

Reform Penalty and Interest Provisions

#27 CONVERT THE ESTIMATED TAX PENALTY INTO AN INTEREST PROVISION FOR INDIVIDUALS, TRUSTS, AND ESTATES

Present Law

Through the combination of wage withholding and the requirement that taxpayers make estimated tax payments, the Internal Revenue Code (IRC) aims to ensure that federal income and payroll taxes are paid ratably throughout the year. IRC § 3402 generally requires employers to withhold tax on wages paid to employees. IRC § 6654 generally requires taxpayers to pay at least the lesser of (i) 90 percent of the tax shown on a tax return for the current tax year or (ii) 100 percent of the tax shown on a tax return for the preceding tax year (reduced by the amount of wage withholding) in four installment payments that are due on April 15, June 15, September 15, and January 15 of the following tax year.¹⁰⁹

IRC § 6654(a) provides that a taxpayer who fails to pay sufficient estimated tax will be liable for a penalty that is computed by applying (i) the underpayment rate established under IRC § 6621 (ii) to the amount of the underpayment (iii) for the period of the underpayment. IRC § 6621 is an interest provision. Therefore, the additional amount a taxpayer owes for failing to pay sufficient estimated tax is computed as an interest charge, even though it is denominated as a “penalty.”

Reasons for Change

For a variety of reasons, taxpayers often have difficulty predicting how much tax they will owe. Self-employed taxpayers or taxpayers who own small businesses experience significant fluctuations in their incomes and expenses from year to year. Taxpayers with significant investment income may experience significant fluctuations. In addition, substantial changes in tax laws, such as those that took effect in 2018, affect tax liabilities in ways that taxpayers may not fully anticipate. As a result, millions of taxpayers do not satisfy the requirements of IRC § 6654 and are liable for penalties, even though many have attempted to comply.

The term “penalty” carries negative connotations, and the National Taxpayer Advocate believes it should be reserved for circumstances in which a taxpayer has failed to make reasonable efforts to comply with the law. Thus, she agrees with the assessment of the Ways and Means Committee when it wrote during a previous Congress: “Because the penalties for failure to pay estimated tax are calculated as interest charges, the Committee believes that conforming their title to the substance of the provision will improve taxpayers’ perceptions of the fairness of the estimated tax payment system.”¹¹⁰ Along these lines, the Office of the Taxpayer Advocate has conducted research studies that have found “tax morale” has an impact on tax compliance.¹¹¹ Accordingly, we believe the failure to pay sufficient estimated tax is better characterized as an interest charge than a penalty for deficient taxpayer behavior.

¹⁰⁹ If the adjusted gross income of a taxpayer for the preceding tax year exceeds \$150,000, “110 percent” is substituted for “100 percent” in applying clause (ii). IRC § 6654(d)(1)(C).

¹¹⁰ H.R. REP. No. 108-61, at 23-24 (2003).

¹¹¹ See National Taxpayer Advocate 2013 Annual Report to Congress vol. 2, at 1-13 (Research Study: *Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?*).

Recommendation

- Convert the penalty for failure to pay sufficient estimated tax to an interest charge. Toward that end, relocate IRC § 6654 from part I of subchapter A of chapter 68 to the end of subchapter C of chapter 67 and make conforming modifications to the headings and text.¹¹²

¹¹² For legislative language generally consistent with this recommendation, see Taxpayer Protection and IRS Accountability Act, H.R. 1528, 108th Cong. § 101 (2003). If the additional charge for failure to pay estimated tax remains a penalty, then the National Taxpayer Advocate reiterates her prior recommendation that Congress enact a reasonable cause exception. See National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, at 34-36 (Analysis: *A Framework for Reforming the Penalty Regime*).

#28 APPLY ONE INTEREST RATE PER ESTIMATED TAX UNDERPAYMENT PERIOD FOR INDIVIDUALS, ESTATES, AND TRUSTS

Present Law

Internal Revenue Code (IRC) § 6654 provides that taxpayers who make estimated tax payments must submit those payments on or before April 15, June 15, September 15, and January 15 of the following tax year. Failure to do so results in a penalty that is determined by the underpayment rate, the amount of the underpayment, and the period of the underpayment. The underpayment rate is established by IRC § 6621(a)(2) to be the federal short-term interest rate, plus three percentage points. Under IRC § 6621(b)(1), the federal short-term interest rate is determined quarterly by the Secretary of the Treasury. If the Secretary determines a change in the federal short-term interest rate, the change is effective January 1, April 1, July 1, and October 1.

