

Penalty Strategies that Work

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Agenda

- Penalties Are an IRS Priority
- The State of Penalty Administration
- Penalty Strategies

Penalties Are An IRS Priority

Penalties Are An IRS Priority

(4) Although penalties support and encourage voluntary compliance, they also serve to bring additional revenues into the Treasury and indirectly fund enforcement costs. However, these results are not reasons for creating or imposing penalties.

(5) **Penalties advance the mission of the IRS when they encourage voluntary compliance.** The IRS has formalized this obligation to the public in its mission statement.

(6) Voluntary compliance is achieved when a taxpayer makes a good faith effort to meet the tax obligations defined by the Internal Revenue Code. ...

(10) **Penalties should relate to the standards of behavior they encourage.** Penalties best aid voluntary compliance if they support belief in the fairness and effectiveness of the tax system

I.R.M. 20.1.1.2.1 Encouraging Voluntary Compliance.

Penalties Are An IRS Priority (cont'd)

- Many of the key court decisions in the last year have focused on penalties
- IRS has been listing more transactions- focus on information reporting and penalties
- 2023-24 priority guidance plan includes finalizing regulations on supervisory approval of penalties
- IRS practice includes systemic penalty assessments by campus functions for various penalties
- “The IRS stated that the Dollars per Hour metric does not include the assessment of penalties, and that **penalties are a significant focus of [LB&I] WEIIC’s compliance effort.**”
 - Takeaway point: LB&I WEIIC has spent the vast majority of its examination resources pursuing middle class taxpayers focusing on penalties.
 - See Treasury Inspector General For Tax Administration, Rep. No. 2023-30-019, The IRS Large Business and International Division Should Consider Shifting Individual Examination Resources to More Productive Examinations (May 25, 2023)

IRS Penalty Administration Is Broken



IRS Penalty Administration Is Broken

- Civil examiners are encouraged to make fraud referrals to Criminal Investigation
- Civil examinations often result in IRS agents asserting maximum penalties
- “Innocent” mistakes may be recast by IRS as fraud or willful errors
- Some examiners hint that managers will not allow case closure without penalties



IRS Penalty Administration Is Broken (cont'd)

- Systemic campus-based penalty assessments decrease voluntary compliance
 - Penalties for late filed information returns regardless of reasonable cause statements
 - Abatement consideration is slow, mechanical, and almost always against abating

IRS Penalty Administration Is Broken (cont'd)

- Penalty computations are often wrong
- At times IRS penalty notices reference completely incorrect penalties
 - IRS penalty assessments can be completely disconnected from reality
- No consideration of facts if submitted with late filings
- IRS approach is to penalize at maximum levels and force taxpayers to beg for relief through a lengthy administrative process
- IRS ignores textbook cases of reasonable cause

IRS Penalty Administration Is Broken (cont'd)

- The IRS treats timely filings untimely and penalizes them
 - Ueland v. United States, docket no. 1:23-cv-00931 (Court of Federal Claims)
 - IRS ignored the filing of a Form 7004 extension of time to file and treated Form 3520-A as untimely
 - IRS penalized taxpayers nearly \$100,000 for timely filing of Forms 3520-A reporting Australian Superannuation funds
 - IRS took nearly \$100,000 from the next year's refund for the penalty
 - IRS failed to notify taxpayers of penalty assessment
 - IRS failed to provide penalty computation under I.R.C. sec 6751(a)
 - IRS failed to establish a supervisor approved the penalty in writing prior to assessment under I.R.C. § 6751(b)(1)
 - IRS Independent Office of Appeals lost request appealing penalty
 - Taxpayers were forced to hire attorneys and sue
 - DOJ Tax Division conceded the case without filing a responsive pleading

Example of a Broken Process

- Late filing with reasonable cause statement
- Penalty assessed at maximum rates
- Penalty notice issued
- Contest the penalty notice based on reasonable cause within 30 days
- **IRS Collection may begin efforts to collect the assessed penalty**
- IRS campus issues letters 2644C notifying it needs time to consider submission
- Next filing year refund offset against assessed penalty
- IRS campus denies reasonable cause and issues a letter providing review by the Independent Office of Appeals (60 day timeline to appeal)
- Appeal IRS determination within 60 days for review by the Independent Office of Appeals and case enters queue

Penalty Strategies

Assessment – The Process Begins

- IRS determines penalty during return processing
- IRS assesses penalty and places the penalty on its books
- IRS sends a notice sent to taxpayer (e.g., CP 14, CP 15, CP215...) which satisfies the procedural requirement for the IRS to send notice and demand under I.R.C. § 6303(a)

