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#7**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 34 decisions issued by federal courts from June 1, 2018, to May 31, 2019, regarding additions to tax for:

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

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. Three cases involved the successful imposition of the estimated tax penalty in conjunction with the failure to file and failure to pay penalties; 30 cases involved the failure to file and/or failure to pay penalties without the estimated tax penalty; however, the estimated tax penalty was not the sole issue in any of the cases.

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.<sup>1</sup> The estimated tax penalty is imposed unless the taxpayer falls within one of the statutory exceptions.<sup>2</sup> Taxpayers were unable to avoid a penalty in just two of the 34 cases.

**TAXPAYER RIGHTS IMPACTED<sup>3</sup>**

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *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 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 reasonable cause and not willful neglect.<sup>4</sup> For the taxpayer to avoid the penalty by showing there was a

<sup>1</sup> IRC § 6651(a)(1), (a)(2).

<sup>2</sup> IRC § 6654(e).

<sup>3</sup> See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are also codified in the Internal Revenue Code. See IRC § 7803(a)(3).

<sup>4</sup> 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). 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 did not pay on time, or a specific dollar amount which is adjusted annually due to inflation.

reasonable cause, the taxpayer must have exercised ordinary business care and prudence.<sup>5</sup> The failure to file penalty applies to income, estate, gift, employment, self-employment, and certain excise tax returns.<sup>6</sup>

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.<sup>7</sup> 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.<sup>8</sup> 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.<sup>9</sup> The failure to pay penalty applies to income, estate, gift, employment, self-employment, and certain excise tax returns.<sup>10</sup>

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.<sup>11</sup> In addition, “consideration will be given to the nature of the tax which the taxpayer has failed to pay.”<sup>12</sup>

IRC § 6654 imposes a penalty on any underpayment of estimated tax by an individual or by certain estates or trusts.<sup>13</sup> The law requires four installments per tax year, each generally 25 percent of the required annual payment.<sup>14</sup> 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.<sup>15</sup> The IRS lowered to 80 percent the threshold required for certain taxpayers to qualify for estimated tax penalty relief if their federal income tax withholding and estimated tax payments fell short of their total tax liability in tax year 2018.<sup>16</sup>

5 Treas. Reg. § 301.6651-1(c)(1).

6 IRC § 6651(a)(1).

7 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). 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.

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 maximum limitation.

9 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.

10 IRC § 6651(a)(2).

11 Treas. Reg. § 301.6651-1(c)(1). See, e.g., *East Wind Indus., Inc. v. United States*, 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). 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 110 percent of the tax shown on the return of the individual for the preceding tax year (if the preceding tax year was 2002 or after). IRC § 6654(d)(1)(C)(i).

16 Notice 2019-11, 2019-05 I.R.B. 430, *modified and superseded by* Notice 2019-25, 2019-15 I.R.B. 942. Notice 2019-25 updated procedures for requesting the waiver of the addition to tax and provided procedures for requesting a refund of penalties paid for TY 2018. On August 14, 2019, the IRS announced it would automatically waive the estimated tax penalty for the more than 400,000 eligible taxpayers who already filed their 2018 federal income tax returns but did not claim the waiver. IR-2019-144.

The amount of the penalty is dependent upon the particular facts of the underpayment.<sup>17</sup> 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;<sup>18</sup>
- 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;<sup>19</sup>
- It is determined that because of casualty, disaster, or other unusual circumstances, the imposition of the penalty would be against equity and good conscience;<sup>20</sup> 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.<sup>21</sup>

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.<sup>22</sup>

## ANALYSIS OF LITIGATED CASES

We analyzed 34 opinions issued between June 1, 2018, and May 31, 2019, where the failure to file penalty, failure to pay penalty, or estimated tax penalty was in dispute. Twenty-eight of these cases were either litigated in the U.S. Tax Court, or an appeal of a Tax Court decision. A detailed list appears in Table 7 in Appendix 5. Twenty-four cases involved individual taxpayers and ten involved businesses (including individuals engaged in self-employment or partnerships).

Of the 19 cases in which taxpayers appeared *pro se* (without counsel), the outcomes always favored the IRS. Taxpayers were represented in the only two cases in which the court ruled in their favor.

### Failure to File Penalty

In 30 out of the 32 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.<sup>23</sup> 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.<sup>24</sup>

### *Physical Injury/Mental Illness or Pending Litigation as Defense*

A physical injury or mental illness may provide a basis for a taxpayer to establish reasonable cause for not filing if the condition affected the taxpayer to such a degree that he or she could not file a tax return on

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. The amount of the underpayment is the excess of the required payment over the amount paid by the due date.

18 IRC § 6654(e)(1).

19 IRC § 6654(e)(2).

20 IRC § 6654(e)(3)(A).

21 IRC § 6654(e)(3)(B).

22 IRC § 7491(c). See also *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).

23 A taxpayer avoided the failure to file penalty by successfully proving reasonable cause in just one case.

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

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 *Namakian v. Commissioner*, the court held the taxpayer did not establish reasonable cause for failure to file his 2011, 2012, and 2013 tax returns.<sup>25</sup> The taxpayer argued that his financial decline beginning in 2007, along with the death of his mother-in-law in 2011, and his father-in-law in 2014, invoked stress-induced anxiety and depression, which caused insomnia and an inability to retain focus. The taxpayer stated that these stress-induced health problems rendered him unable to file his returns.<sup>26</sup> The court sympathized with the taxpayer's circumstances, but did not believe these setbacks constituted reasonable cause, as the taxpayer was still able to generate significant income during these time periods, showing that he was capable of managing his business affairs.

The taxpayer also argued that his failure to file was due to awaiting a pending outcome on litigation regarding his 2007 and 2008 returns that he believed would affect the filing of these later years. The court pointed out that a stipulated decision on his 2008 matter was entered on August 27, 2013, several months prior to the due date for his 2013 return; thus, this explanation for his late filing of his 2013 return was unconvincing. The court further pointed out, in regard to the 2011 and 2012 returns, that the reasonable and prudent course of action would have been to file timely using the best information available, disclosing that a dispute existed regarding how he should be treated regarding his stock sales, (*i.e.*, investor or trader).

### *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 for ensuring timely filing.<sup>27</sup> Taxpayers have a non-delegable duty to file a tax return on time.<sup>28</sup> In order for reliance on an agent to rise to the standard of reasonable cause for failing to fulfill the filing requirement, the taxpayer must make full disclosure of all relevant facts to the tax professional that he or she relies upon.<sup>29</sup> In other words, merely hiring a tax professional (*e.g.*, accountant, lawyer, or Enrolled Agent) to handle tax return filing is not enough to establish that the taxpayer used ordinary business care and prudence if there are facts that indicate otherwise.

In *Burbach v. Commissioner*, the IRS imposed failure to file penalties on the taxpayer (Mr. Burbach) and the taxpayer's business (Burbach Aquatics Inc. or BAI, Inc.).<sup>30</sup> Both Mr. Burbach and BAI argued that their failure to file was due to their reliance on their tax professional and advice given by this professional. However, the court held that both Mr. Burbach's and BAI's reliance was unreasonable.

In regards to BAI, Inc.'s corporate tax returns, Mr. Burbach relied on his tax professional's statement that corporations have six years to file their returns. The court stated that it did not find credible

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25 *Namakian v. Comm'r*, T.C. Memo. 2018-200.

26 *Id.*

27 The Supreme Court held in *United States v. Boyle* that reasonable cause may exist when a taxpayer relies on the erroneous advice of counsel concerning a question of law. To escape liability for the failure to file penalty, the taxpayer bears the heavy burden of proving both (1) that the failure did not result from "willful neglect," and (2) that the failure was "due to reasonable cause." 469 U.S. 241, 245, 250 (1985).

28 *United States 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." *Boyle*, 469 U.S. at 252.

29 *Boyle*, 469 U.S. at 241.

30 *Burbach v. Comm'r*, T.C. Memo. 2019-17.

Burbach's statement that he relied on this advice, because he had timely filed his own business and personal returns for decades, and described Burbach as a sophisticated businessman.<sup>31</sup>

Regarding Mr. Burbach's individual tax returns, the court also rejected his reasonable cause defense for many of the same reasons stated above (*i.e.*, Mr. Burbach was a sophisticated businessman), concluding that it was unwilling to excuse his late filing because he relied on advice that he knew, or should have known, was inaccurate.

In *Estate of Sanders v. Commissioner*, the taxpayer disputed a failure to file penalty under IRC § 6651(a)(1) for 2002, arguing that he was not required to file a return with the IRS because he was a *bona fide* resident of the U.S. Virgin Islands (USVI) for that year. Further, the taxpayer stated that even if he was not a *bona fide* USVI resident, and thus was required to file a return with the IRS, the penalty should be abated under reasonable cause because he reasonably relied on professional advice.<sup>32</sup>

In regards to the *bona fide* resident argument, the court determined, after considering 11 factors that fell into one of four broad categories,<sup>33</sup> that the taxpayer was a non-*bona fide* USVI resident for 2002,<sup>34</sup> meaning the taxpayer was required to file two income tax returns — one with the IRS and another with the Virgin Islands Bureau of Internal Revenue (VIBIR).<sup>35</sup> The taxpayer filed a return with the VIBIR for 2002, but did not file a return with the IRS for that year. However, the court held that the taxpayer's failure to file was due to reasonable cause and not willful neglect, because he had relied on advice from his attorney that he was a *bona fide* resident of the USVI, and thus did not need to file a return with the IRS.<sup>36</sup>

### Failure to Pay an Amount Shown Penalty

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 the payment of his or her tax liabilities, but nevertheless was either unable to timely pay the tax or would suffer undue hardship if the payment was made on time.<sup>37</sup> 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 *Deaton Oil Company v. United States*, the taxpayer, Deaton Oil Co., LLC, was assessed a failure to pay penalty under IRC § 6651(a)(2) for 2010 through 2013 for failure to pay its employment taxes.<sup>38</sup> In 2015, the taxpayer paid the penalties and interest on the unpaid employment taxes, and subsequently

31 The court was unable to verify whether Mr. Burbach's tax return preparer was actually an enrolled agent. See *Burbach v. Comm'r*, T.C. Memo. 2019-17.

32 *Estate of Sanders v. Comm'r*, T.C. Memo. 2018-104.

33 The four categories are: intent; physical presence; social, family, and professional relationships; and the taxpayer's own representation.

34 "The single filing requirement of section 932(c)(2) applies only if a taxpayer 'is a bona fide resident of the Virgin Islands'. Sec. 932(c)(1)(A). The term 'bona fide resident of the Virgin Islands' was not defined by the Code until 2004. The Secretary did not promulgate final regulations for determining whether a taxpayer is a bona fide resident of the USVI until 2006. As a result, a taxpayer attempting to determine whether he or she was a bona fide resident of the USVI for tax years 2002-03 would not find the answer in either the Code or the regulations." *Estate of Sanders v. Comm'r*, T.C. Memo. 2018-104, 2018 Tax Ct. Memo LEXIS at \*36-37 (July 15, 2018).

35 Under IRC § 932, non-bona fide residents of the US Virgin Islands who derive income from the USVI, must file two income tax returns: one with the IRS, and another with the VIBIR.

36 *Estate of Sanders v. Comm'r*, T.C. Memo. 2018-104.

37 See Treas. Reg. § 301.6651-1(c)(1).

38 *Deaton Oil Company v. United States*, 904 F.3d 634 (8th Cir. 2018), *aff'g* 119 A.F.T.R.2d (RIA) 1945 (W.D. Ark. 2017).

filed Form 843, Claim for Refund and Request for Abatement, seeking a refund of penalties and interest. The IRS refunded most of the penalties and interest assessed for 2013, but denied the claims for 2010, 2011, and 2012. Shortly thereafter, the taxpayer filed a refund suit in federal district court, which was dismissed for failure to state a claim.<sup>39</sup> The taxpayer appealed this decision.

The taxpayer argued that the paid IRC § 6651(a)(2) penalties should be refunded because the failure to pay was due to reasonable cause. Specifically, the taxpayer's operations manager failed to pay the taxes, which were part of his official responsibilities. Further, Deaton's operations manager did not inform Deaton's owner of these missed filing deadlines, withheld IRS notices from him, and even began settlement negotiations with the IRS without the express consent of Deaton's owner. Additionally, the taxpayer argued that it reasonably relied on its outside Certified Public Accountant's (CPA) assurances that tax returns were filed, and taxes paid timely.

The Court of Appeals for the Eighth Circuit determined that the failure of the operations manager (an agent of Deaton) to fulfill his obligations to Deaton (the principal) by filing tax returns and making payments on behalf of Deaton does not establish reasonable cause for Deaton's failure to comply with its tax obligations, because that failure did not render Deaton disabled with regard to its tax obligations. Further, the court concluded that disability is not established because the operations manager was subject to Deaton's control, regardless of whether or not Deaton sufficiently exercised that control. Therefore, the actions of the operations manager do not establish reasonable cause.

Additionally, the court held that the taxpayer's reliance on its outside CPA to confirm with its operations manager that all filings and payments had been timely made was not a basis for relief. The taxpayer's outside CPA merely asked the operations manager if such filings and payments had been completed and then relayed to the taxpayer that the necessary filings and payments had been made, even though the CPA did not request documentation to verify these actions. The court stated the CPA was not offering tax advice on which the taxpayer could rely, but was merely stating whether or not the tax obligations had been met.<sup>40</sup> Thus, the Court of Appeals determined that the taxpayer did not establish reasonable cause, and consequently was not entitled to relief, thereby affirming the district court's decision to dismiss the taxpayer's case.<sup>41</sup>

### *Estimated Tax Penalty*

In court proceedings involving individuals, the IRS has the burden to produce evidence that IRC § 6654(d)(1)(B) requires an annual payment from the taxpayer.<sup>42</sup> If a taxpayer did not pay enough tax throughout the year, either through withholding or by making estimated tax payments, the IRS will assess a penalty for underpayment of estimated tax.

In all four cases where an IRC § 6654 penalty was imposed, the IRS was able to show that the taxpayer had a required annual payment.<sup>43</sup> In none of these cases did the taxpayer present any evidence to show that he or she qualified for any of the statutory exemptions to the penalty. Thus, the penalty was imposed in all four cases.

39 *Deaton Oil Company v. United States*, 119 A.F.T.R.2d (RIA) 1945 (W.D. Ark. 2017).

40 *Deaton Oil Company v. United States*, 904 F.3d at 638.

41 *Deaton Oil Company v. United States*, 904 F.3d at 642.

42 IRC § 7491(c).

43 *Namakian v. Comm'r*, T.C. Memo. 2018-200; *Wells v. Comm'r*, T.C. Memo. 2018-188; *De Sylva v. Comm'r*, T.C. Memo. 2018-165.

## CONCLUSION

Only two taxpayers prevailed in full out of the 34 (about six percent) of the failure to file, failure to pay, and estimated tax penalty cases analyzed in this report. The number of cases in which failure to file, failure to pay, or estimated tax penalties were at issue decreased by almost 28 percent from last year, and the portion of cases where the taxpayer received at least some form of relief decreased from 13 percent to six percent. This decline may be attributed to the general decline in tax litigation in recent years.<sup>44</sup>

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<sup>44</sup> David McAfee, *Tax Court: Tax Court Caseload Drops as Enforcement Lags: Former Chief Judge* 142 DTR 8 (July 24, 2018). Former Chief Judge L. Paige Marvel noted that the Tax Court's inventory is dropping, due in part to lax enforcement. This trend could correlate with the fewer litigated lien cases in the U.S. District Courts. See also National Taxpayer Advocate 2019 Annual Report to Congress (Most Litigated Issue: *Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under IRC § 7403*), *supra*.