



MANUAL TRANSMITTAL

Department of the Treasury
Internal Revenue Service

4.10.6

AUGUST 25, 2025

EFFECTIVE DATE

(08-25-2025)

PURPOSE

- (1) This transmits revised IRM 4.10.6, Examination of Returns, Penalty Considerations.

MATERIAL CHANGES

- (1) Significant changes to this IRM include the following:

Reference	Description of Change
IRM 4.10.6.1	Added internal control framework as required by IRM 1.11.2.2.4, Address Management and Internal Controls, to provide background information, legal authorities governing the actions covered in this IRM, responsibilities, terms, acronyms and related resources available to assist examiners.
IRM 4.10.6.1.1, Background	Incorporated content previously included in IRM 4.10.6.1, Overview. Moved content from IRM 4.10.6.1.3, Purpose of Chapter.
IRM 4.10.6.1.3(7)	Incorporated content from IRM 4.10.6.1.1, Examiners Responsibility.
IRM 4.10.6.3	Moved content from IRM 4.10.6.1.2 and added specific citations.
IRM 4.10.6.6.4.1, Timing of Supervisory Approval IRM 4.10.6.6.4.2, Written Supervisory Approval of Penalties Under IRC 6751(b)	Added content to incorporate provisions of SBSE 04-0625-0028, Interim Guidance for Timing of Supervisory Approval of Penalties Subject to IRC 6751(b).
IRM 4.10.6.6.4.3, Supervisory Approval for Penalty Abatement	Added content to incorporate provisions of Interim Guidance SBSE-04-1024-0061, Supervisory Approval for Penalty Abatement.

- (2) Editorial changes have been made throughout this IRM. Also, legal and IRM references were reviewed and updated as necessary.

EFFECT ON OTHER DOCUMENTS

This supersedes IRM 4.10.6, Penalty Considerations, dated July 13, 2001. Interim Guidance Memorandum SBSE 04-1024-0061, Supervisory Approval for Penalty Abatement, dated October 22, 2024, and SBSE 04-0625-0028, Interim Guidance for Timing of Supervisory Approval of Penalties Subject to IRC 6751(b), dated June 20, 2025, are incorporated into this IRM.

AUDIENCE

Small Business and Self-Employed (SB/SE) Field Examination and Specialty Examination employees.

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4.10.6

Penalty Considerations

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4.10.6.1 (08-25-2025) Program Scope and Objectives

- (1) **Purpose.** This IRM provides techniques for examiners to recognize, develop and finalize penalty determinations. It also discusses common taxpayer defenses and furnishes guidelines for documenting workpapers. The IRS maintains an ongoing effort to develop, monitor and revise programs designed to assist taxpayers in complying with legal requirements and avoid penalties.

Note: This IRM describes general penalty considerations and complements the legal analysis of penalties and penalty policies provided in IRM 20.1, Penalty Handbook, by providing guidelines and examination techniques to be considered and used to develop penalty issues.

- (2) **Audience.** These procedures apply to examiners in SB/SE Field and Specialty Examination.
- (3) **Policy Owner.** The Director, Examination Field and Campus Policy, who reports to the Director, Examination Headquarters.
- (4) **Program Owner.** Field Examination General Processes (FEGP), who reports to the Director, Examination Field and Campus Policy.
- (5) **Primary Stakeholders.** Small Business and Self-Employed (SB/SE) Field Examination and Specialty Examination employees are the primary stakeholders of this IRM.
- (6) **Contact Information.** To recommend changes or make any other suggestions related to this IRM section. See IRM 1.11.6.5, Providing Feedback About an IRM Section - Outside of Clearance.

4.10.6.1.1 (08-25-2025) Background

- (1) Although each penalty has its own legal basis and criteria, there are commonalities for determining applicability of penalties at the examiner's level and emphasis is on examination techniques common to civil tax penalties. As indicated in *Policy Statement P-20-1*, **the IRS uses penalties to encourage voluntary compliance by:**
 - a. Demonstrating the fairness of the tax systems to compliant taxpayers, and
 - b. Increasing the cost of noncompliance.
- (2) *Policy Statement P-20-1* also states the IRS must develop procedures to promote:
 - a. Consistency in the application of penalties compared to similar cases;
 - b. Unbiased analysis of the facts in each case; and
 - c. The proper application of the law to the facts of the case.
- (3) The IRS will demonstrate the fairness of the tax system to all taxpayers by:
 - a. Providing every taxpayer against whom the IRS proposes to assess penalties with a reasonable opportunity to provide evidence the penalty should not apply;
 - b. Giving full and fair consideration to evidence in favor of not imposing the penalty, even after the IRS' initial consideration supports imposition of a penalty; and
 - c. Determining penalties when a full and fair consideration of the facts and the law support doing so.

