June 25, 2014

The Honorable Ron Wyden
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Dave Camp
Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Orrin G. Hatch
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Sander Levin
Ranking Member
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

Re: Comments on Summary of Staff Discussion Draft on Reforming Tax Administration

Dear Chairmen and Ranking Members:

Enclosed please find comments on the staff discussion draft of proposed reforms to the administration of the tax laws (the “Discussion Draft”) issued by former Chairman Max Baucus of the Senate Finance Committee (“Comments”). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely yours,

Michael Hirschfeld
Chair, Section of Taxation

Enclosure

cc: Mr. Joshua Sheinkman, Majority Staff Director, Senate Finance Committee
Mr. Christopher Campbell, Minority Staff Director, Senate Finance Committee
Ms. Jennifer Safavian, Majority Staff Director, House Ways and Means Committee
Ms. Janice A. Mays, Minority Chief Counsel, House Ways and Means Committee
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
Honorable Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
Honorable John Koskinen, Commissioner, Internal Revenue Service
Honorable William J. Wilkins, Chief Counsel, Internal Revenue Service
On November 22, 2013, then Chairman Max Baucus of the U.S. Senate Committee on Finance, released a staff discussion draft of proposed reforms to the administration of the tax laws (the “Discussion Draft”). These comments (“Comments”) on the Discussion Draft are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These Comments were prepared by individual members of the Administrative Practice, Civil and Criminal Tax Penalties, Court Procedure and Practice, Pro Bono and Tax Clinics, and Standards of Tax Practice Committees of the American Bar Association Section of Taxation. The principal drafters of the Comments were Diane Ryan of the Administrative Practice Committee, John M. Colvin of the Civil and Criminal Tax Penalties Committee and Armando Gomez of the Standards of Tax Practice Committee. Substantive contributions were made by Kevin Johnson of the Administrative Practice Committee, Sanford Boxerman, Matthew Cooper, Tom Cullinan, Stephanie Fiumara, Steve Gremminger, O. A. Ishmael, Clint Massengill, Fred Murray, Otto Shill, Mike Villa and James Washington of the Civil and Criminal Tax Penalties Committee, George Willis of the Pro Bono and Tax Clinics Committee, and Michael J. Desmond of the Standards of Tax Practice Committee. These Comments were reviewed by Mary A. McNulty and Charles P. Rettig on behalf of the Section’s Council, and by Julian Y. Kim, on behalf of the Section’s Committee on Government Submissions.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who may be affected by the federal tax principles addressed in these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: June 25, 2014
EXECUTIVE SUMMARY

On November 20, 2013, then-Chairman Max Baucus of the U.S. Senate Committee on Finance released a staff discussion draft of proposed reforms to the administration of the tax laws (the “Discussion Draft”). These Comments address certain aspects of the Discussion Draft and respond to the request for comment on certain issues affecting tax administration practice and procedure.

The Discussion Draft includes provisions intended to simplify the tax filing process and expand electronic filing, address tax-related identify theft, and reduce the tax gap through enhancements to information reporting. The Section of Taxation of the American Bar Association (the “Section”) supports the goals underlying these proposals. We also note, however, that addressing those goals requires an adjustment to the funding provided to the Internal Revenue Service (the “Service”) through the annual appropriations process. As we recently wrote to Congress, the Section is gravely concerned that the recent trend of funding reductions for the Service is negatively impacting its ability to properly serve taxpayers and enforce the tax laws that Congress enacts.1

The Discussion Draft proposes to amend 31 U.S.C. § 330 to clarify that the Treasury Department and the Service have the authority to regulate all paid tax return preparers. In light of the recent decision to the contrary in Loving v. I.R.S., 742 F.3d 1013 (D.C. Cir. 2014), the Section strongly supports this proposal, with clarifications discussed below to ensure that the legislation adequately remedies the issues raised in the Loving decision.

The Discussion Draft requested comments on whether Congress should create a statutory right to review by the Office of Appeals (“Appeals”) prior to the issuance of a notice of deficiency. The Section supports this proposal because it would increase fairness for taxpayers, resolve cases more quickly and economically for both taxpayers and the government, and help ensure the independence of Appeals. In addition, the Section respectfully recommends that Congress provide a pre-assessment statutory right to review by Appeals of all penalties.

The Discussion Draft also requested comment on reforming the current tax penalty structure to ensure that penalties are used appropriately to effectively promote taxpayer compliance. We applaud Congress for its consideration of reform of the penalty regime. In a 2009 white paper, the Section encouraged Congress to address civil tax penalty reform. With the benefit of five years’ experience since that white paper was issued, we believe that the principles and recommendations set out in the white paper are still timely, and that penalty reform is more important than ever. We also recommend that:

The Internal Revenue Code of 1986, as amended (the “Code”)² be revised to allow taxpayers to assert a uniform reasonable cause and good faith defense with respect to most, if not all, penalties.

In TEFRA partnership proceedings, courts be permitted to take ancillary jurisdiction over the “reasonable cause and good faith” defense of partners, rather than requiring those partners to litigate their penalty defenses in subsequent proceedings.

Congress apply strict liability penalties in only the most narrow of circumstances.

Congress repeal the “disqualified tax adviser” provisions that effectively require taxpayers to obtain “second opinions” with respect to certain transactions in order to assert penalty defenses based on reasonable cause.

Congress clarify the codified economic substance doctrine.

Congress provide taxpayers with an opportunity for pre-assessment judicial review of most penalties.

The government have the burden of proof with respect to the applicability of non-assessable penalties asserted against individual taxpayers (and certain smaller entities) when those taxpayers have been cooperative in the audit process.

Congress enact a catch-all six-year statute of limitations for the assessment of those civil penalties in the Code which are not otherwise subject to a more specific statute of limitations.

Congress clarify that an “understatement” for purposes of the accuracy and fraud penalties includes the full amount of any refundable credits.

Congress clarify that the Anti-Injunction Act applies to all penalties in the Code, not just those found in subchapter 68B.

Penalties generally be based on the amount of tax benefits, and any fixed dollar amount penalties be indexed for inflation.

The Discussion Draft also requested comment on whether to update the “Taxpayer Bill of Rights,” which was last addressed by Congress as part of the Internal Revenue Service Restructuring and Reform Act of 1998. We note that the National Taxpayer Advocate has regularly supported a number of improvements in this area, and we agree that it is important for Congress to periodically review the procedural protections provided to taxpayers in the Internal Revenue Code and to update those protections to remedy situations that fall through the cracks. Importantly, however, the Section believes that Congress should take care to ensure that efforts to address taxpayer rights do not become an opportunity to demonize the Service and its more than 90,000 dedicated employees. While there clearly are areas where the Service can do more to help taxpayers, in our experience the vast majority of the Service’s employees do their utmost to serve taxpayers fairly.

² References herein to statutory “section(s)” or “subsection(s)” are to the Code, unless delineated otherwise.
DISCUSSION

The Section appreciates the substantial efforts that both the House Committee on Ways and Means and the Senate Committee on Finance have made in recent years to examine the need for tax reform, and applauds both Committees for their efforts to provide detailed discussion drafts to the public for review and comment. The Section has long supported open and transparent review and consideration of tax legislative proposals, and we appreciate the opportunity to provide input on these important issues. Through a series of white papers issued in 2008 and 2009, the Section set forth broad principles for tax reform, including a white paper addressing the need for reform of civil federal tax penalties. More recently, the Section has submitted 13 papers providing detailed options for tax reform, and also submitted comments on the financial products discussion draft released by the House Committee on Ways and Means in 2013. These Comments address certain of the Discussion Draft’s proposals for reforms to the administration of the tax laws.

I. CONGRESS SHOULD CLARIFY THE AUTHORITY OF TREASURY AND THE SERVICE TO REGULATE TAX RETURN PREPARERS

Section 19 of the Discussion Draft would amend 31 U.S.C. § 330(a)(2)(D) to clarify that Treasury may require taxpayer representatives to demonstrate competency in preparing and filing tax returns. This proposal is intended to clarify that Treasury and the Service have the authority to regulate all paid tax return preparers, which is an objective that the Section strongly supports. However, as discussed below, we believe that the language in section 19 of the Discussion Draft may not be adequate to achieve this objective in light of the recent decision by the U.S. Court of Appeals for the D.C. Circuit in Loving v. I.R.S.

In testimony delivered to a public forum convened by then-Commissioner Shulman on July 30, 2009 as part of the Service’s tax return preparer review, the Section supported the establishment of minimum qualifications for return preparers, mandatory continuing education, a uniform system of identifying paid preparers, and regulation of paid preparers through the rules of practice set forth in Treasury Department Circular 230. In making those recommendations, the Section concluded that regulation of paid

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preparers would improve the quality of return preparation, which would help taxpayers avoid inadvertent or intentional errors, and help to reduce the tax gap.

In 2011, the Treasury Department promulgated amendments to Circular 230 requiring paid tax return preparers to pass certification examinations and complete a minimum amount of continuing education courses each year. Those regulations were challenged in the U.S. District Court for the District of Columbia, which ruled against the government, finding the regulations to exceed the scope of the statutory authority provided in 31 U.S.C. § 330 for the Treasury Department to regulate practice before the Service. On February 11, 2014, the U.S. Court of Appeals for the D.C. Circuit issued its decision in Loving v. I.R.S., affirming the district court’s conclusion that the regulations exceeded the statutory authority to “regulate the practice of representatives” before the Service. Key to the D.C. Circuit’s conclusion was its analysis that paid tax return preparers are not “representatives” and that return preparation does not constitute “practice . . . . before the Department of the Treasury.” The court of appeals noted in concluding its decision that “It might be that allowing the IRS to regulate tax-return preparers more stringently would be wise as a policy matter. But that is a decision for Congress and the President to make if they wish by enacting new legislation.”

The Section continues to believe that regulation of paid tax return preparers is necessary to help ensure that taxpayers have access to competent assistance when preparing their returns. As we observed in 2009, it is ironic that Congress clarified in 2004 that a tax professional who renders a single written tax opinion to a taxpayer can be subject to regulation under Circular 230 regardless of whether the tax opinion is ever disclosed to the Service, but that a tax return preparer who is paid to prepare hundreds of returns that are filed with the Service is not subject to regulation. To remedy this situation, and ensure that Circular 230 can be applied to regulate paid tax return preparers, we respectfully recommend that Congress amend 31 U.S.C. § 330 by adding at the end a new subsection (e) that would read as follows:

New § 330(e): “The Secretary of the Treasury shall prescribe such regulations as may be necessary to impose standards applicable to persons who receive compensation to prepare, file, or submit tax returns, claims for refund, or any other forms, schedules, documents or other materials on behalf of others in connection with any law or regulation administered by the Treasury Department. In promulgating such regulations, the Secretary may develop a series of examinations designed to test the technical knowledge and competency of each applicant for registration to prepare Federal tax returns and may establish rules of conduct to which successful applicants will be required to comply. The Secretary may provide exemptions from such examinations for certain classes of federally authorized tax practitioners within the meaning of 26 U.S.C. § 7525.”


