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THE FRIVOLOUS RETURN PENALTY: Protect Good Faith Taxpayers by Expanding the Availability of Penalty Reductions, Establishing Specific Penalty Abatement Procedures, and Providing Appeal Rights

TAXPAYER RIGHTS IMPACTED¹

- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

PROBLEM

By the early 1980's, Congress became concerned with the rapid growth of deliberate defiance of the tax laws by "tax protestors."² As a result, Congress passed Internal Revenue Code (IRC) § 6702, which, as currently formulated, generally imposes an immediately assessable \$5,000 penalty on tax returns adopting a position which the IRS has identified as frivolous or reflecting a desire to delay or impede the administration of federal tax laws.³ This penalty, however, was primarily intended to address "protest" returns and was not aimed at taxpayers making good faith mistakes on their returns, such as innocent mathematical or clerical errors.⁴

In order to mitigate the harshness of the frivolous return penalty, Congress also allowed for a reduction of the penalty, which now can be decreased from \$5,000 to \$500, if the IRS determines that such reduction would promote compliance with and administration of the federal tax laws.⁵ Nevertheless, when adopting procedures implementing this provision, the IRS denied potential penalty reduction to any taxpayers to the extent they have already paid the penalty, including by means of an automatic or involuntary refund offset.⁶ This broad exclusion is particularly problematic because no clearly defined procedures exist allowing an abatement of the penalty for reasonable cause and good faith.⁷ Further, the IRS Office of Appeals (Appeals) refuses to consider any appeals of frivolous return penalties even if those appeals are contending that the penalties were incorrectly applied in the first instance or are in some other way substantively

1 See Taxpayer Bill of Rights, available at www.TaxpayerAdvocate.irs.gov/taxpayer-rights.

2 S. REP. NO. 97-494(I), at 277 (1982). Subsequently, Congress enacted the IRS Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, Title III, Subtitle H, § 3707(a) (July 22, 1998), which prohibited the IRS from labeling taxpayers as Illegal Tax Protestors or adopting similar terminology based on fear of stigmatization. In RRA 98 § 3707(b), Congress, however, did allow IRS personnel to designate appropriate taxpayers as "nonfilers."

3 IRC § 6702(a)(2). The frivolous return penalty can also be imposed by the IRS in response to the filing of a specified frivolous submission. IRC § 6702(b). These IRC § 6702 penalties are sometimes also referred to as "postassessment penalties" because they can be assessed in the absence of deficiency procedures and because they do not provide prepayment review rights in the U.S. Tax Court. Internal Revenue Manual (IRM) 8.11.1.1.2(1) (Nov. 12, 2013).

4 S. REP. NO. 97-494(I), at 277 (1982).

5 IRC § 6702(d); Rev. Proc. 2012-43, 2012-49 I.R.B. 643. Taxpayers can also avoid assertion of the penalty if they withdraw a frivolous return within 30 days of receiving notice by the IRS. This right is statutory in the case of IRC § 6702(b), *Specified Frivolous Submissions*, and a matter of IRS policy in the case of IRC § 6702(a), *Frivolous Tax Returns*. See IRC § 6702(b)(3); IRM 4.10.12.1(10) (Sept. 5, 2014).

6 Rev. Proc. 2012-43, § 3, 2012-49 I.R.B. 643.

7 An abatement can be obtained if the IRS has asserted the penalty in error. IRM 25.25.10.8.4, *Post Penalty Assessment Processing* (Aug. 13, 2015).

erroneous.⁸ Appeals may well be concerned with having to rehear arguments that gave rise to application of the frivolous return penalty in the first instance. However, mechanisms already exist that could be used and expanded to properly balance taxpayers' need for post-assessment, prepayment or post-payment appeal reviews with Appeals' legitimate need to address the proliferation of baseless claims.⁹

As options for relief have been narrowed by the IRS, opportunities for inappropriate application of the frivolous return penalty have been simultaneously increased. The number of frivolous positions specifically identified by the IRS has grown to over 50, some of which are sufficiently broad as to encompass unintentional tax reporting errors.¹⁰ Further, as the IRS enlarges its reliance on automated systems for application of the frivolous return penalty, the likelihood of incorrect penalty application correspondingly will expand. Thus, an increasingly broad swath of taxpayers are exposed to application of the frivolous return penalty and are left with no meaningful administrative recourse.¹¹ The approach of the IRS, to shoot first and then not even ask or answer questions later, all too often results in application of the frivolous return penalty in a way that jeopardizes a range of fundamental taxpayer rights including *the right to challenge the IRS's position and be heard*, *the right to a fair and just tax system*, and *the right to appeal an IRS decision in an independent forum*.

