Legislative Recommendation #30

Extend Reasonable Cause Defense for the Failure-to-File Penalty to Taxpayers Who Rely on Return Preparers to E-File Their Returns

SUMMARY

- *Problem:* A taxpayer who fails to file a tax return by the deadline is subject to a late-filing penalty unless the taxpayer can demonstrate "reasonable cause" for the failure. In 1985, the Supreme Court held that reliance on a tax return preparer to file a return cannot constitute "reasonable cause" for a late filing because the taxpayer had a responsibility to ensure the deadline was met. While that conclusion may be appropriate in the context of paper-filed returns, where a taxpayer can mail the return himself, it is not appropriate in the context of e-filed returns, where the preparer typically submits the return and the taxpayer cannot easily verify whether a return has been filed (and accepted).
- *Solution:* Allow taxpayers who rely on tax return preparers to e-file their returns to receive "reasonable cause" relief from the failure-to-file penalty.

PRESENT LAW

IRC § 6651 imposes an addition to tax when a taxpayer fails to file a return by the return due date, unless the taxpayer can show the failure was due to reasonable cause and not due to willful neglect (hereinafter, the "failure-to-file penalty").[1] Reasonable cause exists when a taxpayer has exercised ordinary business care and prudence but was unable to file the return within the prescribed time.[2]

In *United States v. Boyle*, the Supreme Court held that a taxpayer's reliance on an agent to file a return did not constitute "reasonable cause" for late filing.[3] In *Boyle*, the tax return at issue was filed on paper. At least two U.S. district courts have ruled that the *Boyle* holding applies in the e-filing context as well.[4]

In the IRS Restructuring and Reform Act of 1998, Congress adopted a policy that "paperless filing should be the preferred method and most convenient means of filing Federal tax and information returns" and gave the Secretary broad authority to incentivize taxpayers to file returns electronically.[5]

IRC § 6011(e)(3) authorizes the Secretary to require tax return preparers to file returns electronically unless they reasonably expect to file ten or fewer individual income tax returns during a calendar year. Treas. Reg. § 301.6011-7 implements this requirement.

REASONS FOR CHANGE

At the time *Boyle* was decided, all tax returns were filed on paper. Taxpayers generally could fulfill the basic responsibility of mailing returns to the IRS themselves, even when they engaged tax professionals to prepare them. In ruling that the taxpayer in *Boyle* was not entitled to "reasonable cause" abatement as a matter of

1 IRC § 6651(a)(1). The penalty amount is five percent of the tax due for each month or partial month the return is late, up to a maximum of 25 percent. The penalty increases to 15 percent per month up to a maximum of 75 percent if the failure to file is fraudulent. IRC § 6651(f).

2 Treas. Reg. § 301.6651-1(c)(1). *See also* Internal Revenue Manual (IRM) 20.1.1.3.2, Reasonable Cause (Nov. 21, 2017).

3 *Boyle*, 469 U.S. 241 (1985).

4 *See, e.g.*, *Haynes v. United States*, 119 A.F.T.R.2d (RIA) 2202 (W.D. Tex. 2017), *vacated and remanded*, *Haynes v. United States*, 760 F. App'x 324 (5th Cir. 2019); *Intress v. United States*, 404 F. Supp. 3d 1174 (M.D. Tenn. 2019).

5 Pub. L. No. 105-206, § 2001, 112 Stat. 685, 723 (1998); IRC § 6011(f).

law, the Supreme Court stated that "[i]t requires no special training or effort to ascertain a deadline and make sure that it is met."[6]

In effect, the *Boyle* decision concluded that the duty to file a return is non-delegable. While that rule may make sense in a paper-filing context, it is not reasonable to apply it in the e-filing context. Today, most taxpayers effectively delegate the electronic filing of their returns to preparers or use software providers. Particularly when a taxpayer uses a preparer, the taxpayer is generally several steps removed from the filing process. When a preparer e-files a tax return, he or she must transmit it through an electronic return originator (typically, a software company) to the IRS. Thus, there are four parties sequentially involved in this chain: (i) the taxpayer; (ii) the preparer; (iii) the software company; and (iv) the IRS. If the IRS rejects an e-filed tax return, it generally sends a notification back through the software company to the preparer, but it will not notify the taxpayer directly.[7] In these circumstances, there is no practical way for a taxpayer to ensure his or her return has been properly submitted by the preparer and accepted by the IRS. In addition, the IRS rejects e-filed returns before processing for a wide variety of reasons, and unlike with paper filing, a return that is e-filed with the IRS but rejected is not treated as timely filed.