Statutory language such as this would address the concerns presented in *Loving* by ensuring that the Treasury Department has authority for the regulations that were at issue in that case, and would authorize Treasury to exempt lawyers, certified public accountants and enrolled agents from examinations given the training and examinations that they are required to take to obtain those qualifications.

II. **CONGRESS SHOULD ESTABLISH A STATUTORY RIGHT TO REVIEW BY THE OFFICE OF APPEALS**

The Discussion Draft requested comments on whether Congress should create a statutory right to review by Appeals prior to the issuance of a notice of deficiency. The Section supports this proposal because it would increase fairness for taxpayers, resolve cases more quickly and economically for both the taxpayer and the government, and help ensure the independence of Appeals. In addition, the Section respectfully recommends that Congress provide a statutory right to review by Appeals of all penalties prior to assessment.

Section 1001(a) of the Internal Revenue Service Restructuring and Reform Act of 1998 required the Commissioner of Internal Revenue to develop a plan that accomplishes four goals, one of which was to “ensure an independent appeals function within the Internal Revenue Service, including the prohibition in the plan of ex parte communications between appeals officers and other Internal Revenue Service employees to the extent that such communications appear to compromise the independence of the appeals officers.”

The principle of independence for the Office of Appeals was a key feature of the 1998 legislation. As described by the late Senator William Roth, then Chairman of the Senate Committee on Finance:

One of the major concerns we heard throughout our oversight initiative was that the taxpayers who get caught in the IRS hall of mirrors have no place to turn that is truly independent and structured to represent their concerns. This legislation requires the agency to establish an independent Office of Appeals – one that may not be influenced by tax collection employees or auditors.

Senator Roth’s admonition holds true today. When steps are taken to circumvent Appeals and to deny taxpayers an opportunity for review of their cases by Appeals, those steps undermine Appeals’ independence. This, in turn, undermines the success and credibility of the Service as a whole by adversely affecting taxpayers’ confidence and trust in the fairness of the tax system.

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A. Background

1. Statutory and Regulatory Background

The Code does not provide an explicit right for review by Appeals of all tax disputes. However, section 7123(a) of the Code contemplates procedures under which taxpayers can request early referral of unresolved issues from the examination or collection functions to Appeals. Section 6330(b) of the Code establishes a right for taxpayers to seek a hearing with Appeals before their property becomes subject to levy. Similarly, section 6320(b) of the Code establishes a right for a hearing in Appeals in connection with the Service’s filing of a notice of federal tax lien.

The Treasury Regulations provide taxpayers who have received a 30-day letter a “right” to an administrative review by Appeals. Specifically, the Regulations state “Appeal is at the option of the taxpayer.” Upon the taxpayer’s request, the district director is instructed to refer the case to Appeals.

The Treasury Regulations grant Appeals “exclusive settlement jurisdiction […] over cases docketed in the Tax Court” after a petition is filed. Again, the Regulations indicate that whether to settle in Appeals should be at the taxpayer’s option: “The taxpayer must request Appeals consideration.” The Regulations go on to explain what type of request (e.g., written or oral) is required to “obtain Appeals consideration” in the various types of cases. The Regulations direct the district counsel to refer cases “to the Appeals office for settlement as soon as [a deficiency notice] is at issue in the Tax Court” and reiterate that the “Appeals office will have exclusive settlement jurisdiction” over these cases.

Proposed Regulations were issued in 1993 that would, if finalized, formally limit a taxpayer’s ability to reach Appeals in docketed cases. The Preamble to the Proposed Regulations states that the goal was to “revise[] the rules . . . for disposition and settlement of cases docketed in the Tax Court to reflect Revenue Procedure 87-24” and to

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10 Treas. Reg. § 601.106(b). Certain specific issues are excepted.
11 Id.
12 Id.
13 Treas. Reg. § 601.106(a)(1). Certain specific types of cases are excluded.
15 Id.
16 Treas. Reg. § 601.106(d)(3)(iii). Appeals review over docketed cases is limited to those where there has not been prior Appeals involvement, and exclusive settlement jurisdiction is provided for only a limited period of time.
“make clear that Appeals’ authority does not extend to include issues designated for litigation by the Chief Counsel.”¹⁷ The referenced Revenue Procedure states:

The Director of the Tax Litigation Division [...] may, after consulting with the Director of the Appeals Division and the appropriate Regional Counsel, determine that a case, or an issue or issues in a case, should not be considered by Appeals. In such a situation Appeals will forego settlement authority over such case or issues.¹⁸

In other words, a taxpayer’s ability to reach Appeals would be eliminated if the case is docketed in the Tax Court and then “designated” for litigation, limiting the exclusive jurisdiction of Appeals at this stage. The Proposed Regulations expressly provide that issues designated for litigation are not within the scope of Appeals’ settlement authority.¹⁹ Further, the Proposed Regulations, if finalized, would amend the requirement that docketed cases be transferred to Appeals with the proviso that Chief Counsel may reserve (and thus withhold) a case or issue from Appeals, thereby retaining sole settlement authority over it.²⁰

IRS Commissioner Delegation Order Number 60,²¹ issued in 1994, expresses views that are contrary to Revenue Procedure 87-24, stating “Chief Counsel’s delegate [...] will have exclusive jurisdiction over any case docketed in the Tax Court if the notice of deficiency, liability or other determination was issued by Appeals officials.”²² The grant of jurisdiction here is conditioned on the taxpayer’s case having been previously reviewed by Appeals prior to docketing in the Tax Court. The Order goes on to explicitly grant Appeals exclusive settlement jurisdiction over the other docketed cases and only grants Counsel jurisdiction “[i]f Appeals concludes that the case is not susceptible of settlement.”²³ Again, the language indicates the design is to give Appeals an opportunity to review the case before it is litigated (if the taxpayer so desires).

Taxpayers face another potential bar to Appeals in the Internal Revenue Manual: “Appeals does not settle Compliance Coordinated Issues (CCI), formerly known as Industry Specialization Program (ISP), or other issues designated for litigation by the appropriate Associate Chief Counsel.”²⁴ CCI issues are chosen in the discretion of

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²¹ I.R.S. Deleg. Order 8-1 (formerly DO-6, Rev. 7), IRM 1.2.47 (May 5, 1994).
²² Id. The Delegation Order also gives exclusive jurisdiction to the Chief Counsel’s delegate in a few specific subject areas.
²³ Id.
Service employees outside Appeals.\textsuperscript{25} The restriction on “other issues designated for litigation” is consistent with Revenue Procedure 87-24.

Finally, the Tax Court has also concluded that taxpayers, under the current statutory regime, have no legal right to an Appeals conference.\textsuperscript{26}

2. Practical Considerations

As set forth above, the Code does not provide an explicit right to review of most cases by Appeals. Although the Treasury Regulations permit taxpayers who receive a 30-day letter to seek review by Appeals, that review can be circumvented if the Service’s examination function suspends a case indefinitely, or if the Service issues a notice of deficiency in lieu of a 30-day letter. If a notice of deficiency is issued, the taxpayer may petition the United States Tax Court for review, in which case it may still be possible to seek a hearing in Appeals if the Chief Counsel does not designate the case for litigation. But if the taxpayer decides instead to litigate in district court or the Court of Federal Claims, there will be no opportunity to first have the case considered by Appeals. Tax disputes pending in bankruptcy court proceedings are similarly not subject to consideration by Appeals.

In some cases, decisions to prevent review by Appeals are made on an \textit{ad hoc} basis. However, in other cases, the Service has precluded review by Appeals on a wholesale basis. For example, in 2004 the Service provided a “take it or leave it” settlement offer for taxpayers who participated in so-called “Son of BOSS” transactions that expressly precluded Appeals Office consideration. Taxpayers who declined to participate in the settlement offer were required to litigate for the full tax, denial of any related expenses or transaction costs, and full assertion of accuracy-related penalties.\textsuperscript{27}

Many protested that this approach forced taxpayers to accept unfavorable settlement terms to avoid litigation without giving such taxpayers an opportunity to present the merits of their positions to an independent Appeals officer.\textsuperscript{28} Congress took note as well, making clear that circumventing Appeals should be limited to rare cases. For example, Senator Charles Grassley, then Chairman of the Senate Finance Committee, stated at the time that “the commissioner and I discussed the limitations of appeals rights in this crackdown, and I’m satisfied that he recognizes my view that this should happen only in rare situations.”\textsuperscript{29}

On the same date, Representative Amo Houghton, then Chairman of

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\item[26] See \textit{Estate of Weiss v. Comm’r}, T.C. Memo 2005-284 (2005). See also \textit{Ward v. Comm’r}, 784 F.2d 1424 (9th Cir. 1986) (holding that the Service has no duty to comply with the Statement of Procedural Rules because they do not have the force and effect of law).
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\end{footnotesize}
the House Ways and Means Oversight Subcommittee, cautioned that “[i]n the process the IRS must be careful not to overuse its power to deny access to its appeals system.”

We recognize that the “Son of BOSS” cases may have been a unique situation, but there have been other situations where the Service has effectively precluded groups of taxpayers from pursuing independent review of their particular cases in Appeals. For example, when the Chief Counsel has designated particular cases for litigation, other similar cases typically cannot be resolved administratively, either because the Service’s examination function will not issue 30-day letters permitting the taxpayers to seek review in Appeals, or because Appeals officers are hesitant to grant even partial concessions on issues that they understand the Service is litigating elsewhere.

The danger of Appeals being influenced by other Service personnel is illustrated by a statement from a senior Service examination executive that has sparked concern for Appeals independence in transfer pricing cases. Specifically, the official was quoted as having stated at a tax conference that:

[T]he IRS’s advance pricing and mutual agreement program is working with Appeals to “reengineer the process” […] Part of that process includes increasing communication with Appeals and being more aggressive in letting Appeals know where [advance pricing and mutual agreement] staff believe it went wrong after an appeal has concluded, he said. “We want to understand what Appeals is looking for and remind them what their role is,” he said. “Their role is not to assess cases; it’s to assess the hazards.”

This understanding of how Appeals should operate is simply inconsistent with its role as a settlement authority that operates independently from the Service’s enforcement functions.

B. Recommendation

Despite organization and jurisdictional changes over the eighty-seven years of the existence of Appeals, the office has consistently stated that its mission is to “resolve tax controversies, without litigation, on a basis which is fair and impartial to both the government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service.” Appeals is successful in resolving cases, regularly closing approximately eighty-five percent of those presented on an agreed basis. The Office has explained that the key to effectively

30 Id.
31 Jeremiah Coder, Maruca Highlights Transfer Pricing Exam Changes, 136 TAX NOTES 503 (July 30, 2012).
32 I.R.M. 8.1.1.1 (Rev. 02-10-2012); I.R.S. Doc. 7225, History of Appeals, 7 (Nov. 1987). The language has varied somewhat over the years, but the essence of the mission has not changed.
accomplishing its mission is convincing taxpayers to trust in the fairness and impartiality of the office:

Long ago our Government concluded that it is preferable to settle tax disputes through administrative processes rather than to litigate them in the courts. […]

When an attempt is made to devise an administrative Government procedure, officials come face-to-face with the very practical fact that citizens will not accept it should they perceive it as unreasonable, unfair or arbitrary. In that event, they would rather litigate their disputes every time.

