REFORM PENALTY AND INTEREST PROVISIONS

Legislative Recommendation #30

Convert the Estimated Tax Penalty Into an Interest Provision to Properly Reflect Its Substance

PRESENT LAW

Through the combination of wage withholding and estimated tax payments, the 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 individual 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 due on April 15, June 15, September 15, and January 15 of the following tax year.[1] IRC § 6655 generally requires corporate taxpayers to pay at least 100 percent of the tax shown on a tax return for the current tax year or, in some cases, 100 percent of the tax shown on a tax return for the preceding tax year in four installment payments due on April 15, June 15, September 15, and December 15.

IRC §§ 6654(a) and 6655(a) provide 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 may experience significant fluctuations in their incomes and expenses from year to year. Similarly, taxpayers with sizable 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. Corporate taxpayers face similar challenges.

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 House Committee on Ways and Means 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."[2] Along these lines, the Office of the Taxpayer Advocate has conducted research studies that have found "tax morale" has an impact on tax compliance.[3]

1 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).

2 H.R. Rep No. 108-61, at 23-24 (2003).

3 *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?*).

When the IRS imposes a "penalty" on a taxpayer, there is a strong implication that the taxpayer has engaged in improper conduct. For that reason, penalties generally should be subject to waiver for reasonable cause. Under current law, the estimated tax penalty cannot be waived. Thus, an individual who experiences a fire, flood, heart attack, or other exigent circumstance that precludes payment by the estimated tax deadline will still be "penalized." This is not good for "tax morale." If the addition to tax is recharacterized as an interest charge designed solely to compensate the government for the time value of money, it would be easier to justify imposing it without waiver.

RECOMMENDATIONS

- Recharacterize the penalty for failure to pay sufficient estimated tax as an interest charge – which is the basis for the calculation. Toward that end, relocate IRC §§ 6654 and 6655 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.[4]
- If a failure to pay sufficient estimated tax continues to be treated as a penalty, enact a reasonable cause exception so that the penalty will not apply when a payment is late due to circumstances beyond the taxpayer's control, such as a fire, flood, or medical condition that makes compliance impractical.[5]

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4 For legislative language generally consistent with this recommendation, see Taxpayer Protection and IRS Accountability Act, H.R. 1528, 108th Cong. § 101 (2003).

5 For more detail on our recommendation to enact a reasonable cause exception if the additional charge for failure to pay estimated tax remains a penalty, see National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, at 34-36 (Research Study: *A Framework for Reforming the Penalty Regime*).

Legislative Recommendation #31

Apply One Interest Rate Per Estimated Tax Underpayment Period

PRESENT LAW

IRC § 6654(c) 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. Similarly, IRC § 6655(c) provides that corporations required to make installment payments submit those payments on or before April 15, June 15, September 15, and December 15.[1] Failure to make required estimated tax payments results in a penalty that is determined by the underpayment rate, the amount of the underpayment, and the period of the underpayment.

Under IRC § 6621(a)(2), the underpayment rate is equal to 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. This complexity and burden would be reduced if a single interest rate were applied for each period.

RECOMMENDATION

- Amend IRC § 6654 and IRC § 6655 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.[2]

1 To make compliance easier, the National Taxpayer Advocate has recommended that Congress set the estimated tax payment deadlines 15 days after the end of each calendar quarter (April 15, July 15, October 15, and January 15). *See* National Taxpayer Advocate 2022 Purple Book, *Adjust Individual Estimated Tax Payment Deadlines to Occur Quarterly*, *supra*.

2 For legislative language generally consistent with this recommendation, see Taxpayer Bill of Rights Enhancement Act of 2017, S. 1793, 115th Cong. § 305 (2017). If this proposal is adopted, repeal of IRC § 6621(b)(2)(B) may be required. *See also* H.R. Rep. No. 108-61, at 25 (2003); Taxpayer Protection and IRS Accountability Act, H.R. 1528, 108th Cong. § 101 (2003).

