

There's a First Time For Everything: First-Time Penalty Abatements—What They Are and Why You Should Care¹

Most tax practitioners are familiar with the concept of reasonable cause as a ground for penalty abatements. But many often overlook another important ground for penalty abatement—so-called First-Time Abatement (FTA) relief.

This relief is available where a qualifying taxpayer has had no penalties sustained during the preceding three years and has filed and paid all currently required returns or has a valid extension or payment arrangement in place. No other reason or justification is necessary. It is, so to speak, a get-out-of-jail-free card for the otherwise historically compliant taxpayer.

Although FTA relief has, perhaps surprisingly, largely flown under tax professionals' radar, the Treasury Inspector General for Tax Administration (TIGTA) put a spotlight on it late last year. After conducting an audit into the use of FTA relief, TIGTA estimated that annual tax penalties of more than \$181 million have been going unabated for the better part of a decade, even though they qualified for FTA relief. Truth be told, TIGTA's findings went a little further than that—it found that “[t]he FTA waiver is [, in fact,] not being granted to *most* [over 90 percent of] taxpayers who qualify for the waiver.”²

The reasons appear to be rather straightforward. FTA relief is not highly publicized by the IRS, a circumstance that may be—surprise, surprise!—a bit strategic.³ Nor is FTA relief automatic. A taxpayer must affirmatively request an abatement before FTA relief is granted. As a result, to date FTA relief has been highly underutilized.

Background

Our tax system is built on the principle of voluntary compliance.⁴ In other words, to function efficiently, it largely relies on taxpayers to self assess and pay the tax they owe. Keeping with this principle, the Code's civil penalty structure is designed not to generate revenue in and of itself, but to promote compliance with the tax laws. This is an important distinction. And it largely explains the rationale behind the FTA: to reward a taxpayer's history of compliance and, thereby, promote future compliance. At least, that's the idea.

FTA relief is available with respect to two of the most prevalent and frequently asserted penalties: the failure-to-file and failure-to-pay penalties found in § 6651.

I.R.C. § 6651(a)(1) provides a delinquency penalty for a failure to file a return by the due date or extended due date of the return. Generally, this failure-to-file penalty is equal to 5 percent of the

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² Treasury Inspector General for Tax Administration, *Penalty Abatement Procedures Should be Applied Consistently to All Taxpayers and Should Encourage Voluntary Compliance*, Sept. 19, 2012, Reference No. 2012-40-113, p. 3 (hereinafter TIGTA Report) (emphasis added).

³ TIGTA Report, p. 3.

⁴ I.R.M 20.1.1.2.1 (11-25-2011).

unpaid tax for each month or portion of a month that the return is delinquent.⁵ In the absence of fraud, the maximum penalty generally cannot exceed 25 percent of the unpaid tax.⁶

I.R.C. § 6651(a)(2) provides a delinquency penalty for a taxpayer's failure to pay the amount of tax shown on the return by the due date. Generally, this failure-to-pay penalty is 0.5 percent of the unpaid tax for each month or portion of the month the tax remains unpaid.⁷ Much like the failure-to-file penalty, the maximum penalty is capped at 25 percent of the unpaid tax.

Generally speaking, even where penalties are initially assessed, there are a number of possible avenues for relief and abatement. For example, taxpayers can avoid these penalties where their failure to timely file or pay was due to reasonable cause and not willful neglect.⁸ There are other specific statutory exceptions scattered throughout the Code as well, ranging from the more mundane variety like § 6654(e)—providing certain exceptions to the estimated tax penalty where the tax is less than \$1,000—to the more obscure, such as § 7508, prohibiting penalty assessments against taxpayers in combat zones.

In addition to these statutory relief provisions, the IRS can grant administrative waivers. And in 2001, the IRS established an important administrative waiver program known as the First-Time Abate waiver, which is administered through its Reasonable Cause Assistant, an interactive, decision-support software program designed to administer and facilitate penalty abatement decisions.

Under the FTA waiver program, the IRS grants penalty relief to taxpayers who have been compliant for the prior three years.⁹ The IRS, in a memorandum released April 17, 2013, clarified that this condition means a taxpayer must be current with both their tax filing and payment requirements for those years.¹⁰ Importantly, a taxpayer is considered compliant with their filing obligations if they have a return under valid extension.¹¹ They are also considered compliant with their payment obligations even though they may not have fully paid the tax at issue if they have an open installment agreement and are current with all installment payments.¹²

As mentioned, individuals who qualify for relief can utilize the FTA waiver against failure-to-file and failure-to-pay penalties. For businesses, including S Corps and partnerships, the FTA waiver program extends to these penalties, as well as failure-to-deposit penalties, except where the penalty is charged for EFTPS Avoidance.¹³

⁵ I.R.C. § 6651(a)(1).

⁶ An exception exists in the case of a fraudulent failure to file, in which instance the penalty is 15% of the unpaid tax, not to exceed 75% of the unpaid tax.

⁷ I.R.C. § 6651(a)(2).

⁸ Treas. Reg. § 301.6651-1(a).

⁹ TIGTA Report, p. 2.

¹⁰ April 5, 2013 SB/SE Memorandum, SBSE-20-0413-0690, released April 17, 2013.

¹¹ *Id.*

¹² *Id.*

¹³ I.R.M. 20.1.1.3.6.1 ¶ 5D (11-25-2011).

The FTA waiver does, however, have some limitations. It only applies to a single tax year and cannot be used to obtain relief across multiple tax years.¹⁴ And there are other caveats as well: relief under the program does not apply to penalties based on non-compliance with “event-based” filing requirements, including those pursuant to Form 706, *U.S. Estate Tax Return* and Form 709, *U.S. Gift (and Generation-Skipping Transfer) Tax Return*.¹⁵ Nor is it applicable against accuracy-related penalties.

What TIGTA’s Audit Found

TIGTA summed up its findings on the use of FTA relief in one sentence: “The FTA waiver is not being granted to most taxpayers who qualify for the waiver.”¹⁶ Indeed, TIGTA found that FTA relief was not extended to an estimated 90 percent of taxpayers qualifying for failure-to-file waiver relief and 92 percent of taxpayers qualifying for failure-to-pay waiver relief.¹⁷ Again, these numbers indicate that the FTA waiver is highly underutilized.

The Moral: If You Don’t Ask, You Don’t Receive

The primary reason for the shortfall in FTA waivers? FTA is not considered unless a taxpayer actually requests relief,¹⁸ and taxpayers have simply not been requesting it. In other words, if you don’t ask, you don’t receive. The fault, however, does not entirely fall on taxpayers’ shoulders. According to TIGTA, the lack of requests is largely a result of the IRS’s failure to publicize FTA waiver relief.¹⁹ For example, IRS Form 1040 and its instructions fail to reference that the relief is available, and the FTA waiver program has been conspicuously absent from the IRS’s public Internet site, *Eight Facts on Penalties*.²⁰ Nor do balance due notices from the IRS include information on the FTA waiver.²¹

Is First-Time Abatement the Right Choice? Some Subtle Considerations

OK, so now the FTA is no longer a secret—at least to those who have made it this far. But even where it is available, an FTA may not be the best option under some circumstances. Taxpayers who actually qualify for penalty relief based on reasonable cause grounds may prefer reasonable cause relief to FTA relief.

Under its procedures, however, the IRS grants FTA relief by default to taxpayers who qualify for both an FTA waiver and reasonable cause relief.²² And not surprisingly, TIGTA found that a significant number of taxpayers who were granted FTA penalty relief would have also qualified for reasonable cause relief.²³

¹⁴ TIGTA Report, p. 2.

¹⁵ I.R.M. 20.1.1.3.6.1 ¶ 8 (11-25-2011).

¹⁶ TIGTA Report, p. 3.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² I.R.M 20.1.1.3.6.1.

²³ TIGTA Report, p. 7.

So what's the big deal? Well, the following hypothetical example explains one of the primary concerns:

A taxpayer with a clean compliance history asks to have his FTP penalty abated in tax year 2010 for reasonable cause (serious illness). The IRS would first consider the FTA waiver and the taxpayer would be granted penalty relief under FTA criteria. The following year, the taxpayer is late paying his tax year 2011 taxes, but did not have reasonable cause. He will be assessed an FTP penalty, which could not be waived because he had been granted an FTA waiver for the prior tax year. Had the taxpayer been granted reasonable cause for late payment for tax year 2010, the taxpayer would qualify for an FTA waiver for the FTP penalty for tax year 2011.²⁴

This taxpayer would have been better off obtaining a reasonable cause abatement in the first year. Had a reasonable cause abatement been granted, the taxpayer would have qualified for FTA relief in the subsequent year because, under FTA procedures, a fully reversed penalty is considered to be consistent with compliance.²⁵

A reasonable cause determination may be more advantageous than an FTA waiver for other, perhaps even more subtle, reasons. For example, take the next hypothetical:

A taxpayer timely filed a tax year 2010 return with a tax of \$8,000, but only submits \$4,000 with his tax return. At the time the return is processed, an initial \$40 FTP penalty was assessed and additional amounts accrue. The taxpayer had reasonable cause for his failure to pay the full amount and provided the IRS with a written request in May 2012 to abate the FTP penalty. Upon receiving the taxpayer's request, the IRS granted the taxpayer an FTA waiver and abated the \$40 FTP penalty. However, the taxpayer is required to request reasonable cause (a second time) or pay the \$230 of accrued FTP, as well as any additional FTP accruals until the tax is paid in full. If the IRS had abated the penalty under reasonable cause procedures, the initial \$40 and the subsequent \$230 in accruals would have been abated.²⁶

It sounds a little crazy, right? But indeed, TIGTA's audit found that a fairly significant number of taxpayers who met the qualifications for both FTA and reasonable cause relief, but were granted FTA waivers—as opposed to reasonable cause relief—had less penalties abated than would have been abated under reasonable cause relief for precisely these reasons.²⁷

²⁴ *Id.*

²⁵ I.R.M. 20.1.1.3.6.1 (11-25-2011)

²⁶ TIGTA Report, pp. 7-8.

²⁷ TIGTA Report, p. 7.

Conclusion

Under the right circumstances, a First-Time Abatement waiver can be a great tool in the tax practitioner's toolbox—and a historically underutilized one at that. It offers taxpayers who have a clean history over the past three years with a one-time pass (well, technically, one time every three years) to have penalties waived. But there are some subtle factors that should be taken into consideration when seeking an FTA waiver, particularly where the taxpayer may also qualify for reasonable cause relief. With that in mind, practitioners should, at the very least, add the FTA waiver to their arsenal and evaluate its applicability on a case-by-case basis.

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