Penalty Notices

- CP14 says under the heading Penalties: “We are required by law to charge applicable penalties. However, in select situations, we may be able to remove or reduce penalties. Visit [irs.gov/penalties](https://www.irs.gov/penalties) to learn more.”
 - Following www.irs.gov/penalties to www.irs.gov/payments/penalty-relief provides information on how to request relief
- CP15 notices vary in their statements about contesting penalties.
 - Some say pay and file a refund claim
 - Others provide 30 days to provide a written submission to explain reasonable cause
- Other notices- read the notice for information on disagreeing with penalties
- **Takeaway:** Penalty notices provide the path for contesting penalties. In general, within 30 days send by certified mail a letter explaining why taxpayer is entitled to penalty relief with copy of the notice.

Eight Week Band-Aid – Form 656-L

- File Form 656-L, Offer in Compromise Doubt as to Liability, asserting reasonable cause or IRS' failure to obtain supervisory approval of penalty
- Upon receipt of Form 656-L, IRS will implement a collection stay
- Collection stay is generally for eight weeks
- Form 656-L may be returned and not considered
 - Note the “pre-qualifier assessment” steps 5 and 11
 - IRS does not want Form 656-L to be your first attempt to resolve the penalty
- Possible strategy for clients who may suffer serious harm from the filing of a notice of federal tax lien (weigh against CDP rights)

Appeals Settlement Possibilities for Penalties

- First Time Abate
- Reasonable cause
- § 6751(b)(1) supervisory approval
- Hazards of litigation
- Penalty mitigation

See generally IRM 8.11.1 “Return Related Penalties in Appeals”

Other Arguments to Raise

- Reliance on IRS FAQs or oral advice
- I.R.C. § 6751(a) lack of penalty computation
- Constitutional Due Process
- Any other argument applicable to the specific case

Policy Statement 8-47 at IRM 1.2.1.9.6

“Appeals will ordinarily give serious consideration to an offer to settle a tax controversy on a basis which fairly reflects the relative merits of the opposing views in the light of the hazards which would exist if the case were litigated. However, **no settlement will be made based upon nuisance value of the case to either party.** If the **taxpayer makes an unacceptable proposal** of settlement under circumstances indicating a good-faith attempt to reach an agreed disposition of the case on a basis fair both to the Government and the taxpayer, the Appeals official generally should give an **evaluation of the case in such a manner as to enable the taxpayer to ascertain the kind of settlement that would be recommended for acceptance. ...**”

First Time Abate (FTA)

- The IRS focuses on threshold criteria of past compliance as follows:
 - Same return type, if required, for the **past three tax years** before the tax year you received the penalty.
 - Didn't receive any penalties during the prior three years, or any penalty was removed for an acceptable reason other than First Time Abate.
- Does not apply to all penalties but that doesn't mean you cannot ask for FTA
- For general information, see <https://www.irs.gov/payments/penalty-relief-due-to-first-time-abate-or-other-administrative-waiver>

Reasonable Cause

- Appeals often considers
 - Taxpayer compliance history
 - Length of time to come into compliance
- Appeals has favorite cases to cite and consider in nearly all reasonable cause disputes
 - Review Appeals' training material on reasonable cause released pursuant to a FOIA request at <https://www.pricetaxlaw.com/penalty-abatement>
- Resolutions based on reasonable cause range from IRS fully conceding the penalty to hazards of litigation focusing on strengths and weaknesses of reasonable cause

Reasonable Cause (cont'd)

- United States v. Boyle, 469 U.S. 241 (1985)
 - The timely filing of a tax return is not excused by the taxpayer's reliance on an agent
- Neonatology Assocs., P.A. v. Commissioner, 115 T.C. 43, 98–99 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002)
 1. the advisor is competent
 2. the taxpayer provided necessary and accurate information to the advisor
 3. the taxpayer relied in good faith on the advisor

Reasonable Cause (cont'd)

I.R.M. 20.1.1.3.2.2.6 (11-25-2011) provides the following factors to consider in the context of mistakes based on ignorance of the law:

(1) In some instances taxpayers may not be aware of specific obligations to file and/or pay taxes. The ordinary business care and prudence standard requires that taxpayers make reasonable efforts to determine their tax obligations. ...

Reasonable Cause (cont'd)

I.R.M. 20.1.1.3.2.2.6(2) Reasonable cause may be established if the taxpayer shows ignorance of the law in conjunction with other facts and circumstances. For example, consider the following:

- a. The taxpayer's education.
- b. If the taxpayer has previously been subject to the tax.
- c. If the taxpayer has been penalized before.
- d. If there were recent changes in the tax forms or law which a taxpayer could not reasonably be expected to know.
- e. The level of complexity of a tax or compliance issue.

