MSP #17 ACCURACY RELATED PENALTIES: The IRS Assessed Penalties Improperly, Refused to Abate Them, and Continues to Assess Them Automatically, Violating Taxpayer Rights and Reducing Respect for the Law

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DEFINITION OF PROBLEM

In 2012, in a reversal of prior advice, the IRS Office of Chief Counsel determined that the IRS was not authorized to impose an accuracy-related penalty under Internal Revenue Code (IRC) § 6662 against taxpayers for claiming refundable credits that it had frozen (*i.e.*, not actually paid or credited to the account).[1] Yet, the IRS declined to identify and abate (or refund) more than $40 million in penalties that it imposed against more than 46,000 taxpayers prior to changing its position.[2] The IRS's failure to expend the resources needed to remove these improper and inapplicable penalties signals disrespect for the law and a disregard for taxpayer rights, which in turn, is likely to reduce voluntary tax compliance.[3]

The IRS's decision not to abate inapplicable penalties illustrates its resource-driven approach to them. As described in prior reports, the IRS continues to propose penalties automatically when they might apply — before performing a careful analysis of the relevant facts and circumstances — and then burdens taxpayers by requiring them to prove the penalties do not apply.[4] For example, in fiscal year (FY) 2012 the IRS sent over 93,000 (CP 2000) letters as part of its matching program, which proposed nearly $100 million in accuracy-related penalties without first contacting the taxpayers to determine the reason for the apparent mismatch.[5] Thus, contrary to congressional intent, the IRS automatically *assumes* the taxpayer acted negligently and places the burden on the taxpayer to prove otherwise.[6]

In particular, this automated approach imposes a disproportionate burden on unsophisticated taxpayers who have difficulty communicating with the IRS or do not understand the relevant facts and legal rules.

1 Program Manager Technical Advice (PMTA) 2012-16 (May 30, 2012) (concluding that the claim for a refund that is frozen by the IRS does not give rise to an underpayment, as defined in IRC § 6664, to which an accuracy-related penalty could apply).

2 IRS Compliance Data Warehouse, Individual Master File (Nov. 26, 2013).

3 Research suggests that sole proprietors who believe the government, the IRS, and the tax laws are fair are more likely to comply. *See* National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, 1-28. *Accord* National Taxpayer Advocate 2013 Annual Report to Congress, vol. 2, *infra (Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?)*; IRM 20.1.1.1.3(4) (Dec. 11, 2009) ("A wrong [penalty] decision, even though eventually corrected, has a negative impact on voluntary compliance.").

4 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress 275; National Taxpayer Advocate 2010 Annual Report to Congress 198; Most Serious Problem: *The IRS Inappropriately Bans Many Taxpayers From Claiming EITC*, *infra/supra*.

5 IRS Compliance Data Warehouse, Individual Master File (Nov. 26, 2013) (excluding taxpayers who first received CP 2501, which the IRS sometimes uses to inquire about an apparent discrepancy). Moreover, the IRS abated about 20 percent of the tax it assesses through AUR in FY 2012. IRS Compliance Data Warehouse, Individual Master File (Dec. 17, 2013).

6 *See* H.R. Rep. No. 101-386, at 661 (1989) (Conf. Rep.) (directing the IRS to "make a correct substantive decision in the first instance rather than mechanically assert penalties with the idea that they will be corrected later.").

The National Taxpayer Advocate is concerned the IRS may take the same automated approach to the new penalty under IRC § 6676, which applies to excessive claims for credit or refund.

ANALYSIS OF PROBLEM

A refundable credit claim can give rise to an "underpayment" triggering an accuracy-related penalty, according to the IRS.

A taxpayer who submits a return that is not accurate (*i.e.*, reflects an "underpayment") may be subject to an accuracy-related penalty under IRC § 6662. For example, the penalty may apply if the error is "substantial" or if the IRS determines the taxpayer was negligent. Generally, an "underpayment" is W - (X+Y-Z) where:

- W = the correct amount of tax required to be shown on the return;
- X = the tax reported (actually shown) on the return;
- Y = the amount not shown, but previously assessed (or collected without assessment); and
- Z = certain rebates.[7]

It has long been unclear whether or how refundable credits, such as the Earned Income Tax Credit (EITC), the First-Time Homebuyer Credit, (FTHBC), the Additional Child Tax Credit (ACTC), and the Economic Stimulus Payment (ESP) are included in this computation, or how the analysis changes if the IRS has refunded, credited, or frozen these credits.[8] However, the IRS has taken the position that a refundable credit claim can produce an underpayment, and if the underpayment is attributable to a substantial understatement or negligence, the IRC § 6662 penalty applies.[9] In general, the IRS believes these claims reduce the amount shown on the taxpayer's return (W, above).[10] Thus, it continues to impose substantial understatement penalties against taxpayers who make improper credit claims (provided they are not frozen, as discussed below).