It has always been essential to the mission of Internal Revenue to have an appeals procedure which commands the respect and trust of taxpayers and provides them with a prompt and independent review when they do not agree with proposed adjustments to their tax liabilities. But such a procedure will not be effective unless taxpayers use it and give the administrative machinery a chance to dispose of most of the disputes by mutual agreement.

To be fair and impartial in both fact and appearance, the appeals machinery […] cannot be viewed as an adversary, and to be successful must not be considered as an extension of either the examination or litigation functions.³⁴

Appeals must be independent because “taxpayers believe impartiality can be assured only if a dispute is considered by someone outside the area which originally raised the issue.”³⁵ When a taxpayer is not given a right to settle its case with an independent body, the settlement can be perceived to be unfair.

Resolving tax disputes in Appeals is more efficient and cost-effective for both taxpayers and the government. Lengthy and expensive litigation drains the government’s resources, which could be better spent elsewhere. In addition, the entire system suffers when some taxpayers are given a right to Appeal that others are denied without an obvious reason. Such an appearance of unfairness puts pressure on a tax system that depends on the voluntary compliance of the vast majority of taxpayers.

Accordingly, the Section recommends that Congress consider amending section 7123 to provide for a statutory right to review of all audit adjustments in Appeals. In most cases, such review by Appeals comes prior to issuance of a notice of deficiency or denial of a refund claim. A pre-notice right to appeal should be granted in most cases unless there is insufficient time remaining on the statute of limitations period for the tax year at issue and the taxpayer is unwilling to extend the statute of limitations or in other rare and extraordinary circumstances.

³⁴ IRS Doc. 7225, History of Appeals, iii (Nov. 1987).
³⁵ Id. at 8.
To ensure that all taxpayers have an opportunity for review by Appeals, we recommend that the legislation ensure that any taxpayer whose case was not previously considered in Appeals prior to issuance of the notice of deficiency or denial of refund claim should have the right to have their case considered by an impartial Appeals officer while the case is in docketed status, regardless of whether the case is docketed in Tax Court, a district court, the Court of Federal Claims, or a bankruptcy court.

In addition, we note that there are a number of penalty provisions in the Code involving assessable penalties. While Appeals has established procedures permitting certain taxpayers an opportunity to pre-assessment consideration of such penalties, and also has established procedures for post-assessment but pre-payment review of certain penalties, those procedures are not guaranteed. Accordingly, if Congress provides a statutory right to review of tax disputes in Appeals, we recommend that such right be provided to all federal tax disputes, including penalty disputes.

If Congress decides to provide for a statutory right to review of tax disputes in Appeals, we recommend that Congress retain the current law provisions providing for early referral of issues to Appeals, as well as those providing for post-Appeals mediation and arbitration. In our experience, resolution of cases through administrative procedures is much more efficient for both taxpayers and the government, and should be encouraged by Congress.

To be sure, the right to have a case considered by Appeals does not mean that a taxpayer has the right to unlimited administrative review. Taxpayers who have had cases considered through the Appeals process before issuance of a notice of deficiency or denial of refund claim should not have an automatic right to have their cases considered again by Appeals while in docketed status. And certain situations, such as whipsaw cases, may need to be handled separately to ensure that the government’s interests are protected.

Finally, to the extent that Congress undertakes a review of taxpayers’ rights to have cases considered by Appeals, the Section would encourage Congress to also evaluate whether the procedural safeguards established in the 1998 legislation have sufficiently strengthened Appeals’ independence or whether, in the alternative, an organizational placement external to the Service might better serve taxpayers and the Service. Tax administration faces a dramatically different set of challenges and taxpayer expectations today than existed in 1998 when Congress last examined the role of Appeals. The vast majority of taxpayers lack the financial resources to pursue litigation if they either cannot access Appeals or they believe it to have acted as a mere extension

36 I.R.M. 8.11.5.2.
37 See, e.g., I.R.M. 8.11.5.3.
38 Section 7123.
39 In this regard, it is our understanding that the post-Appeals mediation program has helped to resolve a significant number of cases. However, there has been limited experience with post-Appeals arbitration so it is not clear whether there is value in retaining that program.
of the Service’s enforcement functions. It is largely the taxpayers’ confidence in the tax administration process that supports the system. Perhaps that review would conclude that all that can be done to ensure a fair and independent consideration of taxpayer challenges is already in place. However, that alone seems a worthwhile pursuit.

III. CONGRESS SHOULD REFORM THE FEDERAL CIVIL TAX PENALTY STRUCTURE

It has been twenty-five years since Congress comprehensively overhauled the penalty regime in 1989. The 1989 reforms simplified a regime that had become quite complicated through patchwork additions. Unfortunately, intervening changes have once again made the penalty regime cumbersome to administer. There are now well over 100 civil and criminal penalties in the Code. Moreover, numerous penalties have been added or revised over the past 20 years and their placement is scattered throughout the Code rather than just in chapter 68 of subtitle F. Exhibit A to this report contains a chart grouping all of the penalties into five main subgroups: (i) penalties related to the failure to file tax returns or information returns and failure to pay any tax due with tax return; (ii) error related penalties; (iii) preparer/promoter penalties; (iv) miscellaneous civil penalties; (iv) excise tax related penalties; and (v) criminal penalties.

A. Previous Successful Efforts at Penalty Reform

The last major overhaul of the civil tax penalty structure occurred in 1989, with the enactment of the Improved Penalty Administration and Compliance Tax Act (“IMPACT”). The simplification of the penalty regime brought about by IMPACT was informed by both a study by the Tax Section’s Civil Penalty Task Force that was presented to Congress in 1988 (“1988 Tax Section Report”), and a February 1989 report (“1989 Task Force Report”) prepared by a task force created by the Commissioner of Internal Revenue to study civil tax penalties. We commend Congress for adopting many of the recommendations contained in the 1988 Tax Section Report and the 1989 Task Force Report when it last reformed the civil tax penalty provisions.

In the two years leading up to IMPACT, both the House and Senate held hearings on penalty reform that revealed much discontent with the penalty system among taxpayers, tax practitioners, and the Service. Congress recognized that the “hodgepodge” of civil and criminal tax penalties had been added to the Code in “piecemeal” fashion, resulting in penalties that were “too complex to administer, too complex to understand, too numerous, and too harsh.” Through IMPACT, Congress

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greatly simplified and harmonized the then-existing penalty provisions, making them more administrable and fair.

The Section believes that we have come full circle. The Code once again contains a menagerie of approximately 150 civil tax penalties that have been added in piecemeal fashion without any obvious design for coherent application.

**B. Guiding Principles and Recommendations from the 2009 Statement of Policy**

On April 21, 2009, the Section issued a Statement of Policy Favoring Reform of Federal Civil Tax Penalties (“2009 Statement of Policy”). A copy of the 2009 Statement of Policy is attached as Exhibit B to this report. The Section believes that the guiding principles identified in the 2009 Statement of Policy provide the appropriate framework for reforming the civil tax penalty regime. The 2009 Statement of Policy’s six guiding principles for the revision of civil tax penalties are:

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. Because it is not fair to punish acts that may reasonably be believed to be permitted prior to specifying the identified misconduct, and because acts are not deterred by penalties enacted after 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.

The 2009 Statement of Policy, the 1988 Tax Section Report, and the 1989 Task Force Report all explain why each of the six guiding principles is important to tax administration. We continue to believe that penalty reform should be guided by these six principles.

The 2009 Statement of Policy also made a number of recommendations for reforming the federal civil tax penalty regime:
• Clearly define behavior to be penalized.
  o If civil tax penalties 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. The combination of imprecision and complexity impairs effective enforcement and does little to encourage compliance (e.g., a “tax shelter” under section 6662(d)(2)(C)).

• Ensure penalties are consistent.
  o Consistency in the penalty regime encourages compliance and makes administration easier and more readily understandable by those whose conduct is governed by such penalties. 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 (e.g., what is a “tax shelter” for purposes of sections 6662 and 6694).

• Promote fairness by imposing penalties in proportion to misconduct and by penalizing a single act only once.
  o 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 intentional noncompliance. Taxpayers should not be penalized for inadvertent

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42 Ordinarily, a taxpayer can avoid an accuracy penalty by making an adequate disclosure of the transaction on a tax return. In order to adequately disclose a transaction, a taxpayer generally must complete a Form 8275, which requires detailed factual information about the transaction as well as a description of the possible disagreement between the taxpayer and the Service. Yet, the adequate disclosure exception to the penalty does not apply to “tax shelters” - precisely the type of transaction for which disclosure is most vital for sound tax administration. The statutory definition of a “tax shelter” for this purpose encompasses any arrangement, “a significant purpose” of which is the avoidance or evasion of federal income tax. Under a broad reading of section 6662(d)(2)(C), almost any arrangement designed to reduce taxes can be viewed as a “tax shelter,” and taxpayers are never entitled to avoid penalties by making adequate disclosure to the Service. In Notice 2009-5, which addressed the October 2008 amendments to section 6694, the Service indicated that it is considering issuing further guidance on the definition of “tax shelter.” While we understand that Congress intended to establish a higher threshold for avoiding penalties attributable to what might be considered more questionable transactions, given the breadth of the definition of “tax shelter” in section 6662(d)(2)(C), the effective scope of the penalty provision is also quite broad.

43 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).”
errors or good faith disputes. In addition, multiple penalties (“stacking”) should not be imposed on the same conduct.

- As detailed in the National Taxpayer Advocate’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 in fact proportional to the misconduct.  

- The Section shares the National Taxpayer Advocate’s concerns with 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. Automatic assertion of penalties can detrimentally impact perceptions regarding fairness and proportionality, which does little to enhance the cause of voluntary compliance.

- Retain the reasonable cause and good faith defense for all penalties.

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

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45 Id.
that disclosure is required. Such overdisclosure hampers the Service from focusing its limited resources on true areas of concern. Moreover, compliant taxpayers who might otherwise amend prior returns when errors are discovered may be significantly less likely to do so if the result is the automatic assertion of penalties for failing to disclose on the originally filed returns.

- Do not enact penalties merely to punish.
  - Contrary to the underpinnings of our voluntary compliance system, strict liability penalties (i.e., those for which there is no reasonable cause defense) eliminate the opportunity, and the incentives, to remediate and to become compliant. A penalty may be imposed regardless of whether the failure is due to inadvertence, rather than willfulness. Most troubling is the fact that a statute may purport to foreclose any opportunity to challenge in court the correctness of the Commissioner’s exercise of discretion to rescind these penalties, a questionable practice under our constitutional system of checks and balances.

- Do not use penalties for raising revenue or offsetting the costs of tax benefits.
  - As stated in the 1988 Tax Section Report and the 1989 Task Force Report, 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.

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

- Do not penalize foot faults where substantial compliance is shown.
  - The Section believes it is inappropriate to impose penalties for minor technical non-compliance when the taxpayer has substantially complied with the Code. If a penalty is imposed when there has been substantial compliance, the fairness of a penalty is likely to be questioned, and the imposition of the penalty might lead to future non-compliance.