Reasons for Change

Under current law, more than one interest rate may apply for a single estimated tax underpayment period. For example, if a taxpayer fails to make an estimated tax payment due June 15 and the Secretary determines a change in the federal short-term interest rate effective July 1, one interest rate would apply for the period from June 16 through June 30, while another interest rate would apply for any continued delinquency from July 1 through September 15. The application of more than one interest rate for a single underpayment period causes unnecessary complexity and burden for taxpayers and the IRS alike. This complexity and burden would be reduced if a single interest rate were applied for each period.

Recommendation

- Amend IRC § 6654 to provide that the underpayment rate for any day during an estimated tax underpayment period shall be the underpayment rate established by IRC § 6621 for the first day of the calendar quarter in which the underpayment period begins.¹¹³

¹¹³ For legislative language generally consistent with this recommendation, see Taxpayer Bill of Rights Enhancement Act of 2017, S. 1793, 115th Cong. § 305 (2017). See also H.R. REP. NO. 108-61, at 25 (2003); Taxpayer Protection and IRS Accountability Act, H.R. 1528, 108th Cong. § 101 (2003).

#29 REDUCE THE FEDERAL TAX DEPOSIT PENALTY IMPOSED ON CERTAIN TAXPAYERS WHO MAKE TIMELY TAX DEPOSITS

Present Law

Internal Revenue Code (IRC) § 6656(a) imposes a penalty, computed as a percentage of a tax underpayment, for the failure to deposit (FTD) taxes in a manner prescribed by regulation, unless such failure is due to reasonable cause and not due to willful neglect.

Treasury Regulation § 31.6302-1(h) requires that federal tax deposits be made electronically via electronic funds transfer. To comply with this requirement, most taxpayers use the Electronic Federal Tax Payment System (EFTPS), a free service offered by the Department of the Treasury. The penalty rate for FTD varies, depending on the length of the taxpayer's delay in making the deposit. IRC § 6656(b)(1) provides that the penalty is two percent for an FTD of not more than five days, five percent for an FTD of more than five days but not more than 15 days, and ten percent for an FTD of more than 15 days. Thus, taxpayers must make deposits on time, in full, and in the correct manner to avoid a penalty for FTD.¹¹⁴

Reasons for Change

The IRS has taken the position that the maximum ten percent penalty rate automatically applies if a deposit is not made in the manner prescribed by the regulation.¹¹⁵ As a result, taxpayers who timely remit full payment to the IRS but who do not do so in the manner prescribed are subject to a higher penalty rate than taxpayers who do not make a timely payment at all. The National Taxpayer Advocate believes it is inappropriate to penalize taxpayers who make timely payments more harshly than taxpayers who do not. Moreover, the Ways and Means Committee has observed that this approach “does not reflect the intent of the Congress.”¹¹⁶

Recommendation

- Amend IRC § 6656 to establish a penalty rate of two percent for FTDs that are fully and timely paid, but not in the manner prescribed by the Secretary of the Treasury.¹¹⁷

¹¹⁴ See *F.E. Schumacher Co. v. United States*, 308 F. Supp.2d 819, 830 (N.D. Ohio 2004) (“penalties assessed pursuant to Section 6656 are appropriate even where taxes are timely paid, albeit by means other than [Electronic Funds Transfer]”).

¹¹⁵ Rev. Rul. 95-68, 1995-2 C.B. 272; IRM 20.1.4.2.2.1, Electronic Funds Transfer (EFT) (Feb. 9, 2018).

¹¹⁶ H.R. REP. NO. 108-61, at 36 (2003).

¹¹⁷ For legislative language generally consistent with this recommendation, see Taxpayer Bill of Rights Enhancement Act of 2017, S. 1793, 115th Cong. § 309 (2017); Taxpayer Protection and IRS Accountability Act, H.R. 1528, 108th Cong. § 108 (2003).