Legislative Recommendation #32

Pay Interest to Taxpayers on Excess Payments of Estimated Tax to the Same Extent Taxpayers Must Pay a Penalty on Underpayments of Estimated Tax

PRESENT LAW

Through wage withholding and estimated tax payments, Congress aims to ensure that taxes are prepaid ratably throughout the year. IRC § 3402 generally requires employers to withhold tax on wages paid to employees. IRC § 6654(g) provides that income taxes withheld from wages are deemed paid in equal amounts on the estimated tax installment due dates throughout the year unless the taxpayer establishes the dates on which the amounts were withheld. IRC §§ 6654 and 6655 generally require individual and corporate taxpayers, respectively, to prepay their tax in four installment payments. A taxpayer who fails to pay enough estimated tax will be liable for a "penalty" determined at a rate that is roughly equal to the interest rate on an underpayment under IRC § 6621 beginning on the date the estimated tax payment was due. However, the government does not pay interest on excessive estimated tax payments made by taxpayers.

IRC § 6621(a) provides that the overpayment and underpayment rates are generally the federal short-term rate, plus three percentage points (or two percentage points for corporations).[1] IRC § 6611(b)(2) provides that the government is, in practice, generally entitled to a grace period of up to 30 days before it has to pay interest. IRC § 6611(b)(3) provides that if a return is late, the government does not pay interest for any day before it is filed.

REASONS FOR CHANGE

There are at least three good reasons for the government to pay interest on excess estimated tax payments. First, it would be reciprocal and fair. The government effectively charges interest on estimated tax underpayments.[2] It seems one-sided that it does not pay interest on excess payments of estimated tax.

Second, paying interest could improve voluntary tax compliance. Experts advise taxpayers that it is foolish to make excess estimated tax payments because they are, in effect, giving the government an interest-free loan.[3] But it is difficult for taxpayers to estimate exactly how much they should pay. A telephone survey found approximately two-thirds of individual taxpayers with balances due did not plan to owe a balance upon filing.[4] Taxpayers who owe a balance upon filing are more likely than others to understate their tax liabilities.[5]

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1 Corporations receive a lower overpayment rate to the extent their overpayments exceed $10,000 and are charged a higher underpayment rate to the extent their underpayments exceed $100,000. IRC §§ 6621(a)(1)(B) & (c)(1). To the extent that interest is payable on equivalent underpayments and overpayments made by the same taxpayer, however, the net rate of interest is zero. IRC § 6621(d).

2 Technically, amounts the government charges for tax underpayments are denominated as penalties pursuant to IRC §§ 6654(a) (individuals) and 6655 (corporations), but the amounts are computed by reference to IRC § 6621, which is an interest provision. For a recommendation to convert the estimated tax penalty into an interest provision, see *Convert the Estimated Tax Penalty Into an Interest Provision to Properly Reflect Its Substance*, *supra*.

3 *See*, *e.g.*, Aimee Picchi, *Tax season 2020: Most Americans Don't Understand How Tax Refunds Work, and It Might Cost Them*, USA Today, Dec. 30, 2019.

4 *See* Wage and Investment Division (W&I), Research Group 5, Project No. 5-03-06-2-028N, Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters 7 (Jan. 16, 2004), *citing* W&I Customer Research Group 5, Causes and Potential Treatments for Underwithholding and Insufficient Estimated Payments (2000).

5 Charles Christian, Phoenix District Office of Research and Analysis, *The Association Between Underwithholding and Noncompliance* 1-2 (July 14, 1995) (finding that "[o]n average, understated tax on balance due returns is ten times as large as understated tax on other returns").

More than 20 percent of such taxpayers with a balance due fail to pay it in full.[6] Thus, if encouraging excess estimated tax payments reduces underpayments, it should improve both reporting and payment compliance. Furthermore, estimated tax overpayment interest would provide an additional incentive for taxpayers to file timely – to avoid losing the interest under IRC § 6611(b)(3). Therefore, it might also improve filing compliance.

Third, paying interest would encourage savings and encourage taxpayers to pay their tax obligations during the year that the income is earned. Paying interest on excess estimated tax payments would make it easier for taxpayers to save without buying bonds. If encouraging overpayments increases tax refunds, it could increase savings, which is an independent tax policy goal.[7]

RECOMMENDATION

- Amend IRC § 6621 to pay interest on excess estimated tax payments at the overpayment rate beginning on the due date of the payments. If Congress wishes to minimize the budget impact of this recommendation, it could cap the excess estimated tax payment amount that will bear interest for each taxpayer on an annual basis.

6 *See* W&I, Research Group 5, Project No. 5-03-06-2-028N, Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters 7 (Jan. 16, 2004).