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46 See, e.g. Section 6707A(d)(2).
• Increase transparency in the administration of penalties.
  o The Section recommends periodic and increased analysis and reporting on effectiveness of penalty administration by the Service. The Service does not regularly make public reports of its efforts to comply with its current penalty policy statement, and it is difficult for taxpayers – and even more importantly, for Congress and the public – 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. We applaud the Taxpayer Advocate’s recent efforts to determine the long-term effects of penalty imposition and abatement on subsequent compliance.

• Streamline procedures for resolving penalties imposed in partnership situations.
  o Requiring taxpayers and the government to litigate twice in order to completely resolve a case may not be the most 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 taxpayers participate in a transaction through a partnership subject to the unified audit and litigation procedures that were enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”). The 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 TEFRA partnership proceeding when there are a limited number of partners involved who have such defenses.

The Section continues to believe that these recommendations are appropriate. In addition, we make the following additional general recommendations and observations:


49 Under the TEFRA partnership rules, the potential applicability of any penalty arising out of a partnership item is determined in a partnership level proceeding. However, if a partner wishes to demonstrate to a court that the partner had reasonable cause and good faith (which would negate the application of the penalty), the partner is ordinarily required to do so in separate partner-level proceedings, either in the Tax Court (if the Service issues an “affected item” notice of deficiency) or in a refund forum.
- Complexity in the substantive tax law is a (if not the) dominant factor in noncompliance, creating traps for the uninformed and providing cover for those who purposefully seek to avoid their obligations under the tax law. A penalty regime, no matter how well designed, cannot compensate for the compliance problems created by complexity in the underlying tax law. The current penalty regime has become so complicated that even the most sophisticated taxpayers do not fully understand it. While most taxpayers recognize that underpaying their taxes could expose them to a penalty, few taxpayers are aware of, let alone understand, the myriad penalties that the Code imposes on a litany of proscribed conduct. Thus, we do not believe that specific, “rifle shot,” penalties are effective at deterring that conduct or encouraging voluntary compliance. Moreover, the multitude of penalties at the Service’s disposal often leads taxpayers to question the fairness of those penalties, which we believe could be detrimental to voluntary compliance.

- Penalties linked to targeted types of transactions (e.g., “listed,” “reportable,” “noneconomic substance” or transfer pricing transactions) should generally be avoided because these categories become quickly outdated or are ill-defined. Moreover, the complexity that these rules add to the tax law outweighs any incremental benefit in compliance.

- A penalty regime can only be effective if it is paired with a commitment to robust and long-term funding of the Service to enforce both the substantive provisions of the tax law and the penalty rules.

- Penalty reform should also take into consideration other tax compliance related provisions, including the foreign bank account reporting and penalty regime under the Bank Secrecy Act (codified in Title 31) and the rules relating to practice before the Treasury Department set forth in Circular 230.

- A comprehensive evaluation of the relationship between penalty rules and compliance should be conducted, including Congressional hearings on the issue. In this regard, we recommend that in evaluating whether a particular penalty is effective in encouraging voluntary compliance that Congress consider:
  o How often is the penalty assessed?
  o How much is asserted, and how much is abated?
  o What is the amount of penalties collected (on a penalty-by-penalty basis)?
  o What is the deterrent effect of the penalty even if it is not asserted often by the Service?
  o What is the rate of recidivism by persons subject to penalties?

C. **Strict Liability Penalties are Rarely Justified**

With the above described principles in mind, the Section believes that strict liability penalties are likely to be both generally ineffective and accompanied by negative consequences, such as complexity, unfairness, and various distorting incentives on taxpayers and the Service. We identify criteria for the use of strict liability penalties, and
for the reasons explained below, we believe the circumstances in which they would be satisfied are either non-existent or, at a minimum, extremely rare.

1. **Background**

It is widely recognized that the tax law is both complex and ambiguous.\(^{50}\) Furthermore, those features are to some degree inevitable\(^ {51}\) and they lead to uncertainty (both in the sense that one is unsure of the outcome and in the sense that one cannot know if his or her belief as to the likelihood of a certain outcome is correct).\(^ {52}\)

That means that people will sometimes fail to correctly self-assess their tax liability (or to include all the required information and forms), even if they are trying take the correct tax return position (or include all the required information and forms).\(^ {53}\) Given that inevitable uncertainty and the clear benefits of citizen trust and perceptions of fairness with regard to the Service,\(^ {54}\) tax policymakers should be cautious, in their understandable desire to deter abuse, not to go so far that they penalize reasonable but “incorrect” behavior. While fairness is a virtue in itself, we believe it also is a useful tool for achieving the goal of voluntary compliance.

A fault-based penalty regime grants a taxpayer some latitude in the face of uncertainty to take a moderate position that may later turn out to be incorrect, while at the same time imposing a standard of minimum conduct, such as an obligation to investigate the probabilities that the position is correct. Under the fault-based system, being wrong (i.e., not “correctly” self-assessing one’s tax liability or not filing a required form) does not necessarily lead to a penalty as long as a taxpayer meets the applicable standard of conduct. As a practical matter, therefore, “compliance” does not mean “being correct” but means satisfying the applicable minimum standard of conduct.\(^ {55}\)

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51 *Id.*


53 “Correct” is typically understood as how a court would resolve the issue if it were litigated. Since few issues are actually litigated, this understanding of “correct” is both hypothetical and counterfactual (since it is in fact unlikely that the issue will be litigated). *Id.* at 1042.


55 See Michael Doran, *Tax Penalties and Tax Compliance*, 46 HARV. J. ON LEGIS. 111, 113 (2009) (“There is, however, an absolutely crucial function of tax penalties that the legal and economic literatures have generally failed to recognize: the fundamental role of tax penalties in defining tax
“Strict liability” penalties function differently from “fault-based” penalties by imposing a penalty simply for being wrong. The taxpayer’s good faith efforts to get the right answer do not matter. The circumstances that may have led the taxpayer to get it wrong do not matter. Strict liability penalties, consequently, have the effect of redefining what it means for a taxpayer to comply.

To determine in what circumstances strict liability penalties should apply one must, therefore, decide in what circumstances the meaning of compliance should be “the taxpayer got it right” instead of “the taxpayer acted reasonably under the applicable standard of conduct.”

2. Discussion

a) Potential limits with respect to the deterrent effect of strict liability penalties

Support for strict liability penalties generally has been on grounds that the fault-based penalty regime is not sufficiently effective as a deterrent, especially with respect to certain abusive behavior, and that strict liability penalties eliminate a resource drain/disadvantage to the Service.

The view that strict liability penalties are more effective is generally premised on some form of the economic deterrence model of tax compliance. Like the classic model for punishment in the criminal law context, the economic deterrence model in the tax compliance context assumes that an individual takes an action only when the anticipated benefits of that action outweigh the anticipated cost, with the assumed value of benefits and costs depending on the relative probabilities of the various outcomes of the action. The risk of detection is one of the key factors in weighing the estimated cost of possible negative outcomes.

Strict liability penalties theoretically are more effective than fault-based penalties at deterring taxpayers from unwanted behavior because they make the sanction (i.e., the penalty) for noncompliance certain, which causes the taxpayer contemplating compliance. Our self-assessment tax system looks to taxpayers in the first instance to determine their own tax liabilities. Tax penalties set boundaries around the conduct that constitutes compliance with this duty of self-assessment so that taxpayers who want to comply—whether to avoid legal sanctions or to satisfy social or personal norms—will know how to do so.”

56 Id. at 113 (“before one can figure out how to promote compliance, one must first determine what conduct will count as compliance”).


59 Lawsky, supra n.52 at 1021.
noncompliance to estimate the cost of that noncompliance at a higher level. An example demonstrates how the deterrence model would apply in the tax context. Assume (i) the tax liability is $100; (ii) a 40 percent strict liability penalty applies; (iii) there is a 1 percent risk of detection (i.e., audit rate); and (iv) there is a 50 percent chance that the underlying position is correct (thereby avoiding the penalty). Under these assumptions, the estimated cost of complying is: $100. The estimated cost of noncompliance is: [$0.50 (the estimated value of the risk of having to pay the tax equals $100 X 1% X 50%)] + [$0.20 (the estimated value of the risk of having to pay the penalty equals $40 penalty X 1% X 50%)] = $0.70.\(^6\)

Under the economic deterrence model, a taxpayer will choose noncompliance because the estimated cost of noncompliance ($0.70) is much less than the estimated cost of complying ($100). Under the theory, an increase in the penalty amount or the rate of detection so that the estimated cost of noncompliance is greater than the cost of complying will bring about the desired compliance.

If the example above is changed so that the penalty is fault-based rather than a strict liability penalty, and the chance of obtaining a penalty waiver is 50 percent, the estimated cost of the penalty for noncompliance decreases from $0.20 to $0.10. Thus, the estimated cost of noncompliance drops from $0.70 to $0.60. The change from strict liability to fault-based penalties reduces the estimated cost of compliance, but that change is immaterial: the taxpayer will choose noncompliance in either scenario, because the estimated cost of noncompliance is much less than the estimated cost of compliance.

While the theoretical support for strict liability penalties has an intuitive appeal, there are several reasons to doubt whether the theory holds up in real world circumstances. For example, evidence shows that the economic deterrence model alone does not explain taxpayer behavior.\(^6\) In fact, the numbers used in the example above bear some resemblance to the risks of detection and penalty rates of many individual taxpayers, yet the compliance rate is much higher than would be expected under the deterrence model.\(^6\) Consequently, many commentators support the view that a combination of normative factors, often referred as “tax morale”, are primary features of tax compliance.

To the extent the “tax morale” view actually captures taxpayer behavior, replacing fault-based penalties with strict liability penalties may have no effect on deterring

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60 Many commentators provide similar formulas. See, e.g., Lawsky, supra n.52 at 1025-26 for a more sophisticated formula.


noncompliance or, worse, harmful effects on compliance. For example, some evidence on taxpayer behavior suggests that a penalty may actually reduce the incentive to comply if it is applied to a taxpayer who has made a reasonable good faith effort to get the right answer.\(^{63}\)

In addition, it is possible that the United States’ relatively high compliance rates as compared to other countries can be explained on the grounds that voluntary tax compliance has been adopted by much of society as behavior that signals trustworthiness. If so, moving tax compliance further away from something that is voluntary to something that is done under threat of legal sanction may eliminate the value of tax compliance as a social signal of trustworthiness (or, vice versa, the stigma of noncompliance as a signal of untrustworthiness), because it is the voluntariness of the compliance that makes it valuable as a social signal.\(^{64}\)

While it seems likely that the deterrence model captures some segment of taxpayer behavior, the example above, which is based on the penalty rates and the actual risk of audit that applies to many taxpayers, demonstrates that the risk of detection is so low for those taxpayers that the change from fault-based penalties to strict liability penalties would have no deterrent effect.

