



STATE OF MICHIGAN
DEPARTMENT OF TREASURY
LANSING

JENNIFER M. GRANHOLM
GOVERNOR

JAY B. RISING
STATE TREASURER

Revenue Administrative Bulletin 2005-3

Approved: July 19, 2005

PENALTY PROVISIONS
(Replaces Revenue Administrative Bulletin 1995 - 4)

RAB 2005-3. This bulletin reflects the amendments to the penalty provisions of the Revenue Act by the Taxpayer Bill of Rights amendments, Public Acts 13 and 14 of 1993 and by the enactment of Public Act 657 of 2002, and the administrative rules on waiver of penalty for reasonable cause. The bulletin discusses the mandatory waiver of negligence and failure to file or pay penalties where the taxpayer successfully establishes reasonable cause, and states that the department shall not impose a negligence penalty upon a tax owed by a taxpayer who successfully disputes the intentional disregard penalty.

This bulletin has been updated to reflect statutory changes through the present, and in particular Public Act 657 of 2002. In all other respects this bulletin restates the discussion contained in Revenue Administrative Bulletin 1995-4.

<u>Contents</u>	<u>Page</u>
Definitions	2
Discretionary Penalties	3
How Discretionary Penalties Are Applied	3
Types of Discretionary Penalties	3
Civil Tax Fraud	3
Intentional Disregard	5
Negligence	5
Non-Discretionary Penalties	5
How Non-Discretionary Penalties Are Applied	6
Types of Non-Discretionary Penalties	6
Failure to File	6
Failure to Pay	6
Failure to File Information Return	7
Non-Negotiable Remittance	8
Simultaneous Penalties	8
Objections or Defenses to Penalties	8
Waiver for Reasonable Cause	9
Taxpayer-Initiated Disclosure	10
Frivolous Protest	10

DEFINITIONS

Department:	The Department of Treasury.
Negligence:	Lack of due care in failing to do what a reasonable and ordinarily prudent person would have done under the particular circumstances.
Intentional Disregard:	Knowingly and willfully disregarding the laws, rules and instructions published and/or administered by the department without the intent to commit fraud or evade payment of tax.
Fraud:	Knowingly and willfully acting in a manner to commit fraud, such as: failing or refusing to file a return, or filing a false return with the intent to evade payment of tax or part of a tax; claiming a false refund or a false credit; or aiding, abetting or assisting another in an attempt to evade payment of a tax or part of a tax, claim a false refund or claim a false credit
Information Return:	Any tax return required by the department that does not, by law, require the payment of a tax liability. However, this definition specifically excludes an information return wherein, as a result of reconciliation, a tax is determined due. In such cases, the tax return is treated like a non - information return.
Non-Negotiable Remittance:	A remittance by a taxpayer on an instrument that is not legally capable of being transferred by endorsement or delivery.
Discovery:	Any deficiency or delinquency identified solely as a result of efforts by the department, based on information already in the department's possession or supplied by third parties. Discovery does not include a deficiency or delinquency brought to the department's attention by the taxpayer, when the department made no overt effort, directed either at the specific disclosure or in general at the taxpayer involved, that may have persuaded the taxpayer to disclose.
Discretionary:	A collective term that addresses the negligence, intentional disregard and fraud penalties as judgmental in application and distinctly separate from the obvious errors of failure to file and failure to pay. The application of these penalties requires the reviewer to evaluate facts, circumstances, degrees of action or omission and apply penalty accordingly.
Frivolous:	A term that describes a taxpayer's attempts to avoid or delay the payment of tax by raising arguments that are clearly insufficient or have been repeatedly found to have no merit in prior litigation.

DISCRETIONARY PENALTIES

The revenue act contains the penalty provisions applicable to the taxes administered under the act. The discretionary penalties of negligence, intentional disregard, and fraud are found in MCL 205.23(3), (4), and (5), respectively.

How Discretionary Penalties Are Applied

Every case involving a tax deficiency must be reviewed as to whether discretionary penalties apply. Facts, circumstances and taxpayer intent must be examined using the best information available. If the examination reveals that a discretionary penalty applies, then a determination is made as to which penalty applies. This determination is made in descending order of the severity of the penalty.

- First - Fraud 100% (no minimum)
- Second - Intentional Disregard 25% (minimum of \$25.00)

Third - Negligence 10% (minimum of \$10.00)

Once it is determined that a discretionary penalty applies and which penalty will be applied, it must be determined on what amount the penalty will apply. As used in section 23 of the revenue act [MCL 205.23] "deficiency" is the amount to which the discretionary penalties are applied. Deficiency is a tax liability determined by the department. A deficiency may result from an underpayment of tax or an excessive claim for refund. Generally, adjustments reducing the amount of a refund are not subject to these penalties because there is no deficiency.