7 IRC § 6664(a)(1)-(2); Treas. Reg. § 1.6664-2(a)(1)-(2).

8 *See, e.g.*, TAM 2841039058 (Mar. 21, 1998) (acknowledging disagreements between Examination and Counsel); SCA 200113028 (Feb. 26, 2001) (concluding penalty is applicable on frozen EITC refunds, but acknowledging a contrary conclusion in prior advice); *Akhter v. Comm'r*, T.C. Summ. Op. 2001-20 (concluding frozen refund claims could not give rise to underpayments); *Solomon v. Comm'r*, Summ. Op. 2008-95 (same); CCA 200851079 (Dec. 19, 2008) ("The court [in *Solomon*] seems to have gotten it wrong"); PMTA 2010-01 (Nov. 20, 2009) (the regulations "do not specifically address how to factor the FTHBC into the formula for calculating an underpayment"); PMTA 2011-03 (Aug. 27, 2010) (addressing confusion); PMTA 2012-16 (May 30, 2012) ("We have reconsidered our advice…"). *See also* Carlton Smith, *IRS Wrongly Ignores the 20 Percent Excessive Refund Penalty*, 2013 TNT 39-10 (Feb. 27, 2013) (discussing longstanding uncertainty).

9 *See, e.g.*, TAM 2841039058 (Mar. 21, 1998); SCA 200113028 (Feb. 26, 2001); CCA 200851079 (Dec. 19, 2008); PMTA 2011-03 (Aug. 27, 2010); PMTA 2012-16 (May 30, 2012). For individuals, a "substantial understatement" penalty may apply if an understatement exceeds the greater of $5,000 or ten percent of the tax required to be shown on the return. *See* IRC § 6662(d)(1)(A)(i)-(ii). Understatements generally must be reduced by any portion attributable to (1) an item for which the taxpayer had substantial authority; or (2) any item for which the taxpayer adequately disclosed the relevant facts affecting the item's tax treatment, provided the taxpayer had a reasonable basis for such treatment. IRC § 6662(d)(2)(B).

10 PMTA 2012-16 (May 30, 2012). The Tax Court recently agreed, in part, with the IRS, holding that for purposes of computing the IRC § 6662 penalty a refundable credit claim reduces the amount shown on the taxpayer's return. *See Rand v. Comm'r*, 141 T.C. No. 12 (2013) [hereinafter *Rand*]. However, it disagreed with the IRS's computation of the penalty, holding that the claim could not reduce the amount shown below zero. *Id*.

In 2012, the Office of Chief Counsel determined it was not appropriate to impose the accuracy-related penalty for "frozen" refundable credit claims.

On May 30, 2012, the IRS Office of Chief Counsel changed its position, as advocated by TAS.[11] It concluded that when a taxpayer claimed a refundable tax credit that the IRS had frozen, there could be no underpayment of tax, and consequently the IRC § 6662 penalty was not applicable. Counsel reasoned that a frozen refundable credit is an amount "assessed or collected without assessment" (Y, above). Thus, if the only error on a return is a frozen refundable credit claim, which is treated as collected, there is no "underpayment" (*i.e.*, W and Y cancel each other out). Without an underpayment, the accuracy-related penalty (including the substantial understatement penalty) does not apply.[12]

The IRS abated some improper penalties, but not others.

The IRS continued imposing substantial understatement penalties on frozen refund claims for about ten months after receiving the May 30, 2012 guidance. Following additional advocacy by TAS, the IRS identified and abated the penalties imposed on frozen refunds between June 1, 2012 and March 31, 2013, as shown in the following table.

