

# Practice

*By Charles P. Rettig*

## 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.<sup>1</sup> 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.<sup>2</sup> 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.<sup>3</sup> The Improved Penalty Administration and Compliance Tax Act of 1989 (IMPACT)<sup>4</sup> 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.”<sup>5</sup> There has been no comprehensive reform of the civil tax penalty provisions within the Code since the enactment of IMPACT in 1989.



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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 ... .”<sup>6</sup> 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.

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## 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.<sup>7</sup> 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.<sup>8</sup>

## 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.<sup>9</sup>

## 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.<sup>10</sup> 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.<sup>11</sup>

Taxpayers have reasonable cause when their conduct justifies the nonassertion or abatement of

a penalty. Each case must be judged individually based on the relevant facts and circumstances. Examiners are to consider various factors in determining penalty relief based on reasonable cause. What happened and when did it happen? During the period of time the taxpayer was noncompliant, what facts and circumstances prevented the taxpayer from filing a return, paying a tax and/or otherwise complying with the law? How did the facts and circumstances result in the taxpayer not complying? How did the taxpayer handle the remainder of their affairs during this time? Once the facts and circumstances changed, what attempt did the taxpayer make to comply?

Death, serious illness or unavoidable absence of the taxpayer may establish reasonable cause for filing, paying or delinquent deposits. Information examiners consider when evaluating a request for penalty relief based on reasonable cause due to death, serious illness or unavoidable absence includes, but is not limited to, the relationship of the taxpayer to the other parties involved; the date of death; the dates, duration and severity of illness; the dates and reasons for absence; how the event prevented compliance; if other business obligations were impaired; and if tax duties were attended to promptly when the illness passed, or within a reasonable period of time after a death or return from an unavoidable absence.<sup>12</sup>

Explanations relating to the inability to obtain the necessary records may constitute reasonable cause in some instances, but may not in others. Reasonable cause may be established if the taxpayer exercised ordinary business care and prudence, but due to circumstances beyond the taxpayer's control, they were unable to comply. Relevant information includes, but is not limited to, an explanation as to why the records were needed to comply; why the records were unavailable and what steps were taken to secure the records; when and how the taxpayer became aware that they did not have the necessary records; if other means were explored to secure needed information; why the taxpayer

did not estimate the information; if the taxpayer contacted the IRS for instructions on what to do about missing information; if the taxpayer promptly complied once the missing information was received; and supporting documentation such as copies of letters written and responses received in an effort to get the needed information.<sup>13</sup>

**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.**

### **Reliance on Advice**

In certain situations, reliance on the advice of others may justify relief from penalties. Information to consider

when evaluating a request for abatement or non-assertion of a penalty due to reliance on advice includes, but is not limited to, a determination of whether the advice in response to a specific request and was the advice received related to the facts contained in that request, and if the taxpayer reasonably relied upon the advice. The taxpayer is entitled to penalty relief for the period during which they relied on the advice. The period continues until the taxpayer is placed on notice that the advice is no longer correct or no longer represents the IRS's position.

The IRS is required to abate any portion of any penalty attributable to erroneous written advice furnished by an officer or employee of the IRS acting in their official capacity.<sup>14</sup> Administratively, the IRS has extended this relief to include erroneous oral advice when appropriate. Relevant inquiries include: Did the taxpayer exercise ordinary business care and prudence in relying on that advice? Was there a clear relationship between the taxpayer's situation, the advice provided and the penalty assessed? What is the taxpayer's prior tax history and prior experience with the tax requirements? Did the IRS provide correct information by other means (such as tax forms and publications)? What type of supporting documentation is available?

Reliance on the advice of a tax advisor generally relates to the reasonable cause exception in Code Sec. 6664(c) for the accuracy-related penalty under Code Sec. 6662.<sup>15</sup> However, in certain situations, reliance on the advice of a tax advisor may provide relief

from other penalties when the tax advisor provides advice on a substantive tax issue.

## First Time Abatement

The IRS Reasonable Cause Assistant (RCA) is a decision-support interactive software program developed to reach a reasonable cause determination.<sup>16</sup> The RCA will be used when considering penalty relief due to reasonable cause. RCA is to be used after normal case research has been performed, (*i.e.*, applying missing deposits/payments, adjusting tax or researching for missing extensions of time to file, etc.) for the Failure to File (FTF), Failure to Pay (FTP) and Failure to Deposit (FTD) penalties.

RCA provides an option for penalty relief for the FTF, FTP and/or FTD penalties if the taxpayer has not previously been required to file a return or if no prior penalties (except the Estimated Tax Penalty) have been assessed on the same account in the prior three years.<sup>17</sup> If RCA determines a “First-Time Abate” is applicable, the taxpayer will be advised that the penalty(s) was removed based solely on their history of compliance, that this type of penalty removal is a one-time consideration available only for a first-time penalty charge and that any future (FTF, FTP, FTD) penalties will only be removed based on information that meets reasonable cause criteria.<sup>18</sup>

## Summary

Civil tax penalty administration pending any potential comprehensive tax reform must continue to promote and enhance voluntary compliance. Penalties should only be imposed in proportion to the misconduct. The IRS should continue to implement administrative systems to avoid automatic assessments of accuracy-related penalties without considering all of the facts and circumstances, while clearly defining the behavior to be penalized. Taxpayers and practitioners need clear, transparent and detailed guidance on the interpretation of penalties.

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

- <sup>1</sup> Speech by President Barack Obama at George Washington University on April 13, 2011 and Fact Sheet: The President's Framework for Shared Prosperity and Shared Fiscal Responsibility (April 13, 2011).
- <sup>2</sup> IRM 20.1.1.1.1 (02-22-2008).
- <sup>3</sup> Report on Civil Tax Penalties, Commissioner's Executive Task Force on Civil Penalties, Internal Revenue IRS (Feb. 22, 1989).
- <sup>4</sup> Improved Penalty Administration and Compliance Tax Act of 1989 (IMPACT) (P.L. 101-239); Subtitle G of the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) contained the IMPACT.
- <sup>5</sup> H.R. Conf. Rep. No. 101-386, 101st Cong., 1st Sess. (1989) at 194.
- <sup>6</sup> IRM 20.1.1.1.1 (02-22-2008). Refer to IRM 9.1.3, Criminal Investigation—Criminal Statutory Provisions and Common Law for Criminal Penalty provisions.
- <sup>7</sup> Penalty Policy Statement 20-1 (IRM 1.2.20.1.1; June 29, 2004).
- <sup>8</sup> IRM 20.1.1.2.1 (02-22-2008).
- <sup>9</sup> IRM 20.1.1.2.2 (02-22-2008).
- <sup>10</sup> IRM 20.1.1.3.2 (02-22-2008).
- <sup>11</sup> IRM 20.1.3.2.2 (02-22-2008).
- <sup>12</sup> IRM 20.1.1.3.2.2.1 (12-11-2009).
- <sup>13</sup> IRM 20.1.1.3.2.2.3 (12-11-2009).
- <sup>14</sup> Code Sec. 6404(f) and Reg. §301.6404-3.
- <sup>15</sup> See IRM 20.1.5, Return Related Penalties and Reg. §1.6664-4(c).
- <sup>16</sup> IRM 20.1.1.3.6.1 (12-11-2009).
- <sup>17</sup> *Id.*
- <sup>18</sup> *Id.*

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