

By-Lined Article

PENALTY ABATEMENTS AND THE RCA PROGRAM: WHAT'S A TAXPAYER TO DO?

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In today's economic climate of declining government revenues, the IRS has become more aggressive in its penalty assessment and enforcement efforts. While the IRS has the authority to waive penalties if a taxpayer can prove he or she acted reasonably and in good faith, or relied on the incorrect advice of IRS personnel, the IRS has been less generous in its penalty abatement allowances.

In an effort to ensure consistency, the IRS has recently begun utilizing select automated systems in a variety of areas, including the analytical process through which decisions are made regarding whether to abate or reduce penalty assessments. As a result of the IRS's new approach, the quality and completeness of the content of a request for penalty abatement is essential for success. This is particularly true when requesting abatement of penalties because of the reasonable cause standard. This article provides some insight as to how the IRS may determine reasonable cause for penalty abatement and what can be done to increase the likelihood of success in these matters for you and your clients.

According to the IRS Data Book for 2008, issued in March 2009, the IRS assessed more than 40 million civil penalties of all types during the 2008 tax year (regardless of the tax year to which the assessment applied), representing more than \$28 billion in assessed penalty value. Of these assessments, just under 3.1 million civil penalties (about 7.6 percent of assessments) were abated (the IRS defines penalty abatement as a reduction in penalties, meaning not all penalties are abated in their entirety — some penalties are merely reduced) representing just under \$12 billion, or about 42.2 percent of assessments. This is a significant source of revenue for the government and one that the government would likely prefer to retain in an environment of declining tax revenue.

When a taxpayer is assessed a penalty by the IRS for late filing, late payment or negligence, for example, an abatement of penalty application may be filed requesting relief under the reasonable cause standard. While the IRS will consider the facts and circumstances of each case to determine if the reasonable cause standard has been met when considering a request for penalty relief, penalties are often abated when taxpayers can prove that ordinary business care and prudence were

exercised in determining tax obligations, but the taxpayer was unable to comply with those obligations because of death, illness, casualty or other unavoidable circumstances.

In most cases, the IRS will automatically assess the penalty and force the taxpayer to pay then make affirmative application for relief of the penalty. However, there are new procedures under consideration by the IRS that will permit some taxpayers to appeal certain penalties within 90 days of assessment but prior to payment. These new procedures will affect penalties related to reporting requirements for foreign corporations and partnerships.

As noted above, not all applications for penalty relief are successful. In fact, based on the statistics, penalties are likely not to be waived. While the process is consistent — the IRS will review the request, consider the basis for abatement using all information provided and issue a decision — reasonable cause decisions are frequently inconsistent.

In an effort to achieve consistency and equitable administration of penalty relief consideration, the IRS utilizes a Reasonable Cause Assistant, or RCA, a decision-support interactive software program that was developed to reach a reasonable cause determination. This product is the result of research conducted by the IRS Artificial Intelligence Lab and is expected to dramatically affect taxpayers for years to come. The RCA analyzes vague concepts like illness and ignorance, considers a taxpayer's tax reporting history and evaluates the factors. The RCA is employed after normal case research (including the application of missing deposits/payments, adjusting tax or searching for missing extensions of time to file) has been conducted.

The RCA recommends a decision, provides a measurement of how strongly the system is convinced of that decision and provides an explanation of why a penalty should be sustained, assuming this was the decision concluded upon. The RCA will be utilized to determine if penalty relief will be granted for any penalty abatement request based on reasonable cause, whether requested verbally or in writing. In order to achieve a successful abatement, the taxpayer must answer the questions who, what, when and how and supply appropriate supporting documentation to prove their assertions. In order to increase the likelihood of success, it is critical to consult with a qualified tax professional with successful penalty abatement experience because there are many "terms of art" to facilitate the IRS's review, case law that can be cited to further support the application for abatement and IRS policy may be helpful irrespective of competing authority.