Finally, assuming the economic deterrence model correctly predicts the behavior of some taxpayers, a taxpayer can only be deterred by a strict liability penalty when he is able to appreciate the fact that a tax return position he is going to take represents an intolerable risk in light of the strict liability penalty. As noted above, the tax law (including the current penalty regime) is exceedingly complex. In many areas of the tax law, it is impossible for a layperson to understand what the “correct” tax position is without the advice of a tax professional. And even seasoned tax practitioners can be uncertain of the law. In this setting, a strict liability standard will inevitably fail to deter unwanted behavior (e.g., an incorrect return position) with respect to some taxpayers who did not intend to risk noncompliance. When that happens, it is likely that the affected taxpayer will have a diminished view of the fairness of the tax system.

\[b) \text{ Potential limits on the resource saving effect of strict liability penalties}\]

Supporters of strict liability penalties correctly note that fault-based penalties require fact-intensive (and therefore resource intensive), case-by-case review. In fact, it is likely that sometimes tax cases are litigated because the taxpayer hopes he can prevail on the penalty question, rather than on the substantive tax issues. It has been observed that, because strict liability penalties do not require the Service to wade through a

\(^{63}\) Taxpayer Advocate Service, 2013 Annual Report to Congress, Volume Two, Section One, p. 11.

taxpayer’s paper trail of due diligence, applying such penalties is simpler and less resource intensive.  

While this is undoubtedly true in some cases, certain real world problems of the strict liability regime can create the opposite effect. The current penalty regime is already quite complex. In the case of the accuracy-related penalties, for example, taxpayers must make their way through a daunting maze of rules, exceptions, and defenses. Even if the penalty regime were to be simplified, it is likely to remain relatively complex to apply. The addition of strict liability penalties adds another source of potential complexity, which can harm the effectiveness of penalties because it “works against both a taxpayer’s ability to understand the consequences on noncompliance and the Service’s ability to administer the system effectively and fairly.”

In addition, having one penalty standard for certain legal deficiencies and another standard for other deficiencies adds complexity when there is a potential for the two standards to overlap the same conduct. That will inevitably lead to ambiguities as to the scope and application of the penalty and taxpayers will have incentives to argue that, if they are wrong on the merits, the less restrictive penalty regime should govern the outcome of their case so that they will be eligible for penalty relief.

c) Other potential negative consequences of strict liability penalties

Commentators have voiced other concerns with strict liability penalties. One concern, voiced by many commentators, is the potential unfairness and disproportionality of strict liability penalties, especially in view of the tax law’s complexity. For example, for many observers it seems unfair to penalize a taxpayer who has made a good faith effort to correctly self-assess its liability but made a mistake in applying complex laws to its situation.

Observers also have noted that the severity of the penalty is likely to create perverse incentives for taxpayers to litigate, since a concession will be subject to a penalty in every case. In those situations, the penalty actually increases the burden on Service and judicial resources.

68 Id. at n. 98.
69 Id. at n. 105.
The severity of the penalty creates potential enforcement issues, as well. Observers have expressed concern that judges may be reluctant to rule in the Service’s favor on substantive questions where they know that such a ruling will inevitably lead to a penalty that seems harsh or unfair. Likewise, strict liability provisions limit agency discretion: once these penalties are asserted, the Service cannot take steps to rectify the situation, which tends to further undermine taxpayer confidence in the fairness of the system. One understandable response is reluctance on the part of the Service’s examiners to assert the penalties.

Finally, strict liability penalties can create the risk of unduly cautious behavior by risk-averse taxpayers. In some cases, taxpayers may forego behavior that is benign from a tax policy standpoint and otherwise economically beneficial because they are uncertain as to the resolution of a complex issue and choose not to accept any risk of penalty.

3. Recommendations

It is the Section’s view that once the criteria for applying a strict liability penalty that is fair, proportionate, administrable and effective are identified, it becomes clear that they would be satisfied so rarely that the costs of having them in the Code are outweighed by any incremental benefits. We believe that strict liability penalties should be limited to the following circumstances:

1) The taxpayer has an unambiguous, easily understood, legal duty;
2) The tax position is rule-based (rather than principle-based) and does not involve questions of valuation;
3) The incorrect return position the penalty seeks to deter is unlikely to overlap with one or more incorrect return positions that are subject to fault-based penalties; and
4) The taxpayer’s incorrect tax return is attributable to some affirmative action by the taxpayer to reduce his taxes.

Limiting the strict liability penalty to clear, easily understood obligations would eliminate many of the concerns described above. Taxpayers who are able to understand what is required to correctly self-assess their tax liability can knowingly adjust their

70 Id. at n. 107.
72 Mark P. Gergen, Uncertainty and Tax Enforcement: A Case for Moderate, Fault-Based Penalties, 64 TAX L. REV. 453, 454 (2010-2011) (“It is impossible to design a penalty structure that deters risk-neutral taxpayers from aggressively underpaying uncertain taxes without making risk-averse taxpayers unduly cautious in transactions with uncertain tax consequences.”)
73 Rule-based tax positions are those for which a specific rule is provided (e.g., taxpayers should report interest income paid by a bank and reflected on a Form 1099-INT).
74 Principle-based positions provide general guidelines (or principles) from which the taxpayer is to deduce his obligation (e.g., the step-transaction doctrine or “ordinary and necessary business expenses”).
behavior in response to the incentives presented by the penalty. Furthermore, under those circumstances, it is less likely that the application of the penalty will result in a perception of unfairness that harms voluntary compliance.

The second criterion reinforces the first, as the limitation to rule-based duties, rather than principles-based duties, eliminates much of the uncertainty that creates difficulties for taxpayers, the Service, and the courts.\textsuperscript{75} Similarly, applying strict liability penalties to questions of valuation is inappropriate because, by their very nature, they involve a range of potentially “correct” positions, with positions approaching either end of the spectrum less likely to be accepted by a court (or the Service). Applying fault-based penalties to valuation issues have the beneficial effects of rewarding moderate positions while rapidly scaling up the risk for aggressive positions.\textsuperscript{76} At the same time, fault-based penalties avoids the unfairness (and accompanying potential harm to tax compliance) that results from those inevitable instances when the courts or the Service end up adopting positions that are highly government favorable which, though plausible on the value spectrum, are at the lower end of probability.

As to the third criterion, avoiding situations of overlap between incorrect legal positions, one of which is subject to strict liability and the other of which is not, is necessary to lessen the risk that the strict liability will both increase complexity and disparate treatment among similarly situated taxpayers.

Finally, limiting strict liability penalties to situations in which taxpayers are taking affirmative steps to reduce taxes means that the behavior is more likely to resemble the economically rational actor postulated by the economic deterrence model, who has actually weighed the benefits and costs of a planned action. In contrast, applying a strict liability penalty to a return position or transaction with little or no tax motivation would have no deterrent effect and likely would only create the perception that the tax laws are unfair or arbitrary.

We believe that the circumstances that would satisfy these criteria are so narrow and rare that any incremental deterrence benefits would inevitably be outweighed by the added complexity of having the penalty in the Code.\textsuperscript{77}

We note that the recently added strict liability standard for transactions that lack economic substance, as reflected in section 6662(b)(6), falls well short of meeting the first three criteria set forth above:

(1) It lacks the first criterion because the scope and application of the economic substance doctrine is far from being clear and unambiguous.

\textsuperscript{75} Lawsky, \textit{supra} n.52 at 1032.

\textsuperscript{76} Gergen, \textit{supra} n.72 at 467.

\textsuperscript{77} Where the legal duty is clear and easily understandable, the strict liability penalty would almost certainly overlap with other fault-based penalties (including the fraud penalty) that are in place and is unlikely to contribute any deterrent effect beyond those penalties. Where the legal duty is not clear, strict liability is unfair and potentially lacking in any deterrent effect (or even harmful to voluntary compliance), for the reasons described above.
(2) It lacks the second criterion because the economic substance doctrine is principles-based.

(3) It lacks the third criterion because instances of the economic substance doctrine’s potential overlap with other legal standards are easy to find.

A review of the disparate treatment of several similarly-situated taxpayers in the current round of litigation involving so-called “foreign tax credit generators” demonstrates the difficulties for taxpayers and their advisors to determine their tax liability and to predict outcomes. It also demonstrates how a strict liability penalty can exacerbate differences in outcomes for similarly-situated taxpayers. One taxpayer lost in the Tax Court on debt-equity grounds rather than economic substance grounds, which means the resulting deficiency would not have been subject to the strict liability penalty had that penalty been in place at the time. Another taxpayer lost in the Court of Federal Claims on economic substance grounds, as did yet another taxpayer that litigated in the Tax Court. Thus, had the penalty been applicable in the years before the courts in those cases, the strict liability penalty would have applied. And another taxpayer, whose transaction was similar to those two transactions, has won a motion for partial summary judgment in federal district court.

Exacerbating this wide range of potential outcomes with a strict liability penalty would seem to add to the complexity and unfairness in tax administration. Supporters of strict liability penalties might argue that had those penalties been in place the transactions would never have been entered into, especially because the economic deterrence model more closely fits the case of corporate taxpayers. With audit rates for corporate taxpayers with $1 to 5 billion in assets at 38 percent and at lower rates for corporations not as large, it is not clear how much deterrent effect a strict liability penalty would have in this context relative to the fault-based penalty regime. But for every taxpayer who is deterred, there may be many more risk-averse taxpayers who avoid useful and legitimate tax planning transactions.

In short, there are several reasons to doubt that strict liability penalties would be more of a deterrent to undesired behavior than fault-based penalties. At the same time, strict liability penalties increase the level of complexity in an already too-complex tax code and may lead to unfairness. Because strict liability penalties are likely no more effective than fault-based penalties at accomplishing their stated purpose, we believe the

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79 The “foreign tax credit generator” cases discussed herein all involve taxable years prior to the effective date of the strict liability “economic substance” prong of the accuracy penalty.
negative consequences of strict liability penalties outweigh their usefulness and there rarely are situations in which they should be applied.

