IMPROPERLY BURDENED: THE UNCERTAIN AND SOMETIMES UNFAIR APPLICATION OF TAX PENALTIES

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I. INTRODUCTION

For the past seventeen years, the Internal Revenue Service (the "IRS") and the U.S. Tax Court (the "Tax Court") have unfairly penalized unrepresented taxpayers by ignoring safeguards Congress established in reaction to widely-perceived IRS abuses. Those safeguards were enacted when Congress passed the Internal Revenue Service Restructuring and Reform Act in 1998 (the "IRS Reform Act").[1] While the IRS Reform Act stopped many of the more egregious abuses, it has thus far failed to provide the meaningful penalty protections Congress sought.

Prior to passage of the IRS Reform Act, the IRS routinely imposed tax penalties without indicating to taxpayers either the statutory basis for the penalty or how the penalty was calculated.[2] In addition, lower-level IRS examiners assessed penalties against taxpayers without any supervisory approval,[3] which led to the widespread belief that either the IRS was penalizing taxpayers indiscriminately, or using the penalty to strengthen its negotiating position with taxpayers.[4] In the time leading up to enactment, the Senate noted protections were needed because "taxpayers are entitled to an explanation of the penalties imposed upon them … [and] penalties should only be imposed where appropriate and not as a bargaining chip."[5]

The IRS Reform Act was intended to balance the playing field between the IRS and taxpayers. To meet those goals, the IRS Reform Act added three new provision in two new sections[6] of the Internal Revenue Code ("Code") requiring: (i) the IRS to include detailed information about the basis for penalties, as well as the penalty calculations,[7] (ii) IRS supervisors to approve, in writing, all

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1 Pub. L. 105-206, Title III, §3001(a), 112 Stat. 726 (Jul. 22, 1998).

2 *See* H.R. CONF. REP. 105-599, at 260 (1988).

3 *Id*.

4 *See* Philip Jones, *The Burden of Proof 10 Years After the Shift*, 121 TAX NOTES 287, 307 (Oct. 20, 2008) [hereinafter Jones, *10 Years After the Shift*].

5 S. REP. 105-174, at 65 (1988).

6 Unless otherwise indicated, all references herein to "section" refer to the Internal Revenue Code of 1986, as amended. Tax Reform Act of 1986, Pub. L. 99–514, § 2, 100 Stat. 2095.

7 *See* I.R.C. § 6751(a).

discretionary penalties,[8] and (iii) the IRS to bear the burden of production with respect to tax penalties in court proceedings.[9]

While the IRS has generally met the first provision, it has routinely avoided the second and ignored the third. Although the second requirement requires supervisory approval of non-discretionary penalties, the IRS fails to provide taxpayers with any proof that such approval was obtained, and, in at least two recent cases, has argued that taxpayers have no redress if such approval was not obtained. In addition, the IRS has chosen to narrow the definition of discretionary penalties in order to avoid the law.

The third provision requires the IRS to shoulder the "burden of production" with respect to tax penalties in court proceedings. To meet that burden of production, the IRS must generally proffer sufficient facts on the record for a court to justify the imposition of penalties (akin to making a *prima facie* showing that penalties are appropriate).[10] Despite the clear language of the statute, however, the IRS has been able to escape that burden due to (i) a Tax Court rule that is contrary to the law but nevertheless followed by the court, and (ii) the lack of sophistication of most unrepresented taxpayers.

The problems described above are not trivial: last year alone, over 30,000 cases were filed in the Tax Court, and over 18,000 of those cases were filed *pro se*.[11] It is those unrepresented taxpayers

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[8] *See* I.R.C. § 6751(b)(1). Written approval is required only for non-automatic penalties, such as the accuracy-related penalty under section 6662. Other automatic penalties, such as the failure-to-file or failure-to-pay penalties under section 6651, are exempted from section 6751(b). *See* § 6751(b)(2).

[9] *See* I.R.C. § 7491(c).

[10] *See* Joni Larson, *Burden of Proof in the Tax Court after the IRS Restructuring and Reform Act of 1998 and* Shea v. Commissioner 36 Gonz. L. Rev. 49, 55-6 (2001) ("In general, the burden of production requires the party upon whom it is placed to present prima facie evidence to entitle that party to have an issue decided by the trier of fact," citing Senter v. Commissioner, 70 T.C.M. 54, 56 (1995) and Nathan E. Clukey, *Examining the Limited Benefits of the Burden of Proof Shift*, 82 TAX NOTES 683, 686 (1999);).

[11] The U.S. Tax Court does not provided detailed statistics regarding the number of cases filed *pro se*. However, in her 2012 Annual Report to Congress, the National Taxpayer Advocate reported that 63 percent of the most litigated issues were filed by pro se taxpayers. *See* NATIONAL TAXPAYER ADVOCATE 2012 ANNUAL REPORT TO CONGRESS 562–63, *available at*

who are most affected by the improper application of the IRS Reform Act. Unsurprisingly, those same taxpayers are more than twice as likely to lose their cases, even in cases in which the IRS and the courts have acknowledged that the penalties should never have been assessed in the first place.[12]

To provide a notion of the scope of the problem, in 2013, the IRS assessed about $1.5 billion in discretionary, accuracy-related penalties, yet that same year abated about $532 million of those same types of penalties,[13] based in part on IRS errors and taxpayer challenges.[14] Unrepresented taxpayers are often unprepared to mount such challenges, based in part on the procedural hurdles put in place by the IRS and the Tax Court. For unrepresented taxpayers, the ability to follow those procedures is analogous to a first-year law student's ability to file a lawsuit against the government on the first day of law school. The problem is worse, however, for those unrepresented taxpayers, because unlike first-years, they often have neither an undergraduate degree (and generally good grades) nor an interest in studying and understanding the law. Those procedural hurdles are heightened by the IRS's and the Tax Court's failure to enforce the IRS Reform Act's penalty protections, and those failures have generated ripple effects throughout the tax system.

As currently enforced, unrepresented taxpayers with legitimate penalty defenses often discover too late that they have unknowingly waived their ability to challenge penalties. That is particularly troubling because, in many of those cases, the Tax Court had already determined the penalties were inappropriate to begin with.

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http://www.taxpayeradvocate.irs.gov/2012-Annual-Report/downloads/Volume-1.pdf [hereinafter 2012 NTA ANNUAL REPORT].

12 *Id*. at 563.

13 An abatement is a reduction of assessed penalties. The IRS may approve an abatement of a penalty for: IRS error; reasonable cause; administrative and collection costs not warranting collection of penalty; discharge of penalty in bankruptcy; and the IRS's acceptance of partial payment of assessed penalty.

14 *See* IRS DATA BOOK (FY 2013) (Table 17), *available at* http://www.irs.gov/uac/SOI-Tax-Stats-Civil-Penalties-Assessed-and-Abated-by-Type-of-Tax-and-Type-of-Penalty-IRS-Tax-Stats-Table-17. While the IRS does not provide specific data on the cause of the abatements, it lists IRS error and reasonable causes as the first of a list of possible explanations. *See id*. at n.4.

If at this point the reader is wondering what all the fuss is about, a 2013 case helps make it plain. In *Rand v. Commissioner* (*"Rand"*),[15] the Tax Court issued its first precedential opinion[16] on whether certain refundable tax credits (available generally only to low-income taxpayers—the group least likely to be represented) should be included in the IRS underpayment calculation,[17] the basis for the accuracy-related penalty.[18] Prior to *Rand*, the IRS included improperly claimed refundable tax credits in its underpayment calculation, which had the effect of increasing the penalty.[19] In *Rand*, the Tax Court held that improperly claimed refundable tax credits should be excluded from underpayment calculations, and, as a result, the IRS method of computing penalties based on improperly EITC claims ("*Rand*-type penalties") was wrong.

As a result of *Rand*, it became clear that thousands of low-income taxpayers had been over-penalized for as long as the IRS had improperly computed the penalty, dating back to at least

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[15] 141 T.C. 376 (2013).

[16] The Tax Court issues four types of opinions: division opinions, memorandum opinions, bench opinions, and summary opinions. Only division opinions are treated as controlling precedent. *See* Hon. Mary Ann Cohen, *How to Read Tax Court Opinions*, 2000 Hous. Bus. & Tax L.J. 1, 7-10 (2000).

[17] The Tax Court reached effectively the same result in three prior non-precedential opinions. *See* Carlton Smith, *Seven Tax Court Judges Depart from the Court's Penalty Pleading Precedents*, PROCEDURALLY TAXING (Mar. 24, 2014), *available at* http://www.procedurallytaxing.com/seven-tax-court-judges-depart-from-the-courts-penalty-pleading-precedents/ [hereinafter Smith, *Seven Tax Court Judges*].

[18] *See* I.R.C. § 6662. The accuracy-related penalty is generally 20 percent of the underpayment. *See* § 6662(a). Section 6664(a) defines underpayment as "the amount by which any tax imposed by this title exceeds the excess of—

> (1) the sum of—
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> (A) the amount shown as the tax by the taxpayer on his return, plus
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> (B) amounts not so shown previously assessed (or collected without assessment), over
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> (2) the amount of rebates made."

I.R.C. § 6664(a).

[19] In *Rand,* the court decided that how certain refundable credits should be used to calculate a taxpayer's underpayment, which is the basis of the accuracy-related penalty under section 6662. *See* Del Wright, *Bogus Refunds and Bad Penalties*–[forthcoming, Akron L.R.] [hereinafter Wright, *Bogus Refunds*].

1998.[20] The harm caused by those improper penalties was not trivial: in tax year 2000 alone, the IRS issued 17,300 deficiency notices to low-income taxpayers that asserted *Rand*-type penalties.[21] Extending that to 2013, when *Rand* was decided, hundreds of thousands of taxpayers were likely over-penalized based on the IRS's improper calculations. Unfortunately for many low-income taxpayers, however, *Rand* was not the first time the IRS had improperly computed refundable tax credit penalties.

In 2012, the IRS acknowledged another mistake with respect to penalties based on refundable credits—this time with respect to "frozen refunds," i.e., tax refund requests based on refundable credits that taxpayers claimed, but the IRS never paid. Prior to 2012, the IRS included unpaid frozen refunds in its underpayment calculation, which, as in the *Rand* case, increased the penalty. Yes, you read that correctly: the IRS penalized taxpayers based on refunds the taxpayers *never received*.[22] In a 2012 memo,[23] the IRS acknowledged that it had improperly included frozen refunds in its penalty calculations dating back to 2009, based on two internal memos concluding incorrectly that frozen refunds should be

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[20] *See* TREASURY INSPECTOR GEN. FOR TAX ADMIN., THE LAW WHICH PENALIZES ERRONEOUS REFUND AND CREDIT CLAIMS WAS NOT PROPERLY IMPLEMENTED (Sept. 26, 2013), *available at* http://www.treasury.gov/tigta/auditreports/2013reports/201340123fr.pdf [hereinafter 2013 TIGTA REPORT].

[21] Carlton Smith, Rand v. Commissioner*: Tax Court Holds the IRS Miscomputes Accuracy-Related Penalties on Refundable Credit Disallowances*, PROCEDURALLY TAXING (Nov. 19, 2013), *available at* http://www.procedurallytaxing.com/rand-v-commissioner-tax-court-holds-the-irs-miscomputes-accuracy-related-penalties-on-refundable-credit-disallowances/.

[22] There is a law passed in 2007 that penalizes improper refund claims based on refundable credits, section 6676. However, that law has not been effective. *See* 2013 TIGTA REPORT, *supra* note 18, at 2. The report noted that section 6676 penalties have not been assessed because (i) IRS administration had failed to provide guidance to employees about when the penalty should be assessed, and (ii) IRS Counsel had provided incorrect legal guidance to IRS employees regarding the IRS's authority to assess the erroneous refund penalty. *Id.* at 10.

[23] *See* IRS Chief Counsel Memorandum, CC:PA:01:GSemasek POSTS-119273-12 (May 30, 2012), *available at* http://www.irs.gov/pub/lanoa/pmta_2012-16.pdf; *see also* 2013 TIGTA REPORT, *supra* note 18, at 5.

included in the underpayment calculation.[24] Nevertheless, even after acknowledging its penalty calculations were incorrect in 2012, the IRS continued to impose the same penalties on taxpayers for another ten months.[25] To make matters worse, the agency also "failed to remove over 46,000 penalties totaling more than $40 million that it imposed" between 2009 and 2012 based on those internal memos.[26]

In addition to the punitive dollar costs to taxpayers in improper penalties, the IRS has also used its penalty powers to deny thousands of taxpayers the right to claim certain credits for years into the future, contrary to both the law and the IRS's own guidance. This failure stems from how the IRS, by strictly interpreting the term "penalty" and ignoring its own guidance, disallows millions of dollars of Earned Income Tax Credits ("EITC") with little more than a suspicion of an improper claim.

The EITC, one of the government's largest anti-poverty programs, is a refundable tax credit that allows low-income taxpayers to reduce their federal tax liability to zero and have any unused portion of the credit refunded to them.[27] As a way to

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[24] *See* IRS Chief Couns. Mem., CC:PA:01 POSTS-128277-09, Examples 1, 2, 6 (Nov. 20, 2009), *available at* http://www.irs.gov/pub/lanoa/pmta_2010-01.pdf (showing a pre-refund example in which a taxpayer's section 6662 penalty calculation was determined based on an improperly claimed, but unpaid, refundable tax credit); IRS Chief Couns. Mem., CC:PA:01: GSemasek POSTN-125498-10, Example 2 (Aug. 27, 2010), *available at* http://www.irs.gov/pub/lanoa/pmta-2011-003.pdf (including the unpaid refund amount in the underpayment calculation). See also Jennifer Bird-Pollan, *Who's Afraid of Redistribution? An Analysis of the Earned Income Tax Credit*, 74 MO. L. REV. 251, 254 (2009); Hilary Hoynes, *The Earned Income Tax Credit, Welfare Reform, and the Employment of Low-Skilled Single Mothers*, CHICAGO FED. RESERVE BANK (Aug. 22, 2008); Robert Moffitt & Benjamin Cowan, *Trends in Income Support*, in CHANGING POVERTY, CHANGING POLICIES 203, 212 (2009); Jonathan P. Schneller, The Earned Income Tax Credit and the Administration of Tax Expenditures, 90 N.C. L. REV. 719, 725 (2012); Susannah Camic Tahk, The Tax War on Poverty, 56 AZ. L. REV. 791 (May 2014), citing John Karl Scholz.

[25] 2013 TIGTA REPORT, *supra* note 18, at 10.

[26] *Id*.

[27] *See* IRS, *EITC & Other Refundable Credits*, *available at* http://www.eitc.irs.gov/EITC-Central/abouteitc. *See also* Gene Falk & Margot L. Crandall-Hollick, *The Earned Income Tax Credit (EITC): An Overview*, Congressional Research Service (Dec. 3, 2014), *available at*

discourage taxpayers from making improper EITC claims, Congress enacted section 32(k), which gave the IRS the power to ban taxpayers from claiming the EITC if the IRS determined a taxpayer made either a knowing, or at least reckless, claim for the EITC.[28] Thus, at a minimum, the IRS should be required to determine that the taxpayer acted with the requisite *mens rea* to impose the ban, i.e., that the taxpayer was at least reckless. However, the IRS has routinely imposed the ban based on nothing more than a taxpayer's failure to respond to successive IRS notices, despite an IRS Chief Counsel memo explaining that imposing the ban in such circumstances was improper.[29]

The abuse of the EITC ban, as well as the *Rand* and frozen refund fiascos, highlight the reasons the penalty protections in the IRS Reform Act need to be revisited and strengthened. That need is especially acute for low-income taxpayers, whose only option may be to represent themselves *pro se* before the Tax Court, the only forum that does not require pre-payment of the tax liability before a court challenge. The changes needed, as set forth herein, will neither encourage bad behavior by taxpayers, nor unduly burden the IRS. Instead, those changes will balance the scales as Congress intended.

Part II of this Article begins by exploring the impetus for the IRS Reform Act, which ultimately led to the enactment of sections 6751 and 7491, the two penalty protection statutes. It also highlights both the basis for some of those law's compromises, as well as one of the more colorful characters involved in their enactment. Part II concludes by examining the procedural and practical application of tax penalties, as well as the mechanisms taxpayers may employ to challenge those penalties.

Part II serves as a primer for Part III, which discusses how sections 7491(c) and 6751(b) have been largely disregarded, and

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http://fas.org/sgp/crs/misc/R43805.pdf ("In 2012, a total of $64.1 billion was claimed by 27.8 million tax filers (19% of all tax filers), making the EITC the largest need-tested anti-poverty cash assistance program.").

28 *See* I.R.C. § 32(k).

29 *See* I.R.S. Chief Couns. Mem. No. 200245051 (Nov. 8, 2002) ("A taxpayer's failure to adequately respond to a request from the Service for substantiation and verification of EIC alone is not sufficient to be considered reckless or intentional disregard of the rules . . . .").

how such pretermissions have had a detrimental effect on taxpayers. It also explains why sections 7491(c) and 6751(b), unlike other provisions in the IRS Reform Act, should have a more substantive effect on IRS actions than the law, as currently interpreted, has provided. Part III also highlights cases and issues affected by the misapplication of sections 7491(c) and 6751(b), beginning with *pro se* tax litigation, which makes up the gravamen of all federal tax litigation. Next, it demonstrates how that misapplication has trickled down to affect how the IRS applies penalties in other contexts, particularly against unrepresented taxpayers.

Part IV sets forth proposed changes to the sections 7491(c) and 6751(b), and how those provisions are interpreted. It also proposes extending the IRS Reform Act's penalty protections to taxpayers claiming the EITC. The Article concludes by making the case that many of the problems identified in this Article could be avoided if, consistent with Congress's own recommendation, front line IRS personnel become involved in assisting Congress draft legislation. With such involvement, both Congress and the IRS could draft better legislation, and prevent issues from becoming problems in the first place.