7 *See*, *e.g.*, Michael S. Barr and Jane K. Dokko, Tax Filing Experiences and Withholding Preferences of Low- and Moderate-Income Households: Preliminary Evidence From a New Survey, 2006 IRS Research Conference 206 (2006), https://www.irs.gov/pub/irs-soi/06barr.pdf ("Our findings suggest that low- and moderate-income households may find savings plans that are tied to tax refunds… attractive").

Legislative Recommendation #33

Reduce the Federal Tax Deposit Penalty Imposed on Taxpayers Who Make Timely Tax Deposits

PRESENT LAW

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 the failure is due to reasonable cause and not due to willful neglect. The penalty rate for FTD varies, depending on the length of the taxpayer's delay in making the deposit. IRC § 6656(b)(1)(A) 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.[1] Thus, taxpayers must make deposits on time, in full, and in the correct manner to avoid a penalty for FTD.[2]

IRC § 6302(h) directs the Secretary to prescribe "such regulations as may be necessary for the development and implementation of an electronic fund transfer system which is required to be used for the collection of depositary taxes." Treas. Reg. § 31.6302-1(h) implements this directive by requiring that federal tax deposits be made electronically via electronic funds transfer. To comply with this requirement, many taxpayers use the Electronic Federal Tax Payment System (EFTPS), a free service offered by the Department of the Treasury.

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.[3] As a result, taxpayers who timely remit full payment to the IRS but who do not do so in the manner prescribed may be 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 House Ways and Means Committee has observed that this approach "does not reflect the intent of the Congress."[4]

RECOMMENDATION

- Amend IRC § 6656 to establish a penalty rate of two percent for FTDs that are fully and timely paid in a manner other than that prescribed by the Secretary of the Treasury.[5]

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1 IRC § 6656(b)(1)(B) imposes a penalty of 15 percent in certain circumstances.

2 *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]").

3 Rev. Rul. 95-68, 1995-2 C.B. 272; Internal Revenue Manual 20.1.4.2.2.1, Electronic Funds Transfer (EFT) (Feb. 9, 2018).

4 H.R. Rep. No. 108-61, at 36 (2003).

5 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).

Legislative Recommendation #34

Extend Reasonable Cause Defense for the Failure-to-File Penalty to Taxpayers Who Rely on Return Preparers to E-File Their Returns

PRESENT LAW

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 due to willful neglect (hereinafter, the "failure-to-file penalty").[1] Reasonable cause exists when a taxpayer has exercised ordinary business care and prudence but was unable to file the return within the prescribed time.[2]

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.[3] In *Boyle*, the tax return at issue was filed on paper. At least two U.S. district courts have ruled that the *Boyle* holding applies in the e-filing context as well.[4]

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.[5]

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. Treas. Reg. § 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."[6]

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 it 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 it

1 IRC § 6651(a)(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).

2 Treas. Reg. § 301.6651-1(c)(1). *See also* Internal Revenue Manual (IRM) 20.1.1.3.2, Reasonable Cause (Nov. 21, 2017).

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

4 *See*, *e.g.*, *Haynes v. United States*, 119 A.F.T.R.2d (RIA) 2202 (W.D. Tex. 2017), *vacated and remanded*, *Haynes v. United States*, 760 F. App'x 324 (5th Cir. 2019); *Intress v. United States*, 404 F. Supp. 3d 1174 (M.D. Tenn. 2019).

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

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

will not notify the taxpayer directly.[7] 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 filling, 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.[8] This "opt-out" reduces 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 they can reduce their risk of incurring a failure-to-file penalty by filing their returns on paper.[9]

In *Haynes v. United States*, a married couple employed a certified public accountant to prepare and file their joint tax return.[10] 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 return. 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. On appeal, 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. However, the appeals court did not take a position on the *Boyle* issue of whether the taxpayers' reliance on a preparer to e-file their tax return constituted reasonable cause for a failure-to-file.[11]

In 2019, a different U.S. district court reached a conclusion similar to the decision in *Haynes.*[12]

The issue in these cases is not whether the failure-to-file penalty is applicable in the first instance. Based on the wording of the statute, there is no doubt the penalty 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.

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7 IRM 3.42.5.7.2(1), Online Filing (Oct. 10, 2018).

8 Treas. Reg. § 301.6011-7(a)(4)(ii).

9 For context, nearly half of all individual income tax returns filed during 2020 were prepared by professionals and e-filed (81 million returns). *See* IRS 2020 Filing Season Statistics (week ending Dec. 11, 2020), https://www.irs.gov/newsroom/filing-season-statistics-for-week-ending-december-11-2020.

10 119 A.F.T.R.2d (RIA) 2202 (W.D. Tex. 2017).

11 *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.

12 *Intress v. United States*, 404 F. Supp. 3d 1174 (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 timely 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.[13]

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.

13 *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.

Legislative Recommendation #35

Authorize a Penalty for Tax Return Preparers Who Engage in Fraud or Misconduct by Altering a Taxpayer's Tax Return

PRESENT LAW

IRC § 6694(b) 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.[1] IRC § 6695(f) imposes a $500 penalty (adjusted for inflation) on a preparer who negotiates a taxpayer's refund check.[2]

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,"[3] 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 DOJ pursues an erroneous refund suit under IRC § 7405, as resources again constrain the number of suits that can be brought each year.[4] 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 or misconduct. 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."[5] 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.

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1 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.

2 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.

3 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) (2019). The instructions to Form 8888 specifically advise taxpayers not to deposit their refunds into their tax return preparer's account.

4 *See* Internal Revenue Manual (IRM) 21.4.5.15(6), Collection Methods for Category D Erroneous Refunds (Oct. 1, 2007) ("The erroneous refund suit is limited to amounts that exceed the litigating threshold established by the Department of Justice.").

5 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).

In addition, it is unclear whether the IRC § 6695(f) penalty applies. Treasury regulations have interpreted the IRC § 6695(f) penalty as applicable to a preparer who negotiates "a check (including an electronic version of a check)."[6] Although the IRS's internal procedures currently treat direct deposits as subject to the IRC § 6695(f) penalty, the tax code and regulations do not make clear whether a "direct deposit" is legally identical to an "electronic version of a check."[7] Moreover, even if the penalty is applicable, the penalty amount of $530 is typically small in relation to the size of refunds that some preparers have misappropriated and does not serve as a deterrent.

The National Taxpayer Advocate recommends the IRS be given 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(b) 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 purporting to be returns."
- Amend IRC § 6695 to explicitly cover a preparer who misappropriates a taxpayer's refund by changing the direct deposit information and to 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 by altering a taxpayer's tax return.

6 Treas. Reg. § 1.6695-1(f)(1).
7 *See* IRM 20.1.6.5.6, Negotiation of Check – IRC 6695(f) (Aug. 25, 2020).

Legislative Recommendation #36

Clarify That Supervisory Approval Is Required Under IRC § 6751(b) Before Proposing Penalties

PRESENT LAW

IRC § 6751(b)(1) states: "No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate." IRC § 6751(b)(2) carves out two categories of exceptions from this supervisory approval requirement: (i) the penalties for failure to file a tax return (IRC § 6651(a)(1)), failure to pay the tax due (IRC § 6651(a)(2)), and failure to pay sufficient estimated tax (IRC §§ 6654 and 6655) and (ii) any other penalty that is "automatically calculated through electronic means."

REASONS FOR CHANGE

IRC § 6751(b) protects taxpayers' *right to a fair and just tax system* by ensuring penalties are only imposed in appropriate circumstances and not used as a bargaining chip to encourage settlement.[1] However, the phrase "initial determination of [an] assessment" is unclear. A "determination" is made on the basis of calculation or research. An "assessment" is merely the entry of a decision on IRS records. Therefore, while a penalty can be determined and a penalty can be assessed, "one cannot 'determine' an 'assessment.'"[2] Due to this ambiguity in the statute, an increasing number of court cases have had to grapple with when written supervisory approval must be provided.[3] In recent years, courts have found that the supervisory approval must occur at even earlier times than previously determined:

- In 2016, the Tax Court held in *Graev v. Commissioner* (which was later vacated) that supervisory approval could occur at any point before the assessment was made.[4]
- In 2017, the U.S. Court of Appeals for the Second Circuit held in *Chai v. Commissioner* that supervisory approval was required no later than the date on which the IRS issued the notice of deficiency, or if the penalty was asserted through an answer or amended answer, the time of that filing.[5]
- In 2019, the Tax Court held in *Clay v. Commissioner* that supervisory approval was required prior to sending the taxpayer a formal communication that included the right to go to the IRS Independent Office of Appeals.[6]

In late 2019, however, the Tax Court declined to require supervisory approval prior to that point. In *Belair Woods LLC v. Commissioner*, the Tax Court found the IRS did not have to obtain supervisory approval before sending the taxpayer a Letter 1807, TEFRA Partnership Cover Letter for Summary Report, which invited the taxpayer to a closing conference to discuss proposed adjustments.[7] Instead, the court found the Letter 1807 only advised the taxpayer of the possibility that the penalties could be proposed and the pivotal moment requiring supervisory approval was when the IRS sent the 60-day letter, formally communicating its definite decision to assert the penalties.

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1 *See* S. Rep No. 105-174, at 65 (1998).
2 *Chai v. Comm'r*, 851 F.3d 190, 218-219 (2d Cir. 2017) (quoting *Graev v. Comm'r*, 147 T.C. 460 (2016) (Gustafson, J., dissenting)).
3 *See* National Taxpayer Advocate 2019 Annual Report to Congress, 149-157 (Most Litigated Issue: *Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2)*); National Taxpayer Advocate 2018 Annual Report to Congress 447-457 (Most Litigated Issue: *Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2)*).
4 147 T.C. at 460, *superseded by, in part, modified by, in part* 149 T.C. 485 (2017).
5 851 F.3d 190 (2d Cir. 2017).
6 152 T.C. 223 (2019).
7 154 T.C. No. 1, Tax Ct. Rep. Dec. (RIA) 154.1 (Jan. 6, 2020).

The IRS issued interim guidance that instructs employees to obtain written supervisory approval before sending a written communication that offers the taxpayer an opportunity to sign an agreement or consent to assessment or proposal of a penalty.[8] The interim guidance specifies that prior to obtaining written supervisory approval, employees can share written communications with the taxpayer that reflect proposed adjustments as long as they do not offer the opportunity to sign an agreement or consent, or request an Appeals conference.

However, both *Belair Woods* and the IRS's interim guidance leave open the possibility that IRS employees could use penalties as a bargaining chip – precisely what Congress sought to prevent by enacting IRC § 6751(b). Under *Belair Woods*, IRS employees can propose penalties in order to induce a resolution without first obtaining written supervisory approval, as long as the communication is deemed a proposal and not a definite decision. This approach undermines the statutory intent because, as explained in the dissent in *Belair Woods*, "[e]very communication from the Commissioner proposing a deficiency and a related penalty – whether it is a preliminary report, a 30- or 60-day letter, or a notice of deficiency – sets forth proposed adjustments, which do not become final until a decision is entered or an assessment is properly recorded."[9] The IRS's interim guidance seeks to resolve the question of what is merely a proposal versus a definite decision by drawing the line at written communications that offer a chance to agree to assessment or consent to proposal of a penalty. However, employees could still use penalties as a bargaining chip because some taxpayers may feel pressured to resolve their cases when penalties are first put on the table as proposed adjustments.

In addition to the timing issue, the statutory language of IRC § 6751(b)(1) is also problematic because of its focus on "assessment(s)." In *Wells Fargo & Company v. Commissioner*, the U.S. Court of Appeals for the Eighth Circuit found that supervisory approval under IRC § 6751(b) was not required because there was no assessment.[10] There, the IRS asserted the accuracy-related penalty in a refund suit to offset any refund granted to the taxpayer. Because the penalty, if upheld by the court, would only lead to a reduced refund and not a balance to be assessed, the court found there would be no assessment and thus no requirement for supervisory approval. Under this holding, the IRS can assert penalties in refund litigation to persuade taxpayers to settle without supervisory approval to ensure the penalties are appropriate. Thus, IRC § 6751(b)(1) should be revised to specify that supervisory approval is required in situations where the penalty is included as part of a final judicial decision.

In practice, the overwhelming majority of penalties imposed by the IRS are excluded from the supervisory approval requirement through one of the exceptions in IRC § 6751(b)(1).[11] But where written supervisory approval is required, it should be required early enough in the process to ensure it is meaningful and not merely an after-the-fact rubber-stamp applied in the limited number of cases in which a taxpayer challenges a proposed penalty.

RECOMMENDATION

- Amend IRC § 6751(b)(1) to clarify that no penalty under Title 26 shall be assessed or entered in a final judicial decision unless the penalty is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate *prior to the first time the IRS sends a written communication to the taxpayer proposing the penalty as an adjustment*.