Accordingly, the Section recommends that Congress:

- Repeal section 6664(c)(2), which makes the reasonable cause defense inapplicable to the penalty imposed by section 6662(b)(6) for transactions lacking economic substance as defined in section 7701(o). Congress should also repeal section 6676(c), which provides that transactions lacking economic substance are automatically subject to the section 6676 erroneous refund penalty.
- Enact a new section 6676(e) to provide that the penalty for erroneous claims for refund or credit will not apply if the taxpayer acted reasonably and in good faith. In particular, it has been unclear whether taxpayers will be subject to this penalty for filing refund claims in situations where there is ongoing tax litigation by other parties with respect to industry-wide issues. Such claims are often filed prior to the expiration of the statute of limitations to preserve the non-litigating taxpayer’s interests should the issue be favorably decided by the courts. We believe that allowing taxpayers to assert a reasonable cause defense in such cases will provide for a fair resolution of these concerns.
- Repeal section 6664(d)(3)(A), which requires disclosure in order for taxpayers to rely on the reasonable cause defense to a reportable transaction understatement. While we support disclosure, we view this provision which precludes taxpayers from raising a reasonable cause defense to be too harsh. For example, the taxpayer may have acted reasonably in failing to file a Form 8886 (Reportable Transaction Disclosure Statement) as required by the section 6011 regulations, and we believe that such a taxpayer should be given an opportunity to demonstrate why the penalty should not apply.\footnote{Certainly, the failure to file a reportable transaction disclosure statement may be an appropriate factor to take into account in determining whether the taxpayer acted with reasonable cause and in good faith.}
- Rewrite section 6664(c)(3) to allow taxpayers to raise a reasonable cause defense in cases of a gross valuation overstatement under chapter 1 with respect to charitable deduction property. In some cases, a taxpayer may reasonably believe that he or she has obtained a qualified appraisal from a qualified appraiser, but later discover that this understanding was incorrect. While Congress has determined to disallow the charitable deduction in such cases, not permitting a reasonable cause defense may unfairly punish taxpayers who made a good faith effort to comply with the law.\footnote{Section 6695A does provide some protection in that appraisers can be subject to penalty for delivering an appraisal that includes a gross valuation overstatement.}
D. **Repeal the Disqualified Tax Advisor Provisions**

The Section is concerned that the restriction in section 6664(d) against taxpayers relying on “disqualified tax advisors” to avoid the section 6662A reportable transaction understatement penalty is too burdensome on taxpayers and is not well-designed to achieve its purpose. It is common for taxpayers to pay their advisors fees in excess of the materiality thresholds (which would make them “material advisors”) for advice in connection with more complicated transactions. Obviously, taxpayers are most in need of advice with respect to these more complicated transactions. Taxpayers ordinarily rely on their long-time advisors (who understand their business and their past tax reporting history) to assist them with the structuring of complicated transactions. We do not agree with the policy embodied in section 6664(d) that effectively forces taxpayers who have engaged in any transaction that could plausibly be a reportable transaction subject to section 6662A to retain a second advisor who was not materially involved in structuring the transaction, solely to provide advice on its tax consequences. We note that a wide range of transactions that create a loss in excess of $10,000,000 for a corporation or $2,000,000 for an individual can constitute a reportable transaction, thus disqualifying any tax advisor who advised the taxpayer with respect to the transaction and earned more than the applicable minimum in fees.\(^86\) The application of these interrelated rules effectively requires taxpayers to seek second opinions at significant cost. It can also have a detrimental effect on the relationship between the taxpayer and its tax advisors. We believe that the provision offers little protection for the fisc and burdens taxpayers to retain a second advisor at incremental cost. The way the Service interprets the provision, \(^87\) *i.e.*, as disqualifying the second, third, fourth, and any other advisor that “manages” the transaction by providing meaningful structural advice, makes matters worse. Only tax advisors who make no material suggestions or improvements to the transaction are not disqualified under this view, which leaves taxpayers choosing between (1) asking for advice that will improve the transaction and (2) asking for after-the-fact advice that may be relied upon for penalty protection.

Having special rules disqualifying advisors in cases involving reportable transactions is also unnecessary. Subsequent to the adoption of the “disqualified tax advisor” rules of section 6664(d), the courts have demonstrated that they are adept at determining when reliance on a tax professional is not warranted, without relying on the rules set out in section 6664(d). For example, in *106 Ltd v. Comm’r*, \(^88\) the Tax Court addressed when one can have good faith reliance on a tax professional. The *106 Ltd* decision defined a “promoter” (on whom a taxpayer could not rely) as “an advisor who participated in structuring the transaction or is otherwise related to, has an interest in, or profits from the transaction.” The Tax Court noted that some care must be given in applying this definition to some types of transactions (*e.g.*, a tax lawyer is asked by a businessman on how to sell the family business through a tax favored stock sale might be said to have “participated in structuring the transaction”), but noted that “when the

\(^{86}\) Treas. Reg. § 1.6011-4(b)(5).

\(^{87}\) IRS Notice 2005-12, February 14, 2005.

\(^{88}\) 136 T.C. 67 (2011).
As the courts have proven themselves up to the task of determining when reliance on a tax professional is unwarranted, we believe the special rules governing “disqualified tax advisors” should be repealed. In the alternative, the definition of “disqualified tax advisor” could be amended by adding the following sentence to the end of section 6664(d)(4)(B)(ii)(I): “If the transaction is a reportable transaction solely because of the amount of any loss, deduction or credit arising out of the transaction, any person who is a material advisor solely by reason of providing tax advice with respect to the structuring of the transaction shall not be treated as a material advisor for purposes of this section.”

E. Clarify the Economic Substance Provisions

While described as a clarification, the 2010 enactment of section 7701(o) and the related penalties in sections 6662(b)(6) and 6676 have created significant uncertainty in the tax law. It is unclear when the codified doctrine and penalty apply because they are triggered when the doctrine is “relevant.” The statute does not offer any definition of “relevant” or any principled way to determine when the doctrine is “relevant.” Nor does the statute define the “transaction” to which the new doctrine is to be applied. Moreover, if one assumes that the new doctrine applies, the “test” to be applied is vague because many key terms also are undefined. For example, the statute does not explain what is meant by a “meaningful” change in economic position, “a substantial purpose (apart from Federal income tax effects)”, or how large must the “present value of the

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89 The technical explanation provided by the staff of the Joint Committee on Taxation shortly before the enactment of section 7701(o) provides a series of examples suggesting when the codified doctrine would be “relevant”, but those examples do not provide principles that can be readily applied to other contexts. See Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the “Reconciliation Act of 2010,” as amended, in combination with the “Patient Protection and Affordable Care Act” (JCX-18-10) March 21, 2010. Moreover, it is far from clear whether that technical explanation would be afforded deference by the courts. See, e.g., U.S. v. Woods, 134 S. Ct. 557 (2013) (stating that a “blue book” prepared by the staff of the Joint Committee on Taxation “may be relevant to the extent it is persuasive”). While the March 21, 2010 technical explanation was prepared for Congress prior to the enactment of section 7701(o), and thus is not a post-enactment document such as the “blue book” described in Woods, because the technical explanation was not approved by any committee of Congress as part of the legislative process, its persuasiveness remains unclear. See Estate of Hutchinson v. Commissioner, 765 F.2d 665, 669-70 (7th Cir. 1985) (reasoning set forth in Joint Committee on Taxation explanation “does not rise to the level of persuasive”), While the March 21, 2010 technical explanation was prepared for Congress prior to the enactment of section 7701(o), and thus is not a post-enactment document such as the “blue book” described in Woods, because the technical explanation was not approved by any committee of Congress as part of the legislative process, its persuasiveness remains unclear. See Estate of Hutchinson v. Commissioner, 765 F.2d 665, 669-70 (7th Cir. 1985) (reasoning set forth in Joint Committee on Taxation explanation “does not rise to the level of legislative history, because it was authored by Congressional staff and not by Congress. Nevertheless, such explanations are highly indicative of what Congress did, in fact, intend.”). See also, Bank of Clearwater v. United States, 55 AFTR 2d 1552 (Ct. Cl. 1985) (“Absent any definitive legislative history that is more revealing, the court believes it is proper nevertheless, in the absence of any comparable contrary assertions, to give substantial weight to this [Joint Committee on Taxation] Explanation.”); Robinson v. Commissioner, 119 T.C. 44, 73 (2002) (acknowledging that Joint Committee summary “is not the official legislative document” and “may not be a complete or thorough statement” of decisions made by a conference committee, but because it “was provided to the Members of the House and Senate for their reference before Congress enacted [the legislation] . . . it is part of the history of the legislation.”).
reasonably expected pre-tax profit” be in order to be “substantial in relation to the present value of the expected net tax benefits.”

To the Service’s credit, it has issued two internal directives to revenue agents that have helped to mollify some of the concern with the ambiguity in the statute. First, the imposition of the economic substance penalty must be reviewed and approved by the appropriate Director of Field Operations. LMSB-20-0910-024 (September 14, 2010). Second, the Service will not rely on the doctrine (and hence the penalty will not be imposed) if any other judicial doctrine may support the adjustment. LB&I-4-0711-015 (July 15, 2011).

The courts have not yet had the opportunity to address issues raised by the enactment of section 7701(o). Furthermore, court opinions under the common law economic substance doctrine regularly confuse the economic substance doctrine with other judicial doctrines designed to prevent taxpayers from elevating form over substance. Also, some courts have applied the economic substance doctrine as a “trump card” to disallow claimed tax benefits when the court concludes that an uncodified policy would otherwise be subverted.90

As described above, the Section believes that penalties should be imposed when appropriate, but that penalty provisions should be clear so that taxpayers (and their advisors) understand the rules and so that penalties deter and punish specifically and clearly defined misconduct. In furtherance of these principles, the Section recommends that Congress:

- Eliminate the strict liability nature of the economic substance penalty.
- Clarify the key terms of section 7701(o) so that taxpayers, the Service and the courts have clear and unmistakable rules for when the economic substance penalty will apply.
- Clarify the distinctions between the economic substance doctrine and other judicial doctrines, such as substance over form, to ensure that the Service and courts do not conflate the different doctrines.

F. Provide Pre-Assessment Judicial Review of Most Penalties

Congress should provide taxpayers with an opportunity for pre-assessment judicial review for most penalties through deficiency procedures. In the alternative, taxpayers should be able to pay a portion of the asserted penalty and litigate the matter in either the Tax Court or a traditional refund forum.

A penalty is only subject to deficiency procedures under sections 6211-6213, which permit affected taxpayers to litigate the merits of the proposed deficiency in the Tax Court without first having to pay the tax, when the penalty is related to an error in

90 The uncertain state of the law regarding the proper application of the economic substance doctrine is addressed in various briefs of amici curiae filed with the Supreme Court in support of the petition for certiorari filed in WFC Holdings Corporation v. United States, 728 F.3d 736 (8th Cir. 2013), cert denied, 2014 WL 797180 (June 9, 2014).
reporting tax on a return. Because most penalties in the Code (i.e., those codified outside of sections 6651-6663) are not related to the reporting of tax on a tax return, they currently may be assessed and collected by the Service prior to any judicial determination.

In the case of these immediately assessable penalties, the penalty can be contested in a district court or the Court of Federal Claims only after full payment of the tax. The amounts of some of the penalties can vastly exceed any claimed tax benefit, placing a significant burden on a taxpayer who wishes to seek judicial review of these penalties.

We recommend that Congress enact provisions consistent with deficiency-type penalties, providing that the Service be required to propose penalties pursuant to a notice of deficiency, and that the Tax Court should be given jurisdiction to review these penalty determinations prepayment. In the alternative, a taxpayer should be able to pay a portion of the asserted penalty and litigate the matter in the Tax Court, a district court, or the Court of Federal Claims.

We believe that providing access to pre-assessment judicial review will promote consistency in the application of penalties, because the Appeals function is ordinarily involved, either pre-assessment or after a case is filed. Appeals Officers are typically more experienced than the front-line auditors who initially recommend the penalties, and, as generalists, better at determining whether the facts and circumstances of a given case warrant the imposition of a penalty.

G. Clarify the Burden of Proof for Return-Related Penalties

Prior to 1998, taxpayers generally had the burden of proof in civil tax cases not involving fraud. The term “burden of proof” refers to the obligation to prove a disputed matter by a preponderance of the evidence. In a hypothetical world where the taxpayer and the government produced exactly equal evidence at trial, the party with the burden of proof would lose.