II. FEDERAL TAX PENALTY LAW

Prior to the IRS Reform Act, the last time Congress undertook a comprehensive reform of the Code's penalty provisions was 1989.[30] One goal of that reform was to "develop better information concerning the administration and effects of penalties" to ensure that penalty provisions, as well as the IRS's administration of them, promoted voluntary compliance.[31] The IRS Reform Act sought to strengthen those goals and make the IRS "an efficient, responsive, and respected agency that acts appropriately in carrying out its functions."[32]

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[30] *See* Executive Task Force for Internal Revenue Commissioner's Penalty Study, A Philosophy of Civil Tax Penalties (Discussion Draft), *reprinted in* 111 DTR L-1 1988, 9-10 (June 9, 1988); *see also* H.R. REP. NO. 101-386, at 661 (1989) (Conf. Rep.).

[31] H.R. REP. NO. 101-386, at 661 (1989) (Conf. Rep.).

[32] *See* H. REP. No. 105-364, Pt. 1, at 34–35 (1997) and S. REP. NO. 105-174, at 11–12 (1998).

A. The IRS Reform Act of 1998

The IRS Reform Act passed through Congress with overwhelming support: the U.S. House of Representatives approved it by a vote of 426 to 4,[33] and the Senate followed suit shortly thereafter by a unanimous 97–0 vote.[34] President Clinton wasted no time in signing the bill into law.[35]

The law sought to accomplish a number of goals: chief among them were provisions to "protect taxpayers in their dealings with the IRS."[36] To achieve that goal, Congress enacted a number of governance measures to "provide the IRS with more stable oversight, create greater transparency for taxpayers, and provide taxpayers with forums to express their viewpoints to the IRS."[37]

Among its provisions, the IRS Reform Act created:

- the IRS Oversight Board, a nine-member independent body, charged to oversee the IRS and with the express authority to approve IRS budgets and strategies;[38]
- the National Taxpayer Advocate ("NTA"), who is required to provide an annual report to Congress, which, among other mandatory items, includes a summary of at least twenty of the most serious problems encountered by

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[33] *See* FINAL VOTE RESULTS FOR ROLL CALL 577, *available at* http://clerk.house.gov/evs/1997/roll577.xml.

[34] *See* U.S. SENATE ROLL CALL VOTES 105TH CONGRESS—2ND SESSION, *available at* http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?&congress=105&session=2&vote=00126.

[35] *See* David Cay Johnston, *New IRS Law: A Guide to Shifting Burdens*, N.Y. TIMES (July 26, 1998), *available at* http://www.nytimes.com/1998/07/26/business/spending-it-earning-it-new-irs-law-a-guide-to-shifting-burdens.html.

[36] Robert Manning & David Windish, *The IRS Restructuring and Reform Act: An Explanation*, 98 TAX NOTES TODAY 128-104 (July 6, 1998).

[37] Treasury Inspector Gen. for Tax Admin., *The Internal Revenue Service Restructuring and Reform Act of 1998 Was Substantially Implemented but Challenges Remain* (Mar. 1, 2010), *available at* http://www.treasury.gov/tigta/iereports/2010reports/2010IER002fr.html [hereinafter TIGTA, Restructuring and Reform Act].

[38] *See* IRS Reform Act, Title I, § 1101.

taxpayers with corresponding recommendations for administrative and legislative actions;[39] and

- the Treasury Inspector General for Tax Administration ("TIGTA"), the independent Inspector General office in the Department of the Treasury devoted to oversight of the IRS.[40]

When Congress passed the IRS Reform Act in 1998, it believed that its tax writing committees should hear directly from IRS front-line technical experts with respect to the administrability of amendments to the Code. The IRS Reform Act sought to accomplish that goal by providing:

> It is the sense of the Congress that the Internal Revenue Service should provide Congress with an independent view of tax administration, and that during the legislative process, the tax writing committees of Congress should hear from front-line technical experts at the Internal Revenue Service with respect to the administrability of pending amendments to the Internal Revenue Code of 1986.[41]

As of 2015, the IRS has yet to establish a process to encourage such discussions.

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[39] The NTA is a position appointed by the Secretary of the Treasury, after consultation with the IRS Commissioner and the IRS Oversight Board. The individual appointed is required to have a background in customer service as well as tax law and experience in representing individual taxpayers. The NTA reports directly to the IRS Commissioner. *See* IRS Reform Act, Title I, § 1102.

[40] The TIGTA is charged with conducting audits, investigations, and evaluations of IRS programs and operations (including the IRS Oversight Board) to promote the economic, efficient, and effective administration of the nation's tax laws and to detect and deter fraud and abuse in IRS programs and operations. In this regard, the TIGTA specifically is directed to evaluate the adequacy and security of IRS technology on an ongoing basis. In addition, the TIGTA is responsible for protecting the IRS against external attempts to corrupt or threaten its employees. *See* TIGTA, RESTRUCTURING AND REFORM ACT, *supra* note 36.

[41] IRS Reform Act, Title IV, § 4021.

An Interesting Legislative History

How the IRS Reform Act came about is somewhat atypical of most legislation, but explains much about the law. The IRS Reform Act was championed by Congressman James Traficant, who, prior to running for Congress, was indicted for racketeering and, among other things, filing a false income tax return in 1980.[42] Traficant, who was not a lawyer, represented himself at trial and won an acquittal.[43] Based in part on his success against the government and the publicity surrounding his trial, Traficant was elected to Congress in 1984.[44]

The same year he was elected, the IRS asserted Traficant failed to report over $100,000 in bribes on his 1980 tax return and that he owed taxes on those unreported bribes.[45] The IRS also charged Traficant with a civil fraud penalty for knowingly failing to report the bribes on his tax returns.[46] Traficant fought the IRS in Tax

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[42] Traficant was convicted of corruption in 2002 and was expelled from Congress by a vote of 420–1, becoming only the second member of Congress expelled since the Civil War. He died Sept. 27, 2014. *See* Matt Schudel, *James A. Traficant Jr., Colorful Ohio Congressman Expelled by House, Dies at 73*, WASH. POST, Obituary (Sept. 27, 2014), *available at* http://www.washingtonpost.com/politics/james-a-traficant-jr-colorful-ohio-congressman-expelled-by-house-dies-at-73/2014/09/27/fa98868a-4431-11e4-9a15-137aa0153527_story.html.

[43] According to Traficant, he was "the only American ever to defeat [the Justice Department] pro se in a RICO trial." *See* transcript of *On the Record with Greta Van Susteren*, Sept. 10, 2009, *available at* http://www.foxnews.com/story/2009/09/11/exclusive-traficant-was-target-must-have-been-doing-something-right/.

[44] *See* Kim Palmer, *James Traficant of Ohio, Former Congressman and Felon, Is Dead*, REUTERS (Sep. 27, 2014), *available at* http://www.reuters.com/article/2014/09/27/us-usa-traficant-idUSKCN0HM0MA20140927 ("Publicity from that trial was Traficant's springboard to Congress.").

[45] Under U.S. law, all forms of income, both legal and illegal, are subject to federal income tax. *See* I.R.C. § 62; *see also* IRS, YOUR FEDERAL INCOME TAX, PUBLICATION 17, *available at* http://www.irs.gov/publications/p17/ch12.html (noting "Income from illegal activities, such as money from dealing illegal drugs, must be included in your income").

[46] *See* Traficant v. Commissioner, 884 F.2d 258 (6th Cir. 1989) ("The gravamen of the fraud ruling was that Traficant took $108,000 in bribes from two competing factions of organized crime during his campaign for sheriff of

Court. At the trial, he admitted to taking some bribes, but denied that the bribes amounted to over $100,000 and asserted his Fifth Amendment privilege in response to certain IRS questions about the exact amount of bribes.[47] The Tax Court found against Traficant and the Sixth Circuit affirmed the Tax Court's judgment.[48]

Traficant's troubles with the IRS are relevant to this Article because they explain, at least in part, some of the choices Congress made in passing the IRS Reform Act.[49] Prior to the IRS Reform Act, IRS determinations were deemed correct and taxpayers bore the burden of proving that the IRS was incorrect.[50] That precedent, around since almost the inception of the U.S. income tax,[51] meant that Traficant had to prove, by a preponderance of the evidence, that the IRS was incorrect in its determination of the quantum of bribes.[52] However, the Tax Court prevented Traficant from

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Mahoning County, Ohio, knowing that bribes are taxable income, and that he nevertheless failed to report this income in an effort to evade tax.").

47 The IRS had tape recordings of two meetings in which Traficant and others had conversations. The IRS sought, through interrogatories, to have Traficant either admit the tapes accurately reflected the conversations, or, if not, to explain what conversations actually took place. *See* Traficant v. Commissioner, 89 T.C. 501, 502–3 (1987).

48 *See* Traficant v. Commissioner, 89 T.C. 501 (1987); Traficant v. Commissioner, 884 F.2d 258 (6th Cir. 1989).

49 *See generally* Adriana Wos-Mysliwiec, The Internal Revenue Restructuring and Reform Act of 1998: Does It Really Shift the Burden of Proof to the IRS?, 14 J. C.R. & ECON. DEV. 301, 307 (1999).

50 *See* Welch v. Helvering, 290 U.S. 111 (1933) (citing Wickwire v. Reinecke, 275 U.S. 101 (1927)).

51 See Steve Johnson, *The Dangers of Symbolic Legislation: Perceptions and Realities of the New Burden-of-Proof Rules*, 84 IOWA L. REV. 413 (Mar. 1999). Johnson stated:

> In civil tax litigation, however, it was settled, before enactment of § 7491, that the burden of proof typically was on the taxpayer, usually dischargeable through a preponderance of the evidence. That rule enjoyed long tenure. The burden was placed on the taxpayer virtually from the beginning of the modern income tax, and that allocation had antecedents in federal tax law in the 1800s.

Id. at 416 (internal citations omitted).

52 "Petitioner bears the burden of proving by a preponderance of the evidence that the deficiency determined by respondent is not correct. [Tax Court] Rule 142(a); Welch v. Helvering, 290 U.S. 111 (1933)." *Traficant*, 89 T.C. at 522.

testifying or offering evidence about the amount of the bribes because he had asserted his Fifth Amendment privilege.[53]

Traficant appealed his case to the Sixth Circuit, arguing that the Tax Court improperly denied, based on his assertion of his Fifth Amendment privilege, his ability to rebut the IRS determination regarding the exact amount of bribes.[54] In its ruling, the Sixth Circuit held that such denial was one of the "costs imposed in exchange for" asserting the privilege, and found that Traficant failed to rebut the IRS presumption of correctness and therefore failed to meet his burden of proof.[55]

As you may imagine, Traficant was displeased; not only with the court's holding, but also with the rules giving the IRS the presumption of correctness and requiring him to disprove the IRS determinations. He believed it was the government's job to prove its case against him, not his job to disprove government allegations. While in Congress, Traficant took great lengths to highlight what he deemed the unfairness of the system, and often took to the floor of the House of Representatives to give speeches decrying the "Gestapo tactics" of the IRS.[56]

Based in part on Traficant's speeches and the attention he generated regarding the burden of proof issue, the drafters of the IRS Reform Act enacted section 7491(a), a law that, on its face at least, shifted the burden of proof to the IRS in civil tax cases with respect to the tax liability. The reality was quite different.

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[53] *Traficant*, 89 T.C. at 503-5.

[54] Traficant v. Commissioner, 884 F.2d 258 (6th Cir. 1989).

[55] Traficant v. Commissioner, 884 F.2d 258, 265 (6th Cir. 1989).

[56] *See* James Traficant, Address to House of Representatives (Sep. 3, 1997) ("I hope the IRS gets their assets kicked all the way up to their gestapo tactics. The IRS, after all, has deserved it; the IRS has earned it"); *see also* James Traficant, Address to Address to House of Representatives, (Sep. 30, 1997) ("The White House is defending an agency [the IRS] that has become absolutely a Gestapo-type agency, un-American, out of control. I am totally convinced that at the White House they are out for soup with the group; they have gone for lunch with the bunch; and they must be smoking dope, so help me God."). Both speeches are available at http://www.jim-traficant.com/minutearchive/1997minutspeeches.html.

a. Section 7491(a)

Section 7491(a), enacted as part of the IRS Reform Act, reads in pertinent part:

> If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed . . ., the [IRS] shall have the burden of proof with respect to such issue.[57]

Sponsors of that provision claimed that it would no longer permit the IRS "to treat taxpayers as 'guilty until proven innocent.'"[58] However, section 7491(a) did next to nothing to change the law, and some have argued that it was "deliberately designed to fail nearly all the time because of the conditions attached therein before the burden is shifted."[59] To understand why, one first has to look at the law prior to the IRS Reform Act.

Prior to section 7491(a)'s enactment in 1988, an IRS notice of deficiency was presumed correct, and the taxpayer had the burden of showing that the notice was incorrect.[60] To satisfy that burden, the taxpayer had to produce evidence contrary to the notice (the burden of production) sufficient to rebut the presumption of

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[57] I.R.C. § 7491(a)(1).

[58] See Wm. Brian Henning, *Reforming the IRS: The Effectiveness of the Internal Revenue Service Restructuring and Reform Act of 1998*, 82 Marq. L. Rev. 405, 411 (1999) *citing* statement of Rep. Weller, 143 CONG. REC. H10003 (daily ed. Nov. 5,1997).

[59] Section 7491(a) is ineffective because it was enacted with "conditions and exceptions [that] are so broad that they essentially swallow the rule." *See* Johnson, *supra* note 48. *See also* Carlton Smith, *The Congressman James Traficant Memorial Code Section*, PROCEDURALLY TAXING (Sep. 30, 2014), *available at* http://www.procedurallytaxing.com/the-congressman-james-traficant-memorial-code-section/.

[60] *See* Welch v. Helvering, 290 U.S. 111, 115 (1933); Moretti v. Commissioner, 77 F.3d 637, 643 (2d Cir. 1996); Schaffer v. Commissioner, 779 F.2d 849, 857 (2d Cir. 1985); Petzoldt v. Commissioner, 92 T.C. 661, 687 (1989); *cf.* U.S. TAX CT., RULES OF PRACTICE & PROCEDURE 142, *available at* https://www.ustaxcourt.gov/notice.htm (last updated June 5, 2013). *See also* Philip N. Jones, *The Burden of Proof Under the '98 Act—Not Much Substance Under All That Smoke*, 90 J. TAX'N 133 (1999) [hereinafter Jones, *Not Much Substance*].

correctness of the IRS notice (burden of proof).[61] To meet the burden of production, the taxpayer could either present evidence challenging the factual findings in the notice[62] or showing that the notice was based on an erroneous view of the law.[63] If the taxpayer's presentation of evidence rebutted the notice's presumption of correctness, the Tax Court would decide the case based on the merits,[64] but the taxpayer would still bear the ultimate burden of proof.[65] In reality, however, the party bearing the burden of proof rarely makes a difference, because "in nearly all cases, … the result is determined by the preponderance of the evidence, and thus the result would have been the same regardless of which party bore the burden of proof."[66]

The IRS Reform Act did little to change that prior law. Under section 7491(a), the burden of proof shifts to the IRS only <u>after</u> the taxpayer introduces credible evidence with respect to a factual issue. That credible evidence standard is nothing more than a reworded burden of production, i.e., the same requirement

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[61] Schaffer v. Commissioner, 779 F.2d 849, 857–58 (2d Cir. 1985); Hoffman v. Commissioner, 298 F.2d 784, 788 (3d Cir. 1962); Am. Pipe & Steel Corp. v. Commissioner, 243 F.2d 125, 126–27 (9th Cir. 1957).

[62] Erickson v. Commissioner, 937 F.2d 1548, 1551 (10th Cir. 1991); Foster v. Commissioner, 391 F.2d 727, 735 (4th Cir. 1968); Herbert v. Commissioner, 377 F.2d 65, 69 (9th Cir. 1966).

[63] *See* Clinton Cotton Mills, Inc. v. Commissioner, 78 F.2d 292, 295 (4th Cir. 1935); Estate of Bryan v. Commissioner, 22 T.C.M. 864 (1963), *aff'd*, 364 F.2d 751 (4th Cir. 1966).

[64] *See, e.g.*, Jesse Goode v. Commissioner, T.C.Memo 2006-48. In its discussion regarding the parties' dispute about the burden of proof, the court noted that it was "unnecessary to decide whether petitioners have met the prerequisites of section 7491, because the record in this case is not evenly weighted and the resolution of the issues in controversy does not depend upon which party bears the burden of proof. We render a decision on the preponderance of the evidence in the record." *Id* at 7.

[65] *See* Rockwell v. Commissioner, 512 F.2d 882, 885 (9th Cir. 1975) ("After satisfying the procedural burden of producing evidence to rebut the presumption in favor of the Commissioner, the taxpayer must still carry his ultimate burden of proof or persuasion." (citing Brumley-Donaldson Co. v. Commissioner, 443 F.2d 501, 504 n.4 (9th Cir., 1971); Am. Pipe & Steel Corp. v. Commissioner, 243 F.2d 125, 126–27 (9th Cir. 1957)); other citations omitted).

[66] Jones, *10 Years After the Shift*, *supra* note 4, at 297. In the article, the author cites over 100 cases in which the shifting burden was irrelevant. *Id*. at n.112.

taxpayers had prior to the IRS Reform Act.[67] The only real change in the law is with respect to the shift after a taxpayer meets the burden of production by offering credible evidence: only at that point does the burden of proof shift to the IRS. However, as noted above, that burden shift is irrelevant in most cases, because both the IRS and the taxpayer would have introduced at least some evidence of the merits of their respective positions.[68] Thus, only in those rare cases in which both sides have exactly equally compelling evidence will the shift in the burden of proof make any difference.[69]

One reason the law was drafted to be ineffectual was because it was almost universally understood, at least by members of Congress and tax academics, that making the IRS bear the initial burden of proof would be disastrous.[70] It should be noted, however,

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67 *See* Jones, *Not Much Substance*, *supra* note 55. Jones states:

> Under the new law, the taxpayer may elect to shift to the Service the burden of persuasion by offering "credible evidence" contrary to the statutory notice. In effect, the taxpayer's credible evidence merely satisfies the taxpayer's burden of production. Thus the new law makes no significant change to the taxpayer's burden of production.

