11-6-2017

The Inappropriateness of the Bad Checks Penalty

Jeffrey H. Kahn
Florida State University College of Law

Douglas A. Kahn
University of Michigan Law School

The Inappropriateness of the Bad Checks Penalty

by Douglas A. Kahn and Jeffrey H. Kahn

Douglas A. Kahn is Paul G. Kauper professor of law emeritus at the University of Michigan Law School. Jeffrey H. Kahn is Harry W. Walborsky professor of law at the Florida State University College of Law. The authors thank Julia Wischmeier for her research assistance with this piece.

In this article, the authors argue that the penalty for sending a bad check to the IRS is excessive and that the reasonable cause exception should apply to any honest factual error.

The Penalty for a Dishonored Instrument

The Internal Revenue Code of 1986 provides many penalties for actions or failures to act on matters concerning the tax law. Many of those penalties are set forth in chapter 68 of the code.[1] Section 6657 applies a penalty to a person who tenders an instrument to the IRS as a payment if the instrument is not duly paid. The penalty does not apply if the person tendered the instrument in good faith and with reasonable cause to believe that it would be duly paid. This penalty is sometimes called the "bad checks" penalty.[2]

Section 6657 was first adopted as part of the Internal Revenue Code of 1954 and applied only to checks and money orders; it did not apply to any other method of payment. In its initial form, the penalty was 1 percent of the amount of the dishonored check, but if the amount of the check was less than $500, the penalty was the lesser of $5 or the amount of the check. The penalty did not apply if the check was tendered in good faith and with reasonable cause to believe that it would be duly paid. The penalty applied in addition to other applicable penalties and interest.

The current version of the bad checks penalty includes a few changes made over the years. In 1988 Congress doubled the percentage of the amount of the check that constitutes a penalty so that it is now 2 percent.[3] In 2007 Congress increased the maximum amount of a check that was subject to a specific dollar amount of penalty instead of applying a percentage of the amount of the check.[4] In 2010 Congress expanded the types of payments that are subject to the penalty. Instead of limiting the scope of the provision to checks and money orders, the current version applies to "any instrument in payment, by any commercially acceptable means."[5] This amendment was designed to make electronic payments subject to the penalty.[6]

While the current version applies to any commercial instrument of payment, for convenience we refer only to checks with the understanding that the same provision applies to other instruments, including electronic payments.

Section 6657 now applies a penalty of 2 percent of the amount of any bad check, but if the amount of the check is less than $1,250, the penalty will be the lesser of $25 or the amount of the check. Again, no penalty applies if the person tendered the check in good faith and with reasonable cause to believe that it would be paid.

[1] While the code sometimes refers to those penalties as "additional amounts," it also refers to them as penalties, which is what they are.

[2] *See* the title to section 6657.

[3] Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, section 5071. That act also changed the maximum dollar amount that carried a specified dollar penalty instead of using a percentage of the amount of the check.

[4] Small Business and Work Opportunity Tax Act of 2007, P.L. 110-28, section 8245.

[5] Homebuyer Assistance and Improvement Act of 2010, P.L. 111-198, section 3.

[6] 156 *Cong. Rec.* E1631-E1703 (2010).

Good Faith and Reasonable Cause Exception

A good faith and reasonable cause exception applies to several the penalties in the code. For example, the penalty for failure to file a tax return or pay a tax on time does not apply if the failure was due to reasonable cause.[7] What qualifies as a reasonable cause can differ for different penalties.[8] Nevertheless, some guidance can be obtained from viewing the construction of a reasonable cause exception in other penalty provisions.

Many of the code's penalties are triggered by erroneous constructions of tax provisions. For example, a reasonable cause for a taxpayer's failure to file a tax return or to pay a tax on time often will be an error in construing the tax law. While it could be caused by a factual error, it is more likely to be caused by a misconstruction of the tax law. That an error of either fact or law could qualify as a reasonable cause is reflected in reg. section 1.6664-4(b)(1), that "circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances."[9] Regarding the bad checks penalty, the cause is almost certain to be a factual error. It is unlikely that a legal error would cause the tendering of a bad check. Thus, there must be factual errors that qualify for the good faith and reasonable cause exception to the bad checks penalty, and it is likely that the situations to which the exception applies are exclusively based on factual errors.

