



Section of Taxation

10th Floor
740 15th Street, N.W.
Washington, DC 20005-1022
202-662-8670
FAX: 202-662-8682
E-mail: tax@abanet.org

April 21, 2009

The Honorable Max Baucus
Chair
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Charles B. Rangel
Chair
House Ways and Means Committee
1102 Longworth House Office Building
Washington D.C. 20515

The Honorable Charles E. Grassley
Ranking Member
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable David Camp
Ranking Member
House Ways and Means Committee
1139E Longworth House Office Building
Washington, DC 20515

Re: Statement of Policy Favoring Reform of Federal Civil Tax Penalties

Dear Chairmen and Ranking Members:

On behalf of the Section of Taxation of the American Bar Association, I am pleased to transmit the enclosed Statement of Policy Favoring Reform of Federal Civil Tax Penalties. This statement represents the views of the Section of Taxation and has not been approved by the Board of Governors or the House of Delegates of the American Bar Association. Accordingly, it should not be construed as representing the position of the American Bar Association.

We appreciate your consideration of the enclosed statement. Representatives of the Section would be pleased to discuss this statement with you or your respective staffs. Please contact Armando Gomez, the Section's Vice Chair for Government Relations, at (202) 371-7868 if that would be helpful.

Sincerely,

Stuart M. Lewis
Chair- Elect, Section of Taxation

Enclosure

cc: Honorable Timothy F. Geithner, Secretary, Department of the Treasury
Honorable Douglas H. Shulman, Commissioner, Internal Revenue Service
Mr. John L. Buckley, Chief Tax Counsel, House Ways and Means Committee
Mr. Russell Sullivan, Staff Director, Senate Finance Committee
Mr. Jon Traub, Republican Staff Director, House Ways and Means Committee
Mr. Kolan Davis, Republican Staff Director, Senate Finance Committee
Mr. Edward D. Kleinbard, Chief of Staff, Joint Committee on Taxation

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**AMERICAN BAR ASSOCIATION
SECTION OF TAXATION**

Statement of Policy Favoring Reform of Federal Civil Tax Penalties

This white paper is submitted on behalf of the American Bar Association Section on Taxation (the “Section”) and has not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, it should not be construed as representing the position of the American Bar Association.

The Section supports reform of the federal civil tax penalty regime now. It has been nearly twenty years since the last comprehensive overhaul by Congress of federal tax penalties. Since that time, more penalties have been added and even more penalties and amendments to existing penalties have been proposed. Despite the thoughtful work that resulted in the penalty reforms enacted in 1989, subsequent revisions to the federal civil tax penalty regime over the past two decades have not been grounded in a single, sound policy of tax administration.

This paper provides background on the efforts that lead up to the 1989 reform of federal civil tax penalties, reviews the guiding principles that were espoused by that reform effort, and sets forth recommendations for consideration in connection with a comprehensive review of the federal civil tax penalty regime.

Background

In November 1987, the Commissioner of Internal Revenue established a task force to study civil tax penalties. The task force, which was composed of employees from the Internal Revenue Service (“Service”) and the Department of Treasury (“Treasury”) gave careful consideration to the difficult issues involved, and received input from key stakeholders, including the Section.

In July 1988, the Section’s Civil Penalty Task Force presented its study of penalty reform to Congress (“1988 Section Report”).¹ Attached as Exhibit A is a copy of that study, which set forth a number of specific recommendations for Congress’ consideration, including a recommendation to limit the negligence penalty to a percentage of the tax attributable to the underlying negligent conduct. In conjunction with the issuance of the 1988 Section Report, the Section’s Council adopted a resolution identifying the following guiding principles for the revision of civil tax penalty provisions:

- (1) Penalties are appropriate elements of an overall administrative effort to achieve voluntary compliance.
- (2) To be effective in achieving voluntary compliance, the penalty provisions must be understandable and consistent. This requires that the penalties be relatively simple and logical.
- (3) The total penalty imposition should be perceived to be fair and reasonable in relation to the particular misconduct.
- (4) To contribute to a sense of fairness, penalties should be applied, and perceived to be applied, for the purpose of deterring and punishing specifically and clearly defined misconduct. Accordingly, penalties should not be imposed to serve as an independent source of revenue.
- (5) Since it is not fair to punish acts that may reasonably be believed to be permitted prior to specifying the identified misconduct, nor acts deterred by penalties not even in existence when the conduct occurred, penalties should not be adopted retroactively.
- (6) Penalties should not be imposed to punish conduct which is proper, reasonable, appropriate, or not clearly prohibited.