Note: Penalties are not a “bargaining point” in resolving the taxpayer’s other tax adjustments. Rather, the imposition of penalties in appropriate cases serves as an incentive for taxpayers to avoid careless or overly aggressive tax reporting positions.

4.10.6.1.2
(08-25-2025)
Authority

- (1) IRC, Chapter 68, Additions to the Tax, Additional Amounts, and Assessable Penalties, provides the general legal basis for assessment of various penalties.
- (2) *Policy Statement P-20-1* provides the general administrative basis for how the IRS uses penalties to encourage voluntary compliance and deter noncompliance by justly penalizing noncompliant taxpayers.
- (3) The primary source of authority for administration of penalties by the IRS is IRM 20.1. Office of Servicewide Penalties (OSP) has the overall responsibility of coordinating and approving updates to IRM 20.1. Their role is to ensure fairness and consistency in civil penalty administration. See IRM 20.1.1.1, Program Scope and Objectives, for additional information.

4.10.6.1.3
(08-25-2025)
Roles and Responsibilities

- (1) OSP is responsible for the Servicewide delivery of all general penalty guidelines and coordination of procedures.
- (2) The Director, Examination Headquarters, is the executive responsible for providing policy and guidance for SB/SE Examination employees and ensuring consistent application of policy, procedures and tax law to effect tax administration while protecting taxpayers’ rights. See IRM 1.1.16.5.5, Examination Headquarters, for additional information.
- (3) The Director, Examination Field and Campus Policy, reports to the Director, Examination Headquarters, and is responsible for the delivery of policy and guidance impacting the field examination process. See IRM 1.1.16.5.5.1, Examination Field and Campus Policy, for additional information.
- (4) Field Examination General Processes (FEGP), reports to the Director, Examination Field and Campus Policy, is the group responsible for providing policy and procedural guidance on standard examination processes to field employees. See IRM 1.1.16.5.5.1.1, Field Examination General Processes, for additional information.
- (5) All examiners must perform their professional responsibilities in a way that supports the *IRS Mission*. This requires examiners to provide top quality service and to apply the law, including penalties, with integrity and fairness to all.
- (6) Examiners and their managers should thoroughly acquaint themselves with the examination procedures and information contained in this IRM, as well as other resources, such as those listed in IRM 4.10.6.1.7, Related Resources, below.
- (7) Examiners are responsible for following procedural guidance with the objective of bringing the taxpayer into compliance and promoting future compliance. The identification of appropriate penalties, the determination of whether to assert or not assert penalties and the accurate calculation of the penalty is primarily the examiner’s responsibility.

4.10.6.1.4
(08-25-2025)
Program Controls

- (1) SB/SE Field Examination managers verify program and procedural compliance by conducting case consultations, case reviews, performance reviews, and security reviews. Prescribed internal controls are detailed in IRM 1.4.40, SB/SE Field and Office Examination Group Manager, which communicates responsibility to SB/SE Field Examination managers for promoting quality case work and required internal controls. RGS, Embedded Quality Review, and National Quality Review Systems provide the case access, data, and reports used by managers to monitor internal controls.
- (2) Penalties requiring supervisory approval under IRC 6751(b), Approval of assessment, must be personally approved (in writing) by the immediate supervisor of the individual making the initial determination. Additionally, if written supervisory approval was required to assert a penalty under IRC 6751(b) (see IRM 20.1.1.2.3, Approval Prerequisite to Penalty Assessments), or IRS policy (see IRM 20.1.2.3.7.5.1(8), FFTF Penalty Assessment - Procedural Requirements), written supervisory approval must also be secured to abate the penalty, unless the penalty abatement is computational only (e.g., recomputed due to an abatement of the underlying tax, correction of an IRS error, etc.).