Id. at _____.

68 *See id*. ("As a practical matter, in most cases both the taxpayer and the Service have some evidence to support their respective positions, and which party had the burden of persuasion is not a significant issue.").

69 *See id.* Jones notes:

> That may be the only aspect of the new credible evidence rules that actually favors the taxpayer, but the advantage is a very tiny one. Very few (if any) tax trials actually result in equally balanced evidence, such that the court is compelled to rule against the party who had the burden of persuasion.

Id. at ____.

70 *See, e.g.*, Leandra Lederman, *Unforseen Consequences of the Burden of Proof Shift*, 80 TAX NOTES 379 (Jul. 20, 1998) [hereinafter Lederman, *Unforseen Consequences*]; Bernard Wolfman, *Reject Burden-of-Proof Shift, Urges Tax Prof*, 78 TAX NOTES 753 (1998) (reprinting letter from Prof. Bernard Wolfman to Senators William V. Roth, Jr., and Daniel Patrick Moynihan); *Tax Profs Urge Rejection of Burden-of-Proof Shift*, 78 TAX NOTES 755 (1998) (reprinting letter from ninety-seven tax professors to Senate Finance Committee members); *IRS Restructuring: Burden of Persuasion vs. Burden of Production*, 77 TAX NOTES 624 (1997) (reprinting letter from Prof. Calvin H. Johnson to Senator William V. Roth, Jr.); *Burden of Proof Shift Worries Tax Professors From Coast to Coast*, 77 TAX NOTES 623 (1997) (reprinting letter from Profs. Glenn Coven, Jerome Borison, John K. McNulty and Richard Westin to Senators William V. Roth, Jr., and Daniel Patrick Moynihan).

that Representative Traficant thought the burden shift was a great idea.[71]

The reason the burden shift was almost universally understood as wrong is simple: if the IRS had the burden of proof, including the initial burden of production, it would be forced to gather evidence uniquely under the taxpayer's control at the outset. To gather those facts, the IRS would necessarily have to become far more intrusive into the lives of taxpayers, even though "taxpayers have the evidence of the facts of their transactions."[72] Otherwise, if the initial burden was on the IRS, "audits [would] necessarily become more invasive,"[73] the IRS would become more intrusive,[74] and litigation would become "more burdensome, expensive, frequent, and time-consuming."[75]

Thus, the law evolved, from at least 1924, in a way that made taxpayers shoulder that initial burden of production to rebut the IRS determinations.[76] Doing so has proved both less costly and less

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71 *See* 143 CONG. REC. H7202 (daily ed. Sept. 11, 1997) (statement of Rep. Traficant). Representative Traficant stated:

> Mr. Speaker, the American Bar Association does not want it, former IRS commissioners do not want it, the current IRS commissioner does not want it, tax attorneys do not want it, IRS collection agents do not want it. All of these bureaucrats and special interest people do not want Congress to change the burden of proof in a civil tax case. . . . I must admit, the only people in America that support changing the burden of proof in a civil tax case are the American people, in record numbers, and it is very simple: They are taxed off, they are fed up, and they want Congress to right this major wrong.

Id.

72 Lederman,*Unforseen Consequences*, *supra* note 65.

73 *Id*.

74 *See* Leo P. Martinez, *Tax Collection and Populist Rhetoric: Shifting the Burden of Proof in Tax Cases,* 39 HASTINGS L.J. 239, 281 (1988) ("Shifting the burden of proof to the IRS necessarily will increase its costs of collection by requiring an expansion of its investigatory function.").

75 *See* Nathan E. Clukey, *Benefits of Shifting the Burden of Proof to the IRS Are Limited*, 82 TAX NOTES 683 (Feb. 1, 1999).

76 *See* Board of Tax Appeals (a precursor to the IRS) Rule 20 (1924), *reprinted in* GEORGE M. MORRIS ET AL., PROCEDURE AND PRACTICE BEFORE THE UNITED STATES BOARD OF TAX APPEALS 138 (1925) (stating "[u]pon hearing of appeals the taxpayer shall open and close and the burden of proof shall be upon him"). *See also* Wos-Mysliwiec, *The Internal Revenue Restructuring and Reform Act of 1998: Does It Really Shift the Burden of Proof to the IRS?*, 14 ST. JOHNS J. LEGAL COMMENTARY 301, 304–05 (1999).

intrusive to taxpayers, because it follows from the general rule that "the party with the documents and the facts" bears the burden of production and proof.[77]

A number of commenters have argued about the (lack of a) burden shift in section 7491(a), and I restate those arguments in this Article mostly to provide a framework for the discussions that follow. The crux of this Article focuses not on section 7491(a), but its largely ignored relative, section 7491(c). Pursuant to section 7491(c), the IRS bears the burden of production with respect to tax penalties in court proceedings. Unlike section 7491(a), subsection (c) should have changed IRS procedures with respect to penalties. To date, those changes have yet to occur.

B. Tax Penalties

> *"Penalties exist to encourage voluntary compliance by supporting the standards of behavior required by the Internal Revenue Code."*[78]

Tax penalties are supposed to deter intentional non-compliance with the tax laws. Deterrence is particularly necessary in the tax context because the chances of the IRS detecting non-compliance are small, and over the past few years, have gotten even smaller.[79] In 2013, for example, the overall probability of audit for individual taxpayers was just under 1 percent, a decrease from 2012.[80] Absent

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77 Wolfman, *supra* note 65.

78 I.R.S., INTERNAL REVENUE MANUAL 20.1.1.2.1, *available at* http://www.irs.gov/irm/part1/irm_01-004-001.html#d0e612. *See also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-99-567, IRS SHOULD EVALUATE PENALTIES AND DEVELOP A PLAN TO FOCUS ITS EFFORTS 3 (2009) (noting that, "in order to advance the fairness and effectiveness of the tax system, penalties should be severe enough to deter noncompliance, encourage noncompliant taxpayers to comply, be objectively proportioned to the offense, and be used to educate taxpayers and encourage their future compliance").

79 In the 2013 fiscal year, the IRS individual audits decreased 5% from 2012, and the 2013 number was the lowest number of audits since the 2008 fiscal year. See *See* IRS, Data Book, 2013, p. iii (2013), *available at* http://www.irs.gov/pub/irs-soi/13databk.pdf ("In FY 2013, the IRS audited tax returns of approximately 1.4 million individuals, down 5 percent from FY 2012 and the lowest number since FY 2008").

80 In 2013, the IRS audited tax returns of approximately 1.4 million individuals, down 5 percent from 2012 and the lowest number since 2008. *See* IRS, DATA BOOK, 2013, *supra* note 13, at 26, tbl. 9b (providing that for the 2013

a penalty, there would be no rational (as opposed to a moral or ethical) reason for a taxpayer to comply with the tax laws, because the taxpayer would have a 99 percent chance of his non-compliance going undetected.[81]

When taxpayers game the system by intentionally misreporting items on their federal tax returns in the hope that the IRS will not discover the misreporting, it is generally referred to as "audit lottery."[82] That audit lottery helps to explain the difference between what the IRS believes it should collect and what it actually collects, generally referred to as the tax gap.[83] For 2006 (the latest year for which the IRS has an estimate), the tax gap stood at $450 billion, about 17 percent of the federal tax liability.[84] That tax gap has three main components: nonfiling, underpayment and underreporting, and the underreporting gap in 2006 was approximately $376 billion.[85]

Ignoring for the moment moral or ethical reasons to comply with the Code, a simple expected value calculation from a taxpayer's perspective helps to explain why many taxpayers play audit lottery. Assume a taxpayer can claim a $10,000 tax benefit

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fiscal year, the chance of audit for all individual taxpayers was about 0.96 percent).

[81] For a more detailed analysis of taxpayers' cost-benefit analysis, see Del Wright Jr., *Financial Alchemy: How Tax Shelter Promoters Use Financial Products to Bedevil the IRS (And How the IRS Helps Them),* 45 ARIZ. ST. L.J. 611, 654–59 (2013) [hereinafter Wright, *Financial Alchemy*].

[82] *See* Jack Townsend, *Thoughts on the the Corporate Audit Lottery*, FED. TAX CRIMES BLOG (Feb. 11, 2012), *available at* http://federaltaxcrimes.blogspot.com/2012/02/thoughts-on-the-corporate-audit-lottery.html. Mr. Townsend states:

> The audit lottery is a gambit in which taxpayers claim tax benefits to which they are not entitled in the hope that the IRS will never audit the returns or, if audited, the improper benefits will not be discovered. The audit lottery is simply an attempt to exploit the IRS's limited resources. The IRS has limited audit coverage. Most taxpayers are not audited and, when audited, tax benefits may not be reviewed. The taxpayer wins the audit lottery if the IRS does not discover the improperly claimed benefits.

Id.

[83] The IRS defines the tax gap as "the amount of tax liability faced by taxpayers that is not paid on time." *See* IRS, THE TAX GAP, *available at* http://www.irs.gov/uac/The-Tax-Gap.

[84] *Id.*

[85] *Id.*

that he believes is likely illegitimate but not criminal (criminal penalties, as you can imagine, change the calculations).[86] The "rational" taxpayer will enter the transaction if the potential benefits exceed the potential costs.[87]

In this example, benefit is $10,000 multiplied by the likelihood of it going undetected (99 percent), resulting in an expected benefit of $9,900. The cost is a bit more complicated: it consists of (i) the cost of not claiming the benefit ($0) plus (ii) any penalty for seeking to claim the benefit. In general, most penalties are 20 percent of the underpayment (here, the $10,000 benefit), meaning a $2,000 penalty. However, for the sake of making the point, I will use the largest non-criminal penalty available to the IRS, the 75 percent fraud penalty. Thus, the maximum penalty would be $7,500. However, there would only be a 1 percent chance of that penalty being assessed, resulting in an expected cost of $75. Adding the expected cost and benefit, the taxpayer will see that the total net expected value of claiming the tax benefit is $9,825. That expected tax benefit certainly outweighs the benefit of not playing audit lottery (here, $0). As a result, the rational taxpayer claims the benefit and hopes the IRS does not detect it.

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[86] There is a wide gulf between criminal tax evasion and illegal, but non-criminal, tax avoidance. *See* Wright, *Financial Alchemy*, *supra* note 76, at ___ ("the line for most taxpayers is not between 'tax evasion and tax avoidance' . . . [R]ather, the line is really between impermissible tax avoidance and permissible tax avoidance, and that line is not a line at all, but a hazy field where tax professionals play."); *see also* Jeremy Josse, *Stocks and Tax Management: The Curious Logic of Tax "Avoidance" vs. "Evasion,"* THE STREET (Mar. 9, 2015) ("Tax avoidance is understood as the lawful avoidance of tax by using tax management to minimize an individual's or a corporation's tax bill. It differs from "tax evasion," which is simply the breaching of legal tax codes."), *available at* http://www.thestreet.com/story/13071168/1/stocks-and-tax-management-the-curious-logic-of-tax-avoidance-vs-evasion.html.

[87] This "simple" expected value calculation is derived from the groundbreaking works of Jeremy Bentham and Nobel Prize winning economist Gary Becker. *See, e.g.,* Gary Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968); *see* William A. Drennan, *Strict Liability and Tax Penalties*, 62 OKLA. L. REV. 1, 29–30 (2009). Professor Drennan's article describes a rational taxpayer as "homo economicus" (borrowing from other literature) and notes that "economics alone motivates homo economicus. He engages in socially harmful behavior unless his total expected cost from behaving badly, including penalties, equals or exceeds his total expected cost of behaving lawfully." *Id.*

The IRS Reform Act sought to bring fairness to the administration of tax penalties.[88] Fairness promotes voluntary compliance, because, "otherwise, taxpayers will lose respect and support for the tax system if they don't think a penalty is consistently applied."[89] In discussions leading up to the Act's passage, Congress sought to ensure the IRS would make "a correct substantive decision in the first instance rather than mechanically assert penalties with the idea that they will be corrected later."[90]

The IRS has, through its actions and words, disagreed with that mandate. As recently as 2014, the IRS has mechanically asserted penalties, contrary to Congress' wishes, because it "does not consider it unfair to taxpayers for the IRS to assert penalties through a systemic process which applies distinct criteria to identify *potential* instances of noncompliance . . . .".[91]

Although the Code has myriad penalty provisions, this Article will focus primarily on two: the section 6662 accuracy-related penalty and the section 32(k) EITC ban/penalty.[92] Unlike many penalty provisions in the Code, both are (or should be), discretionary, non-automatic penalties applied after the IRS has

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[88] See EXECUTIVE TASK FORCE FOR THE COMMISSIONER'S PENALTY STUDY, INTERNAL REVENUE SERV., REPORT ON CIVIL TAX PENALTIES 30 (1989) [hereinafter IRS Task Force Report] see also Ronald Z. Domsky, Give Taxpayers A Break: Putting The Reliance Element Back Into The Reasonable Reliance And Good Faith Defense, 28 Akron Tax J. 123, 126-127 (2013) ("IRS penalties exist and are imposed in order to encourage voluntary compliance by supporting the standards of behavior expected by the IRS. 'Penalties encourage voluntary compliance by: (1) demonstrating the fairness of the tax system to compliant taxpayers; and (2) increasing the cost of noncompliance.'" (internal citations omitted).

[89] See Jeremiah Coder, *Achieving Meaningful Civil Tax Penalty Reform And Making It Stick*, 27 Akron Tax J. 153, 156 (2012), *citing* IRS Task Force Report, supra note 88, at 40.

[90] H.R. REP. NO. 101-386, at 661 (1989) (Conf. Rep.). *See also* H.R. REP. NO. 101-247 at 2863 (1989) (Budget Comm. Rep.).

[91] See 2014 Annual Report, p. 99, citing IRS response to TAS information request (July 10, 2014) (emphasis added). Available at http://www.taxpayeradvocate.irs.gov/Media/Default/Documents/2014-Annual-Report/PENALTY-STUDIES-The-IRS-Does-Not-Ensure-Penalties-Promote-Voluntary-Compliance-as-Recommended-by-Congress-and-Others.pdf.

[92] The vast majority of other Code penalties apply automatically, such as when a taxpayer fails to file a return, or fails to pay a tax. This Article addresses only those fault-based penalty provisions.

determined that the taxpayer has failed to follow the law with the requisite state of mind.[93] For both penalties, the IRS has fallen far short of the goals identified by Congress of getting it right the first time. A brief description of both penalties, and the regulations helping to explain those penalties, is below:

1. The Accuracy-Related Penalty

Section 6662 imposes a 20 percent penalty on underpayments of tax attributable to, *inter alia*, "negligence or disregard of rules or regulation."[94] "Negligence" is defined to include "any failure to make a reasonable attempt to comply with" the Code.[95] The term "underpayment," defined in section 6664 and its implementing regulations, seeks to capture the difference between the tax paid and the tax that should have been paid.[96] In general, the accuracy-

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[93] Unfortunately for taxpayers, some section 6662 penalties are calculated through automatic means. In its Automated Underreporter program:

> when IRS computers detect a discrepancy on a taxpayer's return, the IRS will issue an initial letter to the taxpayer, asking for an explanation. If the taxpayer does not respond, the IRS will issue a statutory notice of deficiency, proposing assessment of a liability and penalty, if the discrepancy occurred for a second year. If a taxpayer responds to either the initial letter or the notice of deficiency, the proposed penalty assessment will receive managerial approval. Taxpayers who do not respond will not receive managerial review of their penalty assessments.

See NATIONAL TAXPAYER ADVOCATE, 2014 ANNUAL REPORT TO CONGRESS, LEGISLATIVE RECOMMENDATION #17, *available at* http://www.taxpayeradvocate.irs.gov/2014AnnualReport [hereinafter 2014 NTA REPORT]. The National Taxpayer Advocate has recommended Congress amend section 6751(b) "to require written managerial approval prior to assessment of the accuracy-related penalty imposed on the portion of underpayment attributable to negligence or disregard of rules or regulations under IRC § 6662(b)(1)." *Id.*

[94] I.R.C. § 6662(b)(1) . The section 6662 penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. The penalty for underpayments attributable to these failures is generally 20 percent of the underpayment, but in the case of a gross valuation misstatement, is 40 percent.

[95] *See* I.R.C. § 6662(c).

[96] *See* I.R.C. § 6664(a), which defines underpayment as:

> the amount by which any tax imposed by this title exceeds the excess of—
>
> (1) the sum of—

related penalty can be avoided upon a showing of reasonable cause.[97]

For fiscal year 2013 (the latest year available), the IRS proposed over $1.5 billion in accuracy-related penalties for individual taxpayers.[98] Approximately $500 million of those penalties were abated, leaving roughly $1 billion outstanding in accuracy-related penalties.[99]

2. The Earned Income Tax Credit "Penalty"

Section 32(k) permits the IRS to ban taxpayers from claiming the EITC for either two or ten years. The word "penalty" is in quotes in the section heading above because the ban in section 32(k) falls outside the part of the Code that deals with penalties.[100] Section 32(k) is phrased as a "restriction on taxpayers who improperly claimed" the EITC, not a *per se* penalty. Nevertheless, the ban fits the lay definition of a penalty, and is generally understood as such.[101] The Conference Report accompanying the enactment of section 32(k) noted that the bans were "in addition to

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> (A) the amount shown as the tax by the taxpayer on his return, plus
>
> (B) amounts not so shown previously assessed (or collected without assessment), over
>
> (2) the amount of rebates made.

Id.

97 *See* I.R.C. § 6664(c)(1).