These principles, together with the specific recommendations contained in the 1988 Section Report, were presented to Congress through testimony before the House Committee on Ways and Means² and the Senate Committee on Finance.³

¹ *Penalties Study Report*, Penalties Task Force of the Section of Taxation of the American Bar Association (July 28, 1988).

² *Statement of Michael I. Saltzman on behalf of the Section of Taxation of the American Bar Association*, Subcommittee on Oversight, House Committee on Ways and Means (July 28, 1988).

The Commissioner’s task force published a final report in February 1989 that advocated positions that the Section continues to support today, including: (1) designing civil tax penalties for the purpose of encouraging voluntary compliance, (2) measuring compliance – and non-compliance – by clear standards of behavior, and (3) administering penalties with the aims of encouraging voluntary compliance and penalizing only knowing failures to comply.⁴

Later that year, penalty reform became a reality with the enactment of the Improved Penalty Administration and Compliance Tax Act (“IMPACT”).⁵ Among other things, that legislation completely overhauled the various penalty provisions relating to the accuracy of tax returns, and established a new penalty “structure that operates to eliminate any stacking of the penalties.”⁶

Ten years later, in July 1999, the Joint Committee on Taxation published a study on penalty and interest provisions that reaffirmed the principles underlying the 1989 penalty reform effort.⁷ Specifically, that report concluded that tax penalties “should (1) encourage voluntary compliance, (2) operate fairly, (3) deter improper behavior, and (4) be designed in a manner that promotes efficient and effective administration of the provisions by the IRS.”⁸

Notwithstanding the clear message of the 1989 penalty reform effort, which message was echoed in the 1999 Joint Committee study, numerous additional penalties have been enacted over the past decade for a variety of reasons, which do not always adhere to the stated principles underlying the IMPACT legislation, including those resulting from recent efforts to combat the growth in so-called “technical” tax shelters and to deter practitioner misconduct. For example, the American Jobs Creation Act of 2004⁹ resulted in the enactment of new penalties under sections 6662A and 6707A to increase the standards of conduct required to avoid the imposition understatement penalties on certain “reportable avoidance transactions” and to address failures to disclose “reportable transactions.”¹⁰ The 2004 Act also authorized the Office of Professional Responsibility to impose monetary penalties for violations of the rules of practice under Treasury Department Circular 230. More recently, Congress has twice revised the penalties imposed on tax return preparers, changing the standards required of tax return preparers and significantly increasing the maximum penalty amounts that can be imposed under

³ *Statements of Charles J. Muller and James E. Merritt on behalf of the Section of Taxation of the American Bar Association*, Subcommittee on Private Retirement Plans and Internal Revenue Service Oversight, Senate Committee on Finance (September 28, 1988).

⁴ *Report on Civil Tax Penalties*, Commissioner’s Executive Task Force on Civil Penalties, Internal Revenue Service (February 22, 1989), available at 89 TNT 45-36.

⁵ P.L. 101-239, 101st Cong., 1st Sess. (1989). (Subtitle G of the Omnibus Budget Reconciliation Act of 1989 contained the Improved Penalty Administration and Compliance Tax Act of 1989.)

⁶ H.R. Conf. Rep. 101-386, 101st Cong., 1st Sess. (1989) at 194.

⁷ Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99), July 22, 1999.

⁸ *Id.* at 30.

⁹ P.L. 108-357, 108th Cong., 2d Sess. (2004).

¹⁰ Unless otherwise indicated, all section references are to sections of the Internal Revenue Code of 1986, as amended (the “Code”).

section 6694 for violations of those standards.¹¹ At the same time, there have been a number of other new penalties considered by Congress over the past several years, including several proposals to codify the “economic substance” doctrine and to impose strict liability penalties for transactions found to lack “economic substance.” Some of those proposals would further curtail the ability of taxpayers to avoid understatement penalties either through disclosure or based on a higher standard of belief in the correctness of the return position giving rise to the understatement.

The Section has always supported efforts by Congress, the Treasury Department, and the Service to combat abusive tax shelters and increase voluntary compliance. In that regard, the Section has supported efforts to increase transparency, through the requirement to disclose “reportable transactions” and through promulgation of rules of practice that provide clearly articulated standards governing the conduct of tax professionals. Our comments on those and other rules regulating conduct of taxpayers and their advisors have been mindful of the principles set forth in the 1988 Section Report and in the 1989 penalty reforms. However, as discussed below, the Section does not support penalties that depart from these principles. In particular, the Section does not support efforts to stack new penalties on top of existing penalties, as those efforts result in increased complexity, can result in the imposition of disproportionate or multiple sanctions for a single transgression, and do little to enhance the perception of the tax system as reasonable.