One might ask whether the exception for honest factual errors is limited to situations in which the taxpayer was not at fault for not knowing the facts — that is, the taxpayer did not know the facts and could not reasonably have been expected to know them.[10] That would constitute much too narrow a construction of the exception. The circumstance in which there was no fault of the taxpayer who tendered a bad check would be extremely rare. It is highly unlikely that Congress intended the exception to have such little scope and such rare application. If Congress had intended to limit the reasonable cause exception to circumstances in which there was no fault of the taxpayer, it surely would have drafted the statute to state that the taxpayer could not reasonably have had knowledge that the check would be dishonored. To the contrary, Congress used broader language to reflect a broader scope for the exception. Moreover, if Congress had intended the reasonable cause exception to be construed so narrowly, there would likely have been a mention of that restriction in the legislative history of the statute. The report of the House Ways and Means Committee on the act adopting the 1954 IRC describes the operation of section 6657 and the exception and makes no suggestion that the exception should be so limited.[11] Also, as noted earlier, reg. section 1.6664-4(b)(1) states that an "honest misunderstanding" of fact that is reasonable can qualify for the exception.[12] Finally, the number of bad checks that the IRS received annually and for which a penalty was abated (presumably because of the reasonable cause exception) is substantial enough to infer that the IRS lacks a requirement that there be no fault on the part of the taxpayer.[13]

What, then, should be the standard for applying the reasonable cause exception to the bad checks penalty? Clearly some carelessness or negligence can be treated as a reasonable cause. We suggest that only an act of gross negligence or great carelessness should fail to qualify for the exception. Congress must have intended that ordinary honest human errors in thinking that the check would be honored should not trigger a penalty as long as the taxpayer acted in good faith.

---

[7] Section 6651(a).

[8] Reg. section 301.6651-1(c)(2).

[9] That regulation addresses the application of the reasonable cause exception to a penalty for an underpayment of tax.

[10] An example of that situation appears to have existed in the underlying facts of the decision of the IRS Laguna Niguel District that is described in *infra* note 15.

[11] H.R. Rep. No. 1337, 83d Cong , 2d Sess. at A420 (Mar. 9, 1954).

[12] That regulation deals with the reasonable cause exception to the penalty for an underpayment of tax.

[13] The IRS Data Book for fiscal 2016 states that penalties were abated for 31,585 bad checks that fiscal year. The total number of bad checks for which penalties were assessed by the IRS that fiscal year was 846,483.

There is little authority for how the reasonable cause exception should be applied to the bad checks penalty. One case is the Sixth Circuit's unreported decision in *Gregory*,[14] in which the taxpayer filed in 1992 a form for an extension of time to file his 1991 tax return. He estimated that he would owe $725,000 in tax for 1991, and he sent the IRS two checks drawn on separate bank accounts for a total of $725,000, with the knowledge that he had insufficient funds in both banks. The taxpayer claimed that he intended to sell securities before the checks were presented to the banks and deposit sufficient funds to cover them. Because that did not happen, both checks were dishonored. The government imposed a penalty for the bad checks and another penalty for late payment. The court upheld the trial court's judgment for the government, saying that issuing a check on an account that the taxpayer knows has insufficient funds cannot constitute a reasonable cause. The court held that the taxpayer had failed to prove that he had an arrangement to increase the size of his bank accounts so that the checks would be honored when submitted.

One IRS district reported allowing a reasonable cause exception in the following circumstance. The taxpayer sent the IRS a money order that was dishonored because a state government had frozen the assets of the company from which the money order had been purchased.[15] It appears that this was a situation in which the taxpayer was not at fault in failing to know that the money order would be dishonored. But as noted above, the reasonable cause exception is not limited to no-fault situations.

Those decisions are not helpful in determining the scope of the reasonable cause exception. If a taxpayer exercises ordinary care and prudence but makes an honest error, that should be sufficient to constitute reasonable care for purposes of the bad checks penalty.

Excessiveness of Applying Bad Checks Penalty

The bad checks penalty applies in addition to all other penalties that might apply to the same act — for example, the late payment of tax penalty imposed by section 6651. Note that in *Gregory*, the Sixth Circuit upheld the imposition of penalties for both the bad checks and the late payment of tax.

