

# Penalty Abatement Basics & Techniques

# Penalty Abatement

## BASICS & TECHNIQUES

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### INTRODUCTION

Like much of tax law, penalties can be overwhelming if a person is unfamiliar with their workings. If left unchecked, penalties can spiral out of control rapidly, adding tens of thousands of dollars (or more) of tax burden. Working with the IRS to abate penalties can be a complex, high-stakes process, but this ebook is designed to arm you with a foundational knowledge of penalties and abatements.

We'll cover:

- The two most common penalties— Failure to Pay and Failure to File.
- Interest on unpaid tax and how to reduce the total tax owed.
- First Time Abatement and five different categories of Reasonable Cause Abatement.

Disclaimer: This ebook is not designed to be a comprehensive or authoritative commentary on tax law. Rather, it is designed to provide a basic overview of tax penalties and abatements to the best of our knowledge at the time of publication. Tax law is complex and changes frequently. None of the information in this book should be taken as a law without further consulting the most recent Internal Revenue Manual and other relevant legal references.

# Penalties

## FAILURE TO PAY | FAILURE TO FILE | INTEREST

Tax penalties are designed “to encourage voluntary compliance by supporting the standards of behavior required by the Internal Revenue Code,” (IRM 20.1.1.2). In other words, they are intended to make non-compliance—neglecting to pay the right amount of taxes, on time, in the right way—more painful than paying voluntarily. This section covers the two most common penalties—Failure to Pay and Failure to file—as well as interest on unpaid tax.

# Failure to Pay

**FAILURE TO PAY (FTP) PENALTY IS .5% PER MONTH, UP TO 25%**

The first and most common penalty is Failure to Pay (FTP). If taxes are not paid in full by their due date (generally the infamous April 15th), then the Failure to Pay penalty kicks in. The penalty is one half of one percent (.5%) of the unpaid balance, added every month or partial month the payment is late. That penalty will continue to grow until it either reaches the maximum 25%, or the balance is paid.

## Examples



**Danielle Jones** owes \$7,000 in taxes. She files a return, but can only pay \$2,000 at the time her taxes are due and then \$1,000 per month every month thereafter. By the time her taxes are completely paid, Danielle will have paid \$75 in FTP penalties.



**John Evans** owes \$80,000 in taxes. He files his return, but doesn't pay for 6 years. Assuming nothing more drastic happens to John, he will owe \$20,000 in penalties in addition to his \$80,000 tax bill.

Failure to Pay penalties aren't fun by anyone's definition of the word, but as you can see from Danielle and John's examples, they don't have to be a big deal as long as they don't go unpaid for too long.



# Failure to File

**FAILURE TO FILE (FTF) PENALTY IS 4.5% PER MONTH, UP TO 22.5%**

The Failure to File penalty is another of the most common penalties. FTF applies, as the name suggests, when someone does not file a return by the required due date. The penalty is 4.5% of the unpaid tax per month. However, because a person cannot pay taxes without having filed a return, FTF is inevitably combined with a Failure to Pay penalty, making the effective penalty 5%.

FTF is obviously much more severe than Failure to Pay, but it maxes out at 5 months, or 22.5%. Unlike the Failure to Pay penalty which can be relatively mild if not left to fester, the Failure to File penalty becomes painful quickly. Keep in mind, if the taxpayer files their return more than 60 days after it was due, there's an additional minimum penalty for late filing which is the lesser of \$435 or 100% of the tax owed.

Additionally, if a taxpayer does not file their own return the IRS will eventually file a Substitute For Return (SFR), which calculates taxes without accounting for deductions or exemptions. When this happens, the taxpayer is most likely going to owe far more tax than if they had filed a proper return in the first place. Tax professionals like you are often the first place that reluctant taxpayers turn when they have failed to file their income taxes.

## Examples



**Danielle Jones** figures she owes \$7,000 in taxes, but only has \$2,000 when the deadline to file comes. Rather than filing her tax return on time, Danielle decides to wait until she has all \$7,000. Five months later when she files her return, Danielle finds that she owes an additional \$1,750 (25%) in combined FTF and FTP penalties.



**John Evans** fails to file a return and makes no payments for six years. The IRS decides to take matters into their own hands and, after filing an SFR, determines that John owes \$80,000 in taxes. Assuming the IRS lets it go that long without taking more emphatic measures, John has managed to max out both FTF and FTP penalties, and will owe \$38,000 (47.5%) in penalties in addition to his \$80,000 tax bill.

As you can see, FTF penalties get expensive in a hurry.

## Interest

**INTEREST ON UNPAID TAX IS THE CURRENT FEDERAL SHORT TERM RATE + 3%, COMPOUNDED DAILY**

As if the penalties alone weren't enough, the IRS charges interest on unpaid tax. Interest is charged only on unpaid tax (not including any penalties the taxpayer has incurred).

Interest on unpaid tax is compounded daily, with a rate equal to the current Federal short term interest rate (determined quarterly) plus 3%. As of August 2020, the combined interest rate for unpaid tax was 3.17%. Unlike the penalties we discussed above, interest is not eligible to be abated.

# Abatements

**PARTIAL REMOVALS | FIRST TIME ABATEMENT (FTA) | REASONABLE CAUSE ABATEMENT**

As noted in the previous section, the IRS is more interested in encouraging voluntary compliance than penalizing taxpayers. Partial removal and abatements are methods by which penalized taxpayers can reassert compliance, while also relieving their tax burden.

# Partial Removals

This method isn't a true abatement like the others we will discuss shortly, but it can produce excellent results.

We talked earlier about the Substitute for Return, when, in the absence of a proper return, the IRS estimates a person's tax without taking into account any deductions or exemptions. The tax owed when calculated by the IRS will always be more than when a proper return is prepared by a competent tax professional. Because both interest and penalties are assessed as percentages of the unpaid tax, the penalties and interest will be overinflated as well. Similarly, a poorly prepared return can result in the taxpayer owing more tax than they should.

The solution is to file a proper, well-prepared delinquent or amended return. If the base tax can be reduced, both interest and penalties will reduce proportionally, making partial removals a good place to start most tax resolution cases.

*“...a poorly prepared return can result in the taxpayer owing more tax than they should.”*

## Examples



**Danielle Jones** waits until the last moment to start on her taxes. Because she's in a rush, she has her neighbor prepare her return. According to this hastily-filed return, Danielle owes \$16,000 in taxes. Though she only has \$10,000 to pay her taxes at the time of filing, Danielle wisely decides to pay as much as she can. Unfortunately, she still starts receiving notices that she is accruing interest and penalties on her unpaid tax.

After six months of worrying (and \$292 in accrued interest and penalties), Danielle decides to have a competent tax professional give her return a second look. The tax professional files an amended return showing that Danielle actually owed only \$12,000 in taxes, saving her a total of \$4,195 in taxes, penalties and interest. Filled with joy and gratitude, Danielle pays the remaining \$2,097 in unpaid taxes and fees.



**John Evans** receives a notice in the mail that he owes \$160,000 in taxes, six years overdue. Since he did not file a tax return, the IRS created a Substitute for Return to calculate his taxes, taking no deductions or exemptions into account. In addition to his tax, John owes \$79,823 in interest and \$57,000 in penalties for a total of \$256,823.

John immediately hires a tax lawyer to help him fix his IRS problem. The lawyer, in turn, files a well-prepared delinquent return showing that John actually only owes \$80,000 in taxes. Though John still owes a painful \$137,911 in taxes, interest and fees, filing the delinquent tax return saved him \$118,912.

# First Time Abatement (FTA)

First Time Abatement, or FTA, is a one time, get-out-of-jail-free card of sorts for abating certain penalties. The abatement is intended for taxpayers who are typically on top of their taxes but fell behind one year for any number of reasons. The IRS doesn't actually want to bury people who are typically good, responsible taxpayers.

Unlike Reasonable Cause Abatements we will talk about later, there isn't much room for interpretation with FTA. If the taxpayer meets the specific set of qualifications, they are eligible for the abatement—no need even for a good excuse. Because FTA is a one-time deal, you may want to look at other abatement options first and be sure to use it on the most effective year.

## **There are three requirements for FTA:**

1. FTA can abate three types of penalties—Failure to Pay, Failure to File, and Failure to Deposit.
2. The taxpayer must have at least three years of clean tax history immediately prior to the year they wish to use FTA—no penalties or noncompliance of any kind.
3. The taxpayer must currently be in compliance. This means having filed all required returns or a valid extension and paying or arranging to pay all taxes due.

## *Examples*



Unlike our previously cited tax delinquents, **Brooke Benson** has always been fastidious with her taxes—until this year. She scheduled a backpacking trip through China for the entire month of April (a reward to herself for an especially sweet financial year), and neglected to file a return before leaving. Taxes were the furthest thing from her mind when she came home as well, so when she received an intimidating notice from the IRS in October she was caught entirely off guard.

With the help of a tax professional, Brooke hastily filed her return and paid the balance of her taxes—\$65,000 this year—within a few days of receiving the notice. However, her accountant suggested that they may be able to get her an abatement for the FTF and FTP penalties, which he estimates at \$16,575. Her accountant was correct, and because she has such a squeaky clean history as a taxpayer Brooke was able to take advantage of First Time Abatement to have both penalties completely removed. Brooke's only financial penalty was roughly \$1,200 in interest.

As you may have noticed by now, Danielle Jones and John Evans are both very poor taxpayers. As they have a recent history full of tax penalties, neither has any chance of being granted an FTA.

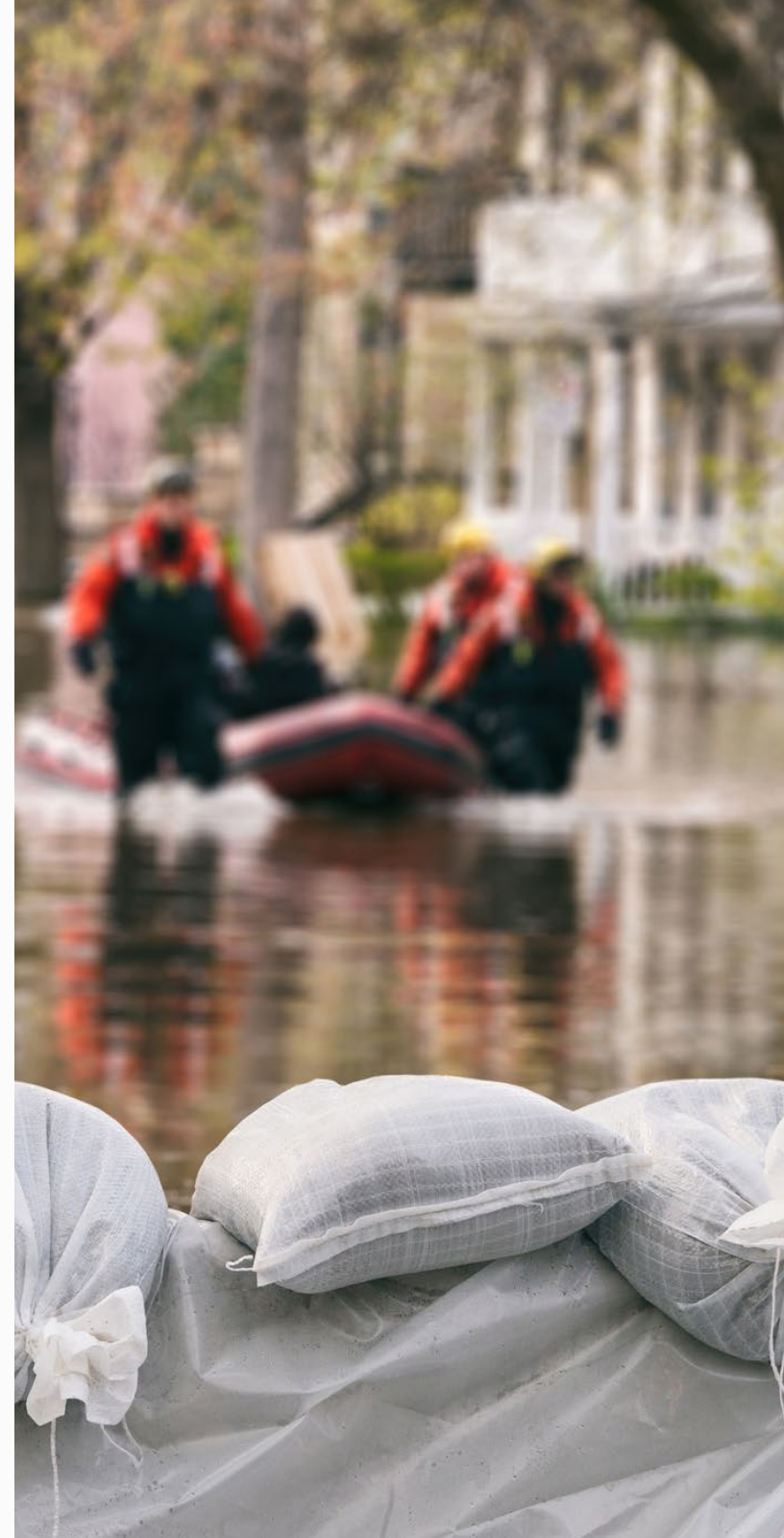
# Reasonable Cause Abatement

Reasonable Cause Abatements (RCA) are, in essence, when a tax professional approaches the IRS and says, “this taxpayer has a really good reason for not paying/filing their taxes on time.” Because Reasonable Cause situations are often multifaceted and complex, RCA can’t be quantified in the same way as FTA. However, this also means you have much more room for persuasion when trying to use Reasonable Cause in order to get penalties abated.

There are dozens of scenarios that can qualify as Reasonable Cause, and they often overlap allowing you to cite several for a given scenario. The examples in this section are designed as an overview of Reasonable Cause considerations, not an exhaustive list. It would be a good idea to become familiar with [section 20 of the IRM](#) so you can reference specific sections and codes from the IRM directly whenever possible with the IRS. They have to input IRM-specific codes into their software as they evaluate each case, so the more precise you can be, the better.

This is also one of many areas where using Canopy to prepare a penalty abatement can be incredibly beneficial. Canopy is designed to keep track of all the relevant tax codes and apply them to each case, then suggest the most likely ways of abating a client’s penalties. Having software assist you through the complex abatement process saves you time without sacrificing accuracy.

The universal point that you will have to prove in any case of Reasonable Cause is what the IRS calls “ordinary business care and prudence.” That phrase saturates section 20 of the IRM. When arguing for an RCA, the IRS will require proof that the taxpayer made a reasonable effort to meet their obligations. This effort will be a little different for each person and scenario, but establishing a taxpayer’s effort to exercise ordinary business care and prudence will be central to any successful RCA.



## Reasonable Cause Abatements

### **DEATH, SERIOUS ILLNESS, OR UNAVOIDABLE ABSENCE**

Death, serious illness, or unavoidable absence, applies only for the taxpayer and their immediate family—spouse, children, parents, siblings, grandparents, and grandchildren.

When looking at death, illness and absence as a reasonable cause, the IRS will consider the context of death, illness, or absence, as well as the overall effects of the same, such as:

- The dates, duration and severity of an illness.
- The length of time after the death or absence the taxpayer is out of compliance.
- Any other financial hardships caused by the death, illness or absence—unpaid bills and obligations besides the IRS.
- Ability to provide proof for all of the above as required.

### **FIRE, CASUALTY, NATURAL DISASTER, OR OTHER DISTURBANCE**

Any major disaster or disturbance can potentially qualify as Reasonable Cause. This could include hurricanes, tornados, flooding, earthquake, mud and landslides, riots, and more. If a client has a scenario you think applies, give it a try. You can't get the abatement if you don't ask.

In these cases, proving care and prudence will likely include:

- The steps the taxpayer took to comply. Just giving up won't get you Reasonable Cause.
- Complying after the disturbance in a timely manner, as the taxpayer is able.
- Showing that the disaster caused other problems—financial hardship, inability to obtain records, death or serious injury, etc.

Sometimes special procedures will be written for nationally declared disasters. Check with the IRS for incident-specific instructions in these cases.

### **UNABLE TO OBTAIN RECORDS**

Records can be lost or unavailable for a number of reasons, from disasters like floods and fires, to negligence on the part of a third party. As with any Reasonable Cause Abatement, the IRS will want to know the steps taken toward ordinary business care and prudence by the taxpayer. In this case, that care and prudence will include:

- A good reason the records were unavailable. Were they lost in a fire? Or just in your attic?
- Attempts to recover the records. Obtain documentation for the attempts whenever possible.
- The taxpayer's attempt at compliance. Did they make a reasonable estimate of tax owed, or just give up?

## Reasonable Cause Abatements

### **IRS ERROR**

If an IRS error caused penalties for a taxpayer, they are obligated to abate the penalty. The hard part about proving IRS Error is providing proof of the error. Written proof works best. If the error or bad advice was given orally, you need the ID number of the agent who gave the advice. The more clearly you can document the error, the better off you will be.

### **FINANCIAL HARDSHIP**

Substantial financial hardship can support an argument for FTP, but it has to be a real hardship—not just an inconvenience. As noted in the Death, Serious Illness, Unavoidable Absence section, the IRS doesn't look kindly on being the only one not getting paid. Proving hardship will require records—bank statements, bills, payments and the like. Financial problems caused by vacation, remodeling a home, or even donating to charity don't qualify as hardship in the eyes of the IRS.

To show ordinary business care and prudence while claiming financial hardship you will need to prove that the crisis immediately preceded the taxpayer's inability to comply, and was both unexpected and financially devastating.

# Get Clients Back on Track with the IRS.

When your client comes to you with a tax issue, you don't want to spend hours on IRM research—your time is valuable, and your clients are under the stress of being contacted by the IRS. You need the tools to evaluate possible outcomes and respond to their issues quickly and accurately. That's where Canopy comes in.

We've built every feature with you and your clients in mind so you can work together to resolve tax issues.

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- ✓ Penalty Abatement assistance
- ✓ Notices tool
- ✓ Offer in Compromise assistance

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