Office of Chief Counsel
Internal Revenue Service
memorandum
CC:PA:01:HMarch
FILEN-119835-13

date: July 12, 2013

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subject: Application of Failure to File Penalties to S Corporations and Partnerships

This memorandum responds to your request for advice on the application of failure to file penalties to S corporations and partnerships. This advice may not be used or cited as precedent.

Issue 1a

Question
If an S-corporation return is filed late, should the taxpayer be subjected both to the failure to file penalty under IRC § 6651(a)(1) and under IRC § 6699(a)(1)?

Response
No. Application of both penalties to the same late-filed return would be inconsistent with the Service's policy position with respect to penalties, which is that penalties exist to encourage voluntary compliance. See IRM 20.1.2.5(3), Failure to File S Corporation Return—IRC 6699; IRM 1.2.20.1.1, Policy Statement 20-1 (Formerly P–1–18).

Moreover, although the section 6651(a)(1) addition to tax applies to some S corporation returns, it seems unlikely that a court would uphold the imposition of both the section 6651(a)(1) addition to tax and the section 6699(a) penalty with respect to the same untimely return. The section 6651(a)(1) addition to tax does not apply to S corporation returns generally, but it would apply to an S corporation return if the S corporation is subject to tax under subtitle A. See section 6651(a)(1) (imposing an addition to tax on the failure to file a return required under authority of subchapter A of chapter 61, such as section 6012, but not on the failure to file an information return required under authority of part III of subchapter A of chapter 61, such as an S corporation return required under section 6037); section 6012 (requiring specified persons to file returns with respect to income taxes under subtitle A of the Code, including corporations

subject to tax under subtitle A); section 1363(a) (providing that an S corporation is not generally subject to the taxes imposed by chapter one of subtitle A of the Code); section 1374 (imposing tax under subtitle A on S corporations with net recognized built-in gain); section 1375 (imposing tax under subtitle A on S corporations with accumulated earnings and profits and passive investment income exceeding 25 percent of gross receipts). The legislative history of section 6699 indicates that it was added to the Code because Congress believed that there was previously no effective penalty regime for the failure to file an S corporation return. See H.R. Rep. No. 110-426, at 35 (2007) (citing a TIGTA report for the proposition that there was no effective penalty regime for failure to file S corporation returns); Treasury Inspector General for Tax Administration, Stronger Sanctions Are Needed to Encourage Timely Filing of Pass-Through Returns and Ensure Fairness in the Tax System, 2005–30–048 (March 2005) ("[T]he law provides no penalty for late-filed S corporation returns, whereas the law does provide penalties when other types of returns are filed late."). Section 6699 was created to fill a gap in the penalty regime. There is no indication in the legislative history that it was intended to penalize some S corporations, those subject to tax under subtitle A, twice for the same misconduct.

Issue 1b

Question
If an Electing Large Partnership Return (Form 1065-B), or a U.S. REMIC Return (Form 1066), is filed late, should the taxpayer be subjected both to the failure to file penalties under IRC § 6651(a)(1) and under IRC § 6698(a)(1)?

Response
No. Only one penalty should be imposed with respect to any late-filed return, even where both could apply, as application of both penalties would be inconsistent with the Service's policy position with respect to penalties, which is that penalties exist to encourage voluntary compliance. See 20.1.2.3.3.5(2), Electing Large Partnership Special Considerations; IRM 1.2.20.1.1, Policy Statement 20-1 (Formerly P–1–18). Moreover, it seems unlikely that a court would uphold the imposition of both the section 6651(a)(1) addition to tax and the section 6698(a) penalty with respect to the same untimely return.

Issue 1c

Question
If a return required to be filed under authority of IRC § 6031 or § 6037 is filed late and fails to show all required information, the penalty for failure to file begins on the return due date. Should the taxpayer be subjected both to the penalties for failure to file (IRC §§ 6698(a)(1) and 6699(a)(1)) and for failure to show required information (IRC §§ 6698(a)(2) and 6699(a)(2)), and if so, do the penalties for failure to show required information begin when the return is filed, or on the return due date?

Example:
S-corporation “A” files its 2010 calendar year return (due March 15, 2011) on December 10, 2011. The return is missing its Schedules K-1 when it is filed. The corporation supplies the missing schedules on August 1, 2012. The corporation had two shareholders in 2010, and it did not obtain an extension of time to file its 2010 return.