#30 EXTEND REASONABLE CAUSE ABATEMENT OF THE FAILURE-TO-FILE PENALTY TO TAXPAYERS WHO RELY ON RETURN PREPARERS TO E-FILE THEIR RETURNS

Present Law

Internal Revenue Code (IRC) § 6651 imposes an addition to tax when a taxpayer fails to file a return by the return due date, unless the taxpayer can show the failure was due to reasonable cause and not to willful neglect (hereinafter, the “failure-to-file penalty”).¹¹⁸ Reasonable cause exists when a taxpayer has exercised ordinary business care and prudence but was unable to file the return within the prescribed time.¹¹⁹

In *United States v. Boyle*, the Supreme Court held that a taxpayer’s reliance on an agent to file a return did not constitute “reasonable cause” for late filing.¹²⁰ In *Boyle*, the tax return at issue was filed on paper. Recently, at least two U.S. district courts have ruled that the *Boyle* holding applies in the e-filing context as well.¹²¹

In the IRS Restructuring and Reform Act of 1998, Congress adopted a policy that “paperless filing should be the preferred method and most convenient means of filing Federal tax and information returns” and gave the Secretary broad authority to incentivize taxpayers to file returns electronically.¹²²

IRC § 6011(e)(3) authorizes the Secretary to require tax return preparers to file returns electronically unless they reasonably expect to file ten or fewer individual income tax returns during a calendar year. Treasury Regulation § 301.6011-7 implements this requirement.

Reasons for Change

At the time *Boyle* was decided, all tax returns were filed on paper. Taxpayers generally could fulfill the basic responsibility of mailing returns to the IRS themselves, even when they engaged tax professionals to prepare them. In ruling that the taxpayer in *Boyle* was not entitled to “reasonable cause” abatement as a matter of law, the Supreme Court stated that “[i]t requires no special training or effort to ascertain a deadline and make sure that it is met.”¹²³

In effect, the *Boyle* decision concluded that the duty to file a return is non-delegable. While that rule may make sense in a paper-filing context, it is not reasonable to apply the rule in the e-filing context.

Today, most taxpayers effectively delegate the electronic filing of their returns to preparers or use software providers. Particularly when a taxpayer uses a preparer, the taxpayer is generally several steps removed from the filing process. When a preparer e-files a tax return, he or she must transmit it through an electronic return originator (typically, a software company) to the IRS. Thus, there are four parties sequentially involved in this chain: (i) the taxpayer; (ii) the preparer; (iii) the software company; and (iv) the IRS. If the IRS rejects an e-filed tax return, it generally sends a notification back through the software company to the preparer, but

118 IRC § 6651(a)(1), (b)(1). The penalty amount is five percent of the tax due for each month or partial month the return is late, up to a maximum of 25 percent. The penalty increases to 15 percent per month up to a maximum of 75 percent if the failure to file is fraudulent. IRC § 6651(f).

119 Treas. Reg. § 301.6651-1(c)(1). See also IRM 20.1.1.3.2, Reasonable Cause (Nov. 21, 2017).

120 *Boyle*, 469 U.S. 241 (1985).

121 See, e.g., *Haynes v. United States*, 119 A.F.T.R.2d (RIA) 2017-2202 (W.D. Tex. 2017), *vacated and remanded*, *Haynes v. United States*, 760 F. App’x 324 (5th Cir. 2019); *Intruss v. United States*, 124 A.F.T.R.2d (RIA) 5420 (M.D. Tenn. 2019).

122 Pub. L. No. 105-206, § 2001, 112 Stat. 685, 723 (1998); IRC § 6011(f).

123 *Boyle*, 469 U.S. at 252.

it will not notify the taxpayer directly.¹²⁴ In these circumstances, there is no practical way for a taxpayer to ensure his or her return has been properly submitted by the preparer and accepted by the IRS. In addition, the IRS rejects e-filed returns before processing for a wide variety of reasons, and unlike with paper filing, a return that is e-filed with the IRS but rejected is not treated as timely filed.

We note that Treasury regulations exempt paid preparers from the e-filing requirements if a taxpayer provides a preparer with “a hand-signed and dated statement” that says the taxpayer chooses to file a paper return.¹²⁵ This “opt-out” will reduce a taxpayer’s risk of incurring a failure-to-file penalty. In light of the congressional directive to incentivize e-filing, however, it makes little sense for the government to tell taxpayers, in effect, that the only way they can limit their risk of incurring a failure-to-file penalty is by filing their returns on paper.¹²⁶

In *Haynes v. United States*, a married couple employed a certified public accountant to prepare and file their joint tax return.¹²⁷ The preparer timely e-filed the return, but the IRS did not accept it for processing because a taxpayer identifying number was listed on the wrong line. The preparer did not receive a rejection notice from the IRS. The preparer notified the taxpayers that their return had been timely filed. Ten months later, the IRS notified the taxpayers that their return had not been received and asserted the failure-to-file penalty.

