Internal Revenue Code – Assessed Penalties

Taxpayer's Right to Challenge Assessment Before Collection

26 USC §6667(e), 26 USC §6679(b), 26 USC §6712(d) and 26 USC §6751(b)

Proposed change:

26 USC Section 6667(e), 26 USC Section 6679(b) and 26 USC 6712(d) shall each be amended to read as follows:

Subchapter B of chapter 63 (relating to deficiency procedures for income, estate, gift and certain excise taxes) shall apply in respect of the assessment and collection of any penalty imposed by subsection (a).

26 USC Section 6751(b) shall be amended by the deletion of sub-section (b)(2) and the re-numbering of section 6751(b)(1) as sub-section (b).

Reason for change:

When the Internal Revenue Code of 1954 was enacted, automatic data processing was in its infancy. Assessable penalties were assessed by individual Internal Revenue Service agents who made a reasonable cause determination at the time they decided whether or not a penalty should be assessed. The fact that these penalties were designated as "assessable penalties" as compared to "deficiencies" made little practical difference.

In today's Internal Revenue Service, the automated IRS computer system automatically generate penalties whenever an information tax return on Form 3520 (section 6667) or Form 5471 (section 6679) is late filed. The penalties are assessable penalties. The penalties are substantial – 35% of the reportable amount in the case of section 6677 penalties and $10,000 per return in the case of section 6679 penalties. These penalties are not reviewed by individual human being before being made because they are automatically calculated through electronic means, as provided in section 6751(b)(2)(b).

Once these penalties are assessed electronically, they are immediately collectable. The assessed penalties are electronically transferred to the Internal Revenue Service automated collection system. As far as IRS collection employees are concerned, the computer system shows that an amount is due, and their job is to collect it.

When a taxpayer receives a collection notice of an assessed penalty from the Internal Revenue Service about which they have had no previous communication, they may write to the Service asking for an explanation of why they are being assessed a penalty. This correspondence with the IRS results in a letter explaining that the Service needs an additional 45 days to research the issue and will contact the taxpayer as soon as the research has been completed. We have been involved in situations where these letters were sent every 45 days for over six months.

During this time, however, the IRS automated collection system continues to generate notices of impending tax liens and levies leading to the eventual notice of intent to levy and right to a hearing on Form CP90, a response to which is due at the IRS (not timely mailing) within 30 days from the date on the letter. We have had letters on Form CP90 arrive as late as twenty-five days from the date on the letter. The IRS views the 30 day time limit as jurisdictional that cannot be changed.

The only way to protest the assessment on one of these penalties is through the collections due process procedures under section 6330. That procedure provides for a hearing prior to levy. The Internal Revenue Service has interpreted the provisions of section 6330 narrowly to provide that a request for a hearing may only be made in response to a specific notice on Form CP90. A request for a hearing upon receipt of any of the prior notices generated by the IRS automated collection system saying that the taxpayer owes tax, interest or penalties, that the IRS is intending to file a tax lien or that the IRS is intending to levy on a taxpayer's assets is treated by the IRS as premature. According to the IRS, that request does not entitle the taxpayer to have a collection due process hearing. A request for a hearing received (not mailed) after the date specified on Form CP90 likewise does not entitle the taxpayer to a collection due process hearing.

Where the Internal Revenue Service receives a request for a hearing that it considers to be outside of the narrow time parameters that it has prescribed, it may permit the taxpayer to have an "equivalent hearing". The difference between a collection due process hearing and an equivalent hearing is that a taxpayer has no right to appeal an adverse determination in the "equivalent hearing" to the Tax Court under section 6330(d)(1). That right of appeal is reserved for a "collection due process" hearing, those for which the request is received within the narrow time parameters prescribed by the Internal Revenue Service. The only remedy available to a taxpayer is to pay the assessed amount, file a refund claim, wait for six months and then to file a refund lawsuit in the United States District Court or the United States Claims Court. The cost of the lawsuit in many instances will exceed the amount of the claim, making it a technically available, but not practical, remedy, particularly since the taxpayer no longer has the funds available.

During the time when an "equivalent hearing" is pending, the IRS will continue collection activities, including levying on taxpayer's bank accounts. An "equivalent hearing" does not stop the IRS collections process. We have seen the IRS levy on Social Security checks of taxpayers during the time the taxpayer is waiting for an "equivalent hearing". If the taxpayer should then be successful in showing that the assessment was in error, the IRS will not refund the amounts levied upon. Rather, the taxpayer is required to file an administrative refund claim and wait for the claim to be processed. If the claim is not processed, the only remedy available to the taxpayer is a refund lawsuit discussed above.

Hearings under section 6330, whether "collection due process hearings" or "equivalent hearings" are conducted by an IRS Settlement Officer. This individual, who administratively is located in IRS Appeals, is actually a collections officer. While the Settlement Officer has authority to hear questions about liability, the Settlement Officers say that by the time a matter reaches them, there must have been a hearing or other opportunity to dispute liability within the meaning of section 6330(c)(2)(B). In the one instance where we were successful in persuading the Settlement Officer that the matter involved a penalty assessed by an IRS Service Center and that the taxpayer had no prior opportunity to dispute the penalty, the result was that the Settlement Officer retained jurisdiction, but transferred the matter for substantive consideration by an IRS Appeals officer, still maintaining that the hearing was an equivalent hearing rather than a collection due process hearing. The transfer of a matter within the Internal Revenue Service exacerbates the cost of resolution of a dispute both to the Government and the taxpayer. In another matter in which a penalty assessment was referred directly by the IRS auditor to the IRS Office of Appeals and is under consideration by the IRS Office of Appeals, the IRS Appeals Officer has told us that they have no authority to stop collection activity because even though the case is in the IRS Office of Appeals, only a settlement officer and not an Appeals officer has the authority to stop collection activity. The process is byzantine in its complexity and very few taxpayers can fail to run afoul of the procedures.

The reality is that a system that was designed as a final due process check point before collecting taxes due when the taxpayer has had the previous opportunity to contest that an amount is actually due has been pressed into service for another function where no previous admistrative procedure existed. It falls far short when it is the only checkpoint on an arbitrary administrative action generated electronically at an IRS Service Center.

We suggest that whatever the justification was for treating these penalties as assessable penalties in the past, the rationale no longer exists in the 21st century. Electronic processing of tax returns and automatic issuance of penalties by electronic means has caused these penalties to become arbitrary and capricious. We have seen how the failure to an IRS employee to properly code an information tax return when transmitting it from an examination office to a service center has led to an assessment of an assessed penalty of three quarters of a million dollars.

We propose that these penalties be removed from the category of assessable penalties and placed into the same category as other penalties imposed as a result of the audit process so that the penalties can be discussed and resolved between a taxpayer and an Internal Revenue Service agent.