

WHY IRS PENALTIES PROBABLY DO NOT APPLY TO YOU

Understanding Who the Penalty Provisions of the Tax Code Actually Reach

A Complete Educational Breakdown | Jennifer Conner

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Introduction: The Penalty Notice That Should Raise Questions

Every year the IRS issues millions of penalty notices — for late filing, late payment, inaccurate returns, and frivolous positions. Most recipients pay without question. They assume the IRS has the authority to impose these penalties, and they never ask for the legal basis.

What the law actually shows is more nuanced. The IRS's own penalty statutes contain specific definitions of who qualifies as a 'person' subject to those penalties. The common law framework from which penalty authority derives requires consent through a contract or agreement. And implementing regulations — required before many penalty provisions can be enforced against private individuals — are conspicuously absent in key areas.

This guide breaks down the legal framework for IRS penalties, identifies the specific statutes and definitions that matter, and gives you the tools to build an informed administrative record when you receive a penalty notice.

The purpose of this guide is education. Understanding the framework is the first step to knowing whether a penalty lawfully applies to your specific situation — and how to respond if it does not.

Section 1: The Common Law Foundation — Penalties Require a Contract

Before examining the Internal Revenue Code's penalty provisions, it is essential to understand the legal foundation from which all civil penalties derive. Under the common law, penalties and forfeitures do not arise from thin air — they arise from a contract or agreement.

Joseph Story, a United States Supreme Court Justice and one of the most respected legal scholars in American history, wrote in his Commentaries on Equity Jurisprudence, Volume III (Fourteenth Edition, 1922), Section 1714:

"At law... if a man undertakes to do a thing either by way of contract or by way of condition, and it is practicable to do the thing, he is bound to perform it or he must suffer the ordinary consequences; that is to say, if it be a matter of contract he will be liable at law for damages for the non-performance."

The implication is direct: before a penalty can be legally imposed, the party imposing it must demonstrate:

1. That the person penalized consented — through a contract or agreement — to be subject to those penalties.
2. That the consent was express, not merely implied by conduct or assumption.
3. That the person had a domicile within the exclusive jurisdiction of the government imposing the penalty — meaning they expressly placed themselves under that government's civil laws.

The FIRST duty of anyone claiming a penalty is owed is to prove that the penalized party consented to be subject to that penalty through an express contract or agreement. Without that showing, the legal basis for the penalty is absent.

Section 2: Who Is a 'Person' Under the IRS Penalty Statutes?

The Internal Revenue Code does not use the word 'person' carelessly. In the context of IRS penalties, Congress provided a specific definition that limits who qualifies as a 'person' subject to those penalties.

26 U.S.C. § 6671(b) — The Statutory Definition

26 U.S.C. § 6671(b): *"For purposes of this subchapter, the term 'person' includes an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs."*

This definition is significant. The term 'person' in the context of the penalty subchapter (Subchapter B of Chapter 68) specifically refers to officers, employees, and members of entities — individuals who hold a position of duty within a corporate or organizational structure. The definition points toward individuals acting in a fiduciary or employment capacity within a recognized entity, not private individuals acting in a purely private capacity.

When a penalty statute says 'person,' look up how the code defines 'person' for that specific subchapter. The definition controls who the provision reaches — and who it does not.

26 U.S.C. § 7343 — The Definition for Criminal Penalties

26 U.S.C. § 7343: *"The term 'person' as used in this chapter includes an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs."*

The pattern is consistent: across the penalty and criminal enforcement chapters of the Internal Revenue Code, 'person' is defined with reference to organizational roles and duties — not as a universal reference to every human being.

26 U.S.C. § 7701(a)(26) — 'Trade or Business'

26 U.S.C. § 7701(a)(26): *"The term 'trade or business' includes the performance of the functions of a public office."*

This definition is foundational to the penalty framework. When the code imposes penalties on persons engaged in a 'trade or business,' and the code defines 'trade or business' to include the performance of public office functions — the penalty provisions trace back to government-related activity. Private individuals not engaged in a public office or government-connected trade or business fall outside this definition.

Section 3: The Franchise and Government Employment Framework

The penalty statutes of the Internal Revenue Code operate within a franchise framework. A franchise, in the legal sense, is a grant from the government conferring a special right or privilege. When a person accepts a government benefit, license, privilege, or franchise, they enter into a relationship with the government that subjects them to the regulatory and penalty framework governing that franchise.

Who Is Subject to the Penalty Framework?

Under this analysis, the following categories of individuals are within the scope of the IRS administrative penalty framework:

- Government employees — federal, state, and local — who receive compensation subject to withholding.
- Government contractors who receive payment from public funds.
- Individuals who have accepted government franchises — including certain licenses, federal benefits, and social insurance programs that create a tax nexus.
- Corporations and their officers who operate under a government-granted corporate charter.
- Individuals who have voluntarily placed themselves under the tax system through specific acts of consent — signing returns, applying for federal identification numbers, accepting withholding.