If any part of the deficiency for a taxable year is subject to one of the discretionary penalty provisions, then generally the penalty is applied to the entire deficiency for that taxable year. If more than one of these penalties is applicable to a deficiency, then the higher percentage penalty applies.

Types of Discretionary Penalties

Civil Tax Fraud

Recommendation of the fraud penalty shall be made when it is supported by facts leading to the conclusion that the taxpayer's intent was to evade payment of tax. Fraud involves deception: a purposeful act of a taxpayer to disguise, present and/or omit facts in such a way as to put forward a false situation. The fraud penalty may be applied when it is evident that the taxpayer knowingly and willfully acted in a manner to evade payment of all or a portion of a tax.

As a general rule, all factors taken together will set forth a course of conduct revealing an intent to defraud. However, the mere failure to file a tax return is insufficient to sustain a charge of fraud without the presence of some overt act showing intention to defraud. The department must prove that a tax is due, and that the taxpayer filed a false return or failed to file a return, and that the taxpayer intended to evade payment of a tax.

Some indicators of an intent to defraud are:

1. Understated, omitted, undisclosed, hidden, or disguised sales, purchases or income resulting in
2. a substantial tax liability.
3. Having a double set of books and records.
4. False, altered, distorted or missing records.
5. Unlicensed or unregistered business operations both legitimate and illegal.
6. Unexplained differences between related items from different tax returns (e.g., gross receipts for single business tax vs. income tax vs. annual sales tax returns).
7. Concealing assets in secret accounts or registering assets or accounts in false names or the names of others.
8. Consistent pattern of failure to file or pay.
9. False, inflated or disguised deductions or expenses resulting in a substantial tax liability.
10. Any action or conduct by the taxpayer having the effect of concealing or misleading.

Examples of fraud:

Department establishes from facts that:

1. Taxpayer buys a car (boat, airplane) from another individual and substantially understates the purchase price on the use tax return.
2. Taxpayer buys a car (boat, airplane) from another individual who is not a relative but claims the purchase is exempt from use tax because it was purchased from a relative (father, mother, brother, sister, etc.).

3. Taxpayer has knowledge of a tax obligation and willfully decides not to comply with obligation.
4. Taxpayer's cost of goods sold, less cost of non-taxable merchandise, substantially exceeds reported taxable sales.
5. Personal representative of an estate substantially under reports taxable asset distributions on an inheritance tax return.
6. Taxpayer falsely claims a deduction where no deduction exists.
7. Taxpayer claims false exemption deductions.
8. Taxpayer supplies a false Withholding Tax Schedule (Schedule W) or W-2 form showing withholding tax in excess of what was actually withheld by the employer.
9. Taxpayer supplies a false or altered property tax bill or false rent receipts to support a false claim for tax credit.
10. Taxpayer claims false Schedule C business losses on a non-existent business.
11. Taxpayer, as part of a scheme, files an excessive number of false credit claims.

Intentional Disregard

The determining factor for intentional disregard is the taxpayer's intent. When applying this penalty, the issue is whether the taxpayer has intentionally disregarded the tax laws, rules or instructions. While the intent of a taxpayer is difficult to discern, such intent will be presumed when a taxpayer has received specific instructions from the department as to the proper reporting of an item of income or deduction, but fails to do so.

Examples of intentional disregard:

1. Taxpayer has been advised of correct reporting by either an office review or audit, but fails to report correctly in a subsequent filing.
2. Taxpayer has been advised of filing requirements for installments of estimated tax under the Income Tax Act by office review or audit, but fails to make quarterly estimated tax payments.

Negligence

A reasonable, prudent person will read the instructions for filing tax returns before making a determination of tax liability. If the facts and circumstances indicate that a taxpayer did not exercise due care in making a determination of tax liability, this penalty may be added. If a taxpayer fails to file an amended return to report a modification to their federal return or has an underpayment of estimated tax, negligence is presumed.

Examples of negligence:

1. The income tax and single business tax instructions clearly require the prepayment of the annual tax, but the taxpayer remits estimated tax payments of less than the required amount.
2. A taxpayer fails to file an income tax or single business tax amended return within 120 days, as required by law, after a final alteration, modification, recomputation or determination of a deficiency under the provisions of the Internal Revenue Code.
3. The taxpayer has been assessed a tax deficiency; there is a subsequent audit of the taxpayer which results in a similar deficiency for a subsequent tax period resulting from the taxpayer's failure to correct internal controls and reporting procedures.
4. The income tax and single business tax instructions clearly require payment of the estimated annual tax at the time of filing an extension request. The taxpayer understates and underpays the annual liability with the extension request.

NON-DISCRETIONARY PENALTIES

The failure to file/pay penalties are found in the revenue act, MCL 205.24.

How Non-Discretionary Penalties Are Applied

Every case involving a return and/or payment filed after the due date must be reviewed as to whether late penalties apply.