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8 Memorandum from Director, Examination Field and Campus Policy, to Directors, Field Examination, SBSE-04-0920-0054 (Sept. 24, 2020).

9 154 T.C. No. 1, Tax Ct. Rep. Dec. (RIA) 154.1, 11 (Jan. 6, 2020) (Marvel, J., dissenting).

10 957 F.3d 840 (8th Cir. 2020), *aff'g* 260 F. Supp. 3d 1140 (D. Minn. 2017).

11 In FY 2020, the IRS imposed 40.5 million penalties on individuals, estates, and trusts in connection with income tax liabilities. The following penalties, generally imposed by electronic means, accounted for over 80 percent of the total: failure to pay (19.3 million), failure to pay estimated tax (10.7 million), failure to file (2.4 million) and bad checks (1.1 million). IRS, 2020 Data Book, Table 26, Civil Penalties Assessed and Abated, by Type of Tax and Type of Penalty, Fiscal Year 2020, at 60 (2021).

Legislative Recommendation #37

Require an Employee to Determine and a Supervisor to Approve All Negligence Penalties Under IRC § 6662(b)(1)

PRESENT LAW

IRC § 6662(b)(1) imposes a penalty equal to 20 percent of any underpayment of tax required to be shown on a tax return that is attributable to negligence or disregard of rules or regulations. IRC § 6662(c) defines "negligence" to include "any failure to make a reasonable attempt to comply with the provisions of this title" and "disregard" to include "any careless, reckless, or intentional disregard."

IRC § 6751(b)(1) provides: "No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate."[1] IRC § 6751(b)(2) carves out two categories of exception from this supervisory approval requirement: (i) the penalties for failure to file a tax return (IRC § 6651(a)(1)), failure to pay the tax due (IRC § 6651(a)(2)), and failure to pay sufficient estimated tax (IRC §§ 6654 and 6655) and (ii) any other penalty that is "automatically calculated through electronic means."

REASONS FOR CHANGE

IRC § 6751 states that the initial determination of penalties must be personally approved (in writing) by the immediate supervisor of the individual making the initial determination, subject to the exceptions described above. In the significant majority of cases, the IRS imposes penalties by electronic means, because it is easier and cheaper to do so.[2] Where the imposition of a penalty is mechanical, such as the penalties for failure to file, failure to pay, or failure to pay estimated tax, that approach is justifiable.

However, imposition of a penalty for "negligence or disregard of rules or regulations" is different. To assess whether a taxpayer made a "reasonable attempt to comply" with the law, an employee must assess both the actions the taxpayer took to comply and the taxpayer's motivations for taking those actions. A computer cannot do this.

Nevertheless, Treas. Reg. § 1.6662-3(b)(1)(i) states that negligence is strongly indicated when a taxpayer omits income from an information return on his or her income tax return. In reliance on this regulation, the IRS has programmed its computers to calculate certain negligence penalties automatically as part of its Automated Underreporter (AUR) program. For example, the AUR system proposes the negligence penalty where IRS data suggests the taxpayer failed to report income reflected on a third-party information return for a second tax year in a row.[3]

Legal advice from the Office of Chief Counsel goes further, concluding that "in the absence of any other evidence suggesting the failure was not negligent, it is appropriate to propose and subsequently assess an

1 The meaning of "initial determination of such assessment" and the timing required for approval have been the subject of litigation. *See*, *e.g.*, *Belair Woods v. Comm'r*, 154 T.C. No. 1, Tax Ct. Rep. Dec. (RIA) 154.1 (Jan. 6, 2020). For a recommendation to clarify the timing, see Legislative Recommendation: *Clarify That Supervisory Approval Is Required Under IRC § 6751(b) Before Proposing Penalties*, *supra*.

2 In FY 2020, the IRS imposed 40.5 million penalties on individuals, estates, and trusts in connection with income tax liabilities. The following penalties, generally imposed by electronic means, accounted for over 80 percent of the total: failure to pay (19.3 million), failure to pay estimated tax (10.7 million), failure to file (2.4 million) and bad checks (1.1 million). IRS, 2020 Data Book, Table 26, Civil Penalties Assessed and Abated, by Type of Tax and Type of Penalty, Fiscal Year 2020, at 60 (2021).