The Ashwander Principle

Ashwander v. Tennessee Valley Authority, 297 U.S. 288 (1936) — *Justice Brandeis, in his concurrence, articulated the principle that the Supreme Court will not pass on the constitutionality of legislation unless necessary, and that individuals should avoid placing themselves in situations where constitutional questions arise. The corollary is that government power is limited to those who have connected themselves to a government-granted benefit or franchise.*

Government authority to regulate and penalize is strongest where the individual has accepted a government benefit, franchise, or privilege. Where no such connection exists, the regulatory authority must trace back to a clear constitutional and statutory grant.

Section 4: The Implementing Regulation Requirement

Under the Administrative Procedure Act and the Federal Register Act, federal agencies — including the IRS — must publish implementing regulations in the Federal Register before those regulations have the force of law against the public.

The Statutory Requirements

5 U.S.C. § 553(a): *The APA exempts from its notice-and-comment requirements only matters relating to military or foreign affairs, or to agency management or personnel, or to public property, loans, grants, benefits, or contracts. Substantive rules affecting private rights must go through notice-and-comment rulemaking.*

44 U.S.C. § 1505(a)(1): *The Federal Register Act requires that documents having general applicability and legal effect — including rules of general applicability — be published in the Federal Register. A rule not published in the Federal Register cannot be enforced against a member of the public who does not have actual knowledge of it.*

26 U.S.C. § 7805(a): *"The Secretary shall prescribe all needful rules and regulations for the enforcement of this title..." — Congress delegated rule-making authority to the Secretary of the Treasury. Rules not promulgated under this authority lack the force of law.*

The Practical Consequence

Before the IRS can enforce a penalty provision against a private individual, the following must exist:

4. A statute authorizing the penalty — found in the Internal Revenue Code.
5. A regulation implementing that statute — promulgated by the Secretary of the Treasury, published in the Federal Register, codified in the Code of Federal Regulations.
6. A clear connection between the statutory definition of 'person' and the individual being penalized.

Where implementing regulations are absent — or where the existing regulations do not reach the conduct at issue — the penalty provision cannot be enforced against a private individual who is not a government employee, franchisee, or contractor.

California Bankers Association v. Shultz, 416 U.S. 25 (1974) — *The Supreme Court held that regulatory requirements published in the Federal Register put the public on constructive notice — but the corollary is that requirements NOT published lack that notice function and therefore cannot bind individuals without actual knowledge.*

Section 5: Key Case Law on Penalty Authority

Flora v. United States, 362 U.S. 145 (1960) — *The Supreme Court acknowledged that the federal tax system is built on voluntary compliance and self-assessment — not distraint. The voluntary nature of the system is foundational to understanding the limits of penalty enforcement.*

Long v. Rasmussen, 281 F. 236 (1922) — *The court stated: 'The revenue laws are a code or system in regulation of tax assessment and collection. They relate to taxpayers, and not to nontaxpayers. The latter are without their scope.' This distinction between taxpayers and nontaxpayers is central to the penalty framework analysis.*

Economy Plumbing & Heating v. United States, 470 F.2d 585 (1972) — *Recognized the distinction between those within the tax system and those outside it, and the limits of IRS enforcement authority.*

Botta v. Scanlon, 288 F.2d 504, 508 (1961) — *The court held: 'A Federal agency can only act within the statutory boundaries set by Congress. Agents cannot enlarge their own jurisdiction through their own acts or interpretations.'*

Broadrick v. Oklahoma, 413 U.S. 601 (1973) — *The Supreme Court addressed the limits of government regulatory authority over individuals and the requirement that such authority be clearly grounded in statute.*

United States v. Lovett, 328 U.S. 303 (1946) — *The Court held that government actions that impose punishments without following proper constitutional process are void. Penalty authority must be lawfully granted and properly exercised.*

The consistent thread through these cases: government penalty authority has limits. It must be grounded in statute, implemented through proper regulation, and applied only to those within the scope of the statutory definition of 'person.'

Section 6: The Four Most Common IRS Penalty Notices

The IRS most commonly asserts penalties for the following:

1. Frivolous Return Penalty — 26 U.S.C. § 6702

The IRS may impose a \$5,000 penalty for what it designates a 'frivolous' return. The statute defines frivolous as a return that does not contain sufficient information to calculate the correct tax liability or that contains a position the IRS identifies as frivolous under its published list.

Challenge points: (a) What is the specific statutory basis for the penalty? (b) Is the position on the IRS's published frivolous position list? (c) Does the implementing regulation reach your specific conduct? (d) Were you given adequate notice of what constitutes a frivolous position?

2. Late Filing Penalty — 26 U.S.C. § 6651

The late filing penalty applies when a return is not filed by the due date. The statute imposes 5% per month, up to 25%, of the tax shown on the return.

Challenge points: (a) Does a filing obligation exist under § 6012 for the individual? (b) Is there 'reasonable cause' and absence of 'willful neglect'? (c) Is the person a 'person' within the definition of § 6671(b)?

