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Reckless Means Reckless: Understanding the EITC Ban

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Reckless Means Reckless: Understanding the EITC Ban

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In this article, Plecnik argues that Congress intended to incorporate in the earned income tax credit ban the well-established definition of reckless or intentional disregard from section 6662, which imposes the accuracy-related penalties.

Introduction

Under section 32(k), a little-known subsection introduced to the code by the Taxpayer Relief Act of 1997, the earned income tax credit is disallowed if a taxpayer improperly claimed that credit in a prior tax year. This disallowance is best known to tax practitioners as the EITC ban. It should be noted at the outset that section 32(k) imposes no ban or penalty for mere negligence.[1] If the improper EITC claim is attributable to fraud, however, the ban is imposed for a 10-year period.[2] If the improper EITC claim is attributable to "reckless or intentional disregard of rules and regulations," the ban is imposed for a two-year period.[3] The IRS does not recognize a formal definition for reckless or intentional disregard under section 32(k), and it imposes the EITC ban without a clear explanation in nearly 90 percent of cases.[4] This article argues that the legislative history of the EITC ban demonstrates that Congress intended to import to section 32(k) the well-established definition for reckless or intentional disregard from section 6662, which imposes the accuracy-related penalties.[5]

Current IRS Practice and Procedure

Unfortunately for taxpayers and their representatives, section 32(k)(1) is brief and nondescript.[6] The terms "reckless" and "intentional" are used but not defined. There are no regulations under the subsection, and the case law is sparse. Further, the IRS has yet to fill the void with substantive administrative guidance.

Because of the difficulty of proving intentional disregard or fraud, the bone of contention in most cases is the definition of recklessness. The IRS recognizes no meaningful definition or standard for a reckless EITC claim. According to the Internal Revenue Manual, a claim is reckless if the IRS technician determines that it is reckless.[7] In other words, the IRS appears to define improper EITC

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[1]The EITC ban makes no mention of negligence, which is legally distinct from reckless or intentional conduct. *See* section 32(k) (no use of word "negligence" or equivalent terminology); and section 6662 (defining negligence separately from reckless or intentional conduct). *See also* Nina Olson, "National Taxpayer Advocate 2013 Annual Report to Congress," at 29 (Dec. 31, 2013) ("This standard requires more than mere negligence on the part of the taxpayer").

[2]Section 32(k)(1)(B)(i).

[3]Section 32(k)(1)(B)(ii).

[4]Olson, *supra* note 1, at 104.

[5]I previously argued that the legislative history demonstrates Congress intended the same definition of reckless or intentional disregard for sections 32(k) and 6662. *See* David van den Berg, "Taxpayer Advocate Criticizes IRS Use of EITC Ban, Plans Review," *Tax Notes*, Aug. 12, 2013, p. 666. That argument was inspired by my work as pro bono counsel on two EITC ban cases in the Tax Court. Both cases were settled last fall on terms favorable to my clients with no ban or other penalties.

[6]The entire text of section 32(k) is less than 200 words.

[7]In a table in the IRM, the IRS prescribes that the two-year ban should be imposed if "the technician can determine the taxpayer's claim was due to reckless or intentional disregard rather than misunderstanding or confusion of the rules." IRM section 4.19.14.6.1. Stated otherwise, a claim is reckless if the technician determines it is reckless rather than innocent. This circular definition is hardly helpful or predictive for taxpayers. Quite the contrary, the national taxpayer advocate criticizes this method for containing "unexamined assumptions" and "even *presupposing!* reckless or intentional disregard." Olson, *supra* note 1, at 104 (emphasis in original). However, in fairness to the IRS, that same table identifies a few specific fact situations and recommends outcomes for them. For instance, the table provides that the EITC ban usually should not be imposed on first-time offenders. Although the table only covers a handful of situations, a tax practitioner would be well-advised to review it in the off chance that her case is covered.

claims under the Supreme Court's standard for hard-core pornography: "I know it when I see it."[8] This standardless approach is affecting a lot of cases. A recent study by the national taxpayer advocate found that nearly 90 percent of EITC ban notices lack a "clear explanation of why the ban was imposed."[9] As a result, taxpayers are left to guess why they are banned from claiming an EITC, sometimes for many years.

The IRS can and does impose multiple, overlapping EITC bans for multiple tax years.[10] In that case, the disallowance continues unabated until the final EITC ban expires. For example, if a taxpayer improperly claims the EITC for 2010, 2011, and 2012, the IRS can impose not one, but three overlapping bans. Assuming reckless or intentional conduct, but not fraud, the 2010 ban would disallow the EITC for 2011 and 2012. The 2011 ban would disallow the EITC for 2012 and 2013. And lastly, the 2012 ban would disallow the EITC for 2013 and 2014. All told, the three EITC bans collectively disallow the credit from 2011 to 2014 for a total of four years.

