judgment for the government.

In *Estate of Hake v. United States*, the court considered good-faith reliance on an agent and reached a different conclusion.[39] Co-executors of their late mother's estate paid the taxes before the due date, but filed the estate's return nearly six months late, resulting in more than $215,000 in failure to file penalties and interest. The executors were inexperienced in tax law and hired a law firm to assist them with several duties related to the estate, including tax filing responsibilities and resolving intra-family disputes regarding valuation of estate assets. After advising the executors to seek additional time to resolve the valuation issues, the law firm told the executors that they had been granted a one-year extension to file the estate return and a one-year extension to pay the taxes. That advice was wrong. While the IRS did grant the extension requests, a filing extension is limited to six months.[40] The executors relied on the advice of their attorneys and filed on the one-year extension deadline, which resulted in the IRS assessing a failure-to-file penalty for the six-month period after the expiration of the extension.[41] Prior to bringing the refund suit in the district court, the executors pursued an appeal with the IRS for abatement of the penalty and exhausted all of their administrative remedies. The district court applied the Supreme Court's standard from *Boyle,* and interpreted the *Boyle* holding in light of the Third Circuit's ruling in *Estate of Thouron v. United States*.[42] The Supreme Court in *Boyle* recognized a split of authority in the circuit courts in cases where the taxpayer relied on erroneous advice of counsel, but declined to address the issue.[43] The Third Circuit read *Thouron* to have identified three distinct categories of late-filing cases:

i. Taxpayers who delegate the task of filing a return to an agent, only to have the agent file the return late or not at all;

ii. Taxpayers who file a return after the actual due date, in reliance on the advice of an accountant or attorney, but within the time that the taxpayer's lawyer or accountant advised the taxpayer was available; and

iii. Taxpayers who reasonably rely on the advice of an accountant or attorney on a matter of tax law (*e.g.,* that it was unnecessary to file a return).

The court distinguished the facts of *Boyle* and *Estate of Hake* in terms of exercising ordinary business care and prudence, commenting that *Boyle* fell within the first category of late-filing cases, whereas the taxpayers in *Estate of Hake* fell squarely within the second. The court granted their claim for refund, finding that the executors reasonably relied on the (albeit erroneous) advice of their counsel and used ordinary business care and prudence. The ruling highlighted that reliance on expert advice can be

37 *Specht*, 661 F. App'x at 363. *See, e.g., U.S. v. Boyle*, 469 U.S. 241 (1985); *Valen Mfg. Co. v. U.S.*, 90 F.3d 1190 (6th Cir. 1996).

38 *Specht*, 661 F. App'x at 362.

39 *Estate of Hake v. U.S.*, 119 A.F.T.R.2d (RIA) 727 (M.D. Pa. 2017), *appeal docketed*, No. 17-2010 (3d Cir. 2017).

40 Treas. Reg. § 20.6081-1.

41 *Estate of Hake v. U.S.*, 119 A.F.T.R.2d (RIA) 727 (M.D. Pa. 2017), *appeal docketed*, No. 17-2010 (3d Cir. 2017).

42 *Estate of Thouron v. U.S.*, 752 F.3d 311, 314 (3d Cir. 2014). The district court in *Estate of Hake* applied the ruling in *Estate of Thouron* because an appeal lies with the U.S. Court of Appeals for the Third Circuit.

43 *Boyle*, 469 U.S. at 251 n. 9 ("We need not and do not address ourselves to this issue.") (citations omitted).

objectively reasonable, but the court noted the narrow scope of its ruling. The IRS has appealed this decision to the Court of Appeals for the Third Circuit.[44]

Failure to Pay an Amount Shown Penalty

The failure to pay penalty is based on the amount shown on the tax return. If the taxpayer did not file a tax return, the IRS can only assess the IRC § 6651(a)(2) penalty if it has introduced a Substitute for Return (SFR) that satisfies the requirements of IRC § 6020(b). During litigation involving an SFR, if the IRS cannot produce the SFR, it fails to meet its burden of production under IRC § 7491 and the taxpayer can avoid a failure to pay penalty.[45]

As with the failure to file penalty, raising a reasonable cause defense to the failure to pay penalty requires that the taxpayer show that he or she exercised ordinary business care and prudence in providing for payment of tax liabilities but nevertheless was either unable to timely pay the tax or would suffer undue hardship if the payment was made on time.[46] Unsurprisingly, taxpayers often use medical illness or reliance on an agent as the basis for establishing reasonable cause to avoid the failure to pay penalty under IRC § 6651(a)(2) as they do for the failure to file penalty under IRC § 6651(a)(1).