The return is filed 9 months late. The penalty for filing late under IRC § 6699(a)(1) is 9 months X 2 shareholders X $195 = $3,510.

The penalty for failure to show required information may be interpreted in one of three ways as follows:

Interpretation A: The penalty for failure to show required information begins on the return due date, and runs until the missing information is received. The penalty for failure to show required information takes precedence over the penalty for filing late when both penalties would apply. The penalty would be 2 shareholders X maximum 12 months X $195 = $3,900. As a result, because the failure to show penalty is greater than the penalty for filing late, the $3,510 penalty would not be charged, but the greater failure to show penalty of $3,900 would represent the total penalty.

Interpretation B: The penalty for failure to show required information begins when the return is received, and runs until the missing information is received. The penalty for failure to show required information is assessed in addition to any penalty for filing late when both penalties would apply. The penalty for failure to show required information would be 2 shareholders X 8 months X $195 = $3,120. As a result, the total penalties for filing late and failure to show would be $6,630.

Interpretation C: The penalty for failure to show required information begins on the return due date, and runs until the missing information is received. The penalty for failure to show required information is assessed in addition to any penalty for filing late when both penalties would apply. The penalty for failure to show required information would be 2 shareholders X maximum 12 months X $195 = $3,900. As a result, the total penalties for filing late and failure to show would be $7,410.

Response
The result reached in interpretation A is correct, but it is incorrect to suggest that there are two penalties within either section 6698 or 6699 and that one of the two takes precedence over the other. Both section 6698 and section 6699 impose a penalty for failure to file a complete information return. Each section imposes only one penalty, although the penalty can be imposed under multiple conditions – if the return is not filed or if the return fails to show required information. If either the failure to file condition or the failure to show required information condition is met, both section 6698 and section 6699 impose “a penalty determined under subsection (b) for each month (or fraction thereof) during which such failure continues (but not to exceed 12 months) ....” Sections 6698(a) and 6699(a) (emphasis added). The legislative history reinforces this

interpretation: The provision "imposes a penalty on partnerships for failure to timely file a complete partnership information return. The penalty is $50 per month (or fraction of a month) that the return is late or incomplete, multiplied by the number of partners in the partnership." H.R. Rep. No. 95-1800, at 221 (1978) (Conf. Rep.). Interpretation B is incorrect because it would impose the penalty for a period greater than 12 months. Interpretation C is incorrect because it would impose the penalty twice in some months.

Issue 2a

Question

Tax returns are generally processed, and penalties related to the filing are systemically assessed, before the maximum 12 month period has expired for which the full extent of these penalties may be assessed. Should IRS automatically assess any additional penalty for failure to show required information, either when the missing information is received, or when the maximum 12 month penalty period has been reached, if the missing information penalty was assessed before the 12 month maximum was reached, and before the missing information was received?

Example:

A partnership files Form 1065 without the required Schedules K-1. We process the return without the missing information 3 months after the return due date, and assess a penalty for failure to show required information for 3 months. The missing Schedules K-1 are never provided. Should IRS assess an additional penalty for failure to show required information for the 9 additional months of noncompliance?

Response

Yes. Where the penalty under section 6698 or 6699 continues to accrue after it is first assessed, there is no prohibition on later assessing the remainder of the applicable penalty after it has accrued. The Service should ensure that the remainder of the applicable penalty is assessed prior to the expiration of the statute of limitations on assessment, which is generally three years after the return is filed. See section 6501(a).

Issue 2b

Question

When IRS processes a substitute partnership or S-corporation return under IRC § 6020(b), the penalty for failure to file under IRC §§ 6698 or 6699 applies. Should IRS compute the penalty for the full 12 months (or until the partnership or S-corporation files its own return, if earlier)? Or, should the penalty only be charged until the substitute return is processed, even if that is earlier than 12 months after the return due date?

Example:

Corporation "H", a sub-chapter S corporation, has not filed a return for tax years 2009 through 2011. The corporation is selected for examination, and substitute returns are

posted in order to control the examination. The corporation filed for an extension of time to file until September 15th for each of the years under examination, but has failed to file a return for any of those years. The revenue agent prepares returns under section 6020(b) for each of the years, and signs the return certification on 2/1/2013, 5 months after the extended due date of the 2011 return. The penalty under IRC § 6699 is assessed on 4/23/2013. Should the penalty be computed to 2/1/2013, because that's the date the RA signed the section 6020(b) return certification, or does the penalty continue to accrue until the corporation files its own return?