Because the government has so many other penalty provisions, what purpose is served by having a bad checks penalty? What loss does the government suffer when a purported payment is dishonored? It seems that the only loss is the administrative cost of dealing with a dishonored check.[16] To the extent that there is also a failure of payment, that loss is covered by the late payment penalty of section 6651. The cost to the government of handling a dishonored instrument would seem to be small and does not warrant imposing a sizeable penalty. For example, in *Gregory*, the amount of the bad checks penalty was $14,500 (2 percent of $725,000).[17] A bank typically will charge a fee for handling a bad check, but the fee is a modest one. Most states charge between $20 and $30 for bad checks.[18] If the federal government wishes to impose a penalty, it should be more modest. The administrative burden on the government cannot be much greater than the one on the bank or the states, and there seems little justification for imposing a large penalty.

Moreover, there is no meaningful relationship between the size of a check and the amount of penalty to be imposed. The burden on the government is the same for a bad small check as for a large one. To the extent that the dishonoring of a large check results in a failure to make a timely payment of a tax, section 6651(a)(2) adequately deals with that problem by imposing a penalty for that failure. The government is no worse off for receiving a bad check than it would be if the taxpayer had made no payment. In the latter case, there would be no bad checks penalty. The only additional loss to the government is the administrative cost of dealing with a bounced check.

---

[14] *Gregory v. United States*, 178 F.3d 1294 (6th Cir. 1999) (unreported).

[15] IRS, "Tax Practitioner Update," Laguna Niguel District, at 2 (Mar. 1990).

[16] For fiscal 2016, the total number of bad checks for which a penalty was assessed and the total amount of penalties that were assessed are set forth below.

[17] Also, the taxpayer incurred a late payment penalty of $14,556.

[18] *See* "Returned Check Fees by State and Common NACHA Return Codes," Profituity.com (2013).

Instead of applying a penalty of 2 percent of the amount of the check, the penalty either should be repealed entirely or changed to a dollar figure. The amount of the penalty should be modest and should not depend on the amount of the check (other than the possibility of a de minimis rule, such as the one in the current provision).

Revenue Obtained from the Penalty

To see the significance of the imposition of a bad check penalty as a source of revenue for the government, we examined the data provided by the IRS for fiscal 2016.[19]

In 2016 the IRS assessed penalties for 846,483 bad checks.[20] In that fiscal year, the government assessed penalties totaling $141,884,000 for receiving bad checks.[21] The IRS did not indicate how much of that $142 million was actually collected, but it abated a total of $97,469,000 of bad checks penalties in that fiscal year.[22] Thus, no more than $44,415,000 of bad checks penalties for that year was actually collected.

While the amount of penalties assessed less abatements ($44,415,000) is eight figures, it represents a very small amount of the revenue that the government collects each year. Moreover, that entire amount is likely to have been collected by the IRS. Also, the net revenue obtained by the government is reduced by the costs incurred in assessing and collecting the penalties, albeit that is a relatively small amount. If Congress were to repeal the penalty or to reduce the amount to be imposed, it would have an insignificant effect on the government's revenue.

Illustration

Consider the following illustration of the types of issues that can arise in determining whether the reasonable cause exception will apply. This example also illustrates how excessive the penalty can be. While the dollar amounts of tax used in the illustration are large, they are substantially less than the dollar amounts that were penalized in *Gregory*.

Arthur and Helen (filed for an extension of their income tax return for 2016, and they must pay the tax they owe for 2016. Being unsure of that amount, Arthur and Helen decided to send a larger figure than they were likely to owe to be certain that their payment is sufficient. When the return was later prepared, they actually owed only $200,000 in tax for 2016, so the amount of the check that was tendered to the IRS exceeded the amount owed by $25,000. Also, they chose to pay all their estimated tax for 2017 in one lump sum rather than in installments. Thus, they decided to pay the IRS $300,000 as an estimated tax payment for 2017.

Arthur and Helen had two bank accounts, each in a different bank. Along with the form requesting an extension of time to file the 2016 return, Arthur sent the IRS two checks — one for $225,000 and one for $300,000. There were sufficient funds in one account to cover both checks, but not enough funds in the other account to cover either check. Arthur wrote both checks on the wrong bank account, and so both were dishonored by the bank. When sending the checks to the IRS, Arthur believed that he had sent checks drawn on the correct account and did not realize his error.

