IRS Penalty Practice May Be Due for Reset

by Kristen A. Parillo

The IRS needs to revamp its heavy-handed approach to penalty administration — and it should start by having Commissioner Daniel Werfel issue clear guidance to agency employees explaining the purpose of penalties, according to a tax attorney and former government official.

"This needs to come from the top," said Caroline D. Ciraolo of Kostelanetz LLP. "After all these years, it's time to have a reset on penalty administration."

Speaking August 15 during a webinar hosted by the Center for Taxpayer Rights, Ciraolo said the IRS has lost sight of the reasons for imposing penalties. Noting the confidentiality provisions of section 6103, she said that if a taxpayer agrees to pay a substantial penalty at the end of an audit, there isn't much of a deterrent effect on other taxpayers because the IRS can't publicly disclose those details.

A strong and clear message from the top of the agency would be needed for any reform, said Ciraolo, former acting assistant attorney general in the Justice Department Tax Division.

"I would ask Commissioner Werfel to provide clear guidance to IRS employees as to the original purpose of penalties . . . and reset the way employees view penalty assertion and consideration of reasonable cause," Ciraolo explained.

While ongoing litigation over the IRS's compliance with section 6751(b) has yielded some positive results, including a significant number of penalty abatements, the agency continues to generally take a no-holds-barred approach to penalties, Ciraolo said.

Tax professionals who ask the IRS to provide evidence that it obtained written supervisory approval of proposed penalties, as required by section 6751(b), "are still getting pushback," said Ciraolo.

"We're getting a lot of different documentation back, including transcripts from the campuses that just say, 'Manager approved,' with no analysis and no further information regarding who that person was," said Ciraolo. The missing information includes details on the approver's role at the IRS and a timeline of the approval, she said.

Overly Strict Standard

The IRS continues to effectively apply a strict liability standard to failure-to-file and failure-to-pay penalties under section 6651, according to Ciraolo. Because those penalties are automatically assessed, they aren't subject to the written supervisory approval requirement of section 6751(b), she noted.

Section 6651 delinquency penalties "can be very significant because they accrue very quickly," Ciraolo said. But the IRS typically refuses to abate them for reasonable cause, even when taxpayers have a legitimate excuse for their failures, she said.

"Using the *Boyle* case, the IRS essentially says, 'These are nondelegable duties, and you have to pay the penalty,'" Ciraolo continued, referring to *United States v. Boyle*, 469 U.S. 241 (1985), in which the Supreme Court held that an executor's reliance on an attorney to file an estate tax return wasn't reasonable cause for a late filing.

The IRS's hard-line stance on delinquency penalties isn't confined to filers of Form 1040, Ciraolo said. "We're seeing it in corporate returns, and we're seeing it significantly in the estate and gift area. So that needs to be addressed," she said.

The IRS's approach to international reporting penalties is especially harsh, Ciraolo said. Provisions in the Internal Revenue Manual explaining how IRS employees should apply them show that for "anyone who's swimming in the international waters — if you have a foreign account, if you have a foreign entity, if you are engaged in foreign activities — you are presumed to know everything that you should know about this area," she said. "And a lack of knowledge, even if it's a negligent mistake or inadvertence, doesn't matter."

The decision trees in the IRM that walk employees through whether they should abate penalties for failure to file, or late filing, forms 5471 and 5472 are "a horror show," Ciraolo said. That guidance is provided in Exhibit 21.8.2-1 and Exhibit 21.8.2-2.

"I am convinced that if the IRS personnel assessing and collecting these penalties were in the shoes of the taxpayer, or had their family

members in those shoes, they would be screaming to the high heavens about the unfairness," Ciraolo said.

Balancing Act

Periodic reviews of the IRS's penalty regime are necessary to rein in overly harsh or aggressive practices, according to Nina Olson, the former national taxpayer advocate who is now with the Center for Taxpayer Rights.

"It goes back to understanding what the purpose of penalties are for and applying that through every single strand that you're doing, and thinking about that key function — which is to encourage voluntary compliance and deter noncompliance," said Olson, a member of Tax Analysts' board of directors.

Eric LoPresti, a former senior attorney-adviser at the IRS Taxpayer Advocate Service who is now a fellow with the Senate Finance Committee, said penalties can be a crucial enforcement tool for the IRS, particularly when dealing with taxpayers that hide assets offshore, but getting the right balance is key.

"Penalties need to be just high enough so that noncompliance doesn't pay, but they need to be proportionate and coupled with procedural safeguards," LoPresti said. ■

IRS Pins Information Security Shortfalls on Staff Shortage

by Jonathan Curry

Insufficient staffing is a key hurdle for the IRS as it plays catch-up on fixing several hundred overdue information security risks, a new watchdog report found.

A Treasury Inspector General for Tax Administration report released August 14 spotlights several ways that the IRS is behind in identifying information security weaknesses and establishing corrective plans, dubbed plans of action and milestones (POA&Ms).

The IRS has 2,555 unresolved POA&Ms, more than 500 of which are categorized as late, according to TIGTA. Twenty-three of those late POA&Ms have risk severity ratings of either high or critical.

The agency has also been sluggish in staying on top of its corrective planning processes. In the past five years, 32 percent of POA&Ms that were created were late in being established, and in a sampling of those plans, 74 percent lacked required status updates or documentation to justify a later due date, according to the report, dated August 9.

TIGTA interviewed IRS representatives from eight business units and listed staffing and funding restraints as the top challenge faced by the agency in its efforts to manage information security risks. Managers from several business units indicated they had been unable to hire the technical personnel needed to resolve some information security issues.

"Throughout the IRS, staffing levels associated with this [POA&Ms] process have not kept pace with increasing workloads," the IRS said in its response to the report. It agreed to prioritize efforts to build up staff to address POA&Ms.

"We expect these efforts will help to reduce risk, ensure system integrity, and maximize system availability for taxpayers," the IRS added. The agency has posted dozens of IT-related job openings, many with multiple vacancies.

TIGTA also advised the IRS to identify best practices and implement a consistent, agencywide process for remediating information security risks, which it agreed to do.