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Tax Politics and a New Substantial Understatement Penalty

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I. Introduction

Concurrent with the IRS investigation of civil penalties in 1988 and 1989, Congress conducted its own inquiry into the penalty regime. Both the House and Senate held hearings on penalty reform in 1988 against the backdrop of tax reform. The review of the penalty system, noted Rep. J.J. Pickle, chair of the House Ways and Means Subcