

Larry's Tax Law

Establishing Reasonable Cause for Purposes of Avoiding the Penalty Imposed by IRC § 6656(a) May Not be a Slam Dunk

By Larry Brant on 5.21.14 | Posted in Tax Procedure

IRC § 6656(a) provides, in the case of any failure to timely deposit employment taxes, unless the failure is due to “reasonable cause and not due to willful neglect,” a penalty shall be imposed. The penalty is a percentage of the amount of underpayment.

- 2% for failures of five (5) days or less;
- 5% for failures of more than five (5) days, but less than 15 days;
- 10% for failures of more than 15 days; and
- 15% for failures beyond the earlier of: (i) 10 days after receipt of the first delinquency notice under IRC § 6303; or (ii) the day on which notice and demand is made under IRC § 6861, 6862 or 6331(a)(last sentence)(jeopardy assessment).

In addition to the “reasonable cause” exception contained in IRC § 6656(a), there are two other means by which taxpayers may avoid the imposition of the penalty.

1. Secretary has authority under IRC § 6656(c) to waive the penalty if:

- The failure is inadvertent;
- The return was timely filed;

- The failure was the taxpayer's first deposit obligation or the first deposit obligation after it was required to change the frequency of deposits; and
- The taxpayer meets the requirements of IRC § 7430(c)(4)(A)(ii) [submits a request within 30 days and comes within certain net worth parameters].

2. The Secretary has authority under IRC § 6656(d) to waive the penalty if:

- The taxpayer is a first time depositor; and
- The amount required to be deposited was inadvertently sent to the Secretary instead of the appropriate government depository.

As the exceptions are limited in application, most taxpayers seeking abatement of the penalty are required to pursue the "reasonable cause" exception.

On April 4, 2014, the Chief Counsel's Office issued Chief Counsel Advice 201414017 (CCA). The CCA offers guidance on this topic. Unfortunately, the guidance reflects the Service's position that the "reasonable cause" exception under IRC § 6656(a) is narrow.

In the CCA, the taxpayer was subjected to a IRC § 6656(a) penalty when it failed to timely deposit employment taxes as the result of some of its employees exercising nonqualified stock options. The taxpayer claimed "reasonable cause" existed because its failure to timely deposit employment taxes was the error of its third-party payroll service. The taxpayer bolstered its position with two important facts.

- Its deposits had always been timely filed in the past; and
- The taxpayer immediately remedied the failure upon learning of it and instituted procedures to avoid future repetition of the failure.

The Service commended the taxpayer for its historic compliance and its prompt remedial efforts. It concluded, however, that "[t]hese actions may amount to the exercise of ordinary business care that the reasonable cause defense requires and to the absence of willful neglect. The reasonable cause defense, however, also requires the taxpayer to demonstrate

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that despite its exercise of ordinary business care and prudence, it was ‘rendered unable to meet its responsibilities.’” The General Counsel’s Office ultimately concluded the taxpayer was liable for the penalty. It stated that the taxpayer’s reliance on its third-party payroll service provider is insufficient to obtain a penalty waiver as the reliance did not render it unable to otherwise meet its responsibilities.

Next, the General Counsel’s Office looked at whether the taxpayer could raise the first-time depositor defense under IRC § 6656(c) on examination rather than be required to wait until an assessment has been issued. It concluded, on the basis of administrative efficiency, the defense may be raised by the taxpayer on audit and the examiner should grant the request when appropriate.

The moral to the story is two-fold. First, the “reasonable cause” exception may be difficult to obtain. Whether it exists requires a facts and circumstances analysis. The burden of proof is on the taxpayer.

Reliance on third parties alone is generally insufficient. Likewise, failures due to mistake, ignorance of the laws or forgetfulness will not carry the day. Also, a taxpayer’s financial problems alone will generally not constitute “reasonable cause.”

The “reasonable cause” exception is narrow. Failures resulting from matters totally outside the taxpayer’s control appear to be required in order to obtain this penalty waiver. Examples of qualifying “reasonable cause” likely include situations where an otherwise compliant taxpayer, with adequate payroll procedures in place, encounters a natural disaster (e.g., fire, flood, storm), rendering it unable to process payroll and make the required deposits in a timely manner. Other examples of “reasonable cause” may include: **(i)** the death or serious illness of the taxpayer or the taxpayer’s immediate family; **(ii)** inability of the taxpayer to obtain necessary records due to no fault of the taxpayer; or **(iii)** embezzlement by the bookkeeper when and only when the taxpayer has reasonable protections in place.*

Second, taxpayers should raise the first time depositor defense, if applicable, on audit. The examiner should be able to accept the defense if the taxpayer qualifies. As confirmed by General Counsel’s Office, taxpayers are not required to wait for an actual assessment before raising this defense.

The courts presented with the “reasonable cause” exception to the imposition of a penalty under IRC § 6656(a) have taken varying positions—some more taxpayer friendly than others. The Service, however, is clearly taking a narrow view of the exception, leading to less taxpayer friendly results. Caution is advised.

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Reliance on a bookkeeper who embezzled funds from the taxpayer was not reasonable cause because the taxpayer did not have adequate checks and balances in place to prevent the embezzlement. **Leprino Foods Co. v. U.S., 85 AFTR 2d 2000-1729 (D. Colo. 2000). Financial difficulties when adequate funds existed, but the taxpayer decided to use the funds for other things, trumped a reasonable cause defense. **Van Camp & Bennion, P.S. v. U.S.**, 251 F.3d 862 (9th Cir. 2001). Failure of the bookkeeper delegated the responsibility of making deposits does not constitute reasonable cause when the bookkeeper was supervised by the owners of taxpayer and the outside CPA. **Janet Nesse v. IRS**, 93AFTR 2d 2004-1022 (DC MD 2004).*

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