A few weeks after sending the checks to the IRS, Arthur discovered the error. He promptly called the bank on which the checks were written requesting it not to return the checks to the IRS when they received it, and Arthur told the banks that he would deposit sufficient funds to cover the checks. The banks informed Arthur that it had already received the checks and returned them to the IRS. Arthur then contacted the IRS and sent them two checks drawn on the correct bank account. The IRS imposed the bad checks penalty of 2 percent of $525,000 for a penalty of $10,500.

Arthur contacted the IRS and explained the circumstances. Arthur requested that no penalty be imposed because there was reasonable cause for the bad checks and they were tendered in good faith. The IRS denied the request and stated that the error in choosing the wrong checkbook did

[19] Data Book, *supra* note 13.

[20] While the penalties were assessed in that fiscal year, not all the bad checks were necessarily received by the IRS in that year. Some of the bad checks may have been received in a prior year and the penalties assessed in fiscal 2016.

[21] *Id.*

[22] While those abatements were recorded in fiscal 2016, some bad checks may have been received in a prior year, and some of the penalties that were abated may have been assessed in a prior year.

not constitute a reasonable cause. Arthur appealed from that decision.

The two decisions noted above (the *Gregory* decision and the action of the Laguna Niguel district of the IRS[23]) are not helpful in determining whether Arthur and Helen qualify for the reasonable cause exception. In *Gregory*, the taxpayer knew that there were insufficient funds to cover the check but claimed to have intended to deposit sufficient funds before the checks were received by the bank. The court held that there was not reasonable cause when the taxpayer knew there were insufficient funds when he sent the checks, and his unproven intention to deposit funds subsequently did not cure that defect. In the other determination in which an IRS district ruled that reasonable cause was established, the money order was dishonored because of the action of a third party of which the taxpayer apparently had no knowledge.

The facts of the above illustration show that Arthur and Helen tendered the checks in good faith, so that part of the exception to the bad checks penalty is established. The question is whether their honest error in writing the checks on the wrong bank account constitutes a reasonable cause. They had reason to believe there were funds in the bank to cover the checks, but they were mistaken because the checks were drawn on the wrong account. It seems clear that some factual errors can qualify as a reasonable cause, but it is far from clear which errors are permitted. In the authors' view, the error in using the wrong checkbook was an honest mistake and did not constitute a gross error. The authors believe that the reasonable cause exception should apply and the bad checks penalty should not be imposed.

If the reasonable cause exception is deemed inapplicable and the bad checks penalty is imposed, the amount of the penalty would be excessive. The dollar amount of the checks the taxpayers sent to the IRS was greater than the amount they owed. The check they tendered as payment for their 2016 tax was $25,000 more that the amount owed for that year. They were required to pay only one-fourth of the estimated tax for 2017 as the first quarterly installment, and so the amount of the check they tendered to the IRS was $225,000 more than they owed for that tax. There is no justification for penalizing Arthur and Helen with more than a percentage of the amount they owed. The additional amount of the checks did not place any more burden on the IRS than the agency would have had if the checks had been written for the correct amounts. The literal language of the statutory provision applies the 2 percent penalty rate to the amount of the instrument. While it is possible that the statute will be construed to limit the figure to the amount owed, it is far from clear that that will be done.

Even if the IRS were to limit the penalty to the correct amount owed ($275,000), that would still impose a penalty of $5,500. That is excessive for an honest error that imposed a small burden on the government.

Conclusion

There is no reasonable justification for having a sizeable penalty for tendering a bad check to the IRS. There is no reasonable basis for making the size of the penalty depend on the amount for which the check was written. The bad checks penalty should be repealed. If it is retained, the penalty should be set at a dollar figure of a modest amount rather than as a percentage of the face amount of the check. While the government collects a small aggregate amount for the bad checks it receives, the penalty on those taxpayers who write large checks will be excessive.

If the penalty is retained, the reasonable cause exception to that penalty should be allowed for honest and ordinary errors of fact. If the parties took normal diligence and care, but made an ordinary error, that should suffice. Also, considering the lack of a justifiable rationale for imposing a sizeable penalty for the government's receipt of a dishonored check, the courts and the IRS should adopt a broad construction of the reasonable cause exception to that penalty. ■

[23] *Supra* note 15.