In addition, the Section has long advocated for efforts to address the complexity of the Code, and we expect that to be an active topic in the 111th Congress. As the Obama Administration and the tax-writing committees focus on those important issues, we strongly encourage each to examine the federal civil tax penalty regime and to include penalty reform as part of any tax simplification efforts.

Others are also examining the current federal civil tax penalty regime. For example, in her most recent annual report to Congress, the National Taxpayer Advocate (the “NTA”) discussed the need for an analysis of the existing penalty framework, citing specific areas of concern to her office.¹² As discussed below, the Section shares many of the concerns raised by the NTA.

Guiding Principles

Administration of civil tax penalty policy by the Treasury Department and the Service is driven by the penalties enacted by Congress. Sound penalty administration can be achieved only if Congress clearly and expressly articulates its goals when deciding whether to retain, amend or add civil tax penalties to the Code; and only if Congress carefully and thoroughly evaluates the impact of any civil tax penalty change on the overall penalty regime. In general, we recommend that penalties be designed to encourage voluntary compliance and discourage intentional or reckless noncompliance. Inadvertent or excusable error should not be punished to the same degree (if at all) as willful misconduct.

¹¹ See P.L. No. 110-28 (2007) § 8264; P.L. No. 110-343 (2008), § 506.

¹² National Taxpayer Advocate, 2008 Annual Report to Congress, vol. 2, p. 2 (hereinafter, “NTA 2008 Report”).

As set forth in the 1988 Section Report, penalty reform should be guided by the six principles enumerated above. Nothing has changed in the past twenty years to change our views on these guiding principles. However, we believe that some of the penalties enacted recently, including the “reportable transaction” penalties under sections 6662A, 6707, 6707A, and 6708 are prime examples of what happens when those principles are not followed, and support our conclusion that penalty reform is needed now.

Section 6662A imposes an accuracy-related penalty on taxpayers with understatements attributable to “reportable avoidance transactions” and section 6707A imposes a penalty on taxpayers for failing to disclose “reportable transactions.” The amount of the penalty under section 6707A does not correspond to the amount of the underpayment, if any, attributable to the reportable transaction. Separately, section 6707 imposes a penalty on “material advisors” who fail to file disclosures under section 6111(a) with respect to “reportable transactions” for which they provided material aid, assistance, or advice; and section 6708 imposes a penalty on “material advisors” for failure to timely provide the Service with list of “advisees” and related information as set forth in the regulations.¹³ While we fully support proper disclosure of potentially abusive transactions, and believe in the power of “sunshine as a disinfectant,” there are issues with each of these penalties that do not comport with the principles of sound penalty administration.¹⁴

Because of the enactment of additional penalties since 1989 and the current administration of penalties, we believe that it is time for a thoughtful and comprehensive review of the federal civil tax penalty regime. Set forth below are our recommendations for such a review.

¹³ The principal focus of this paper is reform of penalties applied to taxpayers; however, where penalties that may be imposed on tax professionals illustrate the principles the Section advocates, we refer to them as well.

¹⁴ The Section recognizes that there may be certain areas where Congress may conclude that it is appropriate to impose heightened standards of conduct (and concomitantly higher potential penalties), but the Section believes that the principles set forth in this paper should apply equally with respect to all federal civil tax penalties.

1. Clearly define behavior to be penalized

If they are to encourage compliance, civil tax penalties must be as simple and clear to understand as possible. When taxpayers and their advisors do not know what is likely to be penalized, they cannot know what behavior is desirable, or take steps to avoid undesirable behavior. Recent experience with penalties applicable to potentially abusive transactions are a prime example of what can happen when penalties are enacted with a confusing array of vague definitions and overly complicated rules.

For instance, in evaluating potential penalties and defenses, taxpayers must determine whether a transaction has “a significant purpose” of tax avoidance or evasion (i.e., whether a transaction qualifies as a “tax shelter” under section 6662(d)(2)(C)) and whether it is a “reportable transaction” under Treasury Regulation section 1.6011-4(b). If the transaction is a reportable transaction, section 6662A instructs that the taxpayer must then determine whether a “significant purpose” of such transaction is tax avoidance or evasion and whether the transaction is a “listed transaction” or a transaction “substantially similar” to a listed transaction. This combination of imprecision and complexity impairs effective enforcement and does little to encourage compliance.¹⁵

2. Ensure penalties are consistent

Penalties must be consistent. Current provisions in the Code penalize taxpayers for failure to comply with conflicting or contradictory standards. Consistency in the penalty regime encourages compliance and makes administration easier and more readily understandable by those whose conduct is governed by such penalties.