4.10.6.1.5
(08-25-2025)
Terms

- (1) The following table contains a list of terms used throughout this IRM.

Term	Definition
Addition to Tax	Any amount computed by reference to the amount of tax. An example is the addition to tax imposed by IRC 6654 for failure by an individual to pay estimated income tax.
Additional Amount	An amount assessable by the IRS that is not an addition to tax or penalty. An example is the amount imposed under IRC 6673 for sanctions and costs awarded by a court when a taxpayer's position is frivolous. Additional amounts under IRC 7491(c) do not include excise taxes imposed by chapters 42 and 43 of the Internal Revenue Code or interest under IRC 6601.
Applicable penalty	Those penalties for which the legal premise for application is present in the case.

Term	Definition
Disregard of rules or regulations	the taxpayer's failure to follow the appropriate law in completing the return, and reflects a disregard of the IRC, temporary or final regulations, revenue rulings, or IRS notices (other than notices of proposed rulemaking). The term "disregard" includes careless, reckless, or intentional disregard.
Negligence	Any failure to make a reasonable attempt to comply with the provisions of the tax law, exercise ordinary and reasonable care in tax return preparation, or keep adequate books and records.
Penalties	Includes all penalties assessed under Title 26 and/or 31. An example is IRC 6662 imposing the accuracy-related penalty on underpayments.

4.10.6.1.6
(08-25-2025)
Acronyms

- (1) The following table lists commonly used acronyms and their definitions used within the IRM:

Acronym	Definition
ACTC	Additional Child Tax Credit
AOTC	American Opportunity Tax Credit
CCP	Centralized Case Processing
CFOL	Corporate Files Online
CTC	Child Tax Credit
EITC	Earned Income Tax Credit
FBAR	Report of Foreign Bank and Financial Accounts
FEA	Fraud Enforcement Advisor
FTA	First Time Abate
MFT	Master File Tax
OSP	Office of Servicewide Penalties
PRC	Penalty Reason Code
PRN	Penalty Reference Number

Acronym	Definition
RGS	Report Generation Software
SFR	Substitute for Return
TC	Transaction Code

4.10.6.1.7
(08-25-2025)
Related Resources

- (1) The following table lists the primary sources of guidance for the penalty program. Together, these materials form the operating rules and responsibilities for the penalty program:
 - IRM 20.1, Penalty Handbook
 - IRM 25.1, Fraud Handbook
- (2) In addition to the list in the table above, there are other relevant IRMs examiners may use, including, but not limited to:
 - IRM 1.2.1.12.1, Policy Statement 20-1, Penalties are Used to Enhance Voluntary Compliance
 - IRM 4.10.4, Examination of Income
 - IRM 4.10.8, Report Writing
 - IRM 4.10.9, Workpaper System and Case File Assembly
 - IRM 4.11, Examining Officers Guide (EOG)
 - IRM 4.26.16, Report of Foreign Bank and Financial Accounts (FBAR)
 - IRM 4.26.17, Report of Foreign Bank and Financial Accounts (FBAR) Procedures
- (3) The following are links to helpful Knowledge Base resources:
 - *Fraud Development Knowledge Base*
 - *Office of Servicewide Penalties Knowledge Base*
- (4) The following are links to additional resources in the Virtual Library on KM:
 - *2-Year / 10-Year Ban*
 - *Documenting Penalties - Creating a Penalty Issue*
 - *Earned Income Credit and RGS*
 - *IRC 32(k) – 10-Year Ban*
 - *Manually Computed Penalties*
 - *Penalty Quick Reference Guide*
 - *Reason Codes for CTC/ACTC and AOTC*
 - *Return Preparer Coordinator Listing*
 - *Return Preparer Information*
 - *RGS and the Failure to File Penalty on Subsequent Assessments*
- (5) The following are links to other helpful resources and job aids:
 - *Civil Penalty Cases and RGS*
 - *Civil Penalty Job Aid*
 - *Failure to File Penalty Job Aid*
 - *Fraud Development Job Aid*
 - *Negligence or Disregard of the Rules Job Aid*
 - *RGS File Naming Conventions Job Aid*
 - *Specialist Referral System (SRS)*

4.10.6.2
(05-14-1999)

Common Penalties

- (1) See IRM 20.1 for a list of common civil tax penalties. This list includes the applicable IRC section, penalty amount and description, penalty reference numbers, and computation methods. These penalties include the following:

Penalty	Reference
Aiding and abetting the understatement of tax liability	IRM 20.1.6, Preparer and Promoter Penalties
Estimated tax understatement	IRM 20.1.3, Estimated Tax Penalties)
Failure to file	IRM 20.1.2, Failure To File/Failure To Pay Penalties
Failure to pay (on returns secured by Examination)	IRM 20.1.2
Fraud	IRM 20.1.5, Return Related Penalties, and IRM 25.1; Fraud Handbook
Frivolous returns	IRM 20.1.10, Miscellaneous Penalties
Negligence	IRM 20.1.5, Return Related Penalties
Penalties for paid tax return preparers	IRM 20.1.6, Preparer and Promoter Penalties
Promoting abusive tax shelters	IRM 20.1.13, Material Advisor and Reportable Transactions Penalties
Substantial understatement	IRM 20.1.5
Valuation misstatement	IRM 20.1.5

4.10.6.3
(05-14-1999)

Recognizing Noncompliance

- (1) The assessment of penalties should be considered throughout the audit. Indicators of noncompliant behavior are specific for individual penalties and each case is unique, but there are common patterns of noncompliance. The following sections discuss negligence and fraud.

4.10.6.3.1
(05-14-1999)

Negligence

- (1) A component of the accuracy-related penalty involves taxpayer's negligence or disregard of rules or regulations. Some audit indicators for the negligence component of the accuracy-related penalty are listed below:
- History of noncompliance — as part of the required filing checks, examiners determine whether the return was timely filed. Corporate Files Online (CFOL) documents will also note penalties, such as most late payment and estimated tax penalties, that are usually assessed as part of return processing. Examiners should review available IRS information when making penalty determinations to establish payment patterns and history of noncompliance. Check the two preceding periods and all open modules. See IRM 4.10.5, Required Filing Checks.

- Similar, prior audit results — copies of any prior audit reports should be reviewed to establish history of noncompliance.
- Failure to keep adequate books and records — analysis of the taxpayer's books and records should include consideration of their adequacy and accuracy.
- Inadequate internal controls for processing and reporting business transactions.
- Unreported or understated income, combined with the taxpayer's failure to offer a reasonable explanation.
- Overstated deductions or credits, including claiming clearly improper or exaggerated amounts, unsubstantiated by facts or documentation.
- Using deduction descriptions in such a manner as to conceal the true nature of the deduction.
- Failure to explain items questioned by the IRS.
- Actions taken by the taxpayer to ensure that the return preparer did not have all the necessary and appropriate information to prepare a correct and/or timely return.
- Information determined from cooperative state programs and state tax reports which determined negligence for transactions having the same or similar Federal and State tax consequences — the decision to assert negligence, however, is the examiner's and is not to be automatically reflected based on the State's determination.

4.10.6.3.2
(05-14-1999)
Fraud

- (1) Fraud, as distinguished from negligence, is always intentional. One of the elements of fraud is an intent to evade tax. See IRM 25.1.2.3, Indicators of Fraud, for examples of actions taxpayer may take to deceive or defraud.

Note: Generally, the presence of only one indication of fraud is not sufficient to sustain fraud (e.g., unreported income alone does not necessarily support fraud).

Example: During the examination of a taxpayer's Form 1040, U.S. Individual Income Tax Return, the examiner found numerous errors resulting in additional tax. One of the adjustments was a large amount of unreported income discovered in a concealed bank account. Other adjustments were supported with altered documents. The taxpayer gave false information and misrepresented the facts throughout the examination. All the acts of the taxpayer, when seen as a whole, indicate fraud.

4.10.6.4
(05-14-1999)
Developing Penalty Issues

- (1) Penalties should be considered whenever adjustments are made to a tax return. This section includes requirements and techniques for developing penalty issues.

4.10.6.4.1
(05-14-1999)
Initial Interview

- (1) Questions asked during the initial interview with the taxpayer and/or representative should provide the examiner with an understanding of the taxpayer's background and knowledge, familiarity with the business operations, and an overview of the taxpayer's books and records. It is also appropriate to ask the taxpayer if they are aware of any errors on the return and discuss any issues identified during the pre-contact analysis. See IRM 4.10.3.4, Interviews: Authority and Purpose, for additional information on interviewing.