98 *See* IRS TAX STATISTICS, CIVIL PENALTIES ASSESSED AND ABATED, BY TYPE OF TAX AND TYPE OF PENALTY, 2013, *available at* http://www.irs.gov/uac/SOI-Tax-Stats-Civil-Penalties-Assessed-and-Abated-by-Type-of-Tax-and-Type-of-Penalty-IRS-Tax-Stats-Table-17. The numbers reported represent assessments and abatements of penalties in fiscal year 2013 regardless of the tax year to which the penalty may apply.

99 Id.

100 Penalties and additions to tax are covered in Chapter 68 of the Code, in sections 6651–6751.

101 *See, e.g.*, Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty,* 106 COLUM. L. REV. 569, 580 n.45 (2006) ("Other types of penalties apply in specific circumstances. *See, e.g.*, I.R.C. § 32(k)"); Leslie Book, *The Ban on Claiming the EITC: A Problematic Penalty*, Procedurally Taxing (Jan. 23, 2014), available at http://www.procedurallytaxing.com/the-ban-on-claiming-the-eitc-a-problematic-penalty/.

any *other* penalty under present law."[102](*emphasis supplied*). In addition, the IRS *Internal Revenue Manual* (the "IRM") includes section 32(k) in its penalty handbook.[103]

Section 32(k) provides that the two-year ban is warranted if the IRS makes "a final determination that the taxpayer's claim of credit under this section was due to reckless or intentional disregard of rules and regulations (but not due to fraud)."[104] The ban is ten years if the taxpayer's claim was "due to fraud."[105]

The terms "reckless" and "intentional" are undefined in the statute, and, to date, the IRS has not issued any regulations under section 32(k) defining those terms.[106] Reckless and intentional, however, are defined in the section 6662 regulations, and provide that a taxpayer's actions are reckless "if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe."[107] Those regulations further provide that disregard is intentional "if the taxpayer knows of the rule or regulation that is disregarded."[108] The IRS has not applied the definitions found in the section 6662 regulations to section 32(k). Instead, the agency has adopted a more relaxed interpretation, allowing for section 32(k) bans based solely on a taxpayer's failure to respond.[109]

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[102] *See* Conference Report to Taxpayer Relief Act of 1997, Rep. 105-220, at 105th Congress 597 (Jul. 30, 1997), *available at* http://www.finance.senate.gov/library/reports/conference/download/?id=1baaf2d9-e489-41c0-9287-b979d0d97189 (emphasis supplied).

[103] *See* IRM, *supra* note 73, at § 20.1.5.2.1. That section notes that, consistent with the legislative history, "the two and ten-year bans are in addition to any other penalty imposed under present law." *Id*. at § 20.1.5.2.1.3.

[104] I.R.C. § 32(k)(1)(B)(ii).

[105] I.R.C. § 32(k)(1)(B)(i).

[106] See John Plecnic, Reckless Means Reckless: Understanding the EITC Ban, TAX NOTES (Feb. 24, 2014).

[107] Treas. Reg. § 1.6662-3(b)(2).

[108] *Id*.

[109] *See* NATIONAL TAXPAYER ADVOCATE 2013 ANNUAL REPORT TO CONGRESS, *available at* http://www.taxpayeradvocate.irs.gov/2013-annual-report/ [hereinafter 2013 NTA REPORT]. The portion of the report dealing with the Earned Income Credit is entitled MSP #9 EARNED INCOME TAX CREDIT: THE IRS INAPPROPRIATELY BANS MANY TAXPAYERS FROM CLAIMING EITC, 103, *available at* http://www.taxpayeradvocate.irs.gov/2013-Annual-

For 2011 (the last year for which data is available), the IRS improperly imposed the section 32(k) EITC "almost 40 percent of the time."[110]

C. Challenging Tax Penalties

1. Notice of Deficiency

Generally, before assessing a tax or tax penalty, the IRS must first send to the taxpayer a legally valid notice of deficiency.[111] That notice, sometimes called a "90-day letter,"[112] consists of the following:

> (i) a letter explaining the notice, the amount of the deficiency, and the taxpayer's options;
> (ii) a waiver to allow the taxpayer to agree to the additional tax liability;
> (iii) a statement showing how the deficiency was computed, and
> (iv) an explanation of the changes the IRS made to the taxpayer's return.[113]

The notice of deficiency starts the clock with respect to any taxpayer challenge, and serves as a prerequisite to any IRS collection activity.[114] Once a taxpayer receives a notice of deficiency, the taxpayer can agree to the penalty, seek to settle the matter with the IRS, or challenge the assessment in the Tax Court.[115] To make a Tax Court challenge, the taxpayer must generally file a Tax Court petition within ninety days of receiving a notice of deficiency.[116]

Report/downloads/EARNED-INCOME-TAX-CREDIT-The-IRS-Inappropriately-Bans-Many-Taxpayers-from-Claiming-EITC.pdf.

[110] *Id.*

[111] *See* I.R.C. § 6212.

[112] *See* IRM, *supra* note 73, at § 4.8.9.2.1.

[113] *See id*.

[114] *See* IRM, *supra* note 73, at § 5.17.15.4.1.

[115] *See* I.R.C. §§ 6212–6213. The procedures for challenging notices of deficiency are outlined in sections 6211–6213, and are commonly referred to as deficiency procedures ("Deficiency Procedures").

[116] *See* I.R.C. § 6213(a). The 90-day period is extended to 150 days in certain circumstances. *Id.* During the 90-day period the IRS is barred from any

2. Fora

The Tax Court is the only pre-payment forum available to taxpayers, meaning it is the only forum that gives taxpayers the right to challenge the IRS before paying the amount of the IRS-determined tax or penalty. If a taxpayer does not timely file a Tax Court petition, the other options to challenge the IRS determinations in court require the taxpayer to first pay the IRS-determined tax or penalty, and then sue for refund either in the U.S. District Court or the Court of Federal Claims.[117]

Most federal tax cases are litigated in Tax Court.[118] For the fiscal year ended September 30, 2013, taxpayers filed 29,837 Tax Court challenges.[119] By contrast, taxpayers filed only 263 tax refund suits in the district courts and the Court of Federal Claims.[120] Between April 1, 2013 and March 31, 2014, roughly 70 percent of Tax Court cases were filed by *pro se* taxpayers, a slight increase from the previous year.[121]

As was the case for the late James Traficant, IRS tax determinations in a notice of deficiency are "presumptively correct," and taxpayers seeking to challenge those determinations generally shoulder the burden of proof with respect to IRS tax

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assessment or collection activity and, if taxpayer files a petition, until the Tax Court decision is final. *See* I.R.C. § 6503(a)(1).

117 A prerequisite for a refund suit is payment of the claimed tax liability. U.S. District Courts and the Court of Federal Claims have original jurisdiction over:

> Any civil action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected under the internal-revenue laws.

See 28 U.S.C. § 1346(a)(1).

118 *See* Danshera Cords, *Tax Court Appointments and Reappointments: Improving the Process*, 46 U. RICH. L. REV. 501, 533 (Jan. 2012) ("Due to a number of factors, including that the taxpayer need not prepay the tax prior to filing a petition in the Tax Court, the majority of tax cases are filed in the Tax Court.").

119 IRS Data Book 2013, *supra* note 13, at p. 61 (Table 27).

120 *Id*.

121 William R. Davis, *ABA Meeting: Number of Pro Se Tax Court Litigants Has Grown Since 2013*, TAX NOTES TODAY (May 13, 2014), 2014 TNT 92-18.

determinations pursuant to section 7491(a). Thus, those taxpayers must introduce credible evidence to rebut the presumption of correctness in order to shift the burden to the IRS. However, that is not the case with respect to penalties.

According to section 7491(c), the IRS shoulders the burden of production with respect to tax penalties. Because the taxpayer must include the notice of deficiency in his petition, that notice of deficiency serves as the first evidence that the IRS has met its burden of production. However, if the notice of deficiency does not contain enough information for a court to determine the penalty is appropriate, section 7491(c) should require the IRS to proffer any additional information required for a court to determine the penalty is appropriate. Unfortunately for *pro se* taxpayers, both the IRS and the Tax Court have generally ignored section 7491(c), and the IRS has been able to expand the presumption of correctness to penalties, contrary to the express intent of Congress.[122]

III. THE PROBLEM

"Although Congress may have enacted section 7491(c) with the intent to benefit taxpayers, the effectiveness of the change may be less than intended."[123]

A. The De-Fanged Section 7491(c)

Although section 7491(a) has done arguably what Congress intended (i.e., nothing), section 7491(c) actually changed the law. In its entirety, section 7491(c) reads:

> Notwithstanding any other provision of this title, the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title.[124]

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[122] *See* S. REP. NO. 105-174, at 45 (1998) ("in a court proceeding, the [Service] should not be able to rest on its presumption of correctness if it does not produce any evidence whatsoever relating to penalties").

[123] Philip Jones, *The Burden of Proof 10 Years After the Shift*, 121 Tax Notes 287, supra note 4, at 308 (Oct. 20, 2008).

[124] I.R.C. §7491(c).

According to the law's legislative history, Congress wanted to ensure that "in any court proceeding, the [IRS] must initially come forward with evidence that it is appropriate to apply a particular penalty to the taxpayer before the court can impose the penalty."[125] That legislative history also noted that the provision was "not intended to require the [IRS] to introduce evidence of elements such as reasonable cause or substantial authority. Rather, the [IRS] must come forward initially with evidence regarding the appropriateness of applying a particular penalty to the taxpayer."[126]

In general, in order to meet the initial burden of production, a party must make a showing sufficient to establish the existence of the elements essential to prove that party's case at trial,[127] or phrased another way, sufficient for a trier of fact to find the existence of the necessary elements.[128] The Tax Court has interpreted the IRS burden of production as requiring the IRS to make "a *prima facie* case that imposition of the penalty or addition to tax is appropriate."[129]

As discussed above, the IRS's first opportunity to meet that burden comes through the requirement that the taxpayer include the notice of deficiency in his petition.[130] If the notice of deficiency is insufficient to make a *prima facie* case the penalty is appropriate, the IRS can proffer additional information in its response to the taxpayer's petition (the "IRS Response"), demonstrating why the penalty is appropriate. It follows, therefore, that in cases in which the notice of deficiency does not include all the essential elements of the penalty, only after the IRS Response has been filed would a court be able to determine whether the IRS has met its burden of production. Once met, the taxpayer would

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125 H.R. CONF. REP. 105-599, at 241.

126 *Id.*

127 Fickling v. United States, 507 F.3d 1302, 1304, (11th Cir. 2007) (citing Celotex Corp. v. Catrett, 477 U.S. 317, 322).

128 Leandra Lederman, *"Civil"izing Tax Procedure: Applying General Federal Learning to Statutory Notices of Deficiency,* 30 U.C. DAVIS L. REV. 183, 194 n.53 (1996).

129 Almquist v. Commissioner, 107 T.C.M. 1217 (2014), *citing* Higbee v. Commissioner, 116 T.C. 438, 446-47 (2001).

130 See Tax Court Rule 34(b)(8).

then have the burden of proof to show that the penalty should not apply.[131]

Section 6751(b), enacted as part of the IRS Reform Act, should have added to the IRS burden of production. That statute provides, in pertinent part:

> 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.[132]

Section 6751(b) excludes certain penalties from its application, including penalties under section 6651 (Failure to file tax return or to pay tax), section 6654 (Failure by individual to pay estimated income tax), section 6655 (Failure by corporation to pay estimated income tax) (collectively, the "Failure to Act penalties"), as well as other penalties "automatically calculated through electronic means" ("Automatic penalties").[133] Excluding the Failure to Act and Automatic penalties, what is left under the penumbra of section 6751(b) are the discretionary penalties, such as the accuracy-related penalty under section 6662.[134]

Thus, in court proceedings after enactment of the IRS Reform Act, the IRS should be required to show that any discretionary

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131 *Id.* at 446–47.

132 I.R.C. § 6751(b)(1).

133 I.R.C. § 6751(b)(2).

134 In addition to the accuracy-related penalty, section 6751(b)'s approval requirement applies to the section 6694 penalty for return preparers. *See* TIGTA, *Improvements Are Needed in Assessing and Enforcing Internal Revenue Code Section 6694 Paid Preparer Penalties,* Ref. No. 2013-30-075 (Sep. 9. 2013), available at http://www.treasury.gov/tigta/auditreports/2013reports/201330075fr.html; *see also* Frank Agostino, Brian D. Burton, and Lawrence A. Sannicandro, *Procedural Challenges to Penalties: Section 6751(b)(1)'s Signed Supervisory Approval Requirement*, Procedurally Taxing (Aug. 4, 2014) [hereinafter Agostino et al., *Procedural Challenges to Penalties]*, available at http://www.procedurallytaxing.com/procedural-challenges-to-penalties-section-6751b1s-signed-supervisory-approval-requirement/.

penalty was approved, in writing, by an IRS supervisory. Once it had done so, the burden would be on the taxpayer to demonstrate why the penalty should not be assessed. Unfortunately for taxpayers, that is not how the IRS and the Tax Court interpret the law.

1. The Requirement to Plead Penalties in the Petition

Section 7491(c), by its terms, does not require taxpayers to do anything. It states only that "[N]otwithstanding any other provision" the IRS has the burden of production with respect to penalties.[135] The law included no precondition that it would apply only in cases in which a taxpayer discussed penalties in his petition. However, longstanding Tax Court rules and precedent created just that precondition. As the law is currently enforced, unless a taxpayer assigns specific errors to the IRS determination of penalties in his pleadings, the penalties are deemed conceded, whether they were legitimately assessed or not.[136]

Tax Court Rule 34(b)(4) requires taxpayers to make "[C]lear and concise assignments of each and every error" in a notice of deficiency, else "[A]ny issue not raised in the assignments of error shall be deemed to be conceded."[137] That rule predated section 7491(c), so the precise question of whether section 7491(c) obviated the need of taxpayers to assign error to a penalty in their petitions was unanswered until 2002,[138] when the Tax Court decided *Swain v. Commissioner*.[139]

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[135] I.R.C. § 7491(c).

[136] See Gordon v. Commissioner, 73 T.C. 736, 739 (1980); see also See Tax Court Rule 34(b)(4) ("Any issue not raised in the assignments of error shall be deemed to be conceded.").

[137] Tax Court Rule 34(b)(4).

[138] The issue was addressed tangentially in 2000 in NIS Family Trust v. Commissioner, 115 T.C. 523 (2000). In that case, the court addressed an IRS concern regarding "whether section 7491(c) added to the Service's burden as the movant for judgment on the pleadings in this case. The court reasoned that section 7491(c) does not do so because the burden is to show that no material facts are in dispute." See Stelio Tellis, Letting the Service Off Easy: The Application Of Section 7491(C) in Funk v. Commissioner, 58 Tax Law. 793 (Spring, 2005), citing NIS Family Trust v. Commissioner, 115 T.C. 537-38.

[139] 118 T.C. 358 (2002).

The taxpayer in *Swain*, a "tax protester,"[140] challenged IRS accuracy-related penalties by making "various frivolous and immaterial arguments," including a claim that the IRS had no authority over her.[141] Although the taxpayer's petition was largely frivolous, Judge Halpern, writing for the Tax Court, noted that there was an open question regarding "whether a taxpayer failing to assign error to a penalty will be deemed to concede the penalty notwithstanding that the [IRS] has failed to produce evidence that imposition of the penalty is appropriate."[142]

Citing *Higbee v. Commissioner*, Judge Halpern decided that, "unless the taxpayer puts the penalty into play, however (by assigning error to the Commissioner's penalty determination), the Commissioner need not produce evidence that the penalty is appropriate, since the taxpayer is deemed to have conceded the penalty."[143] He reasoned that the result is based on Tax Court Rule 34(b)(4), "which requires the petitioner to assign error in the petition to each and every error alleged to have been committed by the Commissioner, including issues with respect to which the

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[140] "Tax protester," as used herein, means a person whom a court has determined has made largely frivolous arguments to such court, in an effort to demonstrate how the U.S. tax laws do not apply to such person. As part of the IRS Reform Act, Congress prohibited the IRS from using the label "illegal tax protester," apparently because "the designation stigmatized the protesters and biased IRS employees against them, even after they paid up." *See* Josh Hick, *What Is an "Illegal Tax Protester," and Why Can't the IRS Use That Term Any More?*, WASH. POST (Sep. 2014), *available at* http://www.washingtonpost.com/blogs/federal-eye/wp/2014/09/11/what-is-an-illegal-tax-protester-and-why-cant-the-irs-use-that-term-any-more/. I will use the term "tax protester" in quotes throughout this Article because in my prior position with the Department of Justice's Tax Division, I prosecuted individuals for whom the label was arguably appropriate. I also learned that they sometimes make random UCC filings against individuals they believe are persecuting them for their beliefs. Hopefully, the "" will keep me from again being a target of those individuals.

[141] Swain v. Commissioner, 118 T.C. 358, 360 (2002):

Attached to the petition is petitioner's declaration of facts (the declaration), in which she declares, among other things, that she is a native and citizen of the State of California, that she has never been notified that she is required to keep books and records and file returns, that no assessments of tax, penalties, or interest have been made against her for the years in question, and that she has no unreported income for those years.

Id.

[142] *Id.* at 363.

[143] *Id*. (citing Higbee v. Commissioner, 116 T.C. 438, 446 (2001)).

Commissioner bears the burden of proof."[144] While the court did not explicitly define what taxpayers were required to plead to assign error to the penalty determination, the court did note that the taxpayer's petition must allege at least "some error in the determination of the penalty."[145]

Because *Swain* was before the court after the IRS Reform Act was passed in 1998, the IRS should have been required to show that the penalty was approved in writing, pursuant to section 6751(b), in order to meet its burden of production.[146] However, by deeming all penalties conceded, the *Swain* court swept aside section 6751(b)'s approval requirement and allowed the IRS to avoid its burden of production under section 7491(c). By allowing the IRS to avoid its burden, *Swain* became the first in a line of cases that effectively de-fanged section 7491(c).