TABLE 1.17.1, Substantial Understatement Penalty Abatements on Frozen Credit Refund Claims[13]

Type of Work	Total Cases	Total Abatements
EITC	99,303	$131,450,817
Discretionary	9,471	11,395,629
Total	**108,774**	**$142,846,446**

However, the IRS has not identified and abated (or refunded) penalties imposed on other similarly-situated taxpayers before June 1, 2012.[14] For example, the IRS has failed to remove over 46,000 penalties totaling more than $40 million that it imposed in the two and a half years between the issuance of the first Counsel opinion (November 20, 2009) (which Counsel has implicitly acknowledged was incorrect) and the most recent Counsel opinion (May 30, 2012).[15] Moreover, it is still trying to collect over $20 million in accuracy related penalties improperly assessed against more than 23,000 taxpayers.[16]

11 After TAS questioned the position taken by Counsel in PMTA 2010-01 (Nov. 20, 2009) and PMTA 2011-03 (Aug. 27, 2010), the Office of Chief Counsel revised this advice. See PMTA 2012-16 (May 30, 2012).

12 This change does not affect the IRS's position that it may assert the accuracy-related penalty (including the substantial understatement penalty) for refundable credit claims that it has not frozen. While the court's holding in *Rand* confirms that refundable credit claims can trigger an accuracy-related penalty, its analysis suggests the penalty would only apply to the portion of the credit(s) used to reduce the tax otherwise due.

13 IRS response to TAS information request (May 10, 2013) (reflecting abatements from June 1, 2012 to March 31, 2013).

14 The IRS's only explanation is that IRS Office of Chief Counsel advised, in an unpublished email, that the IRS is not required to abate these penalties. Email from Attorney, IRS Office of Associate Chief Counsel (P&A) to Senior Analyst, SBSE Campus Compliance Services, Exam Policy (Sept. 12, 2012). According to the IRS, however, it is working to estimate the volume of cases involving similarly situated taxpayers. IRS response to TAS information request (Nov. 20, 2013).

15 IRS Compliance Data Warehouse, Individual Master File (Nov. 26, 2013).

16 *Id*.

In other contexts, the IRS has failed to minimize taxpayer burden by proposing penalties automatically, before making more than a *de minimis* effort to determine if they apply.

The IRS's administration of penalties sometimes prioritizes automation and efficiency rather than accuracy and fairness. For example, before it can be sure if a penalty for negligence applies, the IRS needs to determine if the taxpayer was actually negligent or if an error was due to reasonable cause and not willful neglect.[17] As shown in the following table, however, the IRS may use different levels of effort to communicate with taxpayers and ascertain the reason for an apparent discrepancy before proposing a penalty, depending on the type of examination or matching program.

TABLE 1.17.2, Procedures for Proposing Accuracy-Related Penalties by Program

Program	Significant address research? [18]	Common letter to propose penalty	Examiner's contact information on letter? [19]	Examiner discusses reason(s) for the discrepancy before penalty asserted? [20]	Penalty assessed if taxpayer not located? [21]
Field Exam	Yes	Letter 950 [22]	Yes	Yes	Not usually
Office Exam	Yes	Letter 915 [23]	Yes	Yes	Not usually
Corr. Exam	No	Letter 525 [24]	No	No	Yes
Automated Underreporter	No	Letter CP 2000 [25]	No	No	Yes

If a mismatch occurs with respect to the same item of income reported by a third party but not reported on the return in more than one year, the IRS's Correspondence Examination and Automated Underreporter (AUR) functions automatically propose a negligence penalty.[26] AUR often does so in the

17 IRC §§ 6662, 6664(c)(1); Treas. Reg. § 1.6664-4(b)(1).

18 *Compare* IRM 4.10.2.7.2 (Apr. 2, 2010) (describing how field and office exam employees may use asset locator services, postal traces, credit reports, internet searches, IDRS searches, third party contacts, research of related TINs, and personal visits to locate the taxpayer) *with* IRM 4.19.13.13 (Jan. 1, 2013) (discussing how corr. exam employees research addresses using IRDRs); IRM 4.19.3.19.2 (Sept.1, 2013) (discussing AUR's review of other correspondence to find an updated address); IRM 4.19.3.20.11.2 (Sept. 1, 2013) (discussing AUR default procedures, which do not include additional address research).

19 *See* IRM 4.10.1.5.3.2(4) (May 14, 1999) ([For field and office exams] "[A]ll correspondence must contain an employee name, contact telephone number, employee identification number, and signature"). While corr. exam and AUR letters include a general number, an examiner may not be assigned to a case in corr. exam or AUR unless the IRS receives a response to its computer-generated letters. *See, e.g.*, IRM 4.19.20.1(1) (Jan. 1, 2013). Accordingly, the IRS cannot list the examiner's name or number.