In certain cases, Congress has specified that the Service bears the burden of proof with respect to penalties. In this regard, section 7454 provides that the Service has the burden of proof with respect to fraud, as well as certain penalties applicable to foundation

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92 The taxpayer may be able to challenge liability for a penalty in a collection due process appeal. Section 6330(c)(2)(B). However, if the taxpayer previously received pre-assessment administrative appeal rights with respect to a penalty, the issue may be not presented to Appeals or to a reviewing court as part of the collection due process appeal. Section 6330(c)(4)(A)(i) (“An issue may not be raised at the hearing if the issue was raised and considered … in any other previous administrative or judicial proceeding.”)

93 Section 6703 provides a mechanism for post assessment review of penalties under sections 6700-6702 by allowing persons to pay 15% of the asserted amount within 30 days and litigate the balance in the district court. This statute could serve as a model for a “partial payment” judicial review, except to the extent that it limits the choice of forum to the federal district courts.
managers which require “knowing” conduct on the part of the penalized individual. Also, section 6703(a) provides that the Service has the burden of proof with respect to the penalties under sections 6700 (tax shelter promotion), 6701 (aiding and abetting understatement) and 6702 (frivolous submissions).

In 1998, Congress enacted section 7491, which shifts the burden of proof in certain types of cases. Section 7491(a) shifts the burden of proof to the Service for any tax imposed by Subtitle A (income taxes) or Subtitle B (estate and gift taxes) where the taxpayer has produced credible evidence and cooperated with the Service during the course of the audit. Separately, section 7491(c) provides that the government shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty or addition to tax. The term “burden of production” refers to the obligation on a party to produce enough evidence on an issue in its case in chief (without considering any contrary evidence produced by the opposing party), for the matter to go to the finder of fact (jury or judge), as opposed to being decided by the judge on summary judgment or on a directed verdict. Section 7491 does not specify who has the burden of proof with respect to penalties.

In Higbee v. Comm’r, the Tax Court held that, once the Commissioner meets his burden of production, the burden of proof regarding the applicability of the penalty is placed with the taxpayer, reasoning that most penalties are contained in Subtitle F, which is not subject to the burden of proof shifting provisions of section 7491(a). Taking a position contrary to Higbee, one Judge for the Court of Federal Claims has indicated that section 7491(a) places the burden of proof on the Commissioner in a case involving penalties arising in an income, estate or gift tax case.

This conflict should be resolved. As discussed above, the Section believes that penalties should generally be applied in cases where there is clear fault on the part of the taxpayer. Accordingly, the government should have the burden of proof with respect to the applicability of penalties asserted against individual taxpayers when the taxpayers have been cooperative in the audit. In order to obtain the benefits of burden shifting, the taxpayer will be required to cooperate fully in the audit. Similarly, the Service will have an increased incentive to explore fully the penalty issue at the audit level, rather than simply apply a penalty to the taxpayer’s account, leaving the taxpayer to attempt to have the penalty removed at Appeals or in litigation. While we believe that making this change will lead to more cases being resolved at a lower level, with less expense for all parties, if the matter is not resolved short of litigation, the taxpayer will still be required to introduce credible evidence at trial (e.g., evidence indicating that the taxpayer acted with reasonable cause and good faith) in order to obtain the burden shift under section 7491.

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95 Allison v. United States, 80 Fed. Cl. 568, 582 n.32 and associated text (2008). Section 6665(a)(2) provides that references to the term “tax” includes return-based penalties of sections 6651–6664. Thus, the “tax imposed by subtitle A” (or subtitle B) may be read to include penalties related to the tax imposed by subtitle A (or subtitle B).
We therefore recommend that Congress amend section 7491(a) to provide that, if the taxpayer “introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B (or penalties and additions to such tax under Chapter 68), the Secretary shall have the burden of proof with respect to such issue.” (Proposed addition to the statute in italics.)

H. Establish a Catch-All Statute of Limitations

Congress should enact a catch-all six-year period of limitations for the assessment of those civil penalties in the Code which are not otherwise subject to a more specific period. We also recommend clarification that section 6511 applies as the period of limitations for refund for penalties not otherwise subject to a more specific period.

Section 6501(a) of the Code, the general statute of limitations for assessments, provides that assessments must be made within three years after a return was filed. This three year statute also governs penalties that are based on errors on the return, such as the accuracy penalty set out in section 6662.\textsuperscript{96} Section 6511 provides the period of limitations on refunds, which is generally the later of three years from the return filing date or two years from when the liability is paid. Some penalties have their own specific statutes of limitations.\textsuperscript{97}

Certain penalties in the Code, such as sections 6700 and 6701, do not relate to the filing of tax returns and do not have their own specific statute of limitations.\textsuperscript{98} While the Service has taken the position that there is no applicable period of limitations on assessment governing these penalties, some taxpayers have argued that the general federal five-year statute of limitations governing “proceedings for the enforcement” of all federal penalties in section 2642 of Title 28 is applicable. The courts in \textit{Mullikin v. United States},\textsuperscript{99} \textit{Lamb v. United States},\textsuperscript{100} and \textit{United States v. Capozzi},\textsuperscript{101} have generally upheld the Service’s position and ruled that the general federal “catchall” five-year statute of limitations for penalties was not applicable to tax penalties on the grounds that the act of the “assessment” of such penalties by the Service was not part of “proceedings for the enforcement” of such penalties. However, the logic of these opinions was

\textsuperscript{96} Once an assessment is made, the Service has ten years to administratively collect any assessment. Section 6502(a). If the tax cannot be collected in that period, the Service can ask the Department of Justice to bring suit against the taxpayer, and can collect during the period that a judgment remains enforceable – usually 20 years after the judgment is entered.

\textsuperscript{97} See, e.g., section 6696(d) (providing a three year statute of limitations on assessments with respect to the return preparer penalties of sections 6694, 6695 and 6695A).

\textsuperscript{98} See \textit{Sage v. United States}, 908 F.2d 18 (5th Cir. 1990); \textit{Mullikin v. United States}, 952 F.2d 920 (6th Cir. 1991); \textit{Lamb v. United States}, 977 F.2d 1296 (8th Cir. 1992); and \textit{United States v. Capozzi}, 980 F.2d 872 (2d Cir. 1992).

\textsuperscript{99} 952 F.2d 920 (6th Cir. 1991).

\textsuperscript{100} 977 F.2d 1296 (8th Cir. 1992).

\textsuperscript{101} 980 F.2d 872 (2d Cir. 1992).
questioned by a spirited dissent in *Mullikin*. Moreover, the logic of *Mullikin, Lamb,* and *Capozzi* was rejected in *FEC v. Williams*, and *3M Company v. Browner.*

At the same time, courts have held that the refund limitation period in section 6511 applies on all taxes, even if they do not relate to tax returns, which arguably would govern claims for refund of most penalties as well.

In some cases, there is substantial uncertainty as to whether certain penalties relate to a tax return and therefore whether the general three-year statute of limitations applies. For example, in ILM 201047022, released on November 26, 2010, the Office of Chief Counsel took the position that the pre-American Jobs Creation Act (AJCA) version of the section 6707(a)(1) penalty for failing to register a tax shelter had no applicable statute of limitations, while the revised AJCA-version of that penalty is subject to a three year statute of limitations. The rationale for the differing treatment was that the pre-AJCA statute governing the registration of tax shelters provided that “any tax shelter organizer shall register the tax shelter with the Secretary (in such form and in such manner as the Secretary shall prescribe)” and the post-AJCA version of the statute provides that the “material advisor” shall make “a return (in such form as the Secretary prescribes).” The information required to be submitted to the Secretary under both the pre- and post-AJCA version of the statute is virtually identical; the Service’s differing treatment of the two statutes is based solely on the fact that the Code used the word “return” in the post-AJCA version of the statute, but not in the pre-AJCA version. Thus, the Service reasoned that the post-AJCA version had a statute of limitations, but the pre-AJCA version did not.

Another example of this uncertainty can be found in the application of the statute of limitations to the new penalty under section 6676 for excessive claims for refund. The Service takes the position that the new penalty applies to “informal claims” (claims which may not be made on a tax return) as well as formal claims made on an amended tax return. In an internal FAQ for revenue agents, the Service has indicated that, while the statute is silent as to a statute of limitations, “best practice” is to assess the section 6676 penalty within three years of the date of the claim for refund. It leaves open the possibility that the Service will choose to assess such penalty long after the three year period has elapsed.

Accordingly, we recommend that Congress enact a catch-all statute of limitations for the assessment of civil penalties not otherwise subject to a more specific statute of

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102 952 F.2d at 933 n.1 (“It would seem quite odd to say that the very act that initiates the actions leading to the collection of the penalty, a stream of events that must at some point be a proceeding, is not itself part of the proceeding.”).


105 *See, e.g.,* *RadioShack Corp. v. United States,* 566 F.3d 1358 (Fed. Cir. 2009).
limitations. We recommend the adoption of a new six year statute of limitations for penalties not otherwise subject to a more specific statute of limitations. We also recommend clarification that section 6511 applies as the period of limitations for refund for penalties not otherwise subject to a more specific period.

I. Clarification Regarding Refundable Credits

In Rand v. Comm ’r, the Tax Court held that when taxpayers erroneously claimed refundable credits (including the earned income credit, and additional child tax credit), the amount of refundable credits cannot reduce the amount shown as tax on the return below zero. This decision effectively precludes the Service from determining the accuracy-related penalty under section 6662 or the fraud penalty under section 6663 with respect to a taxpayer’s improper overstatement of credits.

Although the section 6676 penalty for erroneous refund claims might apply to certain of these overstated refundable credits, the section 6676 penalty does not apply to claims relating to earned income tax credit. In addition, the section 6676 penalty is an immediately assessable penalty, not subject to deficiency procedures.

The Rand opinion, therefore, results in uncertainty for both the government and taxpayers as to when overstated refundable credits are subject to penalty and whether these penalties can be challenged in a pre-assessment judicial forum going forward. Accordingly, we recommend that Congress clarify that penalties relating to overstated refundable credits are subject to section 6662 or alternatively provide that the section 6676 penalty is subject to deficiency procedures (as recommended above).

J. Clarification Regarding Anti-Injunction Act

In National Federation of Independent Businesses v. Sebelius, the Supreme Court held that the Anti-Injunction Act (“AIA”) under section 7421, which generally provides that a taxpayer may not challenge the “assessment or collection of [a] tax” (except in the statutorily mandated deficiency and refund procedures), does not apply to the section 5000A individual mandate penalty because the penalty was not treated as a “tax” under the Code. The Court reasoned that, because section 6671(a) provides that assessable penalties in subchapter 68B (i.e., those codified at sections 6671-6725) are “assessed and collected in the same manner as taxes”, most penalties are therefore subject to the AIA. However, because the section 5000A penalty was not found in subchapter 68B, the Supreme Court ruled it should not be treated as a “tax” for purposes of

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106 Section 6501(c)(3) provides that, if the taxpayer fails to file a return, the statute of limitations for assessment and collection remains open. For example, the failure to file a Form 3520 (reporting transactions with certain foreign trusts) as required by section 6048 leaves the statute of limitations for the penalty under section 6677 (which applies to failures to file returns required by section 6048) open indefinitely. We do not recommend any change to the rule that a failure to file a return leaves the statute of limitations open forever.