While Treasury regulations generally require tax return preparers to e-file client returns, the regulations exempt preparers from the e-filing requirements if a taxpayer provides the preparer with "a hand-signed and dated statement" that says the taxpayer chooses to file a paper return.[8] This "opt-out" may reduce a taxpayer's risk of incurring a failure-to-file penalty. In light of the congressional directive to incentivize e-filing, it makes little sense for the government to tell taxpayers, in effect, that they can reduce their risk of incurring a failure-to-file penalty by filing their returns on paper.[9]

In *Haynes v. United States*, a married couple employed a certified public accountant to prepare and file their joint tax return.[10] The preparer timely e-filed the return, but the IRS did not accept it for processing because a taxpayer identifying number was listed on the wrong line. The preparer did not receive a rejection notice from the IRS. The preparer notified the taxpayers that their return had been timely filed. Ten months later, the IRS notified the taxpayers that their return had not been received and asserted the failure-to-file penalty.

The taxpayers requested penalty abatement for reasonable cause, asserting that they had sought to file their return timely, that their preparer had transmitted the return timely, and that both the preparer and the taxpayers believed the return had been received. The taxpayers argued that *Boyle* should not apply in the context of electronic filing because the complexities of e-filing vastly exceed the comparatively simple and verifiable task of mailing a return. The IRS rejected the taxpayers' position, and the taxpayers then paid the penalty and filed a refund suit in a U.S. district court. The district court concluded that the holding in *Boyle* applies to e-filed returns to the same extent as paper-filed returns and ruled in the government's favor as a matter of law. On appeal, the U.S. Court of Appeals for the Fifth Circuit vacated and remanded the district court's decision on the ground that there was a genuine issue of material fact about whether it was reasonable for the preparer to assume, based on the IRS's silence, that it had accepted the taxpayers' return. However, the appeals court did not take a position on the *Boyle* issue of whether the taxpayers' reliance on a preparer to e-file their tax return constituted reasonable cause for a failure-to-file.[11]

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6 *Boyle*, 469 U.S. at 252.

7 IRM 3.42.5.7.2(1), Form 1040 Online Filing (Oct. 10, 2018).

8 Treas. Reg. § 301.6011-7(a)(4)(ii).

9 For context, over half of all individual income tax returns filed during 2022 were prepared by professionals and e-filed (nearly 85 million returns). *See* IRS 2022 Filing Season Statistics (week ending Oct. 28, 2022), https://www.irs.gov/newsroom/filing-season-statistics-for-week-ending-october-28-2022.

10 119 A.F.T.R.2d (RIA) 2202 (W.D. Tex. 2017).

11 *Haynes v. United States*, 760 F. App'x 324 (5th Cir. 2019). The government subsequently conceded the case, but it has not conceded the *Boyle* issue. *See* Keith Fogg, *Reliance on Preparer Does Not Excuse Late E-Filing of Return*, PROCEDURALLY TAXING BLOG (Sept. 4, 2019), https://proceduralltaxing.com/reliance-on-preparer-does-not-excuse-late-e-filing-of-return.

In 2019, a different U.S. district court reached a conclusion similar to the decision by the district court in *Haynes*.[12]

The issue in these cases is not whether the failure-to-file penalty is applicable in the first instance. Based on the wording of the statute, there is no doubt the penalty is applicable if the return is filed late. Rather, the issue is whether taxpayers are entitled to request abatement of the penalty on "reasonable cause" grounds. Because the *Boyle* decision used relatively sweeping language, lower courts have seemingly felt bound to apply its holding in the context of e-filed returns, notwithstanding the significant differences between paper filing and electronic filing.

While the bright-line rule embodied in *Boyle* is convenient for the IRS to administer, the nearly automatic assessment of the failure-to-file penalty for e-filed returns deemed late (often where the return was submitted timely by the taxpayer or preparer but rejected by the IRS) is grossly unfair and undermines the congressional policy that e-filing be encouraged. The American College of Tax Counsel shares this view and submitted a compelling *amicus curiae* brief in the appeal of the *Haynes* decision.[13]

RECOMMENDATION

- Amend IRC § 6651 to specify that reasonable cause relief may be available to taxpayers that use return preparers to submit their returns electronically and direct the Secretary to issue regulations specifying what constitutes ordinary business care and prudence for e-filed returns.

12 *Intress v. United States*, 404 F. Supp. 3d 1174 (M.D. Tenn. 2019).

13 *See* Brief of American College of Tax Counsel (Nov. 27, 2017), https://www.actconline.org/wp-content/uploads/2018/02/ACTC_Amicus_Brief_Haynes.pdf.