Drafting Tips Reasonable Cause Statements

- Put effort into the abatement request
 - identify the issue
 - include all the facts
 - summarize the law and policy
 - apply the law and policy to the facts
- Write the facts to fit into the theme of “reasonable cause” as developed by caselaw
- Support facts with documents

Drafting Tips Reasonable Cause Statements (cont'd)

- Humanize your client and tell a story
- Argue the equities and any other compelling facts to support your reasonable cause request
- Stacy Caplow, *Putting the “I” in Writing: Drafting an A/Effective Personal Statement to Tell a Winning Refugee Story*, 14 *Legal Writing: J. Legal Writing Inst.* 249 (2008).
 - Article has some good tips on writing a compelling story
 - Draft a moving personal account in the first person
 - Persuade a jaded decision maker to grant relief

I.R.C. § 6751(b)(1)

Confirm written supervisory approval of penalties.

I.R.C. § 6751(b) states: “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.”

I.R.C. § 6751(b)(2)

Exceptions to written supervisory approval of penalties under I.R.C. § 6751(b)(2):

(A) any addition to tax under § 6651, 6654, 6655, or 6662 (but only with respect to an addition to tax by reason of subsection (b)(9) thereof); or

(B) any other penalty **automatically calculated through electronic means**

- IRS position is that some penalties are automatically calculated through electronic means
 - Mandatory efilings and IRS improvements in programming are allowing the IRS to use computer systems with no human involvement to assess more and more penalties.



I.R.C. § 6751(b)(1) supervisory approval

- Generally all or nothing resolution
- Appeals Officers should verify timing of penalty approval by locating source document in administrative file
 - Not explicit but implicit at IRM 8.11.1.2.1
- For campus-based penalty assessments, locating source document may be difficult for Appeals
- Practitioner best practice- explicitly raise supervisory approval in protest

FOIA to Optimize § 6751(b)(1) Presentation to Appeals

- **As soon as you anticipate a penalty dispute, send the IRS a FOIA for § 6751(b)(1) documents concerning written supervisory approval**
- **In context of penalties that are campus assessed, highly likely that IRS will not produce actual record satisfying § 6751(b)(1)**
- **Appeal the FOIA production**
- **In the Appeals protest on the penalties, provide Appeals the records obtained in FOIA to make the Appeals Officer's job easier and to present a complete record**

FOIA Request Relating to I.R.C. § 6751(b)

- Was supervisory approval documented in writing?
- Was supervisory approval timely?
- Was person who provided written approval a supervisor as required by the IRC?
 - What if the penalty approver is described as a “team lead” or “work leader”?
- Do you suspect penalty backdating?

Where to send FOIA Request

- Best to use FOIA portal or fax to 877-891-6035
<https://www.irs.gov/privacy-disclosure/freedom-of-information-act-foia-guidelines>
- See <https://www.irs.gov/privacy-disclosure/freedom-of-information-act-foia-guidelines> for general information on filing FOIA requests and appealing IRS responses
- If no acknowledgement within 30 days, contact IRS FOIA Public Liaison at 312-292-3297

Hazards of Litigation

- IRM 8.11.1.2.7.5 states:
 - (4) The hazards of litigation are the uncertainties of the outcome of the court's decision in the event of a trial.
 - (5) Litigating hazards generally fall into three categories: factual, legal and evidentiary.
Note: Lack of case law should not be considered a hazard of litigation.
- Factual hazards- salient facts are unclear as to whether the taxpayer meets reasonable cause. Examples:
 - Taxpayer claims he was ill at the time a return was due but the facts are inconclusive
 - Taxpayer filed a return 10 days late and the facts are inconclusive regarding whether he timely postmarked his filing.
- Legal hazards- status of case law, law of circuit, etc.
- Evidentiary hazards- (admissibility, willingness/availability of witnesses)

Hazards of Litigation - Wrzesinski

- I.R.C. § 6039F penalty refund case
- Appeals offered a hazards of litigation settlement for a case that appears to have textbook reasonable cause for late reporting
- Taxpayer received \$800,000 in gifts from mom in Poland after mom hit the Polish lottery. Gift made in 4 transfers in 2010 and 2011.
- Taxpayer relied on EA's advice that gift was not taxable or reportable
- Later discovered requirement to report on Form 3520 and relied on IRS procedure providing penalty-free path to file late Forms 3520
- IRS assessed maximum penalties
- Appeals abated \$70,000 of the \$87,000 penalty assessed for tax year 2010 and \$96,000 of the \$120,000 penalty assessed for tax year 2011
 - 2010 abatement ratio was 80.4% abated v. 19.6% sustained
 - 2011 abatement ratio was 80% abated v. 20% sustained
- DOJ Tax Division conceded the case without filing a responsive pleading

