

Reducing the Pain: IRS Penalty Mitigation Practice and Procedure

A Primer on How to Assist Clients in Avoiding or Seeking Abatement of Federal Civil Tax Penalties Based on Reasonable Cause

A taxpayer is generally entitled to relief from civil penalties when a taxpayer, despite acting reasonably under the circumstances, incurs penalties relating to either failing to pay a tax on or before its due date and/or filing a required return after its due date. Penalties may also be assessed for "understating taxes", "accuracy related penalties", or fraud. A multitude of circumstances exist that could be the basis for requesting and achieving abatement of penalties; however, there are certain defined categories, as outlined in the Internal Revenue Manual (IRM), that will entitle a taxpayer to an abatement if the taxpayer can demonstrate to the satisfaction of the Internal Revenue Service ("Service") and, in some cases, to a Court's satisfaction, that it acted reasonably under the circumstances. In other words, despite a taxpayer's best efforts, it was unable to comply due to circumstances beyond its control. The term of art for such reasonable failures to comply is reasonable cause.

IRM Part 20.1 is the "Penalty Handbook". Available at www.irs.gov/irm, it is the starting point for the Service's consideration of a taxpayer's request for abatement. IRM 20.1.1.3 lays out the criteria for relief from penalties and is broken down into four categories under which the Service will grant relief: (1) Reasonable Cause; (2) Statutory exceptions; (3) Administrative Waivers; and (4) Correction of Service Error. IRS Appeals can also recommend the non-assertion of a penalty based on hazards of litigation. This article will examine the reasonable cause exception and the circumstances that can give rise to a taxpayer obtaining relief. (Please note that a full discussion of all reasonable cause exceptions including extensive judicial authorities is beyond the scope of this article). We will address the most commonly used exceptions, in our experience, but will list all of them here for your convenience: Ordinary Business Care and Prudence (IRM 20.1.1.3.2.2); Death, Serious Illness, or Unavoidable Absence (IRM 20.1.1.3.2.2.1); Fire, Casualty, Natural Disaster, or Other Disturbance (IRM 20.1.1.3.2.2.2); Unable to Obtain Records (IRM 20.1.1.3.2.2.3); Mistake or Misstatement (IRM 20.1.1.3.2.2.4); Erroneous Advice or Reliance (IRM 20.1.1.3.2.2.5); Ignorance of the Law (IRM 20.1.1.3.2.2.6); Forgetfulness (IRM 20.1.1.3.2.2.7); and Undue Hardship (IRM 20.1.1.3.3.3).

Before delving deeper into what constitutes reasonable cause, it is noteworthy that penalties incurred for first time non-compliance are routinely abated upon request. IRM 20.1.1.3.6.1. This procedure is known as First Time Abate (ETA) 32 MARYLAND BAR JOURNAL May 2013 and it applies to taxpayers who have not incurred penalties in the prior three years, except the estimated tax penalty. "Reasonable cause relief is generally granted when the taxpayer exercised ordinary business care and prudence in determining their tax obligations but nevertheless failed to comply with those obligations." IRM 20.1.1.3.2. We are therefore operating in the ubiquitous realm of the reasonable person standard; however, it is important to convey to the Service that individuals faced with dire circumstances are rarely capable of acting as a reasonable person would absent those circumstances.

"Reasonable cause is based on all the facts and circumstances in each situation and allows the IRS to provide relief from a penalty that would otherwise be assessed." Hence, reasonable cause can be available, theoretically, in an infinite number of different factual scenarios so long as the IRS is convinced that a taxpayer's actions constitute reasonable cause under the given circumstances.

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