In *Franklin v. Commissioner*, the taxpayer did not file a return in 2009 and 2010.[47] The taxpayer received income from a variety of sources including S corporations, IRA distributions, interest, and dividends. The IRS successfully assessed a failure to file penalty against the taxpayer, but the IRS did not introduce into evidence any SFRs and was only able to produce evidence of the taxpayer's non-payment. The court found that the Forms 4340, *Certificate of Assessments, Payments, and Other Specified Matters*, for 2009 and 2010, which the IRS introduced into evidence, were insufficient, even though each form stated "substitute for return" and listed a corresponding date. Because the transcripts did not establish that the SFRs met the requirements of IRC § 6020(b) the court held that the IRS did not satisfy its burden of production under § 7491(c). As a result, the taxpayer was not liable for the addition to tax for failure to pay for either tax year.

In *United States v. Jim*, the taxpayer was a member of the Miccosukee Tribe of Indians and received quarterly distribution payments, based on the number of members in her household, from the net gaming revenue of various casinos and bingo halls owned by the Tribe. The taxpayer claimed the Tribe's former attorney, the Tribe's chairman, and the Business Council advised her that the distributions she received were excludable from federal taxation as general welfare benefits and she was not required to file a tax return for 2001.[48] The IRS concluded that the distributions were taxable under the Indian Gaming Regulatory Act.[49] At the summary judgment stage, the court ruled that the distribution payments were indeed taxable income; however the court determined there were genuine issues of material dispute, including whether the taxpayer was liable for penalties for failure to file and failure to pay, and therefore the case proceeded to a bench trial. The taxpayer then gave contradictory testimony at her deposition by stating she "just completely forgot to file that year," and the Tribe's former attorney testified he did not advise the Tribe members not to file their tax returns. The court held that this

44 *Estate of Hake v. U.S.*, 119 A.F.T.R.2d (RIA) 727 (M.D. Pa. 2017), *appeal docketed*, No. 17-2010 (3d Cir. 2017).

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

46 *See* Treas. Reg. § 301.6651–1(c)(1).

47 *Franklin v. Comm'r*, T.C. Memo. 2016-207.

48 *U.S. v. Jim*, 118 A.F.T.R.2d (RIA) 6360 (S.D. Fla. 2016), *judgment entered by* 2016 U.S. Dist. LEXIS 114118 (S.D. Fla. 2016), *appeal docketed*, No. 16-17109 (11th Cir. Nov. 15, 2016). The United States brought an action in district court to reduce Ms. Jim's tax liabilities to judgment. *See* IRC §§ 7401, 7402.

49 25 U.S.C. § 2701.

was not a situation where the taxpayer relied on a "sincere, albeit erroneous belief" propagated by her advisors that her tribal distributions were not subject to federal income tax. Because the taxpayer was unable to prove reasonable cause, the court held her liable for the failure to pay penalty.

In *Kimdun, Inc. v. United States*, a corporate taxpayer argued that, because it was the victim of embezzlement by a payroll service provider (PSP) (or the PSP's bank), it should not be liable for failure to pay the amount shown on the corporation's tax return.[50] Early in 2009, the taxpayer learned that its payroll tax deposits had been embezzled and that it was possible the owner of taxpayer's PSP had embezzled the funds. Despite this revelation, the taxpayer continued to use the PSP through the third quarter of 2012. The IRS alleged that the taxpayer was delinquent on paying its taxes from multiple quarters throughout 2008 to 2011. The taxpayer asserted that it reasonably relied on its PSP to discharge their duties, but instead, the PSP or its bank absconded with taxpayer's timely submitted federal tax deposits.[51]

In December 2013, the taxpayer filed a claim for refund and request for abatement for each alleged delinquent quarter, claiming that once the funds left the taxpayer's account, it had no control or ability to ensure that the PSP made the required payments. The taxpayer further alleged that a taxpayer "who entrusts the payroll tax deposit function to a hitherto reputable payroll service should not be required to second-guess the company or anticipate that funds will be stolen from it."[52] The court disagreed, holding that the taxpayer cited no authority in support of the assertion that reliance on a third-party agent may constitute reasonable cause for failure to pay.[53] Therefore, the court found that the taxpayer's reliance on the PSP to discharge its duties to pay its federal taxes does not constitute reasonable cause.

