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Dealing with IRS penalties - by Michael Duffy

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Taxpayers who fail to file their tax returns on time or fail to pay the full amount due are automatically hit with hefty charges for interest and penalties. When this happens, taxpayers should expect to receive a bill in the mail a few months after filing.

The best way to deal with interest and penalties is, of course, to avoid them in the first place. When this is not possible, taxpayers should consider applying for a formal penalty abatement request. Obtaining an abatement of penalties from the IRS is challenging, especially when the penalties are old. Taxpayers facing significant penalties from prior periods should consider hiring a qualified professional in order to increase their chances of success.

Common Penalties – Failure to File and Failure to Pay: The two most commonly assessed IRS penalties are for the failure to file and the failure to pay. Combined, these penalties can increase the amount of tax owed by almost 50%.

The failure-to-file penalty is imposed when a taxpayer files his or her income tax return after the legal deadline. The IRS does not impose static penalties for late filing of an individual income tax return. Instead, the penalty is based on a percentage of the amount of outstanding tax reported on the return. Consequently, taxpayers who report an overpayment of tax on a late-filed return, either because tax has been withheld on W-2s or through estimated payments, are not subject to any penalties or interest charges. The penalty for late filing is 5% of the amount of tax due on the return per month the return is late, up to a maximum of 25%.

For taxpayers who file returns, but leave some of the balance due unpaid, a separate failure-to-pay penalty is imposed. The failure-to-pay penalty, like the failure-to-file penalty, is based on the percentage of tax due on the return reduced by the amounts already paid by the taxpayer. The failure-to-pay penalty is 0.5% of the amount of unpaid tax per month, up to a maximum of 25%.

Taxpayers can avoid the failure-to-file penalty by simply filing their returns on time. When filing is not possible due to lack of information or scheduling issues, an automatic extension of six months is generally available. Filing an extension extends the date after which a return will be subject to the failure-to-file penalty but does not extend the deadline by which a taxpayer is required to pay the amount of tax due. Even if a taxpayer knows they have underpaid on the original due date, they should consider filing an extension anyway because the failure-to-pay penalty is significantly smaller than the failure-to-file penalty. The downside is that the taxpayer may be on the IRS's collection radar earlier than they would be otherwise.

Common Penalties Can Be Abated: The failure-to-file and failure-to-pay penalties can be abated if a taxpayer is able to show something called reasonable cause. Reasonable cause is essentially an excuse the taxpayer can point to explaining why they couldn't file or pay their taxes on time. Whether reasonable cause relief is appropriate is heavily dependent on the underlying facts. For example, inability to file due to illness or injury is typically a valid reason for late filing, as is the

reliance on erroneous professional advice. But lack of funds does not constitute reasonable cause. It is advisable to consult a tax professional when a taxpayer is facing significant penalties and anticipates they will need to rely on a reasonable cause argument to obtain an abatement.

There is also the possibility that a penalty is being proposed in error. For example, a return may be lost by the IRS or a payment may be applied to the wrong year. Taxpayers should immediately get their records together and push back if they believe the IRS is proposing a penalty based on incorrect information.

Can I Avoid the Interest? The short answer to whether a taxpayer can get a break on interest is usually “no.” According to the IRS, charging interest on unpaid tax liability is technically required by law. In theory, interest can be waived in certain circumstances, such as a court settlement. But practically speaking, interest cannot usually be waived. However, because interest also accumulates on the part of unpaid taxes attributable to assessed penalties, a taxpayer can retroactively waive interest attributable to tax penalties that are later abated. This can result in a significant amount of savings if penalties are large enough and old enough.

Abatement of Old Penalties Is Possible: Normally, when a taxpayer is charged with a failure-to-file or failure-to-pay penalty, the IRS will demand payment or give the taxpayer a short window to file a protest. Because the penalties often are related to an inability to pay that cannot be resolved shortly after the notice is received, many taxpayers do not follow up on the notice. When this happens, the penalty is formally assessed and becomes part of the tax owed for the period in which the underlying tax was due. Once a penalty is assessed, the IRS is legally able to pursue collections options, as it may do with respect to unpaid taxes reported on a return.

I normally advise clients to fight the assessment of a penalty as soon as they receive a notice. This is because the taxpayer is most likely to have all their information and a fresh recollection of the key facts at this point. Responding before an assessment becomes final also can preserve administrative appeal rights. But too often, clients do not deal with penalty notices head-on.

Old penalties assessed by the IRS actually can be abated, although in my experience taxpayers have a lower likelihood of success in looking for this relief. Getting post-assessment penalties abated can be done either before the taxpayer has paid them--or after, if the taxpayer is willing to file a refund claim. Regardless of which approach is taken, generally a professional should assist the taxpayer with this request.

Although getting penalties abated usually involves a degree of uncertainty, the IRS offers automatic first-time abatement penalty relief in certain circumstances. First-time abatement relief is available to taxpayers who complied with all their filing requirements during the three tax years prior to the assessment of the penalties. First-time abatement eligibility also requires the taxpayer requesting the relief to be currently in compliance and to have paid--or have made arrangements to pay--the underlying tax due. First-time abatement relief is available for both the failure-to-file and failure-to-pay penalties, and otherwise does not require a taxpayer to show reasonable cause when requesting abatement.

The bottom line is that avoidance costs money. Even if you don't have enough funds to pay your taxes in full, coming forward and voluntarily reporting your liability on time can save you money.

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