4.10.6.4.2
(05-14-1999)

Third Party Contacts

- (1) Examiners are authorized to request information from third parties when necessary to determine whether to assert, not assert, or abate a penalty. See IRM 4.11.57, Third-Party Contacts, for additional information.

4.10.6.4.3
(05-14-1999)

Referrals

- (1) Specialists (e.g., international or engineering) can assist examiners factually develop penalty issues (including the fraud and negligence penalties) and are responsible for recommending penalties specific to their specialty. See IRM 4.10.2.7.5, Specialist Referrals.
- (2) When a potential criminal fraud case is identified, preparation of a timely fraud referral to Criminal Investigation is necessary pursuant to the provisions of IRM 25.1, Fraud Handbook.

4.10.6.4.4
(05-14-1999)

Managerial Involvement

- (1) The group manager must be actively involved with the development of penalty issues if:
- The examination of income reveals an understatement of income in a given year, the case should be discussed with the group manager. This discussion is mandatory for any examination with an understatement greater than \$10,000. The purpose of the discussion is to consider possible expansion of the examination scope/depth and the potential of fraudulent activity by the taxpayer. See IRM 4.10.4.4.1, Material Understatements and Managerial Involvement.
 - Coordination with Criminal Investigation and/or area specialists (e.g., FEA, Return Preparer Coordinator, etc.), is required.
- (2) Managerial involvement should be documented on Form 9984.

4.10.6.4.4.1
(08-25-2025)

Timing of Supervisory Approval

- (1) Generally, written supervisory approval should be secured as soon as practicable once the initial determination to assess the penalty has been made, and prior to issuing any written communication of penalties to a taxpayer offering them an opportunity to sign an agreement or consent to assessment of a penalty, or sign a consent to proposal of a penalty. However, for penalties assessed on or after December 23, 2024, written supervisory approval must be obtained no later than the timeframe reflected in the table below (see 26 CFR 301.6751(b)-1, Supervisory and higher level official approval for penalties):

If the penalty is:	Then approval of the penalty, in writing, is required:
NOT subject to pre-assessment review in the Tax Court	Before the penalty is assessed.

If the penalty is:	Then approval of the penalty, in writing, is required:
<p>Included in a pre-assessment notice that provides a basis for Tax Court jurisdiction upon timely petition</p> <p>Examples include: statutory notice of deficiency under IRC 6212, Notice of deficiency; notice of final partnership administrative adjustment under former IRC 6223, Partners bound by actions of partnership; and notice of final partnership adjustment under IRC 6231, Notice of proceedings and adjustment.</p>	<p>On or before the date the pre-assessment notice is mailed.</p>
<p>Raised in the Tax Court after a petition</p>	<p>No later than the date on which the Commissioner requests the court determine the penalty.</p>

- (2) For penalties assessed prior to December 23, 2024, written supervisory approval was required prior to issuing any written communication of penalties to a taxpayer that offered the taxpayer either an opportunity to sign an agreement, or consent to assessment or proposal of the penalty.
- (3) See IRM 20.1.5.2.3(4), Supervisory Approval of Penalties – IRC 6751 Procedural Requirements, for a list of penalties that do not require supervisory approval.

Reminder: As an administrative matter, supervisory approval of the fraudulent failure to file penalty under IRC 6651(f), Increase in penalty for fraudulent failure to file, is required (see IRM 20.1.2.3.7.5.1(8), FTF Penalty Assessment–Procedural Requirements).

4.10.6.4.4.2 (08-25-2025) Written Supervisory Approval of Penalties Under IRC 6751(b)

- (1) Penalties requiring supervisory approval under IRC 6751(b), Approval of assessment, must be personally approved (in writing) by the immediate supervisor of the individual making the initial determination or such higher level official as the Secretary may designate, dated, and retained in the case file. See IRM 20.1.1.2.3(2), Approval Prerequisite to Penalty Assessments.

Note: An acting supervisor with an approved designation to act (e.g., Form 10247, Designation to Act, or a Notification of Personnel Action (SF-50)) is considered an immediate supervisor for the purpose of IRC 6751(b)(1). A copy of Form 10247 must be maintained in the case file.