107 141 T.C. No. 12 (2013).

section 7421, and thus the AIA did not apply (allowing the Supreme Court to rule on the constitutionality of the Affordable Care Act).

This decision may result in disparate treatment of penalties, with those found within subchapter 68B subject to the limitations of the AIA, but those outside of subchapter 68B (for example, the international reporting penalties in sections 6038-6039) not. We recommend clarifying that all penalties in the Code are subject to the procedural rules of section 6671 (and thus the AIA) except to the extent that Congress explicitly removes a penalty from these procedural rules.

K. Recommendations Regarding the Placement and Amount of Penalties

1. Consolidate the Excise Tax and Information Return Penalties

A large number of the penalties in the Code relate to either excise taxes or failure to file information returns. These penalties are spread throughout the Code, which makes it difficult for taxpayers to determine what specific behavior is prohibited. We recommend that Congress consolidate both the excise tax penalties and information return penalties into two specific groups, and place these groups in the same chapter or subchapter within the Code.

2. Penalty Amounts Should be Indexed for Inflation

Most of the penalty amounts within the Code are not indexed for inflation. Periodically adjusting the penalties for inflation allows the Congressional goals for penalties to continue without requiring constant Congressional intervention. Accordingly, we recommend that Congress authorize inflation adjustments for most fixed penalty amounts as was done for sections 6721 and 6722.109

3. Cap Amounts of Penalties that are not Based on Tax Benefits

A number of penalties in the Code do not contain limitations on the maximum dollar amount of the penalty that may be imposed. For example, section 6708 (maintaining list of advisees for reportable transactions), imposes a $10,000 per day, per failure penalty with no cap. A limitless penalty amount discourages taxpayer respect for the Code and likely discourages taxpayer compliance. Therefore, we recommend that Congress establish reasonable caps on the amount of penalties that the Service may impose.

IV. CONGRESS SHOULD UPDATE THE TAXPAYER BILL OF RIGHTS

The Discussion Draft requested comment on whether to update the “Taxpayer Bill of Rights,” which was last addressed by Congress as part of the 1998 IRS Restructuring Act. We note that the National Taxpayer Advocate has regularly supported a number of improvements in this area, and we agree that it is important for Congress to periodically review the procedural protections provided to taxpayers in the Code and to update those

109 See, e.g., section 6721(f).
protections to remedy situations that fall through the cracks.\textsuperscript{110} To that end, the Section encourages Congress to hold hearings to evaluate the effectiveness of the taxpayer rights provisions presently included in the Code. Importantly, however, the Section believes that Congress should take care to ensure that efforts to address taxpayer rights do not become an opportunity to demonize the Service and its more than 90,000 dedicated employees. While there clearly are areas where the Service can do more to help taxpayers, in our experience the vast majority of the Service’s employees do their utmost to serve taxpayers fairly.

The most recent report to Congress by the National Taxpayer Advocate supports the adoption of a thematic “Taxpayer Bill of Rights” to help taxpayers understand their basic rights within the tax system without having to consult multiple specific provisions of the Code.\textsuperscript{111} Legislation approved by the House of Representatives in July 2013 would amend section 7803 for this purpose.\textsuperscript{112} The Section supports efforts to inform taxpayers of their rights within the tax system. And while legislation such as that approved by the House of Representatives last year has merit, we do not believe that legislation is necessary for the Service to periodically update Publication 1 to ensure that taxpayers have access to a readily understandable document that articulates their basic rights within the tax system. In this regard, we note that the Service recently announced that it had adopted a “Taxpayer Bill of Rights” that groups various rights provided under the Code into ten broad categories, and that it had incorporated these rights into an updated version of Publication 1.\textsuperscript{113} The revision to Publication 1 is a helpful way to inform taxpayers of their rights, but we remain concerned in two respects: the Service might not be able to deliver the promised “quality service” without adequate funding from Congress and the Code does not provide adequate remedies when taxpayer rights are not respected.

We note that other pending legislation would address more specific “taxpayer rights” provisions. For example, legislation introduced last year would, among other things, increase the maximum dollar amounts recoverable by taxpayers in respect of certain violations of taxpayer rights, extend the time for contesting levies from nine months to three years, waive fees for installment agreements for taxpayers whose income

\textsuperscript{110} For example, we note that a number of cases decided in recent years have precluded taxpayers from obtaining damages under section 7433 in connection with alleged wrongful collection actions because the claims were not brought within two years of the first violation. \textit{See, e.g.,} \textit{Keohane v. U.S.}, 669 F.3d 325 (D.C. 2012); \textit{Kovacs v. U.S.}, 614 F.3d 66 (7th Cir. 2010); \textit{see also}, Diana Leyden, \textit{Section 7433’s Statute of Limitations: How Courts Have Wrongly Turned a Taxpayer’s Exclusive Sword into the IRS’s Shield Against Damages}, 61 CLEV. ST. L. REV. 1 (2013). In light of the nature of some of the alleged wrongful collection actions for which damages have been denied on that basis, it may be worthwhile for Congress to evaluate whether to clarify that the “continuing violation” doctrine applies to all such actions.

\textsuperscript{111} National Taxpayer Advocate, 2013 Annual Report to Congress (December 2013) vol. 1 at 8, \textit{available at}: http://www.taxpayeradvocate.irs.gov/Annual-Reports-To-Congress/Reports-To-Congress.

\textsuperscript{112} H.R. 2768, 113\textsuperscript{th} Cong., 1\textsuperscript{st} Sess. (2013).

\textsuperscript{113} IRS Adopts “Taxpayer Bill of Rights”; 10 Provisions to be Highlighted on IRS.gov, in Publication 1, IR-2014-72 (June 10, 2014).
does not exceed 250 percent of the poverty level, and provide for de novo review by the Tax Court of determinations regarding equitable innocent spouse relief. Provisions such as these would be helpful.

H.R. 3479 and S. 725 also include several provisions intended to help improve the independence of Appeals. Specifically, the legislation would ban ex parte communications between Appeals and the rest of the Service, and would require termination of any Service employee who violated that ban unless the Commissioner personally determines to impose a different personnel action. Separately, the legislation would prohibit the Service from raising new issues in cases within the jurisdiction of Appeals. Finally, the legislation would authorize post-Appeals mediations and arbitrations to be conducted by independent mediators not employed by the Service. As discussed above, the Section believes that an independent Appeals organization is important to sound tax administration, and we encourage Congress to take steps to ensure that taxpayers have the right to have their cases considered by an independent Appeals officer. Whether it is appropriate for Congress to mandate that employees be terminated for violating the ex parte rules is a matter of policy on which the Section does not take a position, but we do believe that Congress should consider providing taxpayers with a remedy for violations of the ex parte rules. Options in this regard might include monetary damages, issue preclusion, or the right to a new hearing before a new Appeals officer (or perhaps an independent mediator not employed by the Service).

Finally, we note that a recent Tax Court memorandum opinion highlights a structural impediment to the ability of certain taxpayers to recover administrative and litigation fees and costs under section 7430. In Carpentier v. Commissioner, the Tax Court concluded that it could not award costs to the taxpayer under section 7430 even though the taxpayer was the prevailing party in a deficiency proceeding because the

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115 We note that section 2.06 of Rev. Proc. 2012-18, 2012-10 I.R.B. 455, provides that is not an ex parte violation for Appeals to confer with attorneys in the Office of Chief Counsel, but indicates that Appeals should not communicate ex parte with a field attorney who personally provided legal advice regarding the same issue in the same case or personally served as an advocate for the originating function regarding the same issue in the same case. It is not clear in practice how this rule has been applied, whether the taxpayer has a right to be informed that the communications are being undertaken, and what steps are taken to ensure that Appeals’ access to legal advice is structured to ensure that the field attorney who advised the originating function (and his/her managers or reviewers) are screened from the communications.

116 In this regard, we note that Congress may want to consider rules that govern ex parte communications in other contexts. For example, the procedural rules for the Occupational Safety and Health Review Commission provide for disciplinary action in the case of ex parte violations. See 29 C.F.R. § 2200.105. While Appeals officers are not designated as administrative law judges, and thus do not operate under the same rules as might be expected for administrative law judges, they do perform somewhat similar functions and thus it is reasonable for Congress to consider the experience in other areas and how it might inform legislation designed to ensure the independence of Appeals.

117 T.C. Memo 2014-75.
claim for costs was not made until a subsequent interest abatement proceeding. In so holding, the court stated:

Under existing law, however, a taxpayer is left with no remedy or ability to recover costs caused by the delay or actions of the Commissioner’s employees during the period giving rise to the abatement of interest claim. That result, as highlighted by the circumstances of this case, is unfortunate and ironic, but something that can be remedied only by Congress.

We agree with the Tax Court that Congress should act to remedy this problem.
## EXHIBIT A: COMPENDIUM OF CURRENT PENALTY PROVISIONS

### Failure to File Tax/Information Returns and Failure to Pay Penalties

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April 21, 2009

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
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”). 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 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 Means and the Senate Committee on Finance.

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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.  

Later that year, penalty reform became a reality with the enactment of the Improved Penalty Administration and Compliance Tax Act (“IMPACT”). 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.”

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. 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.”

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 2004 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.” 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

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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).
8. Id. at 30.
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. 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. 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.

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.\(^\text{15}\)

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.\(^\text{16}\) 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,\(^\text{17}\) and special rules apply to determine whether the tax advisor or tax opinion is “disqualified.”\(^\text{18}\) 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).

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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{21} The Treasury Department proposed a resolution for this problem in early 2008,\textsuperscript{22} and Congress revised section 6694 again in October 2008 to better harmonize the standards imposed on taxpayer and tax return preparers.\textsuperscript{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.\textsuperscript{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

\begin{itemize}
\item \textsuperscript{19} I.R.C. § 6662(d)(2)(B).
\item \textsuperscript{20} P.L. No. 110-28, 110\textsuperscript{th} Cong., 1\textsuperscript{st} Sess. (2007) § 8264.
\item \textsuperscript{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.
\item \textsuperscript{22} U.S. Department of the Treasury, General Explanation of Administration’s Fiscal Year 2009 Revenue Proposals (February 2008), at 93.
\item \textsuperscript{23} P.L. No. 110-343, 110\textsuperscript{th} Cong., 2d Sess. (2008), § 506.
\item \textsuperscript{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).”
\end{itemize}
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).
\(^{30}\) 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.

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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.\(^\text{35}\)

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.\(^\text{36}\) 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.\(^\text{37}\) 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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{41}

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\begin{thebibliography}{99}
\bibitem{38} T.D. 9436, 73 Fed. Reg. 78430 (December 22, 2008).
\bibitem{39} Temp. Reg. § 301.6707A-1T(c)(1).
\bibitem{40} Temp. Reg. § 301.6707A-1T(d).
\bibitem{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.”
\end{thebibliography}
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. 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.

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, the applicability of any penalty relating to a partnership tax item is determined in a unified proceeding at the partnership level. However, it appears that partner-level defenses may only be raised in subsequent refund litigation instituted after the conclusion of the partnership proceeding. 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. 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...
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.