The flurry of recent legislation enacting penalties relating to potentially abusive transactions has made this area of the penalty regime among the most inconsistent and least understandable – particularly with respect to disclosure and reasonableness of questionable positions. For example, if a substantial understatement penalty imposed on an individual is attributable to a transaction with a significant purpose of tax avoidance that is not a reportable transaction, that individual may establish a defense to the penalty by relying in good faith on the opinion of a professional tax advisor, without disclosure and without establishing that the position had a “more likely than not” level of confidence.¹⁶ On the other hand, for listed transactions (and transactions substantially similar to listed transactions) and other reportable transactions having a significant purpose of tax avoidance, disclosure, substantial authority and a reasonable belief that the treatment was more likely than not the proper treatment are prerequisites to a reasonable cause and good faith defense,¹⁷ and special rules apply to determine whether the tax advisor or tax opinion is “disqualified.”¹⁸ For the same reportable transaction, if a taxpayer is able to demonstrate a lack of a significant purpose of tax avoidance or

¹⁵ In Notice 2009-5, which addressed the October 2008 amendments to section 6694, Treasury and the Service indicated that they are considering issuing further guidance on the definition of “tax shelter” under section 6662(d)(2)(C).

¹⁶ I.R.C. § 6664(c)(1); Treas. Reg. § 1.6664-4(c)(1).

¹⁷ I.R.C. § 6664(d)(2).

¹⁸ I.R.C. § 6664(d)(3)(B).

evasion, and that the transaction is not a listed transaction or substantially similar to a listed transaction, no penalty will apply if the taxpayer discloses the relevant facts relating to the questionable position and can demonstrate a reasonable basis for the tax treatment.¹⁹

The recent experience with the 2007 and 2008 amendments to section 6694 provides a helpful case study in the importance of not revising tax penalty rules without careful and transparent consideration of the consequences. In May 2007, Congress revised section 6694 to increase the minimum threshold required for a tax return preparer to avoid being penalized with respect to positions attributable to understatements on tax returns.²⁰ The 2007 legislation raised the minimum standard for tax filing positions for tax return preparers above those imposed on taxpayers such that, while a taxpayer generally could avoid an accuracy-related penalty under section 6662 for an undisclosed position attributable to non-tax shelter items that were supported by substantial authority, tax return preparers were required to have a reasonable belief that the undisclosed position was more likely than not correct to avoid a penalty under section 6694. This difference in standards created a tension between taxpayers and tax return preparers by providing an incentive for the return preparer to encourage taxpayer disclosure with respect to a return position even though disclosure was not necessary for – or in the best interests of – the taxpayer. Given the inherent subjectivity in quantifying a particular likelihood of success and the intrinsic complexity and ambiguity in the tax law, the Section and other interested stakeholders promptly sounded alarms that legislating conflicting conduct incentives between preparers and their clients was counterproductive to sound tax administration.²¹ The Treasury Department proposed a resolution for this problem in early 2008,²² and Congress revised section 6694 again in October 2008 to better harmonize the standards imposed on taxpayer and tax return preparers.²³ However, these revisions have not solved all the problems in section 6694. In particular, the inclusion of a special rule for “tax shelters” created yet another layer of ambiguity in that the revised statute, without clarifying guidance, could have been read to eviscerate the correction intended by Congress in that very legislation.²⁴

3. Promote fairness by imposing penalties in proportion to misconduct and by penalizing a single act only once

The perception of fairness in the administration of civil tax penalties is critical to fostering taxpayers’ respect for the tax law. Penalties should be targeted at negligent or

¹⁹ I.R.C. § 6662(d)(2)(B).

²⁰ P.L. No. 110-28, 110th Cong., 1st Sess. (2007) § 8264.

²¹ See American Bar Association, Section of Taxation, letter to Congress dated November 15, 2007 commenting on legislative changes impacting standards for imposition of penalties.

²² U.S. Department of the Treasury, *General Explanation of Administration’s Fiscal Year 2009 Revenue Proposals* (February 2008), at 93.

²³ P.L. No. 110-343, 110th Cong., 2^d Sess. (2008), § 506.

²⁴ In Notice 2009-5, Treasury and the Service noted that “a broad interpretation of tax shelter for purposes of section 6694 could be inconsistent with the 2008 Act’s changes to section 6694 by requiring tax return preparers to comply with the general standard previously imposed under the 2007 Act (a reasonable belief that the position would more likely than not be sustained on the merits) rather than the new general standard under the 2008 Act (substantial authority).”

intentional noncompliance. Taxpayers should not be penalized for inadvertent errors or good faith disputes. In addition, multiple penalties (“stacking”) should not be imposed on the same conduct.