The taxpayers requested penalty abatement for reasonable cause, asserting that they had sought to file their return timely, that their preparer had transmitted the return timely, and that both the preparer and the taxpayers believed the return had been received. The taxpayers argued that *Boyle* should not apply in the context of electronic filing because the complexities of e-filing vastly exceed the comparatively simple and verifiable task of mailing a letter. The IRS rejected the taxpayers’ position, and the taxpayers then paid the penalty and filed a refund suit in a U.S. district court. The district court concluded that the holding in *Boyle* applies to e-filed returns to the same extent as paper-filed returns and ruled in the government’s favor as a matter of law.¹²⁸ A different U.S. district court reached a similar conclusion during 2019.¹²⁹

The issue in these cases is not whether the failure-to-file penalty is applicable. There is no doubt that it is applicable if the return is filed late; rather, the issue is whether taxpayers are entitled to request abatement of the penalty on “reasonable cause” grounds. Because the *Boyle* decision used relatively sweeping language, lower courts have seemingly felt bound to apply its holding in the context of e-filed returns, notwithstanding the significant differences between paper filing and electronic filing.

124 We are recommending separately that the IRS be required to provide notice of e-filed return rejections to taxpayers directly. See National Taxpayer Advocate 2020 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration (Revise E-Filing Procedures So That Taxpayers Are Informed of E-Filing Errors and Are Not Subject to Failure-to-File Penalties When Those Errors Are Timely Corrected)*, *supra*.

125 Treas. Reg. § 301.6011-7(a)(4)(ii).

126 For context, more than half of all tax returns filed during 2018 were prepared by professionals and e-filed (80 million returns). See IRS 2018 Filing Season Statistics (week ending Nov. 23, 2018), <https://www.irs.gov/newsroom/filing-season-statistics-for-week-ending-november-23-2018>.

127 119 A.F.T.R.2d (RIA) 2202 (W.D. Tex. 2017).

128 The U.S. Court of Appeals for the Fifth Circuit vacated and remanded the district court’s decision on the ground that there was a genuine issue of material fact about whether it was reasonable for the preparer to assume, based on the IRS’s silence, that it had accepted the taxpayers’ return. The appeals court did not take a position on the *Boyle* issue of whether a taxpayer’s reliance on a preparer to e-file a tax return may constitute reasonable cause for a failure to file. *Haynes v. United States*, 760 F. App’x 324 (5th Cir. 2019). The government subsequently conceded the case, but it has not conceded the *Boyle* issue. See Keith Fogg, *Reliance on Preparer Does Not Excuse Late E-Filing of Return*, PROCEDURALLY TAXING BLOG (Sept. 4, 2019), <https://procedurallytaxing.com/reliance-on-preparer-does-not-excuse-late-e-filing-of-return>.

129 *Intress v. United States*, 124 A.F.T.R.2d (RIA) 5420 (M.D. Tenn. 2019).

While the bright-line rule embodied in *Boyle* is convenient for the IRS to administer, the nearly automatic assessment of the failure-to-file penalty for e-filed returns deemed late (often where the return was submitted by the taxpayer or preparer but rejected by the IRS) is grossly unfair and undermines the congressional policy that e-filing be encouraged. The American College of Tax Counsel shares this view and submitted a compelling *amicus curiae* brief in the appeal of the *Haynes* decision.¹³⁰

Recommendation

- Amend IRC § 6651 to specify that reasonable cause relief may be available to taxpayers that use return preparers to submit their returns electronically and direct the Secretary to issue regulations specifying what constitutes ordinary business care and prudence for e-filed returns.

¹³⁰ See Brief of American College of Tax Counsel (Nov. 27, 2017), https://www.actconline.org/wp-content/uploads/2018/02/ACTC_Amicus_Brief_Haynes.pdf.