3 Internal Revenue Manual (IRM) 4.19.3.22.1.4, Accuracy-Related Penalties (Sept. 21, 2020).

accuracy-related penalty for negligence when a taxpayer does not include on an income tax return an amount of income shown on an information return."[4] However, the AUR system in this scenario solely checks for the presence of information returns and unreported income. It cannot determine there is no other evidence that would rebut the negligence finding, such as whether the information return was mailed to a different address than the one used by the taxpayer when filing the return or whether the information return contained an error. An employee must review the case to consider facts and circumstances that may suggest the taxpayer was not negligent.

Although the AUR program does require supervisory approval for the negligence penalty if the taxpayer submits a response,[5] there are many reasons a taxpayer may not respond. A taxpayer may have moved and not received the notice. A taxpayer may put the notice aside and not reply before the response deadline. Or a taxpayer may accept the proposed tax adjustment without realizing that he or she must respond to avoid the penalty assessment. In these and other circumstances, taxpayers may face a penalty for negligence without any analysis into their reasonable attempts to comply with tax laws. Thus, allowing a computer to determine negligence without employee involvement harms taxpayers and undermines the protections afforded by IRC § 6751(b).

RECOMMENDATION

- Amend IRC § 6751(b)(2)(B) to clarify that the exception for "other penalties automatically calculated through electronic means" does not apply to the penalty for "negligence or disregard of rules or regulations" under IRC § 6662(b)(1).

4 IRS, Program Manager Technical Advice 2008-01249 (Oct. 22, 2007).
5 IRM 4.19.3.22.1.4, Accuracy-Related Penalties (Sept. 21, 2020).

Legislative Recommendation #38

Modify the Definition of "Willful" for Purposes of Finding Report of Foreign Bank and Financial Accounts Violations and Reduce the Maximum Penalty Amounts

PRESENT LAW

U.S. citizens or residents with foreign account balances exceeding $10,000 in the aggregate during the year generally are required by 31 U.S.C. § 5314 and 31 C.F.R. § 1010.350 to report the accounts to the Financial Criminal Enforcement Network (FinCEN) in the Treasury Department. They must do so on FinCEN Form 114, Report of Foreign Bank and Financial Accounts (or FBAR). 31 U.S.C. § 5321(a)(5) imposes civil penalties for failing to report accounts. The amount depends on whether the failure was "willful" or "non-willful." The maximum penalty for a non-willful violation is $10,000 (adjusted for inflation).[1] The maximum civil penalty for a willful violation is 50 percent of the maximum account balance during the year (or, if greater, $100,000 [adjusted for inflation] per violation).[2] Under 31 U.S.C. § 5321(a)(5)(B), no penalty may be imposed for a non-willful violation if the account holder reported all income from the account and had reasonable cause for failing to file the FBAR.

The IRS has created procedures that allow some account holders to correct non-willful noncompliance if they learn about the problem early. Under its Delinquent FBAR Submission Procedures and Streamlined Filing Compliance Procedures, the IRS will not impose a penalty (or will impose a penalty of five percent) for non-willful violations if an account holder reports the accounts on an FBAR and reports and pays tax on the income from the foreign financial accounts before being contacted by the IRS about an examination or FBAR violation.[3] However, account holders who first learn of their FBAR violations when the IRS initiates an exam or contacts them about a violation are ineligible for these procedures.

REASONS FOR CHANGE

The maximum FBAR penalty is among the harshest civil penalties the government may impose. For example, if an account holder maintains a balance of $25,000 in a foreign account that he willfully fails to report, the IRS may impose a penalty of over $100,000 per year and may go back six years, producing an aggregate statutory maximum penalty of over $600,000.[4] Some commentators have suggested the penalty is so severe that it might violate the U.S. Constitution's prohibition against excessive fines.[5] Individuals who have lived in foreign countries or have immigrated to the United States often maintain foreign bank accounts and may overlook this requirement for benign reasons.