The Tax Court's primary error in *Swain* was equating the burden of proof with the burden of production. The court's faulty logic is evidenced by the *Swain* court's analysis of the burden of production using a comparison to the section 6663 fraud penalty discussed in *Higbee*. In *Swain*, the Tax Court reasoned by analogy that its section 7491(c) analysis of the burden of production was based on what the court was required to determine in the case of a fraud penalty, in which the IRS bore the burden of proof.[147]

The *Swain* court noted that for a taxpayer to contest the fraud determination, he must assign error to "each and every determination" in the notice of deficiency pursuant to Rule 34(b)(4).[148] The court then reasoned that "Rule 34(b)(4) and the statute are consistent," thus "[I]f an individual does not challenge a penalty by assigning error to it (and is, therefore, deemed to concede the penalty), the Commissioner need not plead the penalty

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144 TAX CT. R. 34(b)(4).

145 *Swain*, 118 T.C. at 364.

146 See I.R.C. § 6751(b)(1) ("No penalty…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.").

147 Swain, 118 T.C. at 363-4

148 *Id.* at 364, citing Rule 34(b)(4).

and has no obligation under section 7491(c) to produce evidence that the penalty is appropriate."[149]

The fault in the *Swain* court's logic is timing: the burden of production in section 7491(c) must be met no later than the IRS Response. A court must determine whether the IRS has met its burden of production based solely on the notice of deficiency and the IRS Response, i.e., without regard to the taxpayer's petition. As noted in *Higbee*, that means the record before the court must include "sufficient evidence indicating that it is appropriate to impose the relevant penalty."[150] Thus, whether the court is dealing with a taxpayer who is a tax protester or a taxpayer who is having difficulty complying with the court's procedure (*i.e.*, Rule 34), an analysis of the taxpayer's claims is simply not relevant to the proper application of section 7491(c)."[151] In *Swain*, the record did not show that the IRS had satisfied section 6751(b)'s supervisory approval requirement, so the taxpayer should have prevailed.

Had the court in *Swain* enforced section 6751(b)'s supervisory approval requirement, the IRS could have changed its procedures and provided taxpayers with proof of supervisory penalty approval either in notices of deficiency or in IRS Responses to petitions. Had that been the case, *Swain*'s aftermath, as described below, would not have been the further erosion of the IRS Reform Act's penalty protections.

2. Bad Law Makes Bad Precedent

The next Tax Court case discussing the section 7491(c) burden of production was *Funk v. Commissioner*,[152] another "tax protester" case. In *Funk*, the Tax Court, apparently *sua sponte*, directed the IRS to brief the court on whether the IRS bears the burden of production under section 7491(c) if a taxpayer fails to challenge a

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149 *Higbee*, 118 T.C. at 364-5.

150 *Id*. at 446.

151 *See* Stelio Tellis, *Letting the Service Off Easy: The Application of Section 7491(C) in* Funk v. Commissioner, 58 TAX LAW. 793 (Spring, 2005) (internal citations omitted).

152 123 T.C. 213, 217–18 (2004).

penalty in his petition.[153] The issues involved in *Funk* were similar to those in *Swain,* but involved a Failure to Act penalty.[154]

In *Funk,* the IRS issued a notice of deficiency to the taxpayer that included a failure to file penalty under section 6651(a)(1). The *Funk* taxpayer, like the *Swain* taxpayer, was a "tax protestor" who filed a frivolous petition that the court largely ignored.[155] The court noted that:

> [A]lthough it is evident that petitioner disagrees with respondent's determinations, the petition and amended petition lack either a clear and concise statement of the errors allegedly committed by respondent in the determination of the deficiency and addition to tax or a statement of the facts on which petitioner bases his assignments of error. The petition and amended petition contain nothing more than frivolous rhetoric and legalistic gibberish.[156]

Following a motions hearing, the *Funk* court asked the IRS which party bore the burden of production under section 7491(c) with regard to the failure to file penalty.[157] The IRS, citing *Swain*¸ responded that unless the taxpayer assigns error to the IRS penalty determination, the IRS "is not obliged to produce evidence in support of that determination."[158] The court agreed with the IRS, holding that because the taxpayer failed to assign error to the IRS penalty determination pursuant to Tax Court Rule 34(b), "in the absence of a justiciable claim with respect to the addition to tax under section 6651(a)(1), petitioner is deemed to have conceded that item."[159] The *Funk* court deemed *Funk* as "extending and applying the rationale of *Swain v. Commissioner*."[160]

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153 *Id*. at 215.

154 In *Swain,* the issue before the court was an IRS motion to strike various parts of the taxpayer's petition and a motion for summary judgment on penalties. In *Funk,* the issue before the court was a motion to dismiss for failure to state a claim upon which relief could be granted.

155 *Funk*, 123 T.C. at 214.

156 *Id*. at 216–17.

157 *Id*. at 215.

158 Funk v. Commissioner, 123 T.C. 213, 215 (2004).

159 *Id*. at 218.

160 *Id.*

In *Funk*, unlike in *Swain*, because the penalty was for failure to file under section 6651 instead of the accuracy-related penalty under section 6662 penalty, there was no supervisory approval requirement under section 6751(b).[161] Thus, all the IRS needed to proffer was that the taxpayer had failed to file a return, information that was included in the notice of deficiency.[162] Instead, the IRS argued that, contrary to the clear mandate in section 7491(c), it was "not obligated to submit evidence in support of" the penalty.[163] The court agreed with the IRS, and along with *Swain*, gave the IRS two clear holdings that allowed it to undermine the proper application of section 7491(c). The irony, however, is that the *Funk* court came to the correct conclusion but for the wrong reason, and instead of clarifying the law, reinforced *Swain's* faulty holding.

As a preliminary matter, a Tax Court rule cannot override a statute.[164] Thus, Tax Court Rule 34(b)(4), which deems any issue not raised as conceded, could apply only if the statute left a gap for the court to provide rules. Section 7491(c) leaves no such gap. It provides that "notwithstanding any other provisions . . . the [IRS] carry the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or any additional amount imposed by" the Code.[165] That should have meant that the IRS must, whether the taxpayer raises the issue or not, produce evidence either in the notice of deficiency or the IRS Response that demonstrates all required conditions precedent for imposing the penalty have been satisfied.

For imposing the section 6651 penalty in *Funk*, the IRS satisfied that burden by producing the notice of deficiency, which alleged that the taxpayer failed to file a return.[166] However, in

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161 See I.R.C. § 6571(b)(2)(A).

162 Funk at 214.

163 *See id*. at 215.

164 *See* 28 U.S.C. § 2071(a) (requiring all courts to prescribe rules for the conduct of their business "consistent with Acts of Congress").

165 I.R.C. § 7491(c).

166 *See* Higbee v. Commissioner, 116 T.C. 438, 446 (2001) (holding that the Service must come forward with sufficient evidence that the penalty was appropriate); *see also* Maint., Painting & Constr., Inc., v. Commissioner, 86 T.C.M. 376 (2003) (holding that the Service met its burden of production where

Swain, the IRS did not satisfy that burden because it produced no evidence of supervisory approval. In both cases, however, the court based its ruling on an incorrect analysis of the law. Instead of determining whether the IRS met its burden of production by providing evidence that the penalty was appropriate, the court ignored the burden of production and resorted to a Rule 34(b) analysis of what the taxpayer included in his petition, contrary to section 7491(c)'s clear requirements. The Tax Court was wrong in both *Swain* and *Funk*, and the reasons are both simple and dangerous.

> "*Like moths to a flame, some people find themselves irresistibly drawn to the tax protester movement's illusory claim that there is no legal requirement to pay federal income tax. And, like moths, these people sometimes get burned.*"[167]

The taxpayers in *Funk* and *Swain* were "tax protestors" who made patently frivolous arguments about their obligation to pay federal income taxes. Courts, especially the Tax Court, are loath to entertain such arguments, because they tend to encourage more such arguments and waste the court's time. As a result, judges may subconsciously give short shrift to "tax protester" cases. While understandable, it is also dangerous, because those tax protester cases, like *Funk* and *Swain*, create precedents applicable to all taxpayers, and, as noted above, the vast majority of Tax Court cases are filed not by "tax protestors," but by ordinary citizens representing themselves. Unfortunately, those precedents have the potential to create havoc for the overwhelming majority of ordinary taxpayers who simply want to make legitimate challenges to IRS determinations.

Notwithstanding *Funk* and *Swain*, the Tax Court appears to have backtracked in 2006 and fashioned an exception to its flawed section 7491(c) jurisprudence. In *Wheeler v. Commissioner*,[168] again, another "tax protester" case, the court held that, contrary to Rule 34(b)(4), a general statement by the taxpayer that he was not

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the taxpayer failed to file a timely tax return); Turnidge v. Commissioner, 85 T.C.M. 1475 (2003) (holding the same).

[167] United States v. Sloan, 939 F.2d 499, 499–500 (7th Cir. 1991).

[168] 127 T.C. 200 (2006), *aff'd*, 521 F.3d 1289 (10th Cir. 2008).

liable for a penalty would be sufficient to force the IRS to meet its burden of production. Unfortunately, the *Wheeler* decision is consistent neither with section 7491(c), Rule 34(b)(4), nor the Tax Court's own precedent.

In its *Wheeler* ruling, the Tax Court found that the taxpayer did not make a clear and concise assignment of "each and every error" in the IRS determination, as required by Rule 34(b)(4), and simply claimed that he was "not liable" for any penalties.[169] Nevertheless, the court found that the taxpayer's simple claim was somehow enough to put the IRS on notice that the penalty was "an issue."[170] As a result, the court found that the IRS had the burden "to come forward with evidence that it is appropriate to hold" the taxpayer liable for the penalty.[171] Somehow, the *Wheeler* court also found that *Wheeler* was consistent with *Swain*. The explanation of the consistency, however, defies logic.

The *Wheeler* court affirmed the holding in *Swain*, reiterating that Tax Court "Rule 34(b) and section 7491(c) are consistent," and that the critical question was whether the taxpayer assigned error to the penalty.[172] It then concluded that the taxpayer's general denial of liability, because it put the IRS "on notice" that the penalty was "at issue," somehow met the Rule 34(b)(4) requirement of a clear and concise assignment of error.[173] By analogy to civil procedure, the Tax Court in *Wheeler* determined that pleading with particularity (i.e., assigning error to each and every error, required by Rule 34(b)) was satisfied by notice pleading.[174]

That conclusion is problematic enough on its own, but in *Wheeler*, it is even more so because the taxpayer in *Swain* also generally disputed the IRS penalty determinations, including the IRS penalty determinations. However in *Swain*, the court found that the taxpayer's general denial of liability was not enough, and

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[169] *Id*. at 202–03.
[170] *Id* at 207.
[171] *Id*. at 208.
[172] *Id*. at 206–07.
[173] *Id.* at 207.
[174] Notice pleading refers to a system of pleading requirements that only emphasizes pleadings as a way to notify parties of general issues in a case. *See generally* Legal Information Institute, *Notice Pleading*, available at https://www.law.cornell.edu/wex/notice_pleading.

the taxpayer needed to "identify facts [in her petition] tending to show error in the [IRS]'s basis for the deficiencies and penalties."[175] The *Wheeler* court however, contrary to the Tax Court's holding in *Swain*, did not require the *Wheeler* taxpayer to allege any particular error to the IRS penalty determination, other than the general denial.

It is impossible to reconcile *Wheeler* with *Swain*. Either taxpayers are required to assign errors to each and every alleged error in the IRS penalty determination, as required by *Swain* and Tax Court Rule 34(b)(4), or they only need a general denial of liability, as required in *Wheeler*. The Tax Court cannot have it both ways.

Wheeler appears to be a subtle attempt by the Tax Court to reconcile its rulings with section 7491(c). The problem with that should be apparent: if a precedent is contrary to law, that precedent should be reversed. Else, taxpayers, at least in a world in which *Swain* and *Wheeler* coexist, are left with no clear indication of what the law actually is. Unfortunately, as of the time of this Article, that is the world in which we live.

B. The Misapplication of Sections 7491(c) and 6751(b)

> *"In a statutory construction case, the beginning point must be the language of the statute, and when a statute speaks with clarity to an issue judicial inquiry into the statute's meaning, in all but the most extraordinary circumstances, is finished."*[176]

A plain reading of sections 7491(c) and section 6751(b) should require that:

> (1) in any court proceeding, the IRS has the burden of production with respect to a tax penalty, and therefore must show, at a minimum, that the penalty is authorized by the law (pursuant to section 7491(c)), and
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> (2) the initial determination of any discretionary penalty must be personally approved in writing by

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175 Swain v. Commissioner, 118 T.C. 358, 360 (2002).
176 Estate of Cowart v. Nicklos Drilling Co., 505 U.S. 469, 474 (1992).

> the immediate supervisor of the individual making such determination (pursuant to section 6751(b)).

As noted above, neither the Tax Court nor the IRS reads those sections in that manner, and have instead read those sections effectively out of the Code. In the last year or so, however, some taxpayers have challenged that reading.

As noted in the description of the *Rand* case above, prior to 2013, the IRS had improperly calculated penalties based on refundable tax credits. According to the IRS and the Tax Court (notwithstanding *Wheeler*), taxpayers seeking to challenge those *Rand*-type penalties would need to assign error to the IRS underpayment calculation, which was the basis of the penalty. In *Morales v. Commissioner* ("*Morales*"), a taxpayer has challenged that requirement.[177]

Before discussing *Morales*, it is worth asking how realistic is it for unrepresented taxpayers to know enough about IRS underpayment calculations to challenge those calculation at the petition stage? This question is particularly appropriate because the IRS itself has admitted publicly that it had improperly calculated underpayments on at least two occasions in the past five years, and may have over-penalized hundreds of thousands of taxpayers based on those improper calculations.

The underpayment issue presented in *Rand* was far from simple. The excerpt below provides a short explanation, likely comprehensible only to IRS employees and tax litigators:

> The [*Rand*] court explained that prior to 1989, "'underpayment' was defined with an explicit cross-reference to the definition of a deficiency" in section 6211.[178] The court then stated that even though that cross-reference was removed in 1989, section 6211 would nevertheless "assist us in

[177] See Morales v. Commissioner, Memorandum Findings of Fact, T.C. Memo 2012-341 (Dec. 6, 2012) and Morales v. Commissioner, Supplemental Memorandum Opinion, T.C. M. 2013-192 (Aug. 26, 2013).

[178] Rand v. Commissioner, 141 T.C. 376, 386 (2013).

> interpreting" the issues in the case.[179] Looking to section 6211 for guidance, the court noted section 6211(b)(4) authorizes the IRS to treat "any excess of the refundable credits claimed as compared to the amount to which the taxpayer was entitled is treated as a negative tax" for deficiency purposes. However, applying the canon *expressio unius est exclusio alterius,*[180] the court found that because section 6664 does not contain similar language (and Treasury has not addressed the issue in regulations), refundable non-withholding credits "would not be considered a negative tax."[181] As a result, the [portion of the underpayment attributable to refundable tax credits] could not be negative … Thus, Rand's penalty would not be influenced by the erroneously-claimed . . . refundable credits.[182]

If you had trouble understanding that excerpt, you are in good company. The IRS misunderstood it at least twice, and the reader of this Article has, in all probability, some training in the law. However, it was that understanding that was required for the taxpayers in *Rand* to prevail. Fortunately for the Rands, they were not only represented by counsel, but also had the benefit of a Tax Law Clinic filing an amicus curiae brief on their behalf.[183]

Most unrepresented taxpayers likely assume (albeit incorrectly) that a tax penalty is merely a mechanical application of the law. *Rand*, however, showed that is not always the case, and a case

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179 *Rand* at 387. In its decision, the court noted "the historical link between the definitions of a deficiency and an underpayment," but found that Congress had broken that link when in "1988 Congress amended section 6211(b)(4) to specifically provide that certain refundable credits could be taken into account as negative amounts of tax." *Rand* at 391, (citing Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, sec. 1015(r)(2), 102 Stat. at 3572).

180 *See* BLACK'S LAW DICTIONARY 581 (defining "expressio unius est exclusio alterius" as "[w]hen certain . . . things are specified in a law, . . . an intention to exclude all others from its operation may be inferred"). *See also* Clifton Williams, *Expressio Unius Est Exclusio Alterius*, 15 MARQ. L. REV. 191 (1931).

181 *Rand* at 390.

182 *Rand* at 395-6. *See also* Wright, *Bogus Refunds*, *supra* note 17, at 39.

183 An amicus curiae brief was filed by Carlton M. Smith as attorney for the Cardozo Tax Clinic.

currently pending in the Ninth Circuit demonstrates why taxpayers need the full protection of section 7491(c).

1. Challenging Improper Penalties

In *Morales*, decided in the Tax Court while *Rand* was pending, the taxpayers improperly claimed refundable first-time homebuyer credits.[184] The Tax Court found that the taxpayers (i) were not entitled to the credits and (ii) were liable for a penalty based on their improper claim for the credits.[185] The taxpayers moved for reconsideration of the penalty after *Rand* was decided, because the IRS had used the pre-*Rand* calculation of their understatement, which caused the IRS to overstate the penalty.[186] The taxpayers argued that because the IRS had used an improper penalty calculation, it could not establish that the Morales's pre-*Rand* penalty calculation was appropriately calculated, and as a result, the IRS had failed to meet its section 7491(c) burden of production.[187]

The Tax Court found that the IRS had met its burden of production by showing that the taxpayers were negligent in claiming the credit, and that the taxpayers conceded their ability to challenge the penalty calculation because they did not "assign clear and concise error to [the IRS]'s determination of the penalty," citing, *Funk* and *Swain* (curiously, *Wheeler* was not cited).[188] The court concluded that even though the IRS penalty calculation was incorrect as a matter of law, the Morales' could not challenge that incorrect penalty calculation because they failed to assign errors to the penalty in their petition.[189] That decision begs the question: how can the IRS meet its burden of production if it has not followed the law?

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184 First-time homebuyer credits are a refundable tax credits. *See* I.R.C. § 36.