The reportable transaction regime provides one illustration of the resurgence in “stacking” penalties. Under those rules, a single act of failing to disclose a listed transaction on Form 8886, even where inadvertent, results in: (1) an unwaivable and unreviewable penalty for failure to disclose,²⁵ (2) a higher accuracy-related penalty (assuming there is an understatement attributable to the transaction),²⁶ (3) a delay in the running of the statute of limitations,²⁷ (4) ineligibility for beneficial suspension of interest provisions,²⁸ (5) an automatic request for tax accrual workpapers,²⁹ and (6) public company reporting requirement for the first two penalties on financial statements filed with the Securities and Exchange Commission.³⁰

Because these penalties are significant and apply without regard to the impact on tax collection, or on level of misconduct, they are also examples of penalties that may not be in proportion to the misbehavior. For instance, the section 6707A penalty may be as high as \$200,000 for each failure to disclose a listed transaction, regardless of the amount of the underpayment, if any, attributable to the transaction.³¹

Separately, as detailed in the NTA’s 2008 Annual Report to Congress, when penalties are imposed automatically (i.e., through the application of automated matching systems, etc.), there is no mechanism in place to first determine whether the taxpayer’s error was the result of particular conduct of a type that warrants a penalty – or whether the penalty to be imposed is proportional to the misconduct. For example, in 2008, the Service began to notify taxpayers that it would automatically assess penalties under section 6038(b)(1) for failures to file Form 5471, and under section 6651(a)(1), for failures to file. While the Section certainly recognizes the importance of automated processes in the analysis of tax return information, we share the NTA’s concerns for the lack of procedural fairness that can result when penalties are automatically imposed without first providing the taxpayer an opportunity to demonstrate why the penalties are not applicable to a particular situation. Although such penalties may subsequently be abated if the taxpayer manages to navigate the complex procedural requirements of making such a request,³² the

²⁵ I.R.C. § 6707A(a) and (d).

²⁶ I.R.C. § 6662A(c).

²⁷ I.R.C. § 6501(c)(10).

²⁸ I.R.C. § 6404(g)(2)(E).

²⁹ Announcement 2002-63, 2002-27 I.R.B. 72.

³⁰ I.R.C. § 6707A(e).

³¹ For advisors, the section 6707 penalty for failure to file a material advisor disclosure statement with respect to a listed transaction may be as high as the greater of \$200,000 or 50% of the gross income derived by the advisor with respect to the transaction (75% for intentional violations). Similarly, the section 6708 penalty is \$10,000 per day for failure to provide the list of advised persons required under section 6112 without consideration of the number of clients on the list, transactions responsive to the list request, or documents required to be produced as part of the list.

³² As a major labor union discovered to its dismay, the Tax Court recently held that it did not have jurisdiction to consider a challenge to the assertion of the penalty under section 6652(c)(1) for failure to timely file the labor union’s annual returns pursuant to section 6033(a)(1). *See Service Employees International Union v. Commissioner*, 125 T.C. 63 (2005).

automatic assertion of penalties can detrimentally impact perceptions regarding fairness and proportionality, which does little to enhance the cause of voluntary compliance.³³

4. Retention of reasonable cause and good faith defense for all penalties

Because the Section believes that penalties generally should apply only to negligent, reckless or intentional conduct, all penalties should be subject to a reasonable cause and good faith defense and no penalty should be imposed without affording an opportunity to the party who may be sanctioned to defend the conduct. The Section does not support recent changes to the penalty regime that have either eliminated the availability of the reasonable cause defense altogether, e.g., section 6707A, or limited taxpayers' ability to assert the defense only upon fulfillment of certain objective and subjective requirements, e.g., section 6664(c)(2) and (d). The reasonable cause and good faith standard, as interpreted in Regulations and as applied by the Courts, necessarily requires a careful analysis of the pertinent facts and circumstances. Fundamental fairness requires that taxpayers be permitted an opportunity to contest penalties, and to demonstrate why penalties are not appropriate in a particular situation.

5. Enhance compliance through greater disclosure and more enforcement rather than relying on the chilling effect of vague, overly broad, and confusing penalties

Because transparency is widely viewed as critical to the government's efforts to enforce the tax law, the penalty regime should create incentives to encourage disclosure. For instance, under section 6662(d)(2)(B)(ii), taxpayers generally will be able to avoid a substantial understatement penalty if the position has at least a reasonable basis and is adequately disclosed. Penalties regarding tax shelters, listed transactions, and other reportable transactions, however, are so complex and onerous that they either encourage disclosure of transactions otherwise evident from the face of the return or result in overdisclosure of any transaction where there is even the remotest possibility that disclosure is required. In other cases, the penalties discourage disclosure, such as in the case of tax shelters that are not reportable transactions where no amount of disclosure will assist a taxpayer in avoiding the assertion of an understatement penalty.