EXAMPLE

Taxpayer earned \$9,000 of adjusted gross income during the year and qualified for an Earned Income Tax Credit (EITC) of \$3,600. When Taxpayer completed the tax return, however, Taxpayer made a clerical error, overreporting amounts withheld and claiming a refund of \$9,000, rather than the \$5,000 refund that was properly payable. The IRS issued a letter threatening Taxpayer with a frivolous return penalty if Taxpayer did not correct the return within 30 days. This letter frightened Taxpayer who decided to seek the assistance of a tax preparer. By the time a preparer could be located, however, and the return amended, the 30-day period had been exceeded by ten days, and the IRS moved forward with assessment of the \$5,000 frivolous return penalty. This occurred despite Taxpayer's good faith effort to correct the clerical error.

Taxpayer was somewhat heartened when the tax preparer explained the penalty could be reduced from \$5,000 to \$500. This hope did not last long, however, as the IRS collected the full \$5,000 penalty as an offset against the \$5,000 refund to which Taxpayer was properly entitled. As a result, the IRS was unwilling to consider the request for a penalty reduction.¹² Taxpayer had been planning to use much of the claimed refund for essential living expenses, but after offset of the full frivolous return penalty, Taxpayer was left with nothing.

With the assistance of the tax preparer, Taxpayer filed an abatement request arguing that the error was made in good faith, which was summarily denied based on the cryptic explanation that the IRS would only look at the face of the return in determining application of the frivolous return penalty. Not

8 Appeals previously undertook such reviews but has recently modified its policy in this regard. Compare IRM 8.11.8.2(1) (Oct. 28, 2013) with obsolete IRM 8.11.1.7(3) (Feb. 26, 1999).

9 See, e.g., IRM 8.22.5.5.3.1, *Processing Frivolous, Desire to Delay or Impede Requests* (Nov. 8, 2013).

10 These positions identified by the IRS as frivolous are set forth in Notice 2010-33, 2010-17 I.R.B. 609, as supplemented by IRM 4.10.12.1.1, *Frivolous Arguments* (Sept. 5, 2014).

11 Taxpayers theoretically can pay the penalty and file a refund claim in Federal District Court, but such a remedy generally would cost taxpayers more than the underlying penalty and would be particularly burdensome for low income and unsophisticated taxpayers.

12 See Rev. Proc. 2012-43, 2012-49 I.R.B. 643.

believing this answer could be correct, Taxpayer sought to have the matter reviewed by Appeals. Taxpayer, however, was informed Appeals no longer heard any challenges to the frivolous return penalty. Taxpayer was told about the possibility of filing a refund claim in federal court, but Taxpayer no longer had either the funds or energy to pursue the matter further.

RECOMMENDATIONS

In order to protect good faith taxpayers and enable the frivolous return penalty to be imposed more fairly and effectively, the National Taxpayer Advocate recommends that Congress:

1. Amend IRC § 6702(b)(3) to expand the notice period allowing taxpayers to correct their returns and avoid application of the frivolous return penalty from 30 days to 60 days and establish the same mechanism for correcting returns under IRC § 6702(a).
2. Amend IRC § 6702(d) to clarify taxpayers will be eligible for reduction of the frivolous return penalty regardless of whether they have already satisfied the penalty.
3. Amend IRC § 6702 to establish the availability of a full penalty abatement for good faith and reasonable cause.
4. Amend IRC § 6702 to provide that taxpayers will be entitled to obtain either a post-assessment, prepayment or post-assessment, post-payment review of frivolous return penalties within Appeals.

PRESENT LAW

IRC § 6702 generally imposes an immediately assessable \$5,000 penalty on tax returns adopting a position that the IRS has identified as frivolous or reflecting a desire to delay or impede the administration of federal tax laws.¹³ Further requirements for application of the frivolous return penalty are that a taxpayer has filed what purports to be a tax return that does not contain information on which the substantial correctness of the self-assessment may be judged or that contains information that on its face indicates the self-assessment is substantially incorrect.¹⁴ The frivolous return penalty can also be imposed by the IRS in response to the filing of specified frivolous submissions, which include collection due process (CDP) appeals, requests for installment agreements, proposed offers in compromise, and taxpayer assistance orders.¹⁵

The IRS first identified frivolous positions subject to the IRC § 6702 penalty in Notice 2007-30.¹⁶ This list was augmented in 2008, and then again in 2010 when the group was expanded to cover over 50 positions and any others that were the same as or similar to those positions.¹⁷

