Legislative Recommendation #34

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

PRESENT LAW

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

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

REASONS FOR CHANGE

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

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

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

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

2 In FY 2019, the IRS imposed 32.8 million penalties on individuals, estates and trusts in connection with income tax liabilities. The following penalties, generally imposed by electronic means, accounted for about 98 percent of the total: failure to pay (18.8 million), failure to pay estimated tax (9.7 million), failure to file (2.9 million) and bad checks (0.9 million). IRS, 2019 Data Book, Table 26, *Civil Penalties Assessed and Abated, by Type of Tax and Type of Penalty, Fiscal Year 2019*, at 61 (2020).

data suggests the taxpayer failed to report income reflected on a third-party information return for a second tax year in a row.[3]

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

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

RECOMMENDATION

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

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