20 For field and office exams, employees are required to communicate with the taxpayer before asserting penalties. *See* IRM 4.10.6.3.5 (May 14, 1999) ("To ensure the proper consideration and appropriate application of penalties, it is very important to solicit the taxpayer's explanation for adjustments"); IRM 4.10.6.4(3) (May 14, 1999) ("The assertion of penalties, including alternative positions, should be discussed with the taxpayer and/or representative prior to issuing an examination report"). These requirements do not apply in corr. exam or AUR. *See, e.g.*, IRM 4.19.13.5.3 (Jan. 1, 2013) ("[when documenting penalties on a lead sheet] the taxpayer's position must be addressed [only] if the taxpayer responds to the Exam report and addresses the underpayment in the response.").

21 *Compare* IRM 4.10.2.7.2.7 (Apr. 2, 2010) (for field and office exams a penalty is not assessed unless non-assessment would undermine compliance) *with* IRM 20.1.5.7.1(5)(a) (Jan. 24, 2012) (indicating corr. exam will assert the negligence penalty even if a taxpayer is not located); IRM 20.1.5.3.1(2) (Jan. 24, 2012) (discussing how AUR may automatically assert negligence or substantial understatement penalties when a taxpayer does not respond); IRM 4.19.3.16.5 (Sept. 1, 2012) (same for substantial understatement); IRM 4.19.3.16.6 (Sept. 1, 2008) (same for negligence/disregard).

22 IRM 4.10.8.11 (Aug. 11, 2006).

23 *Id*.

24 IRM 4.19.10.1.6 (Feb., 24, 2011).

25 IRM 4.19.3.1 (Sept. 1, 2012).

26 *See, e.g.*, IRM 4.119.4.18.1.4 (Oct. 1, 2012) (BMF AUR); IRM 4.19.3.16.6 (Sept. 1, 2008) (IMF AUR); IRM 20.1.5.7.1(5)(a) (Jan. 24, 2012) (indicating that corr. exam should assert negligence based on a mismatch in a single year if the taxpayer does not respond).

The IRS's general approach to accuracy-related penalties burdens taxpayers by requiring them to prove the penalties are inapplicable.

first letter it sends to the taxpayer that identifies a deficiency (*i.e.*, the CP 2000).[27] The IRS issued 4.5 million CP 2000s in FY 2012.[28] Over 93,000 of these letters proposed nearly $100 million in accuracy-related penalties before the IRS inquired about the discrepancy or called the taxpayer.[29]

The IRS's automatic penalty assessment procedures, which do not even require IRS employees to make outgoing calls (unless the taxpayer responds to a letter)[30] to determine whether the taxpayer was negligent or had "reasonable cause," ignore direction from Congress that the IRS should "make a correct substantive decision in the first instance rather than mechanically assert penalties with the idea that they will be corrected later."[31] Other stakeholders have expressed similar concerns.[32] Penalties that the IRS automatically proposes do not take the taxpayer's effort to comply into account — at least not before being proposed. The latest research also suggests that administering penalties in this way may reduce long-term voluntary compliance by those who are subject to them.[33]

The IRS's general approach to accuracy-related penalties burdens taxpayers by requiring them to prove the penalties are inapplicable.[34] This approach violates taxpayer rights and imposes a disproportionate burden on unsophisticated taxpayers who have difficulty communicating with the IRS or do not understand the relevant facts and legal rules — precisely the taxpayers that Congress intends to benefit with many refundable credits, such as the FTHBC.[35]

The National Taxpayer Advocate is concerned the IRS may take the same automated approach to the new penalty under IRC § 6676, which applies to excessive claims for credit or refund.

Notwithstanding the IRS's practice of imposing a substantial understatement penalty on those claiming refundable credits, the Treasury Department requested and received legislation in 2007 to impose a new

27 In some cases, AUR sends a CP 2501, which asks about the discrepancy before sending the CP 2000. IRM 4.19.3.6 (Sept. 1, 2010).

28 IRS Data Book, *Table 14, Information Reporting Program* (FY 2012), http://www.irs.gov/uac/SOI-Tax-Stats-Information-Reporting-Program-IRS-Data-Book-Table-14.

29 IRS Compliance Data Warehouse, Individual Master File (Nov. 26, 2013). This figure omits the accuracy-related penalties assessed in FY 2012 as a result of AUR cases opened in earlier periods. It also omits taxpayers who received a CP 2000 only after receiving a letter (CP 2501) inquiring about the reason for the discrepancy.

30 Exam generally sends Letter 566 to ask for documentation before sending Letter 525 to propose a deficiency and penalty. IRM 4.19.10.4.10.1 (Jan. 1, 2013). However, even Exam will only try to call the taxpayer if it receives a response. *See* IRM 4.19.13.11 (Jan. 1, 2013).