Legislation introduced in the 110th Congress would have modified the substantial understatement penalty under section 6662 to eliminate any incentive for disclosure in the case of "specified large corporations."³⁴ If enacted, that rule would require imposition of the section 6662 penalty for any substantial understatement, regardless of disclosure, if the taxpayer could not demonstrate that it had a reasonable belief that the position was more likely than not correct. Stated differently, the legislation would raise the bar for large corporations from reasonable basis (which often is interpreted to mean at least a 20% likelihood of success) to more likely than not (greater than a 50% likelihood of success), regardless of whether the taxpayer disclosed the position. Given the complexity and ambiguity present in many aspects of the federal tax laws, the Section does not believe that a more likely than not standard for imposition of penalties is appropriate,

³³ NTA 2008 Report, vol. 2, at 16 – 18.

³⁴ H.R. 3970, 110th Cong., 1st Sess. (2007) § 3502(c).

except perhaps in the case of particularly egregious transactions, such as listed transactions.

6. Do not enact penalties merely to punish

Sections 6707 and 6707A demonstrate what we see as a trend toward using penalties merely to punish rather than to encourage compliance. Contrary to the underpinnings of our voluntary compliance system, strict liability penalties (i.e., those for which there is no reasonable cause defense) such as these eliminate the opportunity, and the incentives, to remediate and to become compliant. Despite the fact that the reportable transaction regime is so complex that many taxpayers and advisors are unable to identify whether a transaction is a reportable transaction in the first instance, a section 6707A penalty may be imposed regardless of whether the failure to disclose the transaction is due to inadvertence, rather than willfulness. Most troubling is the fact that the statute forecloses any opportunity to challenge in court the correctness of the Commissioner's exercise of discretion to rescind the imposition of these penalties, a questionable practice under our constitutional system of checks and balances.³⁵

Likewise, as we have made clear in the past, proposals to impose strict liability penalties in cases where a transaction is not respected as a result of the application of the "economic substance" doctrine are not appropriate.³⁶ Economic substance is a judicial doctrine that is most effective when the facts and circumstances of each case can be individually evaluated. Legislating the definition of economic substance will make the law significantly more complex, will hamstring the government's ability to challenge questionable transactions, and will encourage exploitation of inevitable statutory loopholes. Further, the penalties being proposed for transactions that fail to meet the codified economic substance doctrine are so onerous (strict liability 30% penalties, for example) that they may never be imposed.³⁷ Rather than codifying the economic substance doctrine and enacting yet another new penalty, Congress should consider increasing funding for tax law enforcement, allowing for appropriate use of the ample tools already at the Service's disposal, including civil tax penalties, to combat abusive tax transactions.

Recently, significant attention has been brought to the penalties imposed under Title 31 for failure to properly file reports of foreign bank or financial accounts. Under section 5314 of that title, taxpayers with either a financial interest in, or signature or other authority over, one or more foreign financial accounts having an aggregate balance of

³⁵ I.R.C. § 6707A(d)(2). Taxpayers can litigate the question of whether the penalty was properly applied (e.g., by litigating whether the underlying transaction was a reportable transaction). *See* H.R. Conf. Rep. 108-755, 108th Cong., 2d Sess. (2004) at 373, fn 463.

³⁶ *See* American Bar Association, Section of Taxation, letter to Congress dated April 12, 2007 regarding proposed codification of the economic substance doctrine.

³⁷ Moreover, one version of this proposal as approved by the Senate in 2007 would require the Chief Counsel of the Internal Revenue Service to personally approve each instance in which the new penalty would be imposed. S. 2242, 110th Cong., 1st Sess. (2007) § 512. Such a rule raises a number of administrative concerns, including requiring the Commissioner's lawyer to make enforcement decisions properly reserved to the Commissioner, and would be so unwieldy that it would likely limit the instances in which the penalty was ever imposed.

\$10,000 or more at any time during the calendar year must file a “Report of Foreign Bank and Financial Accounts” or “FBAR” on Treasury Form TD F 90-22.1, indicating the existence of, and providing identifying information with respect to, each account. Because each failure can result in application of a penalty equal to 50% of the balance in the account, a taxpayer who fails to properly file an FBAR at least twice with respect to a particular account can be penalized the entire value of the account, even if the taxpayer properly reported the income from the account on his annual income tax return. While the government is rightly concerned when taxpayers do not properly report income from foreign holdings, penalties of this magnitude are overly punitive. Accordingly, we were pleased to see the Commissioner’s recent announcement of a disclosure initiative that would permit taxpayers to resolve issues involving foreign accounts. Such initiatives are an important part of increasing compliance, and the Service’s appreciation of the overly punitive penalties that can result in the FBAR context provides further evidence that Congress should reconsider the utility of such high penalty rates.

