

University of Texas School of Law
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**Penalties Above 20%:
What Are They, When Are They Applied, and How Do You Defend?**

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I. Introduction

A. Penalties Generally:

1. The Growth of Penalties: “The number of penalties has grown more than ten-fold from the 13 penalties included in the Internal Revenue Code of 1954.” Alan J. Tarr & Pamela Jensen Drucker, Civil Tax Penalties, 634-3d Tax Mgmt. (BNA), at A. Anecdotally, the Internal Revenue Service (“IRS” or “Service”) now asserts penalties with greater frequency and in cases where a penalty historically would not have been asserted. Suffice to say, the number and degree of penalties has steadily risen over time.
 - a. In General: As of the time of this writing, the Internal Revenue Code (“Code”) authorizes the Service to impose more than 150 civil penalties, additions to tax, and additional taxes for a variety of misdeeds.
 - b. Focus of Outline: This Outline focuses primarily on penalties related to taxpayers’ reporting positions.
2. The Purpose of Penalties: “Penalties exist to encourage voluntary compliance by supporting the standards of behavior required by the [Code].” Internal Revenue Manual (“I.R.M.”) 20.1.1.2 (Feb. 22, 2008).

B. Varying Degrees of Penalties:

1. The 20% Accuracy-Related Penalties: The Service is authorized to impose 20% accuracy-related penalties for the following misdeeds:
 - a. Negligence or disregard of rules or regulations, see I.R.C. § 6662(a), (b)(1);
 - b. Any substantial understatement of income tax, see I.R.C. § 6662(a), (b)(2);
 - c. Any substantial valuation misstatement, see I.R.C. § 6662(a), (b)(3);
 - d. Any substantial overstatement of pension liabilities, see I.R.C. § 6662(a), (b)(4);
 - e. Any substantial estate or gift tax valuation understatement, see I.R.C. § 6662(a), (b)(5);
 - f. Any disallowance of claimed tax benefits by reason of a properly disclosed transaction lacking economic substance (within the meaning of I.R.C. § 7701(o) or failing to meet the requirements of any similar rule of law), see I.R.C. § 6662(a), (b)(6);
 - g. Any undisclosed foreign financial asset, see I.R.C. § 6662(a), (b)(7);
 - h. Any inconsistent estate basis, see I.R.C. § 6662(a), (b)(8); and
 - i. Any understatement of tax attributable to a properly disclosed reportable transaction, see I.R.C. § 6662A(a).

2. The 30% Accuracy-Related Penalty: The Service is also authorized to impose accuracy-related penalties greater than 20% in a variety of circumstances set forth below. For example, the Service is authorized to impose 30% accuracy-related penalties for:
 - a. Any understatement of tax attributable to an improperly disclosed (or not disclosed) reportable transaction, see I.R.C. § 6662A(a), (c)
3. The 40% Accuracy-Related Penalties: The Service is authorized to impose 40% accuracy-related penalties for:
 - a. Any gross valuation misstatement, see I.R.C. § 6662(a), (b)(3), (h);
 - b. Any disallowance of claimed tax benefits by reason of an improperly disclosed (or not disclosed) transaction lacking economic substance, see I.R.C. § 6662(a), (b)(6); or
 - c. Any undisclosed foreign financial asset understatement, see I.R.C. § 6662(a), (b)(7) (j).
4. The 75% Fraud Penalty: The Service is authorized to impose 75% fraud penalties for:
 - a. Fraud, see I.R.C. § 6663.
5. International Form and BSA Penalties Above 20%: In addition, the Service is also authorized to assert civil penalties that may be above 20% of the tax due. For example:
 - a. International Form Penalties Above 20%: Under I.R.C. § 6677, the failure to file information returns with respect to certain foreign trusts can result in a penalty equal to 35% of the amount required to be reported, but not reported.
 - b. BSA Penalties Above 20%: Under 31 U.S.C. § 5321(a)(5)(A) and (C), the IRS is authorized to impose a civil penalty on any person who willfully violates or causes a violation of any provision of 31 U.S.C. § 5314 (requiring the filing of FBARs). The maximum civil penalty that can apply to a person who willfully violated the FBAR reporting requirements is the greater of \$100,000 or 50% of the value of the account at the time of the violation. See 31 U.S.C. § 5321(a)(5)(C), (D). An examiner has broad discretion as to the amount of the penalty to impose in connection with a willful violation, see I.R.M. 4.26.16.6 (Nov. 6, 2015), and these penalties often rise above 20%.
6. Penalties Not Exclusive: In addition to the above-mentioned penalties, the Service is also authorized to assert civil penalties, additions to tax, and additional taxes for a number of other misdeeds, including but not limited to:
 - a. The failure to timely file income and employment tax returns, see I.R.C. § 6651(a)(1);

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