Enhancing Voluntary Compliance Through the Administration of Civil Tax Penalties

President Obama recently called for tax reforms to create a simpler, fairer system of taxation. In 1954, there were 14 civil penalties set forth within the Internal Revenue Code ("Code"). Today, the Code is a statutory minefield of more than 130 potentially applicable civil penalties. Compliance is generally defined to include the timely filing of accurate and complete returns, payment of amounts due and reporting of all required information. Penalties must be designed and properly administered to encourage voluntary compliance and discourage intentional or reckless noncompliance. Inadvertent or excusable error should not be punished to the same degree, if at all, as willful misconduct. Civil tax penalties should be administered to encourage voluntary compliance by demonstrating the fairness of the tax system to compliant taxpayers and increasing the perceived cost of noncompliance to others.

In November 1987, the Commissioner of the IRS established a task force to study civil tax penalties. The task force, composed of representatives from the IRS and the Department of Treasury ("Treasury"), published a final report in February 1989 advocating that: (i) civil tax penalties be designed to encourage voluntary compliance, (ii) compliance—and noncompliance—be measured by clear standards of behavior and (iii) penalties be administered for the purpose of encouraging voluntary compliance and penalizing only knowing failures to comply. The Improved Penalty Administration and Compliance Tax Act of 1989 (IMPACT) completely revised the various penalty provisions relating to the accuracy of tax returns and established a new penalty “structure that operates to eliminate any stacking of the penalties.” There has been no comprehensive reform of the civil tax penalty provisions within the Code since the enactment of IMPACT in 1989.
In this environment where many continue to call for simplification and fairness in penalty administration, taxpayers and practitioners are held to various standards of knowledge, responsibility and diligence based on the most recently issued court decisions, statutes and regulations. The Internal Revenue Manual (IRM) contains a Penalty Handbook intended to serve as the foundation for addressing the administration of penalties by the IRS. It is the “one source of authority for the administration of penalties …” and provides a “fair, consistent, and comprehensive approach to penalty administration.” As such, the IRM is often the first stop for IRS examiners attempting to determine whether conduct should be subjected to further review and, potentially, civil penalties.

**Objectives in Penalty Administration**

Similar cases and similarly situated taxpayers are to be treated in a similar manner with each having the opportunity to have their interests heard and considered. Penalty relief is to be viewed from the perspective of fair and impartial enforcement of the tax laws in a manner that promotes voluntary compliance. Penalties encourage voluntary compliance by defining standards of compliant behavior, defining consequences for noncompliance and providing monetary sanctions against taxpayers who do not meet the standard. In this regard, penalty administration should be severe enough to deter noncompliance, encourage noncompliant taxpayers to comply, be objectively proportioned to the offense and be used as an opportunity to educate taxpayers and encourage their future compliance.

**IRM Approach to Penalty Administration**

The IRM’s approach to penalty administration provides:

**Consistency.** The IRS should apply penalties equally in similar situations. Taxpayers base their perceptions about the fairness of the system on their own experience and the information they receive from the media and others. If the IRS does not administer penalties uniformly (guided by the applicable statutes, regulations and procedures), overall confidence in the tax system is jeopardized.

**Accuracy.** The IRS must arrive at the correct penalty decision. Accuracy is essential. Erroneous penalty assessments and incorrect calculations confuse taxpayers and misrepresent the overall competency of the IRS.

**Impartiality.** 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.

**Representation.** Taxpayers must be given the opportunity to have their interests heard and considered. Employees need to take an active and objective role in case resolution so that all factors are considered.

**Relief Due to Reasonable Cause**

Many penalties may be avoided based upon a determination that reasonable cause existed for the positions maintained within a return. Reasonable cause is based on a review of all relevant facts and circumstances in each situation and allows the IRS to provide relief from a penalty that would otherwise be assessed. Reasonable cause relief is generally granted when the taxpayer exercises ordinary business care and prudence in determining their tax obligations, but nevertheless failed to comply with those obligations. Ordinary business care and prudence includes making provisions for business obligations to be met when reasonably foreseeable events occur. A taxpayer may establish reasonable cause by providing facts and circumstances showing that they exercised ordinary business care and prudence (taking that degree of care that a reasonably prudent person would exercise), but nevertheless were unable to comply with the law.

Taxpayers have reasonable cause when their conduct justifies the nonassertion or abatement of
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A comprehensive review of the civil tax penalty structure within the Code is long overdue. Penalties should not be enacted for the purpose of raising revenue or offsetting the costs of tax benefits nor merely to punish behavior without also promoting compliance. Most taxpayers attempt to comply with their filing and payment obligations under the Code. Others comply because of a concern for the imposition of penalties. Somewhere in between are taxpayers who are subjected to penalties for conduct they failed to realize was somehow wrongful. In most situations, the IRS has the experience and dedicated staff to make the proper determination. The penalty provisions set forth within the Code must retain the discretion of the IRS to appropriately punish those most deserving and not punish what are, at most, an inadvertent foot-faults.

Those who carelessly or recklessly ignore their responsibilities should be appropriately penalized. Those who appropriately respect their obligations to our system of taxation should be cautioned and educated about their present and future tax compliance without having to waltz through an almost unintelligible legislative minefield of civil tax penalties.

## Endnotes

2. IRM 20.1.1.1.1 (02-22-2008).
7. Penalty Policy Statement 20-1 (IRM 1.2.20.1.1; June 29, 2004).
8. IRM 20.1.1.2.1 (02-22-2008).
9. IRM 20.1.1.2.2 (02-22-2008).
10. IRM 20.1.1.3.2 (02-22-2008).
11. IRM 20.1.3.2.2 (02-22-2008).
12. IRM 20.1.3.3.2.1 (12-11-2009).
13. IRM 20.1.3.3.2.2 (12-11-2009).
14. Code Sec. 6404(f) and Reg. $301.6404-3.
15. See IRM 20.1.5, Return Related Penalties and Reg. §1.6664–4(c).
17. Id.
18. Id.