26 U.S.C. § 6651(a): *The penalty applies when a person 'required to file' fails to do so. The threshold question is always: is there a requirement to file? That question traces back to § 6012 and the income source rules.*

3. Failure to Pay Penalty — 26 U.S.C. § 6651(a)(2)

A 0.5% per month penalty (up to 25%) for failure to pay the amount shown on a return. This penalty presupposes that (a) a return was filed, and (b) a tax amount was shown as due on that return.

Challenge points: If no valid return was filed, or if no tax was legally shown to be due, the predicate for this penalty is absent.

4. Accuracy-Related Penalty — 26 U.S.C. § 6662

A 20% penalty on any underpayment attributable to negligence, disregard of rules, or substantial understatement. The 'reasonable cause' exception under § 6664(c) is significant: if you had reasonable cause and acted in good faith, the penalty does not apply.

Reasonable cause and good faith are defenses to accuracy-related penalties. A documented, written analysis of your position — citing statutes, regulations, and case law — is evidence of good faith. Build the record before you file or before you respond to a notice.

Section 7: What to Do When You Receive a Penalty Notice

When the IRS sends a penalty notice, you have specific rights and specific deadlines. Here is the step-by-step process:

Step 1: Identify the Statute

7. Read the notice and identify the specific Internal Revenue Code section cited as the basis for the penalty.
8. Look up that statute at uscode.house.gov. Read the exact text — not a summary.
9. Find the definition of 'person' for that penalty provision. Check § 6671(b) for administrative penalties and § 7343 for criminal penalties.

Step 2: Demand the Implementing Regulation

10. Write to the IRS requesting the specific Treasury Regulation (26 C.F.R. section) implementing the penalty provision.
11. Ask for the Delegation Order authorizing the specific agent or office to impose that penalty.
12. Send your request by certified mail, return receipt requested. Keep tracking records.

Step 3: Assert Reasonable Cause

13. For accuracy-related and late-filing penalties, prepare a written reasonable cause statement.
14. Document: what you relied on, what statutes you researched, what your understanding was, why you acted in good faith.
15. Submit the statement to the IRS in writing, certified mail, as part of your administrative record.

Step 4: File an Administrative Appeal

16. Every IRS penalty notice has an appeal right. Exercise it within the stated deadline (typically 30-60 days from the notice date).
17. Request a Collection Due Process (CDP) hearing under 26 U.S.C. §§ 6320 or 6330 if the IRS has filed a lien or issued a levy.

18. In the appeal, raise every ground: absence of statutory authority, improper definition of 'person,' lack of implementing regulation, reasonable cause.

Step 5: Preserve the Record

19. Keep copies of every document you send and receive.
20. Note the date, method, and content of every communication.
21. Your administrative record is the foundation for any subsequent court challenge.

Do not ignore penalty notices. Deadlines are hard and missing them eliminates appeal rights. Even if you dispute the penalty, respond within the deadline to preserve your options.

Section 8: Questions the IRS Should Be Able to Answer

If the IRS imposes a penalty against you, these are the questions you have the right to ask — in writing, on the record:

22. What is the specific Internal Revenue Code section authorizing this penalty?
23. What is the definition of 'person' under that section, and how does it apply to my specific classification?
24. What is the Treasury Regulation implementing this penalty provision, and where is it published in the Code of Federal Regulations?
25. What is the Delegation Order authorizing this agent or office to impose this specific penalty?
26. What is the nexus between my activity and the 'trade or business' definition under 26 U.S.C. § 7701(a)(26)?
27. What evidence of a contract or agreement establishes my consent to be subject to this penalty?
28. Has my reasonable cause defense been properly reviewed and considered?

These are not trick questions. They are the same questions a competent court would ask. If the IRS cannot answer them with specific statutory and regulatory citations, the penalty's legal foundation is questionable.

Section 9: The Administrative Record Is Your Shield

In every interaction with the IRS — from the first notice to any subsequent court proceeding — the administrative record is what determines your options. The record is built by:

- Putting every objection, question, and challenge in writing.
- Sending everything by certified mail with return receipts.
- Citing specific statutes, regulations, and cases in your written responses.
- Requesting, in writing, the statutory and regulatory basis for every IRS action.

- Filing timely appeals and CDP hearings to preserve your rights.

Courts reviewing IRS penalty cases look at the administrative record. An individual who has documented their good-faith analysis, asserted their legal objections, and preserved their appeal rights is in a fundamentally stronger position than one who ignored the notice or paid without question.

The record does not guarantee a favorable outcome. But a missing record almost guarantees an unfavorable one.

Summary: What This Guide Has Covered

- Under the common law, all penalties arise from contract. Consent to the penalty framework must be established before a penalty can lawfully attach.
- The Internal Revenue Code defines 'person' specifically in penalty provisions — limiting its reach to officers, employees, and members of entities with organizational duties.
- The 'trade or business' definition under § 7701(a)(26) includes the performance of public office functions — linking the penalty framework to government-connected activity.
- Implementing regulations are required before penalty provisions can be enforced against private individuals. Their absence is a substantive legal challenge.
- Every penalty notice carries appeal rights and deadlines. Miss neither.
- The administrative record you build is the foundation for every subsequent challenge.

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