31 H.R. Rep. No. 101-386, at 661 (1989) (Conf. Rep.). *See also* IRC § 6751(b)(1) (generally requiring penalties to be personally approved by a supervisor before assessment unless automatically calculated through electronic means).

32 American Institute of Certified Public Accountants (AICPA), *Report on Civil Tax Penalties: The Need for Reform* (Aug. 28, 2009) ("[I]ncreasingly, penalties are assessed using automated processes … without the benefit of pre-assessment rights to pursue reasonable cause and other defenses. In many instances, taxpayers pay penalties even if they are unwarranted because it is so difficult and costly to challenge a penalty once it is assessed."). American Bar Association (ABA) Tax Section, *Comments Concerning Possible Changes to Penalty Provisions of the Internal Revenue Code* (1999) ("Automatic assertion, followed by abatement, is far less satisfactory than assertion after inquiry, because taxpayers resent being penalized first and then having to prove compliance, and because many penalties that are asserted and paid probably should never have been assessed."). *See also* IRM 20.1.1.2.2(1)(b) (Nov. 25, 2011) ("[E]rroneous penalty assessments and incorrect calculations confuse taxpayers and misrepresent the overall competency of the IRS.").

33 National Taxpayer Advocate 2013 Annual Report to Congress, vol. 2 *infra*, *(Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?)*.

34 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress 275; National Taxpayer Advocate 2010 Annual Report to Congress 198; Most Serious Problem: *The IRS Inappropriately Bans Many Taxpayers from Claiming EITC*, *infra/supra*.

35 For a discussion of taxpayer rights, including the rights to be informed, heard, and pay no more than the correct amount of tax see, *e.g.*, National Taxpayer Advocate 2011 Annual Report to Congress 493-518.

penalty for excessive claims for credit or refund under IRC § 6676.[36] It applies to claims (other than those involving the EITC) to which the penalty under IRC § 6662 does not apply.[37]

The National Taxpayer Advocate is concerned that the IRS may similarly apply the new penalty under IRC § 6676 any time a claim for a refundable credit trips whatever "filters" the IRS has established, even if the IRS freezes the claim and does not make a payment to the taxpayer.[38] Because this new penalty contains no reasonable cause exception, such an approach would turn many refundable credits into traps for the unwary.

CONCLUSION

The IRS has improperly assessed accuracy related penalties, has refused to abate them on assessments made prior to June 1, 2012, and continues to assess them automatically without properly determining that they actually apply. The National Taxpayer Advocate is concerned the IRS may take the same automated approach to the new penalty under IRC § 6676, which applies to excessive claims for credit or refund.

RECOMMENDATIONS

The National Taxpayer Advocate recommends the IRS:

1. Identify and abate (or refund) all accuracy-related penalties on frozen refundable credit claims for all open years.[39]
2. If a court determines that accuracy-related penalties do not apply to refundable credit claims that the IRS has paid, and the IRS does not appeal, then identify and abate (or refund) all such penalties on open years.[40]
3. In the meantime, the IRS should direct attorneys handling refundable credit cases involving IRC § 6662 penalties to notify the court and opposing counsel (or *pro se* petitioner) if the IRS is pursuing a larger penalty than would apply under the Tax Court's recent analysis in *Rand*.
4. Avoid proposing the new penalty under IRC § 6676 automatically (*i.e.*, before contacting the taxpayer, considering the facts, and determining that it actually applies).
5. Work with the Treasury Department to seek an amendment to IRC § 6676 to provide a reasonable cause exception, as previously recommended by the National Taxpayer Advocate.

36 For a discussion of the Treasury's request and recommendations to improve this new penalty, see National Taxpayer Advocate 2010 Annual Report to Congress 544-47.

37 IRC § 6676(d).

38 For a discussion of the problems with pre-refund filters, see, *e.g.*, National Taxpayer Advocate 2011 Annual Report to Congress 15-27; National Taxpayer Advocate 2011 Annual Report to Congress 28-47.

39 PMTA 2012-16 (May 30, 2012). The IRS may abate penalties erroneously assessed if it has not collected them. IRC § 6404. Similarly, the IRS may refund any penalties the taxpayer already paid if the period of limitations for filing a claim for refund remains open. IRC § 6511.

40 If the IRS decides to follow *Rand*, it should abate accuracy-related penalties applied to refundable credits (even if not frozen) to the extent the IRS treated them as reducing the tax shown as due below zero.