7. Do not use penalties for raising revenue or offsetting the costs of tax benefits

As stated in the 1988 Section Report and the Commissioner’s 1989 penalty study, using penalties to raise revenue, or to offset costs, is detrimental to tax administration and discourages voluntary compliance. If the principal policy behind the enactment of penalties is to encourage behavior, the revenue to be raised should be incidental to the proposed penalty. Specifically, looking to penalties to offset tax expenditures risks incentivizing the Service to impose and to sustain penalties – particularly large dollar penalty amounts – wherever it can be done, regardless of whether penalties are appropriate in a particular case, and regardless of the consequences for the tax system that can result from even the perception of random or unfair application of tax penalties.

8. Issue clear and detailed guidance on interpretation of penalties and their enforcement

It is important that clear and comprehensive guidance on the interpretation and enforcement of penalties be issued in a timely manner. Lack of timely guidance adds to the confusion for those whose conduct is governed by the penalty regime and makes the uniform administration of penalties which is so essential to the system of voluntary compliance, virtually impossible. Clear and timely guidance is necessary to foster taxpayer and practitioner compliance, and to enhance the perception that the federal civil tax penalty regime is being fairly administered – an essential component of a voluntary compliance system.

For example, the May 2007 revisions to the tax return preparer rules of sections 6694 and 6695 caught the Service (and many practitioners) by surprise and caused widespread concern among practitioners who do not actually prepare returns but who may be considered “tax return preparers” subject to sanction, given the expansive “preparer” definition. Treasury and the Service made commendable efforts to provide immediate guidance to address concerns with the 2007 legislation (which applied to returns prepared after the date of enactment, and thus impacted tax return preparers in the midst of completing returns for transactions completed in 2006), and recently finalized thoughtful

regulations that reflect the interim guidance issued in 2007.³⁸ Without such comprehensive and timely guidance, the differences between statutes, Treasury Regulations (and Circular 230) would have been unmanageable.

Unfortunately, comprehensive and timely guidance has not always been provided with respect to penalties. Taxpayers still await guidance regarding the meaning of “significant purpose” in the definition of tax shelter enacted in 1997, and the importance of that definition is even more important today in light of its incorporation by reference in section 6662A, section 6694 and Circular 230 § 10.35. And taxpayers are still clamoring for more guidance regarding the meaning of “substantially similar” which has been included in the reportable transaction regulations since they were first proposed in 2000. The fact that lack of guidance has continued for so many years regarding these cornerstones of the government’s tax shelter fighting strategy undermines voluntary compliance by painting compliant taxpayers and noncompliant taxpayers with the same broad brush.

9. Do not penalize foot faults where substantial compliance is shown

Concerns about reportable transaction penalties under sections 6662A, 6707, 6707A, and 6708 could be eased administratively by establishing fair and transparent pre-assessment procedures. However, to date the Service has not done so. Instead the rules currently penalize foot-faults, even if there is substantial compliance. For instance, the first time a reportable transaction is disclosed, a disclosure statement must be filed with both the Service’s Office of Tax Shelter Analysis (“OTSA”) and with the return. If a taxpayer files a disclosure with only OTSA, and not with the return, or visa versa, the section 6707A penalty applies even though the Service has actual notice of the taxpayer’s participation in the reportable transaction.³⁹ This result is not required by the statute. Even if equity and good conscience would justify waiving the penalty, waiver is either prohibited or is so limited as to be effectively unavailable.⁴⁰

The structure of these penalties and the fact that section 6707A is being administered without room for any discretion by examining agents leads taxpayers to a “Hobson’s choice.” Taxpayers may remedy a failure to disclose for purposes of reducing the section 6662A reportable transaction understatement penalty from 30 percent to 20 percent by filing a qualified amended return. However, filing a qualified amended return does not eliminate or reduce exposure to the section 6707A penalty. Rather, it puts the Service on notice that a failure to disclose has occurred, leaving the taxpayer to beg for application of the Commissioner’s limited rescission authority. Again, this result is not required by statute. Treasury and the Service can determine administratively when the requirements for disclosure have been satisfied.⁴¹

³⁸ T.D. 9436, 73 Fed. Reg. 78430 (December 22, 2008).

³⁹ Temp. Reg. § 301.6707A-1T(c)(1).