Although the Internal Revenue Manual (IRM) limits the total amount of the penalties for non-willful violations to 50 percent of the highest aggregate balance (HAB) of all unreported foreign financial accounts for all years under examination, examiners are still free to recommend a penalty of up to 100 percent of the

1 31 U.S.C. § 5321(a)(5)(B)(i); 31 C.F.R. § 1010.821.
2 31 U.S.C. § 5321(a)(5)(C), (D)(ii).
3 *See* IRS, Delinquent FBAR Submission Procedures, https://www.irs.gov/individuals/international-taxpayers/delinquent-fbar-submission-procedures (last visited Nov. 3, 2021) (no penalty if no underreporting and fixed before contact); IRS, Streamlined Filing Compliance Procedures, https://www.irs.gov/individuals/international-taxpayers/streamlined-filing-compliance-procedures (last visited Nov. 3, 2021) (five percent penalty for U.S. residents if noncompliance fixed before contact and violation was non-willful).
4 Under current guidance, the IRS is unlikely to impose such a severe penalty. *See* IRM 4.26.16.5.5, Penalty for Willful FBAR Violations (June 24, 2021) (discussed in the text below).
5 *See* Alison Bennett, *New FBAR Penalty Limits Seen Reflecting IRS Concern on Eighth Amendment Litigation*, BNA Tax Mgmt Weekly Rept (June 15, 2015).

HAB for willful violations if a manager approves.[6] Even half the HAB can be more than the current balance if the account value has declined. Account holders have argued in many cases that the harshness of the maximum penalty, particularly the "willful" penalty, is disproportionate to the reporting failure.

While the distinction between willful and non-willful violations makes sense, it generates controversy because it can be difficult for taxpayers to establish that a violation was not willful. Schedule B of Form 1040, U.S. Individual Income Tax Return, asks if the taxpayer has a foreign account and references the FBAR filing requirement. Taxpayers are presumed to know the contents of their returns when they sign the return under penalty of perjury, swearing "Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct and complete." It may be considered reckless or "willful blindness" for them not to learn about the FBAR filing requirement after having been directed to the FBAR form by Schedule B.[7] For this reason, the government might reasonably argue (and a court might reasonably find) that *any* failure to file an FBAR form is willful where a taxpayer filed a federal tax return that included Schedule B, which directs taxpayers to the FBAR filing requirement.[8]

Account holders who do not file required FBAR forms due to negligence, inadvertence, or similar non-nefarious causes may be subject to penalties for non-willful violations (which have a reasonable cause exception). But they should not face uncertainty regarding the possible application of the potentially harsh penalties for "willful" violations. The National Taxpayer Advocate recommends that Congress clarify that the IRS must prove a violation was "willful" without relying so heavily on the instructions to Schedule B or the failure to check the box on Schedule B before imposing a willful FBAR penalty.

RECOMMENDATIONS[9]

- Clarify that the government has the burden to establish willfulness before asserting a civil willful FBAR penalty and that the government cannot meet this burden by relying primarily on the Schedule B attached to a return.
- Reduce the statutory maximum civil penalty for a willful FBAR violation to the maximum penalty the IRM currently allows its examiners to assert without managerial approval (*i.e.*, no greater than 50 percent of the highest annual asset balance in the unreported account during the years of noncompliance).

6 *See* IRM 4.26.16.5.4.1, Penalty for Non-willful Violations – Calculation (June 24, 2021); IRM 4.26.16.5.5.3, Penalty for Willful FBAR Violations – Calculation (June 24, 2021). The IRS also has "mitigation" guidelines that could result in lower penalties. *See* IRM Exhibit 4.26.16-2, FBAR Penalty Mitigation Guidelines for Violations Occurring After October 22, 2004 (June 24, 2021). Commentators have suggested the IRS limited the maximum FBAR its examiners would propose to address concerns that the statutory maximums could violate the Excessive Fines clause of the Eighth Amendment to the Constitution. *See*, *e.g.*, Alison Bennett, *New FBAR Penalty Limits Seen Reflecting IRS Concern on Eighth Amendment Litigation*, BNA Tax Mgmt Weekly Rept (June 15, 2015).

7 *See*, *e.g.*, *Norman v. United States*, 942 F.3d 1111, 1115 (Fed. Cir. 2019).

8 *See*, *e.g.*, *United States v. Bohanec*, 263 F. Supp. 3d 881, 890 (C.D. Cal. 2016) (finding willful blindness, in part, because "Schedule B of Defendants' 1998 tax return put them on notice that they needed to file an FBAR," even though it was checked "yes" to indicate foreign accounts).

9 For more detail, see National Taxpayer Advocate 2014 Annual Report to Congress 331-345 (Legislative Recommendation: *Foreign Account Reporting*: *Legislative Recommendations to Reduce the Burden of Filing a Report of Foreign Bank and Financial Accounts (FBAR) and Improve the Civil Penalty Structure*).