Office of Chief Counsel
Internal Revenue Service
memorandum

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subject: Assessment of penalties under section 6702(a)

This memorandum responds to questions raised about the appropriateness of certain procedures used to assess the section 6702 frivolous submission penalty.

ISSUES

1. Does the assessment of a frivolous submission penalty under section 6702(a) when a computer program selects returns to be assessed, or to be considered for assessment, qualify as a penalty calculated thorough electronic means so that the general rule requiring written supervisory approval prior to the assessment of penalties does not apply?

[redacted]

CONCLUSIONS

1. When the proposal and assessment of a penalty is fully automated, written supervisory approval of the penalty is not required, but it is required when an individual actually considers whether assessment of the penalty is appropriate before assessment occurs.

[redacted]

BACKGROUND

I. Statistical Background, Case Law, and CC-2011-004

A. Section 6702(a)

Section 6702(a) imposes a $5,000 penalty against any person who "files what purports to be a return" but which "does not contain information on which the substantial correctness of the self-assessment may be judged" or "contains information that on its face indicates that the self-assessment is substantially incorrect" and is based on a frivolous position or reflects a desire to delay or impede the administration of Federal tax laws.

B. Section 6751(b)

Section 6751(b)(1) provides that 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 as the Secretary may designate." As an exception to this rule, section 6751(b)(2) provides that section 6751(b)(1) "shall not apply to (A) any addition to tax under section 6651, 6654, or 6655; or (B) any other penalty automatically calculated through electronic means."

Section 6751 was enacted in the IRS Restructuring and Reform Act of 1998 and became effective for penalties assessed after June 30, 2001.[1] The legislative history behind the section is limited. It states that prior law allowed for some penalties to be imposed without supervisory approval.[2] It also states that Congress believed that penalties should only be imposed where appropriate and not used as a bargaining chip.[3]

C. Case Law Interpreting The Interaction Between Sections 6702 and 6751

In 2002 the U.S. District Court for the Western District of Michigan, citing only to the statute itself, held in Cole v. United States that "[n]o approval of the assessment [of the section 6702 penalty] by an immediate supervisor is required because this is an automatic penalty for a fixed amount."[4] Two years later, in Borchardt v. Commissioner, the U.S. District Court for the District of Minnesota copied that sentence from Cole in reaching the same conclusion.[5] Since then, a few other courts, including the Tax Court,

[1] See P.L. 105-206, Sec. 3306, *amended by* Consolidated Appropriations Act 2001, sec. 302, P.L. 106-554, 114 Stat. 2763A-632.
[2] S. Rep. No. 105-174, p. 65.
[3] Id.
[4] Cole v. United States, 2002 U.S. Dist. LEXIS 22892 (W.D. Mich. 2002).
[5] Borchardt v. Commissioner, 338 F.Supp. 2d 1040,1044 (D. Minn. 2004).

have relied on Cole and Borchardt for the same proposition.[6]

In Deyo v. United States, the U.S. District Court for the District of Connecticut cited to Borchardt in concluding that section 6751(b) did not apply to penalties imposed under section 6702.[7] On appeal, the Court of Appeals for the Second Circuit noted the district court's conclusion but found it "unnecessary to decide [the] question" since "even if the supervisory approval requirement of section 6751 applies to penalties assessed for the filing of a frivolous return under section 6702, the IRS satisfied that requirement in this case."[8] The circuit court further found that "section 6751 requires only personal approval in writing, not any particular form of signature or even any signature at all. It does not matter whether a rubber stamp was used to provide the signatures."[9] The court rejected as speculative the taxpayer's claim that the rubber-stamping inferred that the supervisors in question did not actually provide personal consideration and approval of the penalties.[10]

D. CC-2011-004

On November 1, 2010, the IRS released CC-2011-004, alerting Chief Counsel attorneys that the section 6702 penalty is subject to the requirements of section 6751(b)(1). The Notice determined that section 6702 penalties cannot be calculated through electronic means, because an IRS employee must make an independent determination before assessing the penalty. The Notice rejected the holdings of Cole, Borchardt, Lindberg, and Deyo, finding that they provided minimal analysis and were based on an incorrect reading of the statute. Specifically, the notice took issue with the cases' conclusion that the section 6702 penalty was an "automatic penalty for a fixed amount," because the standard established for the section 6751(b)(2)(B) exception was that the penalty be "automatically calculated through electronic means."[11] Although the section 6702 penalty is for a fixed amount, the notice stated, it is not automatically calculated through electronic means and does not come within the exception.

In a 2011 case, the Court of Federal Claims cited CC-2011-004 in a footnote, noting that the IRS takes a position contrary to the holdings of Lindberg, Borchardt, and Cole with respect to the issue of whether section 6751 applies to section 6702(a) penalties. Although clearly dicta, the court stated in the footnote that it "concurs in the IRS Chief Counsel's view."[12]

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[6] See Holyoak v. United States, 2009 U.S. Dist. LEXIS 85323 (D. Ariz. 2009); Lindberg v. Commissioner, T.C. Memo. 2010-67 at *34.

[7] Deyo v. United States, 2006 U.S. Dist. LEXIS 70979 (D. Conn. 2006) (holding that "the government did not have to provide personal approval of the Deyos section 6702 penalties because section 6751 does not apply to penalties "automatically calculated through electronic means.")

[8] Deyo v. United States, 296 Fed. Appx. 157, 158 (2d. Cir. 2008).

[9] Id. at 159.

[10] Id.