The EITC ban is rightly described as a severe and draconian penalty. It should be imposed only when clear standards are plainly met. However, current IRS practice and procedure falls woefully short of that ideal.

Criticism by the National Taxpayer Advocate

The national taxpayer advocate, Nina Olson, is conducting research on the EITC ban,[11] and her 2013 annual report to Congress identified the ban as the ninth most serious problem encountered by taxpayers.[12] That report outlines the scope of the problem: In 2011 the IRS imposed the two-year EITC ban on 5,438 taxpayers.[13] In 39 percent of those cases, the IRS imposed the ban on taxpayers who simply failed to respond.[14] This contravenes a 2002 IRS service center advice memorandum, which provides that a "taxpayer's failure to respond to a request from the Service for substantiation and verification of [the EITC] alone is not sufficient to be considered reckless or intentional disregard."[15] Moreover, IRS data showed that in 2011 "the average amount of denied EITC was $3,731, or 24 percent of adjusted gross income on average."[16] Stated otherwise, the average taxpayer who is subject to the EITC ban loses about a quarter of her adjusted gross income each year.[17]

The national taxpayer advocate also criticizes the IRS for applying the two-year ban "on the basis of unexamined assumptions about the taxpayer's state of mind or even *presuppos[ing]* reckless or intentional disregard of the rules and regulations, potentially causing significant harm to taxpayers who may be entitled to [the] EITC in a subsequent year." In fact, she went as far as to say that the IRS "acts arbitrarily and capriciously" in imposing the EITC ban. Perhaps, but without a standard of review, there is no way for the IRS to impose the ban in a fair and objective manner.

Legislative History of Section 32(k)

Fortuitously, there is a readily available standard for recklessness. Although section 32(k) was new to the code in 1997, the reckless or intentional disregard language was not. Substantially the same phrase appears in section 6662, which imposes the accuracy-related penalties.[18] The regulations under section 6662 provide that disregard is reckless "if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe."[19] They further provide that disregard is intentional "if the taxpayer knows of the rule or regulation that is disregarded."[20]

Also, the definition of reckless or intentional disregard under section 6662 has been the subject of much litigation. There are countless cases that expound on when a taxpayer was reckless or simply

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[8]*Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (Stewart, J., concurring).

[9]The national taxpayer advocate performed this study with "a random, statistically valid sample of 333 instances of the 5,438 cases in which the IRS imposed the two-year ban in 2011." Olson, *supra* note 1, at 104-106.

[10]James Edward Maule, *Tax Credits: Concepts and Calculation* (Tax Management Portfolio 506 3d ed.) ("It is possible for a disallowance period to begin while another disallowance period is underway. In this situation, the disallowance period with a termination date that extends farthest into the future is controlling. Under some circumstances, a chain of disallowance periods could preclude the taxpayer from claiming the credit for a very long period.").

[11]Olson, "National Taxpayer Advocate Fiscal Year 2014 Objectives," at 65 (June 30, 2013).

[12]Olson, *supra* note 1, at 103. Section 7803(c)(2)(B)(ii)(III) requires the national taxpayer advocate to report on "at least 20 of the most serious problems encountered by taxpayers" each year.

[13]Olson, *supra* note 1, at 105.

[14]The IRS imposed the EITC ban on taxpayers who simply failed to respond in 39 percent of cases in 2011, 44 percent in 2010, and 49 percent in 2009. *Id.*

[15]SCA 200245051.

[16]Olson, *supra* note 1, at 106.

[17]*Id.*

[18]*See* section 6662(b)(1) ("disregard of rules or regulations"); section 6662(c) ("the term 'disregard' includes any careless, reckless, or intentional disregard").

[19]Reg. section 1.6662-3(b)(2).