This list of frivolous positions was provided at the express direction of Congress.¹⁸ Nevertheless, Congress also envisioned certain parameters limiting application of the frivolous return penalty. Congress wanted a regime that discouraged “protest” returns, but not one that adopted punitive measures with respect to potentially good faith taxpayers. As a result, Congress also required the IRS to provide taxpayers individual notice that a position they adopted constitutes a specified frivolous submission and furnish the

13 IRC § 6702(a)(2).

14 IRC § 6702(a)(1).

15 IRC § 6702(b).

16 Notice 2007-30, 2007-14 I.R.B. 883.

17 Notice 2008-14, 2008-4 I.R.B. 310; Notice 2010-33, 2010-17 I.R.B. 609.

18 IRC § 6702(c).

opportunity to avoid application of the penalty if the position is withdrawn within 30 days.¹⁹ The IRS now issues these 30-day letters in the case of potential IRC § 6702(a) penalties as well as those arising under IRC § 6702(b).²⁰

As Congress originally explained,

The committee believes that an immediately assessable penalty on the filing of protest returns will help deter the filing of such returns, and will demonstrate the determination of the congress to maintain the integrity of the income tax system The penalty will be imposed, therefore, only on purported returns that are patently improper and not in cases involving valid disputes with the Secretary. This penalty will not be imposed, of course, in the case of innocent or inadvertent mathematical or clerical errors (as defined in § 6213(G)(2)(A) or (B)), including certain incorrect uses of tax tables, etc.²¹

Congress also provided the statutory authority for the IRS to reduce the IRC § 6702 penalty “... if the Secretary determines that such reduction would promote compliance with and administration of the Federal tax laws.”²² When establishing the procedures for this reduction in Rev. Proc. 2012-43, however, the IRS imposed some significant limitations. Among other things, the IRS determined that it would only reduce a frivolous return penalty from \$5,000 to \$500.²³ Further, this reduction would only be available to the extent that the penalty had not already been satisfied by the taxpayer.²⁴

A taxpayer has no appeal rights if the IRS rejects a reduction request.²⁵ Further, Appeals does not currently consider any challenges with respect to application of the IRC § 6702 penalty.²⁶

REASONS FOR CHANGE

The National Taxpayer Advocate applauds both Congress and the IRS, respectively, for allowing taxpayers to avoid application of the frivolous return penalty if they withdraw and correct their frivolous position within 30 days of receiving notice from the IRS.²⁷ This approach allows taxpayers to self-correct unintentional errors without experiencing the stigma and the burden of the frivolous return penalty. It has the additional benefit of using IRC § 6702 as an opportunity to educate taxpayers and encourage their future compliance.²⁸

TAS is aware of a number of circumstances, however, in which taxpayers, despite diligent and good faith efforts, have simply been unable to withdraw and correct their erroneous returns within the 30-day notice period. This challenge is particularly acute for unsophisticated taxpayers who may require the assistance of a tax preparer to amend their tax return or even to understand the contents of the notice letter itself.²⁹

19 IRC § 6702(b)(3).

20 IRM 4.10.12.1(10) (Sept. 5, 2014).

21 S. REP. No. 97-494(I), at 277 (1982).

22 IRC § 6702(d).

23 Rev. Proc. 2012-43, § 4.01(2), 2012-49 I.R.B. 643.

24 Rev. Proc. 2012-43, § 3, 2012-49 IRB (Dec. 3, 2012).

25 See Rev. Proc. 2012-43, § 5.03, 2012-49 IRB (Dec. 3, 2012).

26 See IRM 8.11.8.2(1) (Oct. 28, 2013).

27 This 30-day window is statutory in the case of IRC § 6702(b) and a matter of IRS policy in the case of IRC § 6702(a). See IRC § 6702(b)(3); IRM 4.10.12.1(10) (Sept. 5, 2014).

28 IRM 20.1.1.2.1(8) (Nov. 25, 2011).

29 See, e.g., National Taxpayer Advocate 2014 Annual Report to Congress 163 and 172.

The notice's effectiveness should not be limited by application of a response window that is simply too short for many taxpayers, especially some unsophisticated taxpayers. As a result, the National Taxpayer Advocate recommends that Congress consider statutorily expanding the notice period allowing taxpayers to correct their returns and avoid application of the frivolous return penalty from 30 days to a reasonable but more manageable 60 days, which is in line with the amount of time available to taxpayers to correct summary assessments under IRC § 6213(b)(2), *Abatement of assessment of mathematical or clerical errors*.