⁴⁰ Temp. Reg. § 301.6707A-1T(d).

⁴¹ See preamble to TD 9309, 2007-7 I.R.B. 497, promulgating final Regulations relating to qualified amended returns, noting that the proposed and temporary Regulations’ definition of “qualified amended return” to include an amended return filed solely to disclose information pursuant to Regulation section 1.6011-4 was removed “because it could be incorrectly interpreted to provide relief from the section 6707A penalty. These final regulations are not intended to have any effect upon the applicability of the section 6707A penalty.”

10. Increase transparency in administration of penalties

We recommend periodic and increased analysis and reporting on effectiveness of penalty administration by the Service. The Service's current penalty policy statement (Policy Statement 20-1, reprinted at IRM Exhibit 20.1.1-1) provides that "[t]he Service continually evaluates the impact of the penalty program on compliance and recommends changes when the statutes or administration of penalties are not effectively promoting voluntary compliance." This policy statement reflects the Congressional direction provided in the Penalty Reform Act of 1989.⁴² However, because the Service does not regularly make public reports of its efforts to comply with this policy statement, it is difficult for taxpayers – and even more importantly, for Congress – to take into account the important lessons that can be drawn from regular and comprehensive reviews of the federal civil tax penalty regime. Accordingly, the Service should compile and regularly publish information about penalties and their application that can be used to measure their effectiveness in enhancing compliance with federal tax laws. Included within that analysis, the Service should disclose statistics on the percentages of cases and amounts of: (1) penalties proposed; (2) penalties waived or abated; and (3) penalty dollars collected.⁴³

11. Streamline procedures for resolving penalties imposed in partnership situations

In the case of partnerships subject to the unified audit and litigation procedures of the Tax Equity and Fiscal Responsibility Act of 1982,⁴⁴ the applicability of any penalty relating to a partnership tax item is determined in a unified proceeding at the partnership level.⁴⁵ However, it appears that partner-level defenses may only be raised in subsequent refund litigation instituted after the conclusion of the partnership proceeding.⁴⁶ In the case of large partnerships with numerous partners, reserving resolution of partner-level defenses until after the completion of the underlying partnership proceeding can be understandable, particularly in light of the fact that the unified partnership audit and litigation procedures were first designed to address difficulties that had arisen with widely syndicated partnerships.⁴⁷ However, a number of recent cases that have addressed this rule involved partnerships in which a very small number of individuals held nearly all of the interests in the partnership. To the extent that the courts in those cases concluded that they did not have jurisdiction to decide partner-level defenses in conjunction with the partnership proceeding, the result was that the individual partners

⁴² H.R. Conf. Rep. No. 101-386, 101st Cong., 1st Sess. 661 (1989).

⁴³ In her 2008 report to Congress, the National Taxpayer Advocate cited the lack of data as an impediment to evaluating the effectiveness of IRS penalty administration. *See* NTA 2008 Report, vol. 1, at 412 – 418.

⁴⁴ P. L. 97-248, 97th Cong., 2d Sess. (1982) § 402.

⁴⁵ I.R.C. § 6221. This rule was established in the Taxpayer Relief Act of 1997, P.L. 105-34, 105th Cong., 1st Sess. (1997). Prior to the 1997 legislation, penalties could only be asserted against a partner through the application of deficiency proceedings following completion of the partnership-level proceeding.

⁴⁶ I.R.C. § 6230(c)(4). *See New Millenium Trading LLC v. Commissioner*, 131 T.C. No. 18 (2008) at 9 (collecting authorities).

⁴⁷ *See* Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (JCS-38-82).

were required to pursue a second litigation with the government for the sole purpose of resolving the applicability of those defenses. In such cases, effectively requiring the taxpayers and the government to litigate twice in order to completely resolve a case does not seem to result in an appropriate use of resources for taxpayers, the Service, or the Courts, and can lead to an effective cost of penalties being even more onerous for the mere reason that the taxpayer participated in a transaction through a partnership subject to the unified audit and litigation procedures. These problems could be ameliorated in appropriate cases by, for example, clarifying that Courts can take ancillary jurisdiction to resolve partner-level defenses in conjunction with the resolution of the underlying partnership proceeding when there are a limited number of partners involved that have such defenses to raise.

Conclusion

For the foregoing reasons the Section supports reform of the federal tax penalty regime now. It has been too long since the last comprehensive Congressional overhaul. The developments in the federal tax penalty regime over the past two decades have not been grounded in a single, sound policy of tax administration. The failure to enact comprehensive reform may have serious adverse consequences to enhancing voluntary compliance, which should be the goal of all federal tax penalties.