Response

As described below, the Service should compute the section 6698 and 6699 penalties until the earlier of the date the taxpayer files a complete return or 12 months after the return due date, regardless of whether a section 6020(b) return has been filed.

Section 6020(b) provides that the Secretary shall make any tax return required by law if the taxpayer fails to make such return and states that the Service's substitute return "shall be prima facie good and sufficient for all legal purposes." Sections 6698 and 6699 impose a penalty on partnerships and S corporations that fail to file returns required under sections 6031 and 6037.

Sections 6020, 6698, and 6699 make no mention of whether a section 6020(b) return has any effect on the accrual of the penalties for failure to timely file a complete return. We have been unable to find any authority or prior guidance discussing the interaction between the section 6020(b) return provision and the section 6698 and 6699 penalties.

A similar issue arose in the section 6651(a)(1) failure to file context. Section 6651(g)(1) now explicitly provides that a section 6020(b) return shall be disregarded for purposes of determining the amount of the addition to tax for failure to file under section 6651(a)(1). Section 6651(g)(1) was added to the Code in 1996 by the Taxpayer Bill of Rights 2. Taxpayer Bill of Rights 2, Pub. L. No. 104-168, § 1301, 110 Stat. 1452 (1996). Prior to the addition of section 6651(g)(1), sections 6020 and 6651 made no mention of whether a section 6020(b) return had any effect on the accrual of the section 6651(a)(1) failure to file addition to tax. During that period, the position of Chief Counsel varied somewhat as to whether a section 6020(b) return stopped the accrual of the failure to file addition to tax, but the Service eventually maintained the position that a section 6020(b) return stops the accrual of the failure to file addition to tax.

In 1937, counsel concluded that a substitute return made under the predecessor to section 6020(b) did not stop the accrual of the addition to tax under the predecessor to section 6651(a)(1) because the purpose of that provision was to impose an addition to

tax upon the failure by the taxpayer to file a return, regardless of any subsequent action or inaction on the part of the Service. See I.R.S. Gen. Couns. Mem. 18,214 (March 30, 1937). Later that year, counsel concluded, on the basis of the "prima facie good and sufficient for all legal purposes" language that the making of an substitute return by the Service under the predecessor to section 6020(b) terminated the period of delinquency and no further failure to file addition to tax could be assessed. I.R.S. Gen. Couns. Mem. 18,996 (Aug. 17, 1937) (relating to admission taxes). In 1943, counsel revoked so much of G.C.M. 18,966 as suggested that the substitute return terminated the accrual of the addition to tax. I.R.S. Gen. Couns. Mem. 23,913 (Sept. 27, 1943) (relating to admission taxes and expressing no opinion as to income tax cases).

In 1968, in the employment tax context, counsel concluded that a section 6020(b) return terminated the accrual of the failure to file addition to tax because of the "prima facie good and sufficient for all legal purposes" language and the fact that employment taxes can be immediately assessed, making the "prima facie" quality of the section 6020(b) return "scarcely less than absolute." I.R.S. Gen. Couns. Mem. 33,979 (Nov. 22, 1968). In 1969, the Service issued a revenue ruling concluding that a section 6020(b) employment tax return stopped the accrual of the failure to file addition to tax. Rev. Rul. 69-397, 1969-2 C.B. 263. In 1970, counsel reaffirmed the conclusion of G.C.M. 33,979 but expressly limited its holding to section 6020(b) employment tax returns, suggesting that modification of Revenue Ruling 69-397 be considered, as it could be read to apply more broadly than just to section 6020(b) employment tax returns. I.R.S. Gen. Couns. Mem. 34,344 (Sept. 9, 1970).

In 1976, counsel reconsidered the employment tax limitation and concluded that a section 6020(b) return always terminates the accrual of the addition to tax, regardless of whether the tax is subject to deficiency procedures. I.R.S. Gen. Couns. Mem. 36,819 (Aug. 23, 1976). Counsel cited a prior revenue ruling concerning section 6020(b) returns, which took the position that separate section 6020(b) income tax returns prepared by the Service for a husband and wife constituted separate returns filed by the taxpayers for purposes of the section 6013 limitations on making a joint election after the filing of a separate return. See id. (citing Rev. Rul. 70-632, 1970-2 C.B. 286). Counsel reasoned that a section 6020(b) return is "deemed to be the return of the taxpayer for purposes of determining whether or when the taxpayer filed a return."[1] See id. That year, the Service issued a revenue ruling concluding that a section 6020(b) income tax return stops the running of the delinquency period for purposes of the failure to file addition to tax. Rev. Rul. 76-562, 1976-2 C.B. 430.