#31 AUTHORIZE A PENALTY FOR TAX RETURN PREPARERS WHO ENGAGE IN FRAUD OR MISCONDUCT BY ALTERING A TAXPAYER'S TAX RETURN

Present Law

Internal Revenue Code (IRC) § 6694 authorizes the IRS to impose a penalty when a tax return preparer has understated a tax liability on a “return or claim for refund” and the understatement is due to willful or reckless conduct.¹³¹ IRC § 6695(f) imposes a \$500 penalty on a preparer who negotiates a taxpayer’s refund check.¹³²

Reasons for Change

TAS has handled hundreds of cases involving return preparer fraud or misconduct. In the most common scenario, a taxpayer visits a preparer to get his tax return prepared, the preparer completes the return while the taxpayer is present, and the preparer alters the return after the taxpayer leaves before submitting it to the IRS. In some cases, the items of income, deduction, and credit are accurate, but the preparer alters the direct deposit routing information so the entire refund is directed to his account instead of the taxpayer’s account. In other cases, the preparer increases the refund amount and elects a “split refund,”¹³³ so the taxpayer receives the refund amount he expects and the additional amount goes to the preparer.

The Department of Justice (DOJ) may bring criminal charges against preparers who alter tax returns, but resource constraints generally preclude criminal charges except in cases of widespread schemes. In addition, the dollar amount of a refund obtained by a preparer in these cases often will determine whether the DOJ pursues an erroneous refund suit under IRC § 7405, as resources again constrain the number of suits that can be brought each year. It is therefore important that the IRS have the authority to impose sizeable civil tax penalties against preparers who alter tax returns without the knowledge or consent of taxpayers.

Under current law, the IRS has very limited authority to impose civil penalties in instances of preparer fraud. The IRC § 6694 penalty generally will not apply to either of the scenarios described above for the following reasons:

- When a preparer has altered items of income, deduction, or credit in an attempt to increase a taxpayer’s refund after the taxpayer has reviewed and approved the return for filing, the IRS Office of Chief Counsel has concluded that the resulting document is not a valid “return or claim for refund.”¹³⁴ As a consequence, the IRC § 6694 penalty does not apply.
- When a preparer has altered only the direct deposit information on the return and has not changed the tax liability, there is no understatement of tax.

In addition, it is unclear whether the IRC § 6695(f) penalty applies. The IRS and the Treasury Department have interpreted the IRC § 6695(f) penalty as applicable to a preparer who negotiates “a check (including an

131 The amount of the penalty is per return or claim for refund and is equal to the greater of \$5,000 or 75 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

132 Similarly, Section 10.31 of Circular 230 (31 C.F.R. Part 10) prohibits a tax practitioner who prepares tax returns from endorsing or negotiating a client’s federal tax refund check.

133 Taxpayers can split their refunds among up to three accounts at a bank or other financial institution. See IRS Form 8888, Allocation of Refund (Including Savings Bond Purchases). The instructions to Form 8888 specifically advise taxpayers not to deposit their refunds into their tax return preparer’s account.

134 Program Manager Technical Advice (PMTA) 2011-20, Tax Return Preparer’s Alteration of a Return (June 27, 2011); PMTA 2011-13, Horse’s Tax Service (May 12, 2003).

electronic version of a check).”¹³⁵ It is not clear whether a “direct deposit” is legally identical to an “electronic version of a check.” Therefore, when a preparer diverts a taxpayer’s refund via direct deposit but the return is otherwise accurate, it is not clear whether the preparer’s misconduct is subject to the IRC § 6695(f) penalty. Moreover, even if the penalty is applicable, the penalty amount is typically small in relation to the size of refunds that some preparers have misappropriated.

The National Taxpayer Advocate believes the IRS should have the authority to impose civil penalties on tax return preparers who engage in fraud or misconduct by altering the return of a taxpayer for personal financial gain.

Recommendations

- Amend IRC § 6694 so the penalty the IRS may assess against a tax return preparer for understating a taxpayer’s liability is broadened beyond tax returns and claims for refund by adding the words “and other submissions.”
- Amend IRC § 6695 to explicitly cover a preparer who misappropriates a taxpayer’s refund by changing the direct deposit information and increase the dollar amount of the penalty to deter preparers from engaging in this type of fraud or misconduct. To make the public fisc whole, the penalty should be equal to 100 percent of the amount a preparer has improperly converted to his own use through fraud or misconduct by altering a taxpayer’s tax return.

¹³⁵ Treas. Reg. § 1.6695-1(f)(1).