Further, the previous addition by Congress of IRC § 6702(d) allowing for a reduction of the frivolous return penalty, is laudable. Nevertheless, the IRS is currently applying that reduction in a way that does not comport with Congress' intent and sometimes appears to be arbitrary and capricious.

TAS has received requests for assistance from taxpayers in a number of cases in which a group of taxpayers has been taken in by an unscrupulous tax preparer and all adopted the identical frivolous return position. Nevertheless, some of those taxpayers are eligible for the IRC § 6702(d) reduction while others are not. This distinction is often based solely on whether or not the taxpayers have already satisfied, either through direct payment or refund offset, the \$5,000 penalty initially asserted by the IRS.³⁰

Those taxpayers who have satisfied the \$5,000 penalty are essentially double-penalized for their willingness to pay, or for their overpayment status, by losing eligibility for the reduction to \$500. This practice by the IRS not only violates most taxpayers' notions of fairness, but is particularly hard on taxpayers who rely on certain refundable credits, such as the EITC. When these anticipated refunds fail to arrive, such taxpayers often find themselves in desperate circumstances without the money they had counted on for basic living expenses.

There is no persuasive reason to differentiate between taxpayers based on the payment status of the original penalty, and a very good reason to make application of the reduction more equitable. Voluntary compliance tends to correlate with taxpayers' perceptions that the IRS and the tax laws are fair and may decline if taxpayers feel that the IRS is overreaching or applying arbitrary rules.³¹ Thus, Congress should consider taking steps to require that the IRS abandon the distinction that it currently draws between those who have and have not satisfied the penalty when considering eligibility for the IRC § 6702(d) penalty reduction.

Further, the IRS applies the IRC § 6702 penalty in a highly mechanical fashion, and this process is being increasingly automated. Thus, it is quite possible for taxpayers to be erroneously assessed the penalty in the first instance or for good faith taxpayers to file a return that is technically frivolous without ever intending to do so.

For example, Notice 2010-33 identifies as a frivolous position the assertion of the Fifth Amendment right against self-incrimination as the basis for withholding "all financial information from the Service."³² When a taxpayer asserted this right with respect to the omission of certain information from the interest and dividend schedule on his tax return, the IRS assessed the IRC § 6702 penalty, and, after relief was denied in a CDP appeal, the matter came before the U.S. Tax Court in the form of cross-motions for summary judgment.³³ Judge Holmes granted the taxpayer's motion for summary judgment on the grounds that because the withheld information related to the duty to file a *Report of Foreign Bank and Financial*

30 Note: these refund offsets generally are automatic and involuntary.

31 National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, 134.

32 Notice 2010-33, § III.(9)(f), 2010-17 I.R.B. 609.

33 *Youssefzadeh v. Comm'r*, No. 14868-14 L. (Nov. 6, 2015).

Accounts (FBAR), and because the willful failure to file an FBAR is a crime, the Fifth Amendment had been properly invoked, and the assessed IRC § 6702 penalty was therefore invalid. The frivolous return penalty should not be used by the IRS as a means of doing an end run around Constitutional protections or other legitimately exercised rights.

Some taxpayers have been successful in persuading the IRS to abate the IRC § 6702 penalty where it was incorrectly applied or where it resulted from a position that the taxpayers did not know to be improper.³⁴ Nevertheless, TAS is also aware of other occasions in which similarly situated taxpayers have been treated differently and subjected to the penalty. The IRS is not always consistent in its standards for acknowledging and utilizing its discretion to abate the frivolous return penalty under IRC §§ 7803 and 6404.³⁵

The IRS frequently assumes that anyone caught up in the ever-expanding definition of a frivolous return must, by default, be a bad actor. However, this category now includes many taxpayers who had no desire to delay or impede the administration of federal tax laws. As the IRS itself recognizes in *The Penalty Handbook*, “Voluntary compliance is achieved when a taxpayer makes a good faith effort to meet the tax obligations defined by the Internal Revenue Code.”³⁶ Penalties should be objectively proportioned to the offense, and be used as an opportunity to educate taxpayers and encourage their future compliance.³⁷ Penalties should relate to the standards of behavior they encourage.³⁸ IRS employees are responsible for administering the penalty statutes and regulations in an even-handed manner that is fair and impartial to both the government and the taxpayer.³⁹

Such balance, however, is absent where provision of frivolous return abatements is concerned. Additional clarity and uniformity in this area would benefit both taxpayers and the government. Several IRC provisions expressly allow a penalty abatement for reasonable cause and good faith.⁴⁰ Congress should consider amending IRC § 6702 to clarify the specific availability of such an abatement in appropriate cases where application of the frivolous return penalty is concerned. Congress has already demonstrated its support for this approach in the legislative history quoted above. This step would help eliminate confusion within the IRS and on the part of taxpayers regarding abatement discretion and would perpetuate fairness and consistency in application of the frivolous return penalty.