In 1979, after a lengthy analysis of the relevant case law, statutory framework, and legislative history, counsel briefly reversed its position, concluding that a section

[1] More recently, the Tax Court has held, contrary to the Service's prior position in Rev. Rul. 70-632, that a section 6020(b) return prepared by the Service does not subject the taxpayer to the section 6013(b)(2) limitations on making a joint election that apply where "an individual has filed a separate return." I.R.C. § 6013(b); Millsap v. Commissioner, 91 T.C. 926, 936-38 (1988) ("The plain language of section 6013(b) references a return filed by an 'individual.'").

6020(b) return does not affect the imposition of the failure to file addition to tax. See I.R.S. Gen. Couns. Mem. 38,063 (Aug. 23, 1979). Counsel suggested that revenue rulings 69-397 and 76-562 be revoked. Id.

In 1982, however, counsel again reversed its position, revoking G.C.M. 38,063 and concluding, without further analysis, that "the literal language of the statute supports current Service position" and "there does not appear to be any substantial administrative burden under current Service position which would be relieved." See I.R.S. Gen. Couns. Mem. 38,879 (July 20, 1982) (and attached memorandum). Revenue rulings 69-397 and 76-562 were never revoked.

In 1996, the Taxpayer Bill of Rights 2 was enacted, adding sections 6651(g)(1) and (2) to the Code. As previously stated, section 6651(g)(1) provides that a section 6020(b) return shall be disregarded for purposes of determining the amount of the addition to tax for failure to file under section 6651(a)(1).[2] Prior to the enactment of TBOR2, counsel reviewed draft language contained in H.R. 22, 103rd Cong. (1993) and S. 542, 103rd Cong. (1993), bills that contained provisions of TBOR2. See I.R.S. Field Serv. Advisory (May 19, 1993), available at 1993 WL 1468079 (IRS FSA). Counsel concluded that under then current law, a section 6020(b) return stops the running of the failure to file penalty, citing Revenue Ruling 69-397 without further analysis, and concluding that the draft language would resolve the "problem." Id. We could not find any legislative history explaining the addition of section 6651(g)(1). In contrast, committee reports containing the addition of sections 6651(g)(1) and (2) explain the addition of section 6651(g)(2) as a change in the law that would apply the section 6651(a)(2) failure to pay addition to tax to failure to file situations in which a section 6020(b) return is made. See footnote 2, supra. It is unclear whether Congress believed that a section 6020(b) return would stop the running of the delinquency period under section 6651 as it existed prior to the addition of subsection (g), and added section 6651(g)(1) in order to remedy this problem, or whether Congress believed a clarification was needed only due to the addition of section 6651(g)(2), which provides that a section 6020(b) return shall be treated as the return filed by the taxpayer for purposes of the section 6651(a)(2) and (3) failure to pay additions to tax. In any event, after the enactment of TBOR2, it was clear that a section 6020(b) return did not terminate the section 6651 delinquency period, and so Revenue Ruling 76-562 was obsoleted. Rev. Rul. 98-37, 1998-2 C.B. 133.

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[2] Section 6651(g)(2) provides that a section 6020(b) return shall be treated as the return filed by the taxpayer for purposes of the section 6651(a)(2) and (3) failure to pay additions to tax. Prior to the addition of section 6651(g)(2), the section 6651(a)(2) failure to pay addition to tax, which begins to accrue as of the due date of the return, was interpreted as applying only to unpaid tax claimed on a return filed by the taxpayer and not to unpaid tax shown on a section 6020(b) return. See e.g., I.R.S. Gen. Couns. Mem. 36,819 (Aug. 23, 1976). The section 6651(a)(3) addition to tax for failure to pay amounts not shown on a return, which begins to accrue 10 days after notice and demand, would apply in the case of a section 6020(b) return. TBOR2 was aimed at remedying the inequity caused by imposing the earlier-accruing addition to tax on taxpayers who voluntarily filed delinquent returns and imposing the later-accruing addition to tax on taxpayers who continue in their failure to file a return, forcing the Service to make a section 6020(b) return. See H.R. Rep. No. 104–506, at 53 (1996).