- (2) Supervisory approval may be documented in any format, including electronic. No signature or particular words are required as long as the circumstances of the writing reflect it was intended to be an approval. See IRM 20.1.5.2.3.1(3), Documenting Supervisory Approval of Penalties, for examples of acceptable formats.

Note: An acting supervisor with an approved Form 10247 must sign their name (manually or digitally) “acting for” the supervisor, whose name is listed on the form. See *Signature Guidance for Acting Group Managers* for examples.

Reminder: When documenting supervisory approval, an alternative penalty position, if applicable and subject to supervisory approval, must be identified along with the primary penalty position.

Reminder: Form 8278, Assessment and Abatement of Miscellaneous Civil Penalties, must not be provided to the taxpayer (IRM 20.1.7.5.1(7), Field Examination Delinquent Information Return Procedures).

(3) At a minimum, the digital signature must reflect the first and last name of the approving official. Preferably, the digital signature will reflect an image of the signer’s handwritten signature. Under no circumstances should the form reflect the Standard Employee Identifier (SEID) as the signature. See IRM 4.10.1.4.4, Digital Signatures, and *Adobe Acrobat - Digital Signature with Image of Handwritten Signature (Job Aid)*, for additional guidance.

(4) The signed penalty approval must be saved in the electronic case file.

Caution: If the penalty approval is digitally signed, the original signed document must be preserved in the electronic case file to maintain the signer’s underlying certificates. Do not flatten (i.e., print to PDF) the signed form, as doing so invalidates the certificates associated with the digital signature.

(5) Refer to IRM 20.1.1.2.3 for additional guidance regarding supervisory approval of penalties.

4.10.6.4.4.3 (08-25-2025)

Supervisory Approval for Penalty Abatement

(1) If written supervisory approval was required to assert under IRC 6751(b)(see IRM 20.1.1.2.3), or IRS policy (see IRM 20.1.2.3.7.5.1(8)), written supervisory approval must also be secured to abate the penalty, unless the penalty abatement is computational only (e.g., recomputed due to an abatement of the underlying tax, correction of an IRS error, etc.). The written supervisory approval should be obtained prior to issuing a report reflecting the penalty abatement and must be documented on the specific penalty lead sheet or workpaper, or the activity record.

Note: Abatement of preparer penalties must be coordinated with the Return Preparer Coordinator (RPC) prior to obtaining supervisory approval.

Example: During an audit reconsideration, the examiner abates a portion of the previous tax liability, which was subject to an accuracy-related penalty. The examiner recalculates the accuracy-related penalty based on the corrected tax and abates the penalty proportionately. Supervisory approval for the abatement of the penalty is not required.

Example: A taxpayer requests complete abatement of a previously assessed accuracy-related penalty, stating reasonable cause. The examiner considers the taxpayer’s request and determines the penalty should be abated. The examiner must obtain supervisory approval to abate the penalty.

- 4.10.6.4.5
(05-14-1999)
Soliciting the Taxpayer's Explanations
- (1) To ensure the proper consideration and appropriate application of penalties, it is very important to solicit the taxpayer's explanation for adjustments. Some common explanations include:
- Off-Setting Adjustments. See IRM 4.10.6.4.5.1.
 - Lack of Knowledge. See IRM 4.10.6.4.5.2.
 - Reliance on Representative and/or Return Preparer. See IRM 4.10.6.4.5.3.
- 4.10.6.4.5.1
(05-14-1999)
Off-Setting Adjustments
- (1) When large amounts of unreported income are identified, a taxpayer might claim that there are off-setting cash expenses (i.e., there are additional cash expenses which were not deducted.)
- Note:** The burden is on the taxpayer to show that these expenses were incurred and paid.
- 4.10.6.4.5.2
(05-14-1999)
Lack of Knowledge
- (1) Taxpayers may offer defenses such as blaming others, lack of knowledge, or claiming incompetence. Examiners should solicit explanations and analyze them for reasonableness. Examiners should contact third parties when necessary for corroboration and properly document the results. See IRM 4.10.6.4.2, Third-Party Contacts.
- 4.10.6.4.5.3
(05-14-1999)
Reliance On Representative and/or Return Preparer
- (1) Taxpayers often advise examiners penalties are not applicable because they relied on a representative or return preparer. The representative or preparer is alleged to be the cause of the noncompliance.
- (2) These assertions should be documented and substantiated if possible.
- (3) Various regulations and court decisions have held that although a taxpayer may authorize a representative to prepare and file the tax return, this action does not relieve the client (taxpayer) of meeting their legal obligations as a taxpayer.
- a. 26 CFR 1.6664-4(c)(1) states that "all facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor)."
 - b. 26 CFR 1.6664-4(c)(1)(ii) notes that "the advice must not be based on unreasonable factual or legal assumptions."
 - c. 26 CFR 1.6664-4(b)(1) notes that the substantial understatement penalty does not apply to any portion of an underpayment if there was reasonable cause for the underpayment portion and the taxpayer acted in good faith. Reliance on the advice of a professional tax adviser does not necessarily demonstrate reasonable cause and good faith. However, reliance on professional advice is reasonable cause and good faith if, under all the circumstances, the reliance was reasonable and the taxpayer acted in good faith.
 - d. In considering the failure to file penalty, the United States Supreme Court has held a taxpayer relying on an attorney to file a timely tax return does not relieve the taxpayer of the duty to meet the tax return deadlines (see R.W. Boyle, West Publishing Company: 105 S.Ct. 687).
- (4) The taxpayer's reliance on a representative and/or return preparer should be documented in the case file. The examiner should make any necessary