- | | | |
|---|---|--|
| Failure to file tax return | - | \$10.00 or 5% per month (maximum 50%)
- After February 28, 2003, 5% for first 2 months and 5% for each additional month (maximum 25%) |
| Failure to pay a tax | - | \$10.00 or 5% per month (maximum 50%)
- After February 28, 2003, 5% for first 2 months and 5% for each additional month (maximum 25%) |
| Failure to pay withholding tax according to the federal schedule (where required) | - | 0.167% per day (maximum 50%, after February 28, 2003, maximum 25%) |
| Failure to file information return | - | \$10.00 per day (maximum \$400.00) |

Except for the information returns, these penalties are a percentage of tax due after subtracting credits and prepayments.

The maximum penalty of 25% or 50% is a combined maximum for failure to file and/or pay.

The penalties for failure to file/pay are applied at the stated rate per month or fraction of a month.

Types of Non-Discretionary Penalties

Failure to File

This penalty of \$10.00 or 5% of the tax due per month (maximum 50%) is applied to any monthly, quarterly or annual return, or any other tax return required by law that is filed after the prescribed due date for the return or an authorized extended due date. For returns filed or assessments issued after February 28, 2003, the penalty is 5% of the tax due for the first two months, with an additional 5% for each additional month, to a maximum of 25%. If adjustments are made as a result of a review of the tax return or from an audit of the taxpayer's records and increase the tax due, the additional tax due may be subject to the discretionary penalties.

Failure to Pay

When a taxpayer has filed a return but fails to pay the tax due, the penalty of \$10.00 or 5% of the tax due per month (maximum 50%) is added. For returns filed or assessments issued after February 28, 2003, the penalty is 5% of the unpaid tax for the first two months, with an additional 5% for each additional month the tax remains unpaid, to a maximum of 25%. This penalty is also applied to assessed taxes until the aggregate of 25% or 50% of the tax due has been applied.

For taxpayers meeting the criteria of MCL 205.19(2) requiring payment of withholding taxes according to the federal schedule, failure to make the payment will result in a penalty of 0.167% per day (50% maximum). For assessments issued after February 28, 2003, the maximum penalty is 25% of the tax.

A penalty shall not be imposed if a taxpayer fails to pay an estimated income tax payment if the taxpayer was not required to make estimated tax payments in the taxpayer's immediately preceding year. MCL 205.24(6).

Failure to File Information Return

Since no tax is due on an information return, this penalty is the only penalty applied for the failure to file an information return.

A penalty may be added of \$10.00 per day for each separate return for which there is a failure or refusal to file. The total penalty for each separate return for which there is a failure or refusal to file shall not exceed \$400.00.

Examples of information returns:

1. Annual sales tax reconciliation showing no tax due.
2. Fiduciary income tax return reporting beneficiary information showing no tax due.

NON-NEGOTIABLE REMITTANCE

Any taxpayer who remits a non-negotiable payment (i.e., insufficient funds check) to satisfy a tax liability, including amounts due on estimated tax returns, is subject to a penalty of 25% of the amount of such payment. Assessments for non-negotiable remittances issued after February 28, 2003, shall be \$50.00 for each such remittance. This penalty will be imposed in addition to any other applicable penalties.

Examples of non-negotiable remittance:

1. An individual files and remits payment by check of the tax due on the annual 2002 MI-1040 on April 10, 2003. The bank did not honor the check. Therefore, an assessment is issued for the amount of tax due, penalty of \$50.00, and failure to pay penalty 5% (25% maximum) from April 15, 2003, plus interest.
2. A corporation remits a payment by check of its third quarterly estimate on October 31, 2003. The bank did not honor the remittance. Therefore, an assessment is issued for the amount of payment, penalty of \$50.00, failure to pay penalty from October 31, 2003 until paid, plus interest. Credit will be given on the annual return for the tax amount assessed.
3. A gasoline wholesaler-distributor files its July 2002 report late on August 25, 2002 and remits the tax amount, 5% penalty, plus interest. The bank did not honor the check. Therefore, an assessment is issued on September 10, 2002 for the amount of the payment plus a penalty of 25% of the payment (tax, penalty and interest). The failure to pay penalty will accrue at 5% (maximum 50%).

SIMULTANEOUS PENALTIES

The non-discretionary penalties for failure to file/pay and non-negotiable remittance may be simultaneously applied. In addition to these non-discretionary penalties, a discretionary penalty may be charged for a given return period.

OBJECTIONS OR DEFENSES TO PENALTIES

If the department assesses a discretionary penalty against a taxpayer and the taxpayer objects to the penalty, the taxpayer bears the burden of establishing facts which will negate a finding of intent (in the case of a civil fraud or intentional disregard penalty) or a finding of negligence (in the case of a negligence penalty). The taxpayer must file a written petition with the department, stating in detail the facts relied upon to defeat the penalty assessment.