#32 CLARIFY THE PARAMETERS FOR WRITTEN MANAGERIAL APPROVAL REQUIRED FOR PENALTY ASSESSMENTS UNDER IRC § 6751(B)

Present Law

A taxpayer who submits a return that understates the amount of tax due may be subject to an accuracy-related penalty under Internal Revenue Code (IRC) § 6662. In particular, a penalty for “negligence or disregard of rules or regulations” may be imposed under IRC § 6662(b)(1). IRC § 6662(c) defines “negligence” as “any failure to make a reasonable attempt to comply with the provisions of this title” and defines “disregard” to include “any careless, reckless, or intentional disregard.”

As a taxpayer protection, IRC § 6751(b)(1) requires that the immediate supervisor of an employee making the initial determination of a penalty assessment must personally approve the determination in writing.¹³⁶ However, penalties “automatically calculated through electronic means” are not required to receive managerial approval.¹³⁷

Reasons for Change

The purpose of penalties is to encourage voluntary compliance and deter noncompliance. Unlike penalties that can be assessed by answering a simple yes or no question (for example, the penalty for failing to file a return under IRC § 6651), the determination of whether to assess a negligence penalty requires knowledge of what actions the taxpayer took to comply with the tax laws, as well as his or her motivations for taking those actions. Negligence cannot reasonably be determined by a computer, because a computer cannot assess whether a taxpayer made a “reasonable attempt” to comply with the law.

Nevertheless, the IRS has programmed its computers to apply negligence penalties automatically as part of its Automated Underreporter (AUR) program. More specifically, the AUR program identifies discrepancies between the amounts taxpayers report on their returns and the amounts payors report via Forms W-2, Forms 1099, and other information returns, and it generally assesses penalties automatically based on discrepancies it detects. If the negligence penalty is assessed through the AUR program without an employee independently determining its appropriateness, there is no requirement for managerial approval.

An IRS employee will review a penalty assessment to make a determination of “negligence” only if a taxpayer responds to initial notices issued by AUR. There are many reasons why a taxpayer may not respond to a notice. A taxpayer may not receive it if he or she has moved and does not receive the notice. A taxpayer may put the notice aside and not get back to it before the response deadline. Or a taxpayer may accept the proposed tax adjustment but not realize he or she must respond to avoid the penalty assessment. In these and other circumstances, taxpayers may be assessed a penalty for negligence without any analysis into their reasonable

¹³⁶ This area of law has been the focus of recent litigation. In 2016, a majority of the U.S. Tax Court ruled that the written approval for an accuracy-related penalty could be given at any time prior to assessment, including while a case was in litigation before the Tax Court. As a result, the Tax Court held it was premature for it to consider an argument under IRC § 6751(b). *Graev v. Comm’r*, 147 T.C. No. 16 (2016), *vacated*, No. 30638-08 (T.C. Mar. 30, 2017). However, the decision in *Graev v. Comm’r* has since been vacated, because shortly after the decision was issued, the U.S. Court of Appeals for the Second Circuit (to which *Graev* would have been appealed) came to a different conclusion. In *Chai v. Commissioner*, the Second Circuit ruled that managerial approval for penalty assessments must be obtained before the IRS issues a notice of deficiency. *Chai v. Comm’r*, 851 F.3d 190 (2d Cir. 2017). These two rulings initially suggested a split between the majority of the Tax Court and the Second Circuit. Following the ruling in *Chai*, however, the Tax Court reversed course in a subsequent ruling in *Graev*. Taking *Chai* into account, the Tax Court ruled that it is not premature to consider an argument under IRC § 6751(b) in a deficiency proceeding, and the IRS bears the burden of production under IRC § 7491(c) to show the penalty received managerial approval. *Graev v. Comm’r*, 149 T.C. No. 23 (2017).

¹³⁷ IRC § 6751(b)(2)(B).

attempts to comply with tax laws (or lack thereof). This result undermines the protections afforded in IRC § 6751(b).

The National Taxpayer Advocate believes strongly that a computer cannot determine “negligence” — *i.e.*, whether a taxpayer has failed to “make a reasonable attempt to comply with the provisions of this title.” Therefore, when Congress authorized the IRS to impose certain penalties “automatically calculated by electronic means” without managerial approval, we do not believe Congress intended that exception to apply to negligence penalties.

In response to several judicial decisions, the IRS Office of Chief Counsel recently issued a notice instructing IRS attorneys to submit evidence of compliance with IRC § 6751(b)(1) when addressing penalty disputes.¹³⁸ If an attorney cannot find sufficient evidence of compliance, the notice says the attorney must concede the penalty. We commend the Office of Chief Counsel for taking this step, but a Counsel notice does not have the force of law and can be reversed at any time.