contacts with the representative and/or return preparer to determine appropriate penalty liability before closing the income tax case, since this determination will impact the results of the income tax case. Conclusions regarding the preparer's or representative's responsibility for errors should be documented.

- (5) Discussions with the taxpayer will be limited to the development of facts. The development of return preparer penalties (IRC 6694, Understatement of taxpayer's liability by tax return preparer, and IRC 6695, Other assessable penalties with respect to the preparation of tax returns for other persons,) will not be discussed/proposed in the taxpayer's presence. The preparer is to be given the right to explain why possible preparer penalties are not applicable.

4.10.6.5
(05-14-1999)
**Finalizing Penalty
Determinations**

- (1) Every effort should be made to apply penalties in a fair and consistent manner. Penalties are not to be applied as a "bargaining chip" or because the taxpayer was uncooperative during the examination process. The decision to propose penalties must have a legal basis in the Internal Revenue Code (IRC) or other authority.
- (2) The proposal of penalties, including alternative positions, should be discussed with the taxpayer and/or representative prior to issuing an examination report. Examiners should be prepared to discuss the penalty computation and the underlying law. The taxpayer's decision to agree or disagree with the findings may depend on understanding the penalty computation.
- (3) Taxpayers will have the opportunity to respond to the examiner's conclusion. The taxpayer's explanation(s) must be solicited and documented in the case file, including claims and audit reconsiderations in which the issues involved are penalties or can relate to penalties.
- (4) Taxpayers and/or representatives may respond with a reasonable basis for the examination results. A complete discussion of reasonable basis and relief from penalties is included in IRM 20.1.1, Introduction and Penalty Relief. Examiners should also consider whether the taxpayer could have anticipated the event causing noncompliance, and the length of time between the event cited as a reason for noncompliance and the taxpayer's subsequent compliance.

4.10.6.6
(05-14-1999)
Penalty Computations

- (1) Many penalty computations can be accurately computed using the IRS's software programs.
- (2) Refer to IRM 20.1.5.3.3, Allocation of an Underpayment, when both the accuracy-related and the civil fraud penalty apply.

4.10.6.7
(05-14-1999)
Report Writing

- (1) A complete guide for report writing, including the presentation of penalties, is presented in IRM 4.10.8, Report Writing.

4.10.6.8
(05-14-1999)
**Workpapers — General
Requirements**

- (1) The case file should fully document the consideration, assertion or non-assertion, and computation of all applicable penalties.
- (2) Penalties should not be asserted without an explanation. The extent of the explanation will depend on the nature of the adjustments and the amounts involved. However, canned statements, such as "negligence penalty applicable" or "negligence penalty deemed to be not applicable", are not sufficient.

- (3) Pro-forma check sheets are acceptable documentation when properly completed. Simply checking the boxes is not adequate; a narrative should be included.
- (4) Citing appropriate regulations, rulings and court decisions in the workpapers is encouraged. Research findings, however, should be specific to the case's facts and circumstances, and not just provide exploratory background information on the penalties being asserted.
- (5) Alternative penalty positions should be documented in the workpapers when applicable (e.g. fraud versus negligence penalties, and various components of the accuracy-related penalty).