[11] Note that the District Court in Deyo used the proper language of the statute.

[12] Schlabach v. United States,101 Fed. Cl. 678, 685 n. 14 (Fed. Cl. 2011).

II. Current Procedures for Assessing Certain Penalties Under Section 6702(a)

The identification of frivolous filings can be made in any Service office by any employee.[13] Frivolous filings may be identified during original return processing, amended return or claim processing, during the course of a routine audit, or upon any contact with a taxpayer or their representative. On January 1, 2001, Service-wide consolidation of the receipt and processing of all frivolous documents at the Ogden Compliance Services Campus (Ogden) was completed. Ogden now administers the Frivolous Return Program (FRP).

Computer models have been created to systematically identify potential frivolous filings that have been processed. These predictive analytic models were developed and put into production using the Electronic Fraud Detection System (EFDS). The models were developed and tested using previously identified known frivolous filing patterns that are identifiable in an electronic environment.[14] The models are reviewed on a yearly basis and revised models are placed into production at the beginning of each filing season. All initial tests of models have written management approval, and revisions receive management approval through the processes surrounding the approval and implementation of the yearly Enterprise Plan . These models are currently limited to identifying only certain frivolous positions that are "clear cut." Development of new models is underway, however, with a much broader implementation expected by 2015.

Most of the models (or preprogrammed queries) that currently exist use objective data to identify frivolous positions that generate exaggerated withholding. One example of this is the Form 1099-OID tax fraud scheme. The scheme is based on false withholding credits that generate large refunds. [redacted]

Another example is a scheme involving false Forms 1041. Under that scheme, an individual first requests a "lifetime earnings statement" from the Social Security Administration. The individual then files a Form 1041 listing their name followed by the word "trust" as the name of the trust on the Form and listing themselves as the fiduciary of the trust. The amount of the individual's lifetime earnings subject to social security tax is listed on the Form as "total income." The trust then takes a deduction equal to the amount reported as total income on the line titled, "Fiduciary fees." After a deduction for "exemptions," the Form 1041 reports negative taxable income and zero tax liability. The trust then reports the lifetime social security tax withholding as "Federal income tax

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[13] IRM 4.10.12.1.3.1(1).
[14] The known frivolous filing patterns are based on positions identified as frivolous in Notice 2010-33 or in Counsel opinion.
[redacted]

withheld" on line 24e of the Form. Since the Form 1041 shows no tax liability, the trust requests a refund for the amount equal to the individual's (fiduciary's) lifetime social security withholdings. The EFDS query analyzes the objective data on the return to identify this scheme and propose a penalty.

Other examples include false Forms 2439, which are used to report undistributed capital gains from RICs and REITs, and which have been used to claim slavery reparations[16], and false claims for fuel tax credits.

Under the current procedure, these computer models, through EFDS, analyze both paper and electronic returns. Once EFDS identifies a return as frivolous, it generates a special code on the return to indicate that it has been identified as frivolous.

[redacted]

[redacted]

Under the automatic assessment procedure, the "FRP Master" database keeps track of the date on which the pre-notification letter was sent. At regular intervals, an employee creates a spreadsheet of filings ready for penalty assessment and assesses the penalties via a computer program. A Form 8278, Assessment and Abatement of Miscellaneous Civil Penalties, is computer-generated.[19] [redacted]

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[16] See Rev. Rul. 2004-33; Notice 2010-33, Example (16).

[17] The "FRP Master" database is used, among other things, to identify new scams and techniques, and the promoters behind them.

[redacted]

[redacted] The automatic creation of Forms 8278 is believed to have started one or two years ago.

[redacted]

ANALYSIS

I. Defensibility of Assessments

Section 6751(b) allows assessment of a penalty without written supervisory approval of the initial determination only if the penalty is "automatically calculated through electronic means." Section 6751(b)(2)(B). Additions to tax under sections 6651, 6654, and 6655 are examples of penalties of this type and are expressly exempted from the written supervisory approval requirement. See section 6751(b)(2)(A). Based on objective data, such as the date a return is received, the amounts reported on the return, and the tax paid, Service computers are able to determine whether the imposition of such an addition to tax is warranted.[20] If so, the addition to tax is automatically assessed.

Chief Counsel Notice CC-2011-004 concluded that section 6702 penalties cannot be automatically calculated through electronic means because a Service employee must view a purported return or other submission to determine whether the taxpayer has taken a frivolous position or sought to delay tax administration. This conclusion is incorrect to the extent that, as described above, Service computer models currently use objective data to identify frivolous positions. As with additions to tax under sections 6651, 6654, and 6655, Service computers, using objective data such as the amount of income tax and withholding reported on a return and the type of Forms used to make certain claims, are able to determine whether the imposition of a section 6702 penalty is warranted.

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[20] See generally IRM 8.17.7.3(4); 8.17.7.8(2); 8.21.5.3(1).

[redacted]

[redacted]

[redacted]

II. Form 8278

[redacted]

[redacted]

[redacted]

III. Existing Assessments

[redacted]

[redacted]

Summary

To summarize, we have five points: (1) The electronic returns identified by the EFDS computer program and assessed a penalty without a human exercising judgment on the appropriateness of the penalty do not need to have supervisory approval in writing; (2) Procedure and Administration will issue a new Chief Counsel notice amending the position stated in CC Notice 2011-004; [redacted]

[21] Crites v. Commissioner, T.C. Memo. 2012-267; O'Brien v. Commissioner, T.C. Memo. 2012-326.
[redacted]