While individual cases depend upon the circumstances of the particular case, the following examples illustrate the application of these principles:

1. A finding of intent (in the case of a civil fraud penalty) may be negated where the taxpayer establishes that the taxpayer, acting in good faith, accepted a claim for sales tax exemption from an unrelated third party that ultimately proved to be wrong.
2. A finding of intent (in the case of an intentional disregard penalty) may be negated if a business taxpayer establishes and maintains an accounting system which minimizes the likelihood of mathematical errors or posting errors.
3. A finding of negligence (in the case of a negligence penalty) may be refuted if an individual taxpayer makes simple transpositions or mathematical errors.

Waiver for Reasonable Cause

If the taxpayer establishes that the failure to file or pay was due to reasonable cause and not to willful neglect, the department shall waive the penalty. If a taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return or pay the tax within the prescribed time, then the delay is due to reasonable cause. In determining whether a taxpayer was unable to file a return or pay a tax in spite of the exercise of ordinary business care and prudence, the department will consider all facts and circumstances surrounding the taxpayer, the nature of the tax, and the like.

If a taxpayer subject to the negligence penalty demonstrates to the department's satisfaction that the deficiency or excess claim for credit was due to reasonable cause, the department shall waive the negligence penalty. If a taxpayer successfully disputes a penalty for intentional disregard of the law, the department shall not impose a negligence penalty on the tax due.

Examples that are illustrative, but not conclusive, in showing reasonable cause include:

1. The failure to file or pay is caused by the death or serious illness of the taxpayer responsible for filing;
2. The failure to file or pay is caused by the destruction by fire or other casualty of the taxpayer's records or the taxpayer's business;
3. The failure to file or pay personal taxes is caused by the prolonged unavoidable absence of the taxpayer responsible for filing and the taxpayer is precluded, due to circumstances beyond the taxpayer's control, from making alternate arrangements for filing or paying;

4. A showing that the completed return or payment was timely mailed, that is, the United States postmark stamped on the envelope is dated on or before the due date set for filing the return, including extensions; or
5. A showing that the delay or failure is caused by erroneous written information that has been prepared contemporaneously and given to the taxpayer by an employee of the department.

Any taxpayer may request, in writing to the Treasurer, a waiver of penalty. The written request must contain all facts and circumstances alleged to constitute reasonable cause and an absence of willful neglect.

TAXPAYER-INITIATED DISCLOSURE

Except as applied to estimated tax returns, taxpayer-initiated disclosure means any voluntary disclosure of a tax deficiency when there has been no prior contact by the department.

No penalty will be applied to tax deficiencies on amended returns, providing:

1. There has been no contact by the department,
2. The taxpayer is not under investigation by the department for the tax period involved, and
3. The taxpayer or agent pays the tax deficiency and interest without further action by the department.

No penalty will be applied to tax deficiencies paid with the filing of a delinquent return providing:

1. There has been no contact by the department,
2. The taxpayer is not under investigation by the department,
3. The tax period of the return(s) includes the taxpayer's **first** filing period for that tax, and
4. The taxpayer or agent pays the tax deficiency and interest without further action by the department.

A taxpayer is required to file a written request or statement to be considered for the taxpayer-initiated disclosure exception from penalty.

FRIVOLOUS PROTEST

A penalty (the greater of \$25.00 or 25% of the tax due) may be imposed when a taxpayer attempts to avoid or delay payment of tax by raising arguments that are either not valid on the surface of the argument or have repeatedly been found to have no merit in prior litigation. The Treasurer or authorized agent will apply this penalty when a taxpayer uses this tactic to delay paying a Michigan tax.

Examples include:

1. Fifth Amendment (privilege against self-incrimination) objections:
 - A. Taxpayer engaged in unlawful activities.
 - B. Taxpayer failed or refused to file a return with another taxing authority.
2. Unconstitutionality of the tax, asserting a basis that has repeatedly been found to be without merit:
 - A. Gold and silver standard.
 - B. 16th Amendment to the U.S. Constitution.

3. Arguing that payment received for labor (salaries and wages) is a return of capital and not income.

Additionally, section 21(2)(c) of the revenue act [MCL 205.21(2)(c)] states the following:

"If the taxpayer serves written notice upon the department within 30 days after the taxpayer receives a notice of intent to assess, **remits the uncontested portion of the liability**, and provides a statement of the contested amounts and an explanation of the dispute, the taxpayer is entitled to an informal conference on the question of liability for the assessment." (Emphasis added)

Therefore, a taxpayer is required to remit payment on the uncontested portion of the tax due within 30 days of receiving the billing. If results of the conference indicate that any portion of the unpaid liability is uncontested, the frivolous penalty will apply to that uncontested portion.