4.10.6.8.1
(05-14-1999)
**Workpapers — Dollar
Criteria**

- (1) Whenever the understatement of tax exceeds the dollar criteria for applying a penalty, the examiner must include a comment in the workpapers.

Example: The substantial understatement component of the accuracy-related penalty provides for a dollar criteria; the understatement exceeds the greater of 10 percent (5 percent in the case of any taxpayer claiming the IRC 199A, Qualified business income, deduction) of the tax required to be shown on the return, or \$5,000 (\$10,000 for corporations other than S corporations or personal holding companies).

4.10.6.8.2
(05-14-1999)
**Workpapers — Late
Filed Returns**

- (1) For late filed returns originally reflecting a refund, examiners are required to document in the workpapers the applicability of the failure to file penalty to a subsequent audit deficiency.

4.10.6.8.3
(05-14-1999)
**Workpapers —
Negligence and Fraud**

- (1) Assertion of negligence or fraud must include documentation of the “badges” discovered during the audit (including agreed cases). See IRM 4.10.6.3, Recognizing Noncompliance.

4.10.6.8.4
(05-14-1999)
**Workpapers — Preparer
Penalties**

- (1) Consideration of preparer penalties should be documented in the examiner's case file. The workpapers should document only the taxpayer's statements and inquiries on preparer penalties were made.
- (2) All information on the preparer's activities and the assertion of preparer penalties should be separated from the taxpayer's case file.

4.10.6.9
(05-14-1999)
Other Considerations

- (1) This section includes miscellaneous information.

4.10.6.9.1
(05-14-1999)
Civil and Criminal Fraud

- (1) The taxpayer's explanations, or lack of explanations, may help distinguish between civil and criminal fraud. In both criminal and civil fraud, the burden of proof rests with the Government. However, criminal fraud cases require proof beyond a reasonable doubt, while civil fraud cases require clear and convincing evidence. Note the following:
 - a. A criminal conviction for tax evasion (under IRC 7201, Attempt to evade or defeat tax) usually conclusively establishes liability for the civil fraud penalty.

- b. The civil fraud penalty can be imposed even when the taxpayer is acquitted in a criminal fraud prosecution. The rule of res judicata, that a matter once judicially decided is finally decided, does not operate as a bar to a subsequent civil action (including the civil fraud penalty) because of the difference in the degree of proof required in civil and criminal actions [see the U.S. Supreme Court's decision in *Helvering v. Mitchell*, 303 U.S. 391, 58 S. CT. 630 (1938)].

4.10.6.9.2
(05-14-1999)
**Return Preparer
Penalties**

- (1) Return preparer penalties relate to:
- IRC 6694, Understatement of taxpayer's liability by tax return preparer
 - IRC 6695, Other assessable penalties with respect to the preparation of tax returns for other persons
 - IRC 6700, Promoting abusive tax shelters, etc.
 - IRC 6701, Penalties for aiding and abetting understatement of tax liability
 - IRC 6713, Disclosure or use of information by preparers of returns
 - IRC 7407, Action to enjoin tax return preparers
 - IRC 7408, Actions to enjoin specified conduct related to tax shelters and reportable transactions
- . In the interest of overall sound tax administration, the IRS focuses on preparer conduct and applies sanctions when warranted. Penalty assertion is the key enforcement vehicle for noncompliant preparers. Refer to IRM 20.1.6 and IRM 20.1.13 for specific instructions regarding a preparer penalty case.
- (2) A determination on a preparer penalty case is conducted independently of, and without regard to, the determination on the income tax case. The tax case has bearing on the preparer penalty case only insofar as assertion of the penalty requires an understatement of tax.
- (3) Generally, a return preparer penalty will not be proposed until the income tax examination is completed at the group level. However, if the preparer case is inseparable from the income tax examination, both cases may be completed simultaneously. The examiner may pursue the preparer penalty after an unagreed income tax case is submitted at the group level.

4.10.6.9.3
(05-14-1999)
Nonfilers

- (1) Examiners should ask taxpayers to explain why they did not timely comply with filing requirements. The reasonable cause guidelines (see IRM 20.1.1.3.2) should be followed and fully documented in the workpapers.