Estimated Tax Penalty

Courts routinely found taxpayers liable for the IRC § 6654 estimated tax penalty when the IRS proved the taxpayer:

i. Had a tax liability;

ii. Had no withholding credits;

iii. Made no estimated tax payments for that year; and

iv. Offered no evidence to refute the IRS.

The IRS has the burden under IRC § 7491(c) to produce evidence that IRC § 6654(d)(1)(B) requires an annual payment from the taxpayer.

50 *Kimdun, Inc. v. U.S.*, 202 F. Supp. 3d 1136 (C.D. Cal. 2016).

51 For a detailed discussion of payroll service provider embezzlement, see National Taxpayer Advocate 2012 Annual Report to Congress 426-44 (Most Serious Problem: *Early Intervention, Offers in Compromise, and Proactive Outreach Can Help Victims of Failed Payroll Service Providers and Increase Employment Tax Compliance*). For the fourth consecutive year, Congress enacted legislation that incorporates two of the National Taxpayer Advocate's past recommendations. Section 106 of the Consolidated Appropriations Act, 2017 requires the IRS to: 1) issue dual address change notices related to an employer making employment tax payments (with one notice sent to both the employer's former and new address); and 2) give special consideration to an offer in compromise (OIC) request from a victim of fraud or bankruptcy by a third-party payroll tax return preparer. *See* Consolidated Appropriations Act, 2017, Pub. L. No. 115-31, Division E, § 106, 131 Stat. 135, 334 (2017).

52 *Kimdun, Inc.*, 202 F. Supp. 3d at 1139.

53 *Id.* at 1144.

In *Blair v. Commissioner*, the taxpayer received income via wages, dividends, and a distribution from a retirement plan for the 2010 tax year.[54] The taxpayer disputed the deficiencies the IRS imposed, raising several frivolous arguments, including challenging the constitutionality of the IRC and claiming that the IRS lacked jurisdiction over him. To meet its burden of production under IRC § 7491(c), the IRS had to show that the taxpayer had a "required annual payment" as defined in IRC § 6654(d)(1)(B). This burden requires the IRS to produce evidence that allows the court to determine the amount of the required annual payment. To determine the amount of the taxpayer's required annual payment for 2010, the court needed to know whether the taxpayer filed a return for the preceding tax year and if so, the amount of the "tax shown" on that return. Therefore, it was required that the IRS produce evidence that the taxpayer filed a tax return for 2009, and if so, the amount of "tax shown" on that return. In this case, the IRS was unable to meet its burden of production. Without this evidence, the court was unable to determine the "required annual payment" and thus found the taxpayer not liable for the estimated tax penalty.[55]

CONCLUSION

Taxpayers prevailed in full in only three of 60 (five percent) of the failure to file, failure to pay, and estimated tax penalty cases analyzed in this report. Nine taxpayers prevailed in part (15 percent) of the failure to file, failure to pay, and estimated tax penalty cases, meaning the IRS won 80 percent of the cases. The number of cases in this category rose by more than 30 percent from last year, and the portion of cases where the taxpayer received at least some relief rose substantially from 11 percent to 18 percent.

It is critical that IRS employees thoroughly analyze all facts and circumstances of a case when assessing reasonable cause claims rather than solely relying on the Reasonable Cause Assistant (RCA) software,[56] which is designed to help IRS employees make fair and consistent abatement determinations.[57] 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.[58] Thus, a close review by an employee is essential to ensure that the failure to file penalty or the failure to pay penalty is imposed appropriately. Additionally, as previously recommended by the National Taxpayer Advocate, Congress should amend IRC § 6404 to authorize the Secretary of the Treasury to grant a one-time abatement of the failure to file penalty (IRC § 6651(a)(1)) and failure to pay penalty (IRC § 6651(a)(2)) for first time filers and taxpayers with a consistent history of compliance, where no countervailing factors are present.[59] 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.

54 *Blair v. Comm'r*, T.C. Memo. 2016-215.

55 *See* IRC § 6654(d)(1)(B).

56 The Reasonable Cause Assistant (RCA) can only consider failure to file or failure to pay penalties for certain individual tax returns.

57 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.

58 Internal Revenue Manual 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.")

59 National Taxpayer Advocate 2001 Annual Report to Congress 188.