Recommendation

- Amend IRC § 6751(b)(2)(B) to clarify that written managerial approval is required prior to the assessment of the accuracy-related penalty imposed on the portion of an underpayment attributable to negligence or disregard of rules or regulations under IRC § 6662(b)(1) and consider clarifying which penalties or facts-and-circumstances result in penalties “automatically calculated through electronic means” that are exempt from the managerial-approval requirement.

¹³⁸ IRS Office of Chief Counsel, Notice CC-2018-006, Section 6751(b) Compliance Issues for Penalties in Litigation (June 6, 2018).

#33 COMPENSATE TAXPAYERS FOR “NO CHANGE” NATIONAL RESEARCH PROGRAM AUDITS

Present Law

There is no provision under present law that authorizes compensation of taxpayers who are audited under the IRS’s National Research Program (NRP) or provides relief from the assessment of tax, interest, and penalties that may result from an NRP audit.

Reasons for Change

Through the NRP, the IRS conducts audits of randomly selected taxpayers. The NRP benefits tax administration by gathering strategic information about taxpayer compliance behavior as well as information about the causes of reporting errors. This information helps the IRS update its workload selection formulas and thereby enables it to focus its audits on returns with relatively high likelihood of errors. It also helps the IRS to estimate the “tax gap.” In addition, NRP studies benefit Congress by providing taxpayer compliance information that is useful in formulating tax policy.

For the tens of thousands of individual taxpayers (or businesses) that are subject to NRP audits, however, they impose significant burden. In essence, these taxpayers, even if fully compliant, serve as “guinea pigs” to help the IRS improve the way it does its job. They must contend with random and intensive audits that consume their time, drain resources (including representation costs), and may impose an emotional and reputational toll.

In 1995, the House Ways and Means Subcommittee on Oversight held a hearing on the NRP’s predecessor, the Taxpayer Compliance Measurement Program (TCMP).¹³⁹ Testimony provided during the hearing and subsequent witness responses to questions-for-the-record indicated that TCMP audits imposed a heavy burden on taxpayers and reflected a strong view that audited taxpayers were bearing the brunt of a research project intended to benefit the tax system as a whole. Proposals raised at the hearing included compensating taxpayers selected for TCMP audits as well as possibly waiving tax, interest, and penalties assessed during the audits.

Subsequent to the hearing, the House Budget Committee included a proposal in its 1995 budget reconciliation bill to compensate individual taxpayers by providing a tax credit of up to \$3,000 for TCMP-related expenses.¹⁴⁰ Ultimately, this proposal was not adopted. Instead, the IRS was pressured to stop conducting TCMP audits. The inability to perform regular TCMP audits, however, undermined effective tax administration because it prevented the IRS from updating its audit formulas. Using older formulas likely meant that more compliant taxpayers faced (unproductive) audits and that audit revenue declined.

About a decade later, the IRS reinstated the TCMP under the new NRP name. Some procedures were changed, but the random selection of taxpayers and the burden on many of these taxpayers remained substantially unchanged. For the same reasons identified during the 1995 House hearing, the National Taxpayer Advocate believes it is appropriate to recognize that taxpayers audited under the NRP are bearing a heavy burden to help the IRS improve the effectiveness of its compliance activities. A tax credit or authorized payment would alleviate the monetary component of the burden. Further relief could be provided by waiving any assessment of tax, interest, and penalties resulting from an NRP audit. Such a waiver might also improve the accuracy of the NRP audits, as taxpayers might be more likely to be forthcoming with an auditor if they

¹³⁹ *Taxpayer Compliance Measurement Program: Hearing Before the H. Subcomm. on Oversight of the H. Comm. on Ways and Means*, 104th Cong. (1995).

¹⁴⁰ See H.R. REP. NO. 104-280, vol. 2, at 28 (1995).

were assured they would not face additional assessments. However, this waiver should not apply where tax fraud or an intent to evade is uncovered in an NRP audit.

Recommendation

- Amend the IRC to compensate taxpayers for no change NRP audits through a tax credit or other means. Consider waiving the assessment of tax, interest, and penalties resulting from an NRP audit, absent fraud or an intent to evade federal taxes.