185 T.C. Memo. 2012-341.

186 T.C. Memo. 2013-192.

187 *Id.*

188 *Id.*

189 *Id.*

While the Morales' were arguing for reconsideration regarding their penalty, in eleven other cases[190] Tax Court judges, *sua sponte*, were ordering the IRS to show cause how it could meet its burden under section 7491(c) for the same *Rand*-type penalties. In none of those cases did the taxpayers' petitions either assign specific errors to the IRS penalty determinations or raise the underpayment issue, the crux of the problem in *Rand*. In fact, in only one case did the petition even remotely mention penalties, which according to *Wheeler,* put the IRS on notice that penalties were at issue.[191] That means the Tax Court judges in at least ten of those cases (eleven if *Wheeler* does not apply) should have deemed the penalty issue conceded under *Funk* and *Swain*.

At this writing, the Tax Court judge in *Morales* has decided the IRS has no burden under section 7491(c) in *Rand*-type penalty cases, and eight other judges in eleven other cases have decided the IRS cannot meet its burden under section 7491(c) in *Rand*-type cases.[192] Among other problems, that situation raises an equal protection issue, and the Morales' counsel has blogged: "Why should the Moraleses have to pay a penalty that the IRS is now

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[190] In the Opening Brief for Appellants, Morales v. Commissioner, Ninth Circuit C.A. Nos. 13-74283 and 13-74284 (Apr. 2, 2014) ("Morales Opening Brief"), the taxpayers noted that in seven of those cases, the Tax Court ruled the IRS failed to meet its burden of production because it could not show the underpayment was calculated in accordance with Rand, citing Richardson v Commissioner, T.C. Summary Op. 2014-9; Li v. Commissioner, T.C. Summary Op. 2013-97; Weisinger v. Commissioner, Tax Court Docket No. 15555-11S (order of dismissal and decision, dated Nov. 22, 2013 (Morrison, J.); Arnold v. Commissioner, Tax Court Docket No. 8369-13S (order of dismissal and decision, dated Feb. 27, 2014) (Carluzzo, STJ.); Bey v. Commissioner, Tax Court Docket No. 3469-13 (order of dismissal and decision, dated Mar. 11, 2014) (Carluzzo, STJ.); Bukshpan v. Commissioner, Tax Court Docket No. 24533-10 (order and decision modifying submitted stipulated decision, dated Mar. 13, 2014 (Morrison, J.). The taxpayers further noted that in four unresolved cases, "either the judge or the IRS has raised the 'underpayment' issue and the noncompliance of proposed settlements of the cases with Rand." Morales Opening Brief, pp. 54–55.

[191] See Weisinger v. Commissioner, Tax Court Docket No. 15555-11S ("I would like therefore to request that the court eliminate the fine and approve the refund.").

[192] Judges Dinan, Carluzzo, Panuthos, Haines, Dean, Gale, Morrison, and Lauber all ruled that the IRS had to prove the underpayment issue regardless of whether the issue was raised in the taxpayer's petition, contrary to *Fun*k, *Swain* and *Wheeler*.

conceding was incorrectly computed and where the IRS is no longer trying to collect similarly-miscomputed penalties from other Tax Court petitioners who likewise never raised the penalty computation issue in their pleadings?"[193] Moreover, as noted in the Morales' Ninth Circuit brief, "when one judge enforces a provision inconsistently with eight other judges of the same court … there is something wrong."[194]

2. Challenging Penalties Determined in Litigation

"Breathing new life into section 6751(b), 16 years after it was enacted, may be the only way to curb the IRS's penchant for late-in-the-game penalties."[195]

The penalty problems identified above do not exist solely for unrepresented taxpayers. Two pending cases against represented taxpayers, *Illinois Tool Works v. Commissioner* ("*Illinois Tool Works*")[196] and *Graev v. Commissioner* ("*Graev*"),[197] demonstrate how the IRS has sought to broaden its penalty powers.[198]

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193 See Carlton Smith, DOJ in 9th Cir. Seeks to Keep Penalty Improperly Computed Under Rand Because of Taxpayers' Failure to Timely Plead the Computation Error, PROCEDURALLY TAXING (Jul. 14, 2014), available at http://www.procedurallytaxing.com/doj-in-9th-cir-seeks-to-keep-penalty-improperly-computed-under-rand-because-of-taxpayers-failure-to-timely-plead-the-computation-error/.

194 Morales Opening Brief, p. 57. In their brief, the taxpayers noted that "while Judge Kroupa ruled that the Moraleses waived any right to require the IRS to prove an 'underpayment' in their cases, the eight other judges in 14 other similar cases starting from 2001 in Akhter – Judges Dinan, Carluzzo, Panuthos, Haines, Dean, Gale, Morrison, and Lauber – where the taxpayers also clearly or apparently never specifically raised the 'underpayment' issue – determined that the issue need not have been raised at all by the taxpayer for the court to insist that the IRS prove the existence of underpayments." *Id.*

195 Ajay Gupta, *How Late Is Too Late for Slapping on a Penalty?*, Tax Notes Today (Dec. 11, 2014).

196 Tax Court Docket No. 10418 - 14.

197 Tax Court Docket No. 30638 - 08.

198 Other docketed cases also have mounted challenges to section 6751(b) and section 7491(c). See, e.g., United States v. Rozbruch, 28 F. Supp. 3d 256 (S.D. NY 2014). The case has been appealed to the Second Circuit. See Second Circuit Docket No. 0:14-cv-04330 (filed Nov. 20, 2014); see also 15 West 17th Street et al. vs Commissioner ("15 West"), Tax Court Docket No. 25152-11. In 15 West, the parties appear to agree that the original IRS penalty approval form

In *Illinois Tool Works*, at issue was whether what the taxpayer characterized as a loan should have been characterized instead as income. Prior to sending a notice of deficiency, the IRS and the taxpayer sought to resolve the case but were unable to come to an agreement. Once it became clear no agreement could be reached, the IRS sent the taxpayer a notice of deficiency proposing $70.4 million in additional taxes for the 2006 tax year.[199] After receiving the notice, the taxpayer timely petitioned the Tax Court regarding the additional taxes. In its response, the IRS sought not only to counter the taxpayer's arguments regarding the additional tax liability, but also to assert, for the first time, a section 6662 accuracy-related penalty based on the $70.4 million understatement.

As noted above, one of the reasons section 6751(b) was enacted was to ensure that penalties "should only be imposed where appropriate and not as a bargaining chip."[200] Congress passed the provision, at least in part, because it was concerned that taxpayers could be assessed discretionary penalties merely because they had exercised their "ticket to the court."[201] On its face, that appears to be exactly what the IRS did to *Illinois Tool Works*: the penalty was raised not during negotiations with the IRS, but only after the taxpayer challenged the IRS assessment in Tax Court.

While the practice of asserting penalties for the first time in the IRS Response may raise issues about the IRS's motives, the Tax Court, in a number of cases, has put its imprimatur on the tactic.[202] Those cases have generally held that the IRS can first introduce a penalty in the IRS Response, but when doing so must bear the

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did not include the appropriate supervisory signature. The IRS, three years after litigation ensued, obtained the supervisory signature in an attempt to satisfy section 6751(b). For a thorough discussion of the issues, see Agostino et al., *Procedural Challenges to Penalties*, supra note [ ].

[199] The IRS alleged that a $357 million loan should have been characterized as income, generating the $70.4 million tax liability.

[200] S. REP. NO. 105-174, at 65.

[201] See Gupta, How Late Is Too Late, supra note 194.

[202] *See* Ajay Gupta, *Looking for Caprice in the Commissioner's Answer,* 2014 TAX NOTES TODAY 165-2 (Aug. 2014).

burden of persuasion and the burden of production with respect to any penalties so asserted.[203] In none of those cases, however, did the taxpayers raise the section 6751(b) issue—counsel for *Illinois Tool Works* appears to be the first to have done so.

In its motion to strike the penalty from the IRS Response in *Illinois Tool Works*, the taxpayer argued that because the IRS failed to include the penalty either at the examination level or when it issued the notice of deficiency, it could not have gotten written approval at the "initial determination of the penalty," as required under section 6751(b). The motion also used the presumption of correctness against the IRS by arguing that because notices of deficiency was presumptively correct, the IRS initial determination must have been to "not assert the penalty."[204] The taxpayer then linked those arguments, claiming that the assertion of a penalty after the IRS examiner determined a penalty was inappropriate and after the notice of deficiency violated the Administrative Procedures Act (the "APA").[205]

The Tax Court dismissed the APA argument, reasoning that both Tax Court rules and section 6214(a) give the Tax Court the authority to determine whether the penalty was proper. The court did, nevertheless, seemingly open the door for a more substantive argument about section 6751(b) by noting that the taxpayer was "free to advance" arguments at the upcoming trial, "the thrust of

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[203] *See* Derby v. Commissioner, T.C. Memo. 2008-45, 95 T.C.M.1177, 1194 (2008); Arnold v. Commissioner, T.C. Memo. 2003-259, 86 T.C.M. 341, 344 (2003); Bruner Woolen Co. v. Commissioner, 6 B.T.A. 881, 882 (1927).

[204] Motion to Stroke at 6, Ill. Tool Works v. Commissioner, Tax Ct. Docket No. 10418-14 (citing Veritas Software Corp. & Subsidiaries v. Comm'r, 133 T.C. 297, 318 (2009); Sundstrand Corp. v. Comm'r, 96 T.C. 226, 353 (1991)).

[205] *See* Dec. 2, 2014 Order, Illinois Tool Works Inc. v. Commissioner, Tax Ct. Docket No. 10418-14, stating:

> Citing the Administrative Procedure Act (APA) and Mayo Found. for Med. Educ. & Research v. United States, 562 U.S. 44 (2011), petitioner argues that the assertion of a penalty for the first time in an answer is impermissible as a matter of law because such assertion would be inconsistent with what petitioner describes as a prior 'determination' by respondent not to assert that penalty. As such, the delayed assertion of the penalty would supposedly be analogous to a disfavored 'post hoc rationalization' by the agency.

Id. (other citations omitted)).

which is that the penalty should not be imposed."[206] The decision in *Illinois Tool Works* is pending.

In contrast to the arguments in *Illinois Tool Works*, the taxpayer in *Graev* made a head-on challenge to section 6751(b). In *Graev*, the taxpayers argued that section 6751(b) prevents the IRS from assessing an accuracy-related penalty after the notice of deficiency has been issued, reasoning that if the notice of deficiency did not include a penalty, there could not have been an initial determination of the penalty that was approved by an IRS supervisor.

In *Graev*, the IRS disallowed the taxpayer's deduction for a conservation easement made in 2004, and in the original notice of deficiency, asserted a 40 percent gross valuation misstatement penalty under section 6662(h).[207] The notice of deficiency also stated, as an alternative position, that "in the event the court were to find the taxpayers not liable for the 40 percent gross valuation misstatement penalties," the taxpayers would be liable for accuracy-related penalties under section 6662(a).[208] As part of discovery, counsel for the Graevs requested the IRS penalty approval form, and discovered that the 40 percent gross valuation misstatement penalty had been approved in writing by the IRS agent's supervisor, but the alternative position had no such signature.[209]

The IRS ultimately conceded that the 40 percent gross valuation misstatement penalties were not warranted, but, pursuant to its alternative positon, sought to apply the accuracy-related penalties under section 6662(a) during litigation. The taxpayers, however, moved for summary judgment on the section 6662(a) penalties, arguing that the initial determination of the penalty was not personally approved in writing by the immediate supervisor of

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206 *Id*. *See also* Gupta, *How Late Is Too Late*, *supra* note 188 (noting that the Tax Court "thus seems to be inviting the taxpayer to try to establish at trial whether the supervisory written approval requirement of section 6751(b) was satisfied, and if not, to argue on brief that that failure is fatal to the accuracy-related penalty.").

207 *See* Motion for Partial Summary Judgment, para. 5, Graev v. Commissioner,, Tax Ct. Docket No. 30638-08 (Apr. 14, 2014),

208 *Id.*

209 *Id.* at para. 14–21.

the IRS agent who had made that determination, as required under section 6751(b). In response, the IRS moved to amend its original answer (which was filed over five years before the summary judgment motion) and included specific grounds for the section 6662(a) penalty.

In its amended answer, the IRS boldly asserted that no supervisory approval was required, notwithstanding section 6751(b). Specifically, the IRS argued that its general authority to send a notice of deficiency pursuant to section 6212 meant that it need not follow section 6751(b)'s specific approval requirement. Such a reading effectively would read section 6751(b) out of the Code. Apparently recognizing the "strained logic of that argument," the court invited the IRS to amend its answer (again).

With its next bite of the apple, the IRS made three unique alternative arguments:

- Argument 1: the IRS attorney in litigation made the initial determination to seek the section 6662(a) penalty (when the IRS filed its original answer to the petition) and that determination was approved by the IRS attorney's supervisor, or

- Argument 2: section 6751(b) is only an administrative requirement, and the taxpayers were not prejudiced by the IRS's failure to follow the statute, or

- Argument 3: the Tax Court, not the IRS, makes initial deficiency determinations, so the issue was not ripe until after the court determined if penalties were appropriate.

I will address Argument 3 first, because it borders on frivolous.

Section 6212(a) provides that the IRS, not a court, "determines" deficiencies.[210] Along the same lines, sections

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[210] Section 6212(a) provides that the IRS is authorized to send a notice of deficiency if the IRS "determines that there is a deficiency." *See also* Gray v. Commissioner, 140 T.C. 163, 169 (2013) (noting that the Secretary (or his delegate, the Commissioner) "determines" the existence of a deficiency), supplementing, 138 T.C. 295 (2012); Pagel, Inc. v. Commissioner, 91 T.C. 200, 213 (1998) (recognizing the notice of deficiency as the initial determination), *aff'd*, 905 F.2d 1190 (8th Cir. 1990); Anderson v. Commissioner, T.C. Memo.

6213(a) and 6214(a) give the Tax Court the authority to "redetermine" deficiencies.[211] Those statutes make clear that the IRS position is meritless, and what makes it tantamount to frivolous is the word "initial."

Under the tortured logic of Argument 3, after the IRS has made its initial penalty determination, the Tax Court somehow makes the initial penalty determination. In addition to being absurd, the initial determination is clearly the job of the IRS pursuant to section 6212(a). Moreover, if the Tax Court made the initial determination, it would be contrary to the plain language of sections 6213 through 6215, which tasks the Tax Court with *redetermining* deficiencies. As if the law and common sense were not enough, Argument 3 also directly contradicts an IRS Chief Counsel notice issues ten days before the IRS filed its response. In that notice, the Chief Counsel "reaffirm[ed] the position that supervisory approval is required" before the initial penalty determination.[212]

The other two Arguments are more nuanced, but both also should fail.

<u>Argument 1: The Initial Determination</u>

2009-44, (slip op. at 27) ("Section 6212(a) requires the IRS to determine that a deficiency exists before issuing a notice of deficiency"); *see also* Huff v. Commissioner, 135 T.C. 222, 229 (2010) (citing sections 6211 through 6215 as supporting Court's jurisdiction to redetermine deficiencies in income, estate, gift, and certain excise taxes).

[211] Pursuant to section 6213(a), "the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency." Pursuant to section 6214(a), "the Tax Court shall have jurisdiction to redetermine the correct amount of the deficiency." *See also* I.R.C. § 6215(a), which provides, "the entire amount redetermined as the deficiency by the decision of the Tax Court . . ." and Treas. Reg. § 301.6215-1 ("the entire amount redetermined as the deficiency by the decision of the Tax Court") (emphasis added).

[212] *See* Chief Counsel Notice CC-2014-004, *available at* http://www.irs.gov/pub/irs-ccdm/cc%202014%20004.pdf.; *see also* Chief Counsel Memorandum No. 20125201F n.112 (Dec. 28, 2012) (noting that "the initial decision of whether to apply the penalty rests with the supervisor of the person proposing the penalty (e.g., the IRS case manager)"), *available at* http://www.irs.gov/pub/irs-lafa/20125201F.pdf; and Chief Counsel Memo 20125201F n.112 (Dec. 28, 2012) (noting that "the initial decision of whether to apply the penalty resets with the supervisor of the person proposing the penalty").

The question of what constitutes an "initial determination" does not appear to have ever been decided by the Tax Court. At issue are the following related questions:

(1) When does the "initial determination" of the penalty occur, and

(2) Who at the IRS can make that determination?

Section 6751(b) requires that the initial determination of the penalty be approved in writing by the supervisor of the person making the determination. The taxpayers in *Graev* argued that the initial determination was made by the IRS agent who examined Graevs' tax return (an "Examining Agent") when he proposed the gross valuation penalty as a primary position, and included the section 6662 penalty only as an alternative position. The IRS argued that the initial determination occurred when IRS Counsel decided to pursue the alternative position. The taxpayers have the correct position.

The Graevs argued that there could be three possibilities for when an "initial determination" occurs: (1) when the Examining Agent determines a penalty should be imposed, (2) when the IRS notifies the taxpayer of the potential penalty in a thirty-day letter, and (3) when the notice of deficiency is issued. If we include the IRS argument, there would be an additional option, (4) when the IRS adds a penalty during litigation.

The only logical answer is option (1). Only (1) serves the purpose Congress intended in enacting section 6751(b), i.e., ensuring that, before the IRS sought to assess any discretionary penalty, the penalty was approved by a supervisor, and not included as a litigation tactic. While (2) and (3) may be reasonable, they both fail the logic test—how can an initial determination be made at a time other than the first time it is made? The IRS position in (4) not only fails the logic test, but also directly contradicts section 6751(b)'s intent.

It follows, therefore, that the supervisory approval must be obtained after the Examining Agent has determined the penalty is warranted. That answer is both reasonable, and supported by the often befuddling rules that authorize the IRS.