[20]*Id.*

made a mistake in good faith.[21] Thus, importing the definition of reckless or intentional disregard from section 6662 to section 32(k) would not only provide a formal definition but also a wealth of case law to explicate that definition.[22] For example, we could say with some confidence that a taxpayer is not guilty of reckless or intentional disregard when she reasonably relies on her return preparer.[23] In the seminal case of *Neonatology Associates PA v. Commissioner*, the Tax Court laid out a three-prong test for reasonable reliance on the advice of a return preparer: "(1) The adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment."[24]

We could also say that a taxpayer's understanding of the U.S. tax system is relevant in determining reasonable reliance.[25] For example, in *Podd v. Commissioner*, the Tax Court noted that the taxpayers "were Canadian citizens unfamiliar with the U.S. tax system" in holding that section 6662 penalties were inapplicable because of the taxpayers' reasonable reliance on an accountant.[26] There are even EITC cases on this issue. Recently, in *Edge v. Commissioner*, the Tax Court held that a taxpayer who incorrectly claimed the EITC on his return was not subject to section 6662 penalties because he "relied reasonably and in good faith on his commercial preparer."[27] In that case, the court noted that the taxpayer was a cook and was "not a tax expert or experienced in tax matters."[28] In sum, if the precedent under section 6662 applied, the IRS could stop imposing the EITC ban on unsophisticated taxpayers who do their best to comply with the law.

Moreover, borrowing the definition of reckless or intentional disregard from section 6662 for use in section 32(k) would not only be good policy, it would be the best reflection of congressional intent. The text of the twin statutes, in tandem with their legislative history, demonstrates that Congress intended to import the definition of reckless or intentional disregard. The fact that the same language is used in both statutes would be evidence enough for some courts.[29] However, Congress did more than simply use the same term of art twice. In the legislative history for the Tax Relief Act of 1997, Congress refers to section 6662 as present law in juxtaposition to section 32(k) as proposed law in the House bill.[30] In fact, Congress explicitly mentions reckless or intentional disregard in that same legislative history to describe section 6662.[31] At the very least, this proves that Congress was aware of the well-established definition of reckless or intentional disregard under section 6662 when it enacted section 32(k). Given that awareness, coupled with the fact that Congress chose to reuse the same term of art, the best read of the law is that Congress intended reckless or intentional disregard to have the same meaning in both statutes.

Conclusion

In response to the growing confusion over the definition of recklessness and the IRS's failure to follow its own policies, the national taxpayer advocate has called on the IRS to prioritize the development of regulations under section 32(k).[32] Regulations, which bear the full force of law, are certainly one solution. However, drafting proposed regulations, taking notice and comment, and issuing final regulations is generally a lengthy and involved process. In this case, it is simply unnecessary. The law does not need to be changed or even created — only clarification is necessary. Therefore, the IRS can speedily address the issue by promulgating virtually any type of administrative guidance. This is a golden opportunity for the IRS to

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[21] *See, e.g., Kobel v. Commissioner*, T.C. Memo. 2013-158; *Podd v. Commissioner*, T.C. Memo. 1998-231; *Brown v. Commissioner*, T.C. Memo. 1996-43.

[22] The national taxpayer advocate has also noted that "many circumstances under the accuracy-related penalty could be used to decide a taxpayer had flouted the rules" of the EITC ban. *See* van den Berg, *supra* note 5.

[23] 115 T.C. 43, 98-99 (2000).

[24] *Id.* It is important to note that *Neonatology Associates*, like virtually all section 6662 cases, analyzes good faith through the lens of the reasonable cause exception in section 6664. Arguably, importing the definition of reckless or intentional disregard from section 6662 necessitates importing its exceptions, including the exception for reasonable cause under section 6664. However, the relevant statutes, regulations, administrative guidance, and case law are silent on this critical point. If the IRS were to issue regulations or other guidance on the EITC ban, it should address the applicability of the reasonable cause exception or an equivalent exception.

[25] *See, e.g., Podd*, T.C. Memo. 1998-231 (holding that section 6662 penalties did not apply because of reasonable reliance on a return preparer in the instances in which the taxpayers "provided [the preparer] with the necessary and relevant information to prepare their tax returns").

[26] *Id.*

[27] T.C. Summ. Op. 2013-68.

[28] *Id.*

[29] *See Morissette v. United States*, 342 U.S. 246, 263 (1952) ("Where Congress borrows terms of art in which are accumulated the legal tradition and meaning of centuries of practice, it presumably knows and adopts the cluster of ideas that were attached to each borrowed word in the body of learning from which it was taken and the meaning its use will convey to the judicial mind unless otherwise instructed").

[30] *See* H.R. (Conf.) Rep. 105-220, at 597 (1997).

[31] *Id.*

[32] Olson, *supra* note 1, at 115.

instantly resolve a serious problem and demonstrate its concern for low-income taxpayers.

A half-page revenue ruling could acknowledge that Congress intended to import the definition of recklessness from the accuracy-related penalties to the EITC ban, and it would bind all IRS employees to do the same.[33] "Most serious problem" solved. Reckless means reckless.

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[33]The IRM provides that "Internal Revenue Service employees must follow revenue rulings and revenue procedures." IRM section 4.10.7.2.6.