We find much of the analysis of G.C.M. 38,063 to be persuasive. The same analysis would support a conclusion that a section 6020(b) return does not affect the imposition of the section 6698 and 6699 failure to file penalties. Moreover, when counsel previously took the position that a section 6020(b) return stopped the running of the section 6651 delinquency period, that position was based primarily on the section 6020(b) "prima facie good and sufficient for all legal purposes" language. Based on that language, the Service also took the position that a section 6020(b) return constituted a separate return filed by the taxpayer for purposes of the section 6013 limitations on making a joint election after the filing of a separate return. Rev. Rul. 70-632, 1970-2 C.B. 286. Subsequent to counsel's prior advice regarding sections 6020(b) and 6651, the Tax Court rejected this position in the section 6013 context, pointing to the plain language of section 6013(b), which refers to a return filed by an "individual," as a section 6020(b) return is not filed by an "individual." Millsap v. Commissioner, 91 T.C. 926, 936-38 (1988). The Tax Court's analysis would also lead to the conclusion that a section 6020(b) return filed by the Service does not affect the imposition of the section 6698 and 6699 penalties, which by their terms apply to the failure on the part of a "partnership" or "S corporation" to timely file a complete return. We therefore conclude that a section 6020(b) return does not affect the imposition of the section 6698 and 6699 penalties.

Issue 2c

Question
If IRS does not certify a return under IRC § 6020(b), can the penalty be computed for the full 12 months (if no return is filed by the taxpayer), or until the taxpayer files a return if earlier?

Example:
Corporation "H", a sub-chapter S corporation, has not filed a return for tax years 2009 through 2011. The corporation is selected for examination, and substitute returns are posted in order to control the examination. The corporation has not requested an extension of time to file for any of the years under examination, and has failed to file a return for any of those years. On December 12, 2012, the revenue agent proposes the penalty for failure to file without preparing any returns under section 6020(b) for any of the years. The penalty under IRC § 6699 is assessed on 3/3/2013. Can the penalty be computed for the full 12 month period since a return under section 6020(b) has not been certified?

Response
As we have concluded above, the section 6698 and 6699 penalties can be imposed for

the applicable period even where a section 6020(b) return has been filed. [redacted]

In order to constitute a section 6020(b) return, a substitute return must be subscribed. I.R.C. § 6020(b)(2). A section 6020(b) return may be subscribed by filing Form 13496, IRC Section 6020(b) Certification, or its automated counterpart, the IRC Section 6020(b) ASFR Certification. See Treas. Reg. § 26 CFR 301.6020-1(b)(2); CC Notice 2007-005. Even without a Form 13496, a subscribed substitute return can constitute a section 6020(b) return. The Tax Court has held that the first page of a tax return containing the taxpayer's name, address, taxpayer identification number, and filing status, marked "substitute for return," and attached to a subscribed revenue agent's report, constitutes a section 6020(b) return if the revenue agent's report contains sufficient information from which to compute the taxpayer's tax liability. See Millsap, 91 T.C. at 930. On the other hand, a "dummy return" by itself, consisting of the first page of a tax return that is blank other than the taxpayer's name, address, and taxpayer identification number and is prepared by the Service to facilitate processing, is not a section 6020(b) return because it is not subscribed, among other reasons. See Phillips v. Commissioner, 86 T.C. 433, 437-38 (1986), action on dec., 1992-04 (Oct. 22, 1991) (AOD explaining that the dummy return in Phillips also did not satisfy the requirements of a return as set forth in Beard v. Commissioner, 82 T.C. 766 (1984), aff'd, 793 F.2d 139 (6th Cir. 1986)). If both an unsubscribed "dummy return" and a subscribed revenue agent's report are filed for a particular taxpayer and tax year, the documents do not constitute a section 6020(b) return if they are filed on different days and not attached to one another. See Cabirac v. Commissioner, 120 T.C. 163, 170-73 (2003). As long as an unsubscribed substitute return is not attached to or filed in conjunction with a subscribed revenue agent's report as a section 6020(b) return, and no Form 13496 or ASFR Certification is filed, the unsubscribed substitute return is not a section 6020(b) return, [redacted]