The Mystery of Mitigation in Appeals

- Tax Analysts made a FOIA request to the IRS on Appeals' training material on international penalties
- FOIA production shed light on trend observed by practitioners
 - How do I get this Appeals' training material?
<https://www.pricetaxlaw.com/penalty-abatement>
- Essence of mitigation:
 - Compelling facts that do not equate to reasonable cause
 - Significant portion of penalty is abated
 - IRS wants taxpayer to feel some pain to “learn”

The Mystery of Mitigation in Appeals (cont'd)

- Practitioners have observed Appeals International forcing taxpayers with reasonable cause or highly sympathetic facts to eat 25-40% of assessed penalties in settlements
- May be a product of Appeals' "review and concurrence" process for certain issues
 - See I.R.M. 8.7.3.4.1 Review and Concurrence
 - Issue coordinators insulated from taxpayer contact, may be overconfident in government's position, ignorant of caselaw, jaded, or cavalier
 - When issue coordinators don't approve reasonable cause, Appeals Officers are left with mitigation

The Mystery of Mitigation in Appeals (cont'd)

- Formally adopted in FBAR context by Exam. See I.R.M. Exhibit 4.26.16-2
- Minimal or no hazards
- Extenuating circumstances exist
- According to Appeals penalty training material: “Mitigation is available but should be used sparingly.”

The Mystery of Mitigation in Appeals (cont'd)

- IRS Foundation for penalty mitigation
- Application of macro-level penalty policy to reduce the severity of the penalty
- I.R.M. 20.1.1.2.1 “Encouraging Voluntary Compliance”

I.R.M. 20.1.1.2.1 (8) The IRS has the obligation to advance the fairness and effectiveness of the tax system. Penalties should do the following:

- **Be severe enough to deter noncompliance,**
- Encourage noncompliant taxpayers to comply,
- Be objectively proportioned to the offense, and
- Be used as an opportunity to educate taxpayers and encourage their future compliance.

Appeals Offers Your Client A Crummy Deal

- You feel that you've established reasonable cause, the Appeals Officer hinted that you established reasonable cause, and then after "review and concurrence" the Appeals Officer offers a % reduction in the penalty. Is it game over?
- Ask for a managerial conference to elevate the disagreement over mitigation
- Managerial conferences in Appeals are discretionary
- See I.R.M. 8.7.3.4.1 about review and concurrence: "If the settlement is not acceptable [to the reviewer], provides a written response (rebuttal) to the Appeals Officer. If agreement is not reached, the respective managers attempt to resolve the dispute. If the Appeals Team Managers (ATMs) cannot resolve the dispute, the ATMs will refer it to ..."
 - Key - beg to get the ATM involved to push back against the reviewer

Post Appeals Mediation

- Non-binding mediation
 - factual issues
 - legal issues
- Requires having worked cooperatively with Appeals
- Certain issues excluded (designated for litigation, in court, whipsaw, etc.)
- Rev. Proc. 2014-63 provides option at taxpayer's expense to hire a non-IRS co-mediator
- Appeals' leadership has interest in expanding ADR
 - If Appeals Officer and Appeals Team Manager resist PAM, elevate within Appeals

Refund Litigation – The Last Resort

- IRS unreasonableness on penalties is forcing more taxpayers into costly litigation
- Pay penalty (or penalty was paid by refund offset)
- Request penalty to be refunded (Form 843)
 - Include all theories in the claim for refund to avoid variance
- Sue for refund

Refund Litigation – The Last Resort (cont'd)

- Issues to consider
 - Liquidity issues to pay penalty
 - Costs of litigation and possibility of attorney fees
 - Favorable facts to shame government and seek press attention (Wrzesinski or Ueland type facts may promote prompt government concession)
 - Malpractice claim against CPA and tolling agreement
 - Public record of litigation

Collection Litigation

- CDP
 - IRS collection due process (CPD) may result in Notice of Determination providing Tax Court review
 - CDP cases may provide for de novo review of assessable penalties
- Suits by Department of Justice
 - IRS may refer case to Department of Justice
 - Reduce lien to judgment – extends time to collect
 - Foreclose tax lien- obtain judicial sale of property subject to lien
 - Penalty defenses may be raised