The problems inherent in overly broad application of the penalty are exacerbated by Appeals’ current unwillingness to review IRC § 6702 determinations.⁴¹ Appeals has the authority to review such cases, but has made the “business decision” to terminate the provision of such oversight.⁴² This policy effectively eliminates any higher level administrative review of the actions taken by the IRS’s Frivolous Return

34 See IRM 25.25.10.8.4, *Post Penalty Assessment Processing* (Aug. 13, 2015).

35 IRC § 7803 abatements are premised on the IRS Commissioner’s general authority to administer the IRC. See also IRC § 6404; IRM 25.6.1.10.1.1(2) (Nov. 18, 2011). This general abatement authority can result in a refund to the extent that the refund statute of limitations under IRC § 6511 remains open with respect to any previously paid assessments that are the subject of the abatement. IRM 25.6.1.10.1.1(6) (Nov. 18, 2011).

36 IRM 20.1.1.2.1(6) (Nov. 25, 2011).

37 IRM 20.1.1.2.1(8) (Nov. 25, 2011).

38 IRM 20.1.1.2.1(10) (Nov. 25, 2011).

39 IRM 20.1.1.2.2(c) (Nov. 25, 2011).

40 See, e.g., IRC §§ 6662(c), 6651(a), and 6038D.

41 The importance of appeal rights and other issues currently relating to Appeals are further developed in the National Taxpayer Advocate 2015 Annual Report to Congress, Most Serious Problem: *Appeals: The Appeals Judicial Approach and Culture Project is Reducing the Quality and Extent of Substantive Administrative Appeals Available to Taxpayers*, *supra*.

42 IRS Office of Chief Counsel Memorandum, *Appeals Rights with Respect to a Request to Abate a Section 6702 Penalty*, PMTA 2013-28 (Dec. 20, 2013).

Program (FRP).⁴³ It is also inconsistent with the IRS's adoption of the Taxpayer Bill of Rights, particularly *the right to appeal an IRS decision in an independent forum* and *the right to challenge the IRS's position and be heard*.

Taxpayers are granted the option of paying the assessed penalty and seeking a refund in Federal District Court. Realistically, however, very few taxpayers, particularly lower income taxpayers, will possess the financial resources or the remaining energy to continue fighting a \$500 penalty, or even a \$5,000 penalty, in federal court. Further, in most cases, the legal expenses and other related costs required to contest the penalty would exceed the amount of the penalty itself. The deprivation of appeal rights in the case of IRC § 6702 frivolous return penalties is a punitive and unnecessary denial of fundamental taxpayer rights that Congress should consider taking steps to rectify by allowing for an independent Appeals review regardless of whether the immediately assessable penalty has yet been paid by taxpayers.

Appeals may well be concerned with having to rehear arguments that gave rise to application of the frivolous return penalty in the first instance. Nevertheless, Appeals already has procedures directing Appeals personnel to ignore frivolous arguments raised as part of various proceedings, such as CDP appeals.⁴⁴ Such an approach applied to all appeals of frivolous return penalties presumably would discourage repetition of these arguments and should address case proliferation concerns. Moreover, such potential administrative burdens should not serve as the basis for denying taxpayers basic access to Appeals.

TAS has held ongoing discussions with the IRS operating divisions regarding many of these issues for years. Nevertheless, no significant administrative progress has been made toward implementing these recommendations for protecting taxpayer rights and thereby increasing the effective and equitable application of IRC § 6702.

EXPLANATION OF RECOMMENDATION

Over time, the reach of the IRC § 6702 frivolous return penalty has extended beyond the bad actors for whom it was originally designed. Additionally, the IRS's approach to applying the penalty and the related reduction has confused and harmed many good faith taxpayers. The recommendations, which seek to balance the concern for administrative efficiency with the need for taxpayer protections, would allow taxpayers a broader window for correcting returns and submissions identified as frivolous, would achieve greater uniformity in application of the IRC § 6702(d) reduction, would allow for a reasonable cause abatement of the full amount of the penalty in the case of good faith taxpayers, and would ensure that taxpayers are entitled to obtain review of frivolous return penalty abatement requests by Appeals.

⁴³ The FRP currently resides within the Wage & Investment Division of the IRS.

⁴⁴ IRM 8.22.5.5.3.1, *Processing Frivolous, Desire to Delay or Impede Requests* (Nov. 8, 2013).