Specifically, section 7803(a) authorizes the appointment of an IRS Commissioner, and that Commissioner is delegated with the authority by the Secretary of the Treasury (the "Secretary") to make deficiency determinations through section 6212(a).[213] However, IRS Chief Counsel is authorized under a different section of the law, section 7803(b), and is established as a separate Treasury department from the IRS Commissioner.[214] The Chief Counsel is authorized to "perform such duties as may be prescribed by the Secretary," but has no delegation authority, either under 6212(a) or through any redelegations, to make a deficiency determination.[215] Thus, the IRS Counsel could not, pursuant to current law, make an initial determination of a penalty because the Secretary has not delegated to IRS Counsel the authority to make penalty determinations.

Argument 2: Section 6751(b) is Only Administrative

The IRS argued that, notwithstanding its non-compliance with section 6751(b), any error caused by its non-compliance was harmless. Thus, the Tax Court could excuse its non-compliance as a "procedural omission or error," which, absent prejudice to the complaining party, would be deemed harmless error.[216] The crux of the IRS argument is that section 6751(b) confers on taxpayers no substantive rights, and if the IRS fails to obtain the necessary supervisory approval, the taxpayer has no remedy because no substantive rights were at stake.

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[213] *See* I.R.C. § 7803(a)(1) and (2). *See also* I.R.C. § 6212(a) (providing that "If the Secretary determines that there is a deficiency in respect of any tax imposed by subtitles A or B or chapter 41, 42, 43, or 44 he is authorized to send notice of such deficiency to the taxpayer.").

[214] *See* I.R.C. § 7803(b), which provides that, "[T]here shall be in the Department of the Treasury a Chief Counsel for the Internal Revenue Service who shall be appointed by the President, by and with the consent of the Senate." I.R.C. § 7803(b)(1).

[215] *See* I.R.C. §§ 7701(a)(11) and (12) (providing that a delegate refers only to those "authorized by the Secretary of the Treasury directly, or indirectly through one or more redelegations of authority. . . ."). In *Graev*, the court ordered the IRS to "identify any relevant delegation of authority to his Office of Chief Counsel to determine a penalty in connection with the issuance of a notice of deficiency." *See* Motion for Judgment on the Pleadings at para. 10., Graev v. Commissioner, Tax Ct. Docket No. 30638-08 (Oct. 28, 2014). The IRS did not so provide. *Id.* at para. 11.

[216] *See* IRS Response Brief at 12 (citing Scott v. Commissioner, T.C. Memo. 2007-91, Nestor v. Commissioner, 118 T.C. 162 (2002), Rochelle v. Commissioner, 116 T.C. 356 (2001), *aff'd*, 293 F.3d 740 (5th Cir. 2002), and Boyd v. United States, 121 Fed. Appx. 348 (10th. Cir 2005)).

The taxpayers countered that argument by noting the first words of the statute: "[No] penalty shall be assessed unless…" The taxpayer reasoned that, unlike a procedural error, the language in section 6751(b) is a mandatory pre-condition to the assessment of a penalty. As such, the taxpayer had no need to show prejudice, and only had to show that the IRS did not follow the law.

The taxpayers' argument is the better-reasoned. First, as the taxpayer noted in his brief, Congress' use of the word "shall" indicates mandatory intent.[217] Thus, there was no place for a harmless error analysis because the statute expressly provides the consequence for noncompliance.[218] Second, the cases relied on by the IRS in support of its harmless error argument were based on statutes that, unlike section 6751(b), provided no remedy for noncompliance.[219] Unlike those other statutes, however, section

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[217] Brief, at 25, Graev v. Commissioner, Tax Ct. Docket No. 30638-08 (citing United States v. Myers, 106 F.3d 936, 941 (10th Cir. 1997)) ("It is a basic canon of statutory construction that use of the word 'shall' indicates a mandatory intent."); Forest Guardians v. Babbitt, 174 F.3d 1179, 1187 (10th Cir. 1999) ("The Supreme Court and this circuit have made clear when a statute uses the word 'shall', Congress has imposed a mandatory duty upon the subject of the command.").

[218] *See* Brief, at 26, Graev v. Commissioner, Tax Ct. Docket No. 30638-08 (citing United States v. Felt & Tarrant Mfg., 283 U.S. 269, 273 (1931)) ("it is not within the judicial province to read out of the statute the requirement of its words"); Triestman v. United States, 124 F.3d 361, 379 (2d Cir. 1997) (rejecting government's interpretation of a statute where it would require the court to read out language that was expressly put into the statute because doing so would "violate the cardinal principle of statutory interpretation that courts must 'give effect, if possible, to every clause and word of a statute'") (citing United States v. Menasche, 348 U.S. 528, 538–39 (1955)); *cf*. Commercial Sav. & Loan Ass'n, 53 T.C. 14, 20-21 (1969) ("[w]here the Congress has authorized certain tax privileges and has prescribed the conditions to be met in qualifying for them it has been held that strict compliance with the statute is necessary"); Jeremiah Coder, *Did the Federal Circuit Just Commit Another Murphy?*, 127 TAX NOTES 143 (Apr. 12, 2010) ("[t]here is no harmless error for an invalid assessment.") (quoting Professor Bryan T. Camp).

[219] The IRS relied on *Scott, Nestor, Rochelle,* and *Boyd* to make its point. *See supra* note 206. In *Scott,* the court noted that the statute in question contained "no indication of any consequence or remedy for failure to [comply with the statute]." *Scott,* T.C. Memo. 2007-91 (slip op. at 22). *Nestor* found that the statute in question provided no consequence to noncompliance, and noted that "if a statute does not specify a consequence for noncompliance with statutory timing provisions, the federal courts will not in the ordinary course impose their own coercive sanction." *Nestor,* 118 T.C. at 174 (citing United

6751(b)'s remedy is clear—it precludes the imposition of a discretionary penalty absent supervisory approval of the initial determination of the penalty.

The four arguments advanced by the IRS fail for different reasons, but fail nevertheless. However, as described below, they are consistent with the IRS's broad power grab with respect to tax penalty procedures.

C. The Other Section 6751(b) Problem

By administrative fiat, the IRS has decided that it can avoid section 6751(b)'s supervisory approval requirement for negligence penalties, without ever determining if the taxpayers were, in fact, negligent. As noted above, section 6751(b)'s supervisory approval requirement does not extend to penalties Failure to Act or Automatic penalties.[220] When Congress enacted section 6751(b), it did not explain explicitly why automatic penalties should be exempted from the law, but the rationale is apparent: Congress did not want to impose an extra burden on the IRS in cases in which a penalty determination was based on a "true/false" analysis.[221]

As Congress likely intended the law to be understood, management approval would not be required if IRS computers determined the taxpayer failed to do something he or she was obligated to do—a true/false issue easily accomplished by a computer. That explains why Congress listed the specific Failure-to-Act penalties in the law.

The determination of whether a taxpayer was negligent, a prerequisite to the imposition of the section 6662 accuracy-related penalty, cannot be analyzed using such a simple true/false

States v. James Daniel Good Real Prop., 510 U.S. 43, 63 (1993)). *Rochelle* and *Boyd* similarly were based on statutes that did not provide a consequence to noncompliance.

220 *See* I.R.C. § 6751(b)(2)(B).

221 *See* 2014 NTA REPORT, *supra* note 87, at 406. In one of the few explanations in the Congressional Record, Chair of the Senate Finance Committee, noted that: These enhanced rights are meant to protect honest taxpayers. We do not excuse those who evade their responsibility or cheat on their income tax returns. The protections contained in this legislation exclude the failure to file, failure to pay, and penalties related to fraud." *See* 144 CONG. REC. S7623-89 (1988) (statement of Senator Roth).

dichotomy. Instead, the determination must be made based on the unique facts of the taxpayer's situation. While the IBM Watson computer may be up to the task,[222] the IRS's "antiquated, non-standard, and poorly designed" computers are not.[223] Nevertheless, by agency fiat and contrary to the clear intent of Congress, the IRS has deemed certain negligence penalties as automatic penalties, thus excepted from section 6751(b)'s approval requirement.

At least as far back as 2002, the IRS has assessed computer-generated negligence penalties against taxpayers without managerial approval. The basis for the IRS position is a 2002 memo from the IRS Office of Chief Counsel that sanctioned the tactic.[224] That memo responded to a request for advice on whether the section 6662(b)(1) negligence penalty could be automatically assessed, without managerial approval, against taxpayers identified by the IRS "Automated Underreporter" computer program.[225] The Automated Underreporter program proposed penalties when (i) the taxpayer was identified as an underreporter in the current year and a prior year, and (ii) the taxpayer did not respond to any IRS communications (collectively, the "Automated Underreporter Negligence Penalty Criteria").[226]

The Chief Counsel's arguments supporting the use of the Automated Underreporter program are, well, creative. However, like many of the rules applied mostly to unrepresented taxpayers,

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[222] IBM's Watson is "a cognitive system that enables a new partnership between people and computers that enhances and scales the human expertise." *See* IBM Watson, *Say Hello to Watson*, *available at* http://www.ibm.com/smarterplanet/us/en/ibmwatson/.

[223] See John Bodoh, *Tech Timebomb: The IRS Is Still Living in the 1960s*, WASH. EXAMINER (Dec. 17, 2014), *available at* http://www.washingtonexaminer.com/tech-timebomb-the-irs-is-still-living-in-the-1960s/article/2557483.

[224] *See* SCA 200211040, Office of Chief Counsel, Memorandum for Associate Area Counsel, Managerial Approval and Notice Requirements of Penalties—Section 6751(b) 3 (Jan. 30, 2002).

[225] *Id*. The memo notes that the:

> Automated Underreporter program is a document matching program. The program compares a taxpayer's return with third party information returns concerning the taxpayer. If there is a discrepancy between the two, the computer program calculates a proposed deficiency and prepares a letter to the taxpayer requesting the taxpayer to explain the discrepancy.

Id. at 2.

[226] *Id.* at 2.

they do not withstand serious scrutiny. The Chief Counsel's arguments (paraphrased) are as follows:[227]

1. Congress did not explain what it meant by "automatically calculated through electronic means," and the legislative history does not explain the phrase, so we are free to make up a definition.

2. We believe it must mean *something more* than a mathematic calculation; else all penalties could be excepted because they all are based on a mathematical calculation.

3. The *something more* must be an independent IRS employee determination of whether the penalty applies, and because we have programmed our computers to identify Automated Underreporter Negligence Penalty Criteria, no IRS employee makes such a determination.

As a result, according to the Chief Counsel memo, the negligence penalty is "automatically calculated through electronic means," and no managerial approval is necessary for penalties proposed by the Automated Underreporter computer program.[228] The problems with the IRS arguments are:

> Argument 1 is false, because Congress did explain what it meant when it included the phrase "automatically calculated through electronic means,"
>
> Argument 2 is a false dichotomy and "No True Scotsman,"[229] and
>
> Argument 3 is based on the false premise in 2), and contrary to the entire purpose of the law.

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[227] *Id.* at 2–4.

[228] SCA 200211040.

[229] "This fallacy is a form of circular reasoning, in that it attempts to include a conclusion about something in the very definition of the word itself. It is therefore also a semantic argument. The term comes from the example: If Ian claims that all Scotsman are brave, and you provide a counter example of a Scotsman who is clearly a coward, Ian might respond, 'Well, then, he's no true Scotsman.' In essence Ian claims that all Scotsman are brave by including bravery in the definition of what it is to be a Scotsman. This argument does not establish any facts or new information, and is limited to Ian's definition of the word, 'Scotsman.'" See Logical Fallacies, Introduction to Argument, available at http://www.theskepticsguide.org/resources/logical-fallacies.

Section 6751(b)'s admittedly scant legislative history does indeed explain that Congress did not intend the approval requirement be extended to discretionary penalties like negligence. Congress explicitly included the Failure to Act penalties in the law, and the addition of the "any other penalty automatically calculated through electronic means"[230] proviso was likely intended to cover additional scenarios, like the Failure to Act penalties, that fit within a true/false dichotomy. Moreover, because the negligence penalty is the most-used discretionary penalty provision in the Code,[231] it is reasonable to assume that if Congress wanted to give the IRS the power to avoid the supervisory approval requirement for negligence penalties, it would have done so explicitly.

The second argument presents an interesting piece of misdirection. The IRS Chief Counsel's memo presents two supposedly opposing views: the language means either only a mathematic calculation, or, necessarily, everything else. The misdirection occurs by the analogy to the mathematical calculation, which is only used as a strawman to make the contrary argument. No one, other than the IRS Chief Counsel in the memo, argued that section 6751(b) applied only to mathematical calculations: it is not in the legislative history, not in the law, and appears no place other than counsel's argument. Rhetorically however, the mathematical calculation argument forms the basis of the regulatory reach—if it is not just math, it must be everything short of an actual IRS employee determination. Thus, unless an IRS employee makes the determination, section 6751(b)'s supervisory approval requirement does not apply.

The problem with that argument is that Congress, in passing section 6751(b), wanted to ensure that an IRS supervisor approved all discretionary penalties. Allowing the IRS to avoid the purpose and spirit of the law through the Automated Underreporter program would give the IRS unfettered discretion, through more sophisticated computer programs, to make any and all penalties

[230] *See* I.R.C. § 6751(b)(2)(B).

[231] In its 2013 Data Book, the IRS lists six penalties and one category for "Other." They are (1) Accuracy, (2) Bad Check, (3) Delinquency, (4) [Failure to pay] Estimated Tax, (5) Failure to pay, and (6) Other. The "Other" category represents "penalties related to failure to supply taxpayer identification number and failure to report tip income." Of those penalties, the Accuracy penalty is the only discretionary penalty.

computer-determined and gut the law. That clearly was not the intent of Congress.

A broader problem with the position advanced by the IRS is that it would likely deter taxpayer compliance. In 2013, the Taxpayer Advocate conducted a study that examined the compliance behavior of taxpayers who were subject to automatic accuracy-related penalties. The study found that taxpayers who were subject to automatic penalties "were significantly less compliant than those who were not penalized."[232] The IRS's expansion of those automatic penalties, which is now IRS policy, represents the perfect storm of bad policy: illegal, unfair, and counterproductive.

D. EITC and the Phantom Penalty

> *"The IRS often ignores the statutory requirements for imposing the [EITC] ban, contravenes its own Chief Counsel guidance, and bypasses its own procedural safeguards to impose the ban."*[233]

The average taxpayer claiming the EITC has an adjusted gross income ("AGI") of $15,478, and an average EITC claim of $3,731, approximately 24 percent of their AGI. Section 32(k) gives the IRS the right to ban taxpayers from claiming the EITC in future years if those taxpayers' claims was due to "reckless or intentional disregard of the rules and regulations."[234]

As noted in Part II, "reckless" and "intentional" are undefined in the statute and no regulations have been issued under section 32(k).[235] Recklessness is generally regarded as "one of the murkiest [legal] standards," and courts and commenters have long struggled with an exact definition.[236] For tax penalty purposes, however,

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232 2013 NTA REPORT, *supra* note 104, vol. 2 11.
233 *Id*. at 311.
234 I.R.C. § 32(k)(ii).
235 *See* Plecnic, *supra* note 100.
236 *See* Geoffrey Rapp, *The Wreckage of Recklessness*, 86 WASH. U. L. REV. 111, 115 (2008) (citing W. Kip Viscusi & Richard J. Zeckhauser, *The Denominator Blindness Effect: Accident Frequencies and the Misjudgment of Recklessness*, 6 AM. L. & ECON. REV. 72, 73 (2004) ("[W]hat is meant by recklessness is not well defined."); Kenneth W. Simons, Should the Model Penal Code's Mens Rea Provisions be Amended?, 1 OHIO ST. J. CRIM. L. 179, 189

Treasury regulations provide generally that reckless means "the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe."[237] For the IRS to make a reckless determination pursuant to section those regulations, it must come to some determination about the taxpayer's efforts to follow the law, which would appear to require at least some interaction with the taxpayer.

Unfortunately for taxpayers, however, the IRS has chosen to apply a standard well short of recklessness to the section 32(k) ban. That lesser standard has allowed the IRS to routinely impose the ban without ever interacting with the taxpayer.[238] This is true despite the IRS's own guidance to the contrary.

In a 2002 advisory memo, the IRS Chief Counsel stated that a ''taxpayer's failure to respond to a request from the Service for substantiation and verification of [the EITC] alone is not sufficient to be considered reckless.''[239] That same guidance concluded that

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(2003) (meaning of elements of recklessness is "ambiguous"); Gregory A. Williams, Note, Tuttle v. Raymond: *An Excessive Restriction upon Punitive Damages Awards in Motor Vehicle Tort Cases Involving Reckless Conduct*, 48 OHIO ST. L.J. 551, 572 n.176 (1987) (judicial imprecision with regard to terminology makes tracking the meaning of various recklessness standards difficult)). The murkiness of the term "recklessness" extends outside of the law. For instance, a "contemporary edition of Noah Webster's *An American Dictionary of the English Language* makes no mention of recklessness." Rickie Sonpal, Note, *Old Dictionaries and New Textualists*, 71 FORDHAM L. REV. 2177, 2204 (2003) (citing NOAH WEBSTER, AN AMERICAN DICTIONARY OF THE ENGLISH LANGUAGE 1490 (Springfield, Mass. 1869)).

237 *See* Treas. Reg. §§ 1.6662-3(b)(2) and 1.6694-3(c).

238 *See* 2013 NTA REPORT, *supra* note 104, Most Serious Problems #9. The report notes that:

> [W]ith startling frequency, the IRS imposed the ban on taxpayers with whom it had had no interaction 49 percent of the time in 2009, 44 percent of the time in 2010, and 39 percent in 2011. There was no occasion on which the IRS could ascertain anything about these taxpayers' states of mind. As discussed below, IRS procedures permitted automatic imposition of the ban in some cases because the taxpayer did not respond to IRS audit notices, despite Chief Counsel guidance to the contrary.

Id. at 105.

239 IRS Service Center Advisory Mem. 200245051 (Nov. 8, 2002), *available at* http://www.irs.gov/pub/irs-wd/0245051.pdf.

if an EITC claim was disallowed because the taxpayer did not respond (or did not respond adequately) to a request for substantiation, the ban should not be imposed.[240] Nevertheless, the IRS has continued to impose the ban automatically, contrary to its own counsel's guidance.[241]

With respect to the section 32(k) ban, which is a penalty in all but name, the IRS has chosen to ignore the definition of reckless in the section 6662 regulations. Instead, it has advised its employees that a claim is reckless, for EITC purposes, "if the [IRS] can determine the claim was reckless."[242] That circular definition is, in effect, the Potter Stewart definition of pornography, "I know it when I see it."[243]

As a result, the IRS has systematically imposed section 32(k) bans "on the basis of unexamined assumptions about the taxpayer's state of mind … potentially causing significant harm to taxpayers who may be entitled to EITC" in subsequent years.[244] In almost 90 percent of the cases in which the two-year ban was imposed, "there was no clear explanation of why the ban was imposed or the 'explanation' was that EITC had been disallowed in a prior year."[245]

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[240] *Id*.

[241] *See* 2013 NTA Report, *supra* note [ ], pp. 103-115.

[242] IRM, *supra* note 73. at § 4.19.14.6.1.

[243] Plecnic,*supra* note 100 (citing Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring)).

[244] 2013 NTA REPORT, *supra* note 104, at 104.

[245] 2012 NTA REPORT, *supra* note 10, at 106. The report further noted that

[T]here were 233 cases in which there was no clear explanation for imposing the ban other than the prior year's disallowance. There were 62 cases in which the only explanation for imposing the ban was the prior year's disallowance. Two hundred thirty-three + 62 is 295, and 295 out of 333 is 89 percent. A typical statement in a communication to a taxpayer was simply: "Based upon the information we have available, we propose that you should be restricted from receiving the EITC for the following 2 years. This 2-year ban is asserted for the reckless or intentional disregard of the rules and regulations regarding the EITC under IRC Section 32(k)(1)(B)(ii)." Moreover, the [Taxpayer Advocate Service] team reviewing the cases in the sample reported that IRS examiners sometimes indicated they were imposing the ban because they believed the taxpayer acted negligently (as opposed to recklessly or with intentional disregard of the EITC rules). The team did not quantify the number of cases in which the examiner gave this explanation for imposing the ban and

So What Does This Have To Do With Section 7491(c)?

Despite the fact that section 32(k)'s two-year ban is clearly a punishment for improper EITC claims, the Code does not treat it as such. Section 32(k), enacted as part of the Taxpayer Relief Act of 1997,[246] is part of Subtitle A of the Code, which governs income taxes. Penalties are governed by Subtitle F of the Code, and it is in Subtitle F where sections 6751(b) and 7491(c) can be found. Thus the IRS Reform Act's protections do not extend to the section 32(k) ban.

Absent such protections, the IRS has routinely applied the ban in situations contrary to the law. Under its current internal procedures, the IRS bases many section 32(k) bans on two factors: (i) whether the EITC was disallowed in a prior year, and (ii) whether the taxpayer responded to IRS correspondence.[247] If the taxpayer's prior year EITC claim was disallowed and the taxpayer fails to respond to IRS correspondence, the IRS automatically imposes the two-year ban, even in cases in which the notification to the taxpayer had been returned to the IRS as undeliverable.[248]

"For this vulnerable population of low-income taxpayers, inappropriately being deprived of the credit for two years is a serious burden that may be difficult to relieve."[249] It is highly unlikely any group of taxpayers, other than the unrepresented, would allow the IRS to ignore the law and penalize them improperly. However, this is the current state of affairs facing low-income taxpayers eligible to claim the EITC.

Pursuant to section 32(k), the IRS should only be able to ban taxpayers from claiming the EITC if it determines that a taxpayer's improper EITC claim was reckless or intentional.[250] If the IRS

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therefore we cannot project the frequency with which it occurs. However, this terminology certainly suggests inappropriate application of the ban. *Id.*

[246] Pub.L. 105–34, H.R. 2014, 111 Stat. 787, enacted August 5, 1997. I added "so-called" because it clearly did not provide relief for low-income taxpayers improperly claiming the EITC.

[247] 2013 NTA REPORT, *supra* note 104, at 106–07.

[248] *Id*.

[249] *Id*. at 314.

[250] *See* I.R.C. § 32(k)(1). If the IRS determines the claim was fraudulent, a ten-year ban applies. *See* I.R.C. § 32(k)(1)(B)(i).

Reform Act's protections were extended to section 32(k), the IRS would have the burden of production whenever it sought to impose the two-year EITC ban and an IRS supervisory would have to personally approve the ban. The absence of the burden shift in section 7491(c) means that taxpayers challenging the ban are forced to prove a negative: that their EITC claim was not due to reckless or intentional disregard of rules and regulations. In other contexts, particularly in unreported income cases, courts have deemed such a burden unfair.[251] Nevertheless, that is the burden unrepresented taxpayers face when challenging the section 32(k) ban.

Extending the IRS Reform Act protections to section 32(k) would ensure that an EITC ban, which could amount to 24 percent of a taxpayer's income, was being administered fairly and consistent with Congressional intent. Absent such protections, unrepresented taxpayers have little, if any, real protection from whatever rules the IRS deems appropriate.

IV. THE SOLUTION

"The various sections of the Code should be construed so that one section will explain and support and not defeat or destroy another section."[252]

To bring some much needed clarity and fairness to the administration of tax penalties, three changes are warranted.

- First: eliminate the requirement that taxpayers need to assign error to IRS penalty determinations in order for the IRS to shoulder its burden of production.

[251] *See* Gatlin v. Commissioner, 754 F.2d 921, 923 (11th Cir. 1985) (citing Cohen v. Commissioner, 266 F.2d 5, 12 (9th Cir.1959)) ("The rationale behind this rule is that a taxpayer should not bear the burden of proving a negative (no unreported income) if the Commissioner can present no substantive evidence to support his deficiency claim.").

[252] Blak Invs. v. Commissioner, 133 T.C. 431, 439–40 (2009) (citing Crane v. Commissioner, 331 U.S. 1, 13 (1947)).

- Second: clarify that penalties "automatically calculated through electronic means" should not include discretionary penalties.
- Third: prohibit the IRS from imposing EITC bans automatically.

These changes would ensure that taxpayers, particularly unrepresented taxpayers, would be able to rely on the protections Congress gave them when it passed the IRS Reform Act.

The changes identified above could be instituted by the IRS and Treasury alone. However, to date, the IRS has shown no willingness to do so, and Treasury has not stepped in and promulgated regulations addressing the issues identified in this Article. Instead, the IRS has read sections 7491(c) and 6751(b) together in a manner completely at odds with Congressional intent, and Treasury has sat idly by on the sidelines.

The IRS interpretation of sections 7491(c) and 6751(b), with editorial comment by this author based on IRS public positions in parenthesis, would be:

> Section 7491(c)
>
> In any court proceeding (*in which the taxpayer raises the issue with at least some undeterminable degree of specificity*), the IRS has the burden of production with respect to a tax penalty (*unless Tax Court Rule 34(b) trumps the statute and relieves the IRS of its burden of production*), and therefore must show, at a minimum, that the penalty is authorized by the law (*well, laws that the IRS believes are important, not that silly signature requirement*).
>
> Section 6751(b)
>
> The initial *("initial" can mean initial, intermediate or final*) determination (*determinations are supposed to be made by IRS examiners, but we'll delegate that privilege to IRS lawyers or the Tax Court if it helps our litigating position, despite the fact that no law allows the IRS to so delegate*) of any discretionary penalty *(unless our computers can make such a determination automatically, at which point the discretionary penalty becomes an*

> *automatic penalty, and this provision no longer applies),* must be personally approved in writing by the immediate supervisor of the individual making such determination (*unless the IRS never got such a signature, at which point the IRS can either (i) get a supervisory signature during litigation, (ii) have IRS Counsel approve the penalty during litigation, or, if all else fails, (iii) simply ignore the requirement*).

While admittedly tongue-in-cheek, each of the above editorial comments is based on an argument put forth by the IRS since the IRS Reform Act was enacted, and each acted to erode the IRS Reform Act's protections.

The courts could force the IRS to respect the penalty protections in the IRS Reform Act. At least with respect to the burden of production issue, however, the Tax Court has been part of the problem. It is too early to tell whether the Second Circuit in *Rozbruch*,[253] or Tax Court in *15 West 17th St*,[254] *Illinois Tool Works* or *Graev*, will hold the IRS to its supervisory approval requirement, but the mere fact that courts are at least countenancing such challenges is promising. However, courts are an imperfect vehicle to affect policy change, because their task is not to set policy, but to decide cases.

As a rule, broad policy changes should not be based on the vagaries of a particular taxpayer's circumstance. This is especially true in the tax arena, because the Tax Anti-Injunction Act prohibits interested stakeholders, like low-income taxpayer clinics, from broad-based legal challenges to IRS policies.[255] That leaves with

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[253] *See supra* note [].

[254] *See supra* note [].

[255] The Tax Anti-Injunction Act, codified at section 7421, provides generally that except for taxpayers challenging their own assessment of a tax or tax penalty, "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed." *See* I.R.C. § 7421(a). *See also* Diane P. Wood, *Fine-Tuning Judicial Federalism: A Proposal for Reform of the Anti-Injunction Act*, 1990 B.Y.U. L. Rev. 289 (1990); Ian Millhiser, *SCOTUS Preview Part I: What The Heck Is The Tax Anti-Injunction Act?*, ThinkProgress.Org (Mar. 23, 2012) available at http://thinkprogress.org/justice/2012/03/23/450172/scotus-preview-part-i-what-the-heck-is-the-tax-anti-injunction-act/.

Congress the responsibility to clarify the IRS Reform Act's penalty provisions and provide the protections it sought when it enacted those provisions seventeen years ago. A brief explanation of how Congress could bring about those clarifications is as follows.

The Burden of Production

Section 7491(c) unequivocally provides that the IRS has the burden of production "any court proceeding." Nevertheless, the IRS and the Tax Court have adopted procedures that continue to allow it to shirk that burden. That must change.

The change required would put the onus on the IRS to clearly demonstrate why the penalty was appropriate in court proceedings. The IRS accomplishes this task routinely for the Failure to Act penalties by including the basis of the penalty in the notice of deficiency as required by section 6751(a).

However, for discretionary penalties, what is currently included in the notice of deficiency is insufficient. The simplest way for the IRS to meet its burden would be for it to include a copy of the signed penalty approval form in the notice of deficiency for all discretionary penalties. Also, Treasury could, by regulation, require the IRS to include the penalty approval form.

If neither the IRS nor Treasury acted, the courts, particularly the Tax Court, could require the IRS to include the penalty approval form in the IRS Response in any case in which discretionary penalties were proposed. However, under its *Funk*, *Swain* and even *Wheeler* precedents, the Tax Court has implicitly allowed the IRS to avoid meeting its burden of production by requiring taxpayers to assign error to the IRS determinations in the petition. While in line with Tax Court precedent and Rule 34(b), such a rule ignores the plain language of the law.

Notwithstanding action by either the courts, Treasury, or the IRS, Congress should amend section 6751(a) to require the IRS include proof of it has satisfied section 6751(b) in notices of deficiency. An amended section 6751(a) would read as follows (with amendments in italics):

> (a) Computation of penalty included in notice
>
> The Secretary shall include with each notice of penalty under this title information with respect to the name of the penalty, the section of this title under which the penalty is

> imposed, *proof the penalty was approved as required under subsection (b) below,* and a computation of the penalty.

This change would not unduly burden the IRS, and would ensure the IRS follows Congress mandate that the IRS, not taxpayers, bear the burden of production with respect to penalties.

Penalty Approval in Writing

For discretionary penalties, the IRS should be required to determine, at a minimum, that the IRS consider the taxpayer's specific facts and circumstances to determine if the penalty is appropriate. However, through its use of the Automated Underreporter program, the IRS is assessing section discretionary penalties without such considerations. A properly functioning section 6751(b) would end that practice, because it would require IRS supervisors, not IRS computers, to be the final arbiter on the proposed penalty assessment.

The IRS clearly will not impose this burden upon itself. As noted earlier, the IRS has concluded that it is far more efficient to, in effect, let its computers determine some penalties and let the taxpayers fix it later.[256] For example, in 2014, the IRS sent over 71,000 letters to taxpayers proposing over $71 million in accuracy-related penalties "before the IRS ever inquired about the discrepancy or called the taxpayer … [which] leaves the burden on the taxpayer to prove that the penalty does not apply."[257] That burden means that taxpayers need to contact the IRS, a "disproportionate burden on unsophisticated taxpayers who have

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[256] *See supra* note [?], IRS "does not consider it unfair to taxpayers for the IRS to assert penalties through a systemic process which applies distinct criteria to identify potential instances of noncompliance . . . ." (emphasis added). *See* 2014 Annual Report, p. 99 citing IRS response to TAS information request (July 10, 2014); *see also* 2013 Annual Report, p. 185, 186 ("The IRS's administration of penalties sometimes prioritizes automation and efficiency rather than accuracy and fairness. . . . . The IRS's general approach to accuracy-related penalties burdens taxpayers by requiring them to prove the penalties are inapplicable.").

[257] *See* 2014 Annual Report, p. 409, citing the IRS Compliance Data Warehouse, Individual Master File (Dec. 22, 2014). This figure omits the accuracy-related penalties assessed in FY 2014 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.

difficulty communicating with the IRS or do not understand the relevant facts and legal rules."[258] Moreover, "in an environment of continuing budget cuts, the inability to contact the IRS is a challenge faced not only by low income taxpayers, but by *all* taxpayers. [For example, in the 2014] fiscal year…, only 64.4 percent of taxpayers calling to speak to an IRS customer service representative could get through and the average time on hold was 19.55 minutes."[259]

Although the IRS interpretation of section 6751(b) is incorrect, no court has yet made that determination. While pending cases may clarify the law, decisions in those cases could take years. A better solution would be for Congress to step in and clarify section 6751(b)'s meaning, and make it clear to the IRS that discretionary penalties, such as the section 6662 accuracy-related penalty, cannot escape section 6751(b) supervisory approval requirement under any circumstances. Moreover, Congress should "specify which penalties and facts or circumstances result in penalties 'automatically calculated through electronic means.'"[260]

The EITC Penalty

The IRS should not impose the EITC ban on unsophisticated taxpayers who do their best to comply with the law. In passing section 32(k), Congress mandated that the IRS determine that a taxpayer was at least reckless before imposing the ban, and the IRS should follow that mandate. Instead, the IRS has adopted lesser standards for imposing the ban, including a simple failure to respond, a finding well short of recklessness.

To prevent the IRS from improperly imposing the ban, Treasury could adopt regulations adopting the definition of reckless or intentional disregard from section 6662 or 6694 for use in section 32(k). Alternatively, Congress could amend section 32(k) to cross-reference the definition of reckless in those regulations. However, while either choice would provide a legal basis for taxpayers to challenge the ban, both would still require

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258 *See* 2013 Annual Report, p. 182.

259 *See* 2014 Annual Report, p 409, citing IRS, Joint Operations Center, Snapshot Reports: Enterprise Snapshot (week ending Sept. 30, 2014).

260 *See* 2014 Annual Report, p. 303.

some action on the part of the taxpayer to be effective. For the unrepresented taxpayers seeking to claim the EITC, such a requirement would likely be ineffective because the onus would still be on the taxpayer to challenge the ban.

A better solution would be for Congress, after clarifying that section 6751(b) applies to all discretionary penalties, to extend section 6751(b)'s supervisory approval requirement to section 32(k). Not only would that be good policy, it would be the best reflection of congressional intent. However, unless and until Congress acts, the IRS will likely continue to blithely impose the ban based on its internal guidelines. The reason is simple: it is more efficient to apply a blanket penalty than to individually assess each case, notwithstanding the fact that the law requires the latter.

V. CONCLUSION

The problems highlighted in this Article stem from, among other things, a lack of coordination between the laws Congress enacts, and how the IRS administers those laws. When requested by Congress to comment on pending legislation, the IRS generally seeks the views of its business operating divisions, who are supposed to solicit comments from the front-line technical experts as needed.[261] Yet, as of 2014, the IRS had failed to "identify any front-line technical expert(s) who had ever been consulted."[262] As the Taxpayer Advocate concluded in her most recent report:

> If the IRS establishes a process by which it automatically identifies specific front-line technical experts who can discuss the administrability of pending (or existing) legislation directly with the tax-writing committees, then members of Congress and their staff are more likely to

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[261] 2014 Annual Report, p. 110.

[262] *Id.* The 2014 Annual Report did note, however, that the "IRS later clarified that it does not maintain a list of these communications and did not create one in response to [Taxpayer Advocate Service]'s information request." According to an IRS database that tracks the steps it takes to implement various provisions, the IRS's only activity in response to the IRS Reform Act § 4021 was to "[A]dvise JCT and Treasury that Legislative Affairs is the contact point" on December 28, 1998. IRS, Enacted Law Report – Actions, AT-2009-13387 (May 28, 2014). When asked about what other actions it took to implement this provision, the IRS did not identify any. IRS response to TAS information request (July 15, 2014).

> consult with these experts before finalizing legislation, and that legislation is likely to be simpler, easier for taxpayers to understand and for IRS employees to administer.

The report further noted that "[S]uch laws would better effectuate the taxpayer rights to a fair and just tax system and quality service," a goal put forward by the IRS.[263]

The IRS has a tough job, and Congress has not made that job any easier by failing to provide proper funding for the agency. As a result, it is no wonder the IRS often seeks efficiency over fairness. However, that quest for efficiency should not allow the IRS to trample the rights of unrepresented taxpayers by avoiding or ignoring the protections Congress gave those taxpayers when it passed the IRS Reform Act. Congress should act to restore those protections, and provide citizen taxpayers with the justice they deserve.

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[263] 2014 Annual Report, p. 110, citing IRS, Publication 1, Your Rights as a Taxpayer (2014).