For example, when requesting an abatement of penalty, it is often helpful not only to include appropriate documentation in support of reasonable cause, but also include provisions from the IRS's own advice memoranda, such as Chief Counsel

Advises, the Audit Reconsideration Handbook and the Internal Revenue Manual, which often provide guidance to IRS personnel as to when penalties may be abated, such as abating a portion of a deficiency assessment when the IRS determines that a taxpayer's return is correct. Also, consider utilizing, as documentation in the abatement request, excerpts from IRS Penalty Policy Statements, which often provides that penalties must also enhance voluntary compliance, and may not, in certain circumstances, be imposed solely as a punitive or revenue raising measure.

In order to prevail, a taxpayer must select one of the appropriate indentifying reasonable cause categories, highlighted above and discussed below, and provide a thorough and precise explanation of the circumstances and events that support the reasonable cause assertion. After conducting the normal case research, the IRS agent will enter the taxpayer's information and supporting documentation into the RCA for a determination. The taxpayer's information should be as complete, clear, concise and compelling as possible, which will increase the likelihood of success of compliance with the reasonable cause standard as determined by the RCA. This will help facilitate maximum opportunities for penalty abatement.

Below are indentifying reasonable cause categories with related issues and likely questions that may be raised and will need to be answered as completely and thoroughly as possible to achieve abatement success. Comprehensive attention to the listed questions and the availability of adequate and thorough supporting documentation will assist in the consideration process and will help increase the likelihood of penalty abatement success. Keep in mind that reasonable cause is a fact and circumstance analysis, therefore, an appropriate level of substantiation is critical. Additionally, even though one or more of the defenses below may exist, not all will result in abatement.

Absence: Taxpayers may claim they were unable to comply because of an absence, either their own absence or the absence of another person.

- Who was absent?
- Date of the absence.
- Reason for absence.
- How did the absence prevent compliance?
- Is documentation provided?

Assessment Error: The penalty should not have been assessed in the first place or there is disagreement with the amount of the penalty. Types of assessment error include:

- Taxpayer disagrees with penalty computation.
- Missing payments according to the IRS.
- Payment was refunded in error.
- Credit not given for extension.
- Taxpayer timely mailed return.

Casualty: Taxpayers may claim they were unable to comply because of a casualty.

- Date of casualty.
- Type of casualty — *e.g.*, fire, theft, accident.
- Is taxpayer in a FEMA declared area?
- What was destroyed?
- Nature and type of documentation provided?

Death: The taxpayer, a relative or someone affecting the taxpayer's business died.

- Date of death.
- Who died?
- Is documentation provided?

Divorce: A divorce prevented the taxpayer from complying.

- Who got divorced?
- How did the divorce prevent the taxpayer from meeting his or her obligation?

Elderly taxpayer: The taxpayer did not comply because they are elderly or incapacitated.

- Has someone taken responsibility for the affairs of the taxpayer?
- Has a legal guardian been appointed?
- Does a child or relative exist with power of attorney?

- Is there adequate and sufficient documentation?

Ignorance: The taxpayer did not know about or was unfamiliar with filing requirements, withholding, etc.; the taxpayer was unaware of income or didn't know it was taxable. Taxpayer may claim ignorance related to:

- Filing requirements.
- First time under-withholding of tax.
- First time self-employment.
- First time unanticipated income.
- Level of income required to file.
- Due dates.
- Taxability of income.
- Communication that may involve a foreign language or custom.

Reliance: The taxpayer relied on another to file or pay or relied on the advice of another:

- Whom did the taxpayer rely on?
- What was the nature of the reliance?
- Did the individual relied upon indicate that the taxpayer did not need to file or pay?
- Did the individual relied upon handle everything?
- Did the individual relied upon fail to mail the return or send payment?
- Did the individual relied upon fail to file an extension?
- What is the nature and adequacy of the documentation available?

Taxpayers can expect penalty assessments by the IRS to increase in both volume and dollar value along with increased scrutiny of penalty abatement requests by the IRS through its RCA program. Should you or your clients receive a notice assessing penalty, it is important to engage a qualified tax professional with IRS tax controversy experience to handle the response, particularly in an environment where IRS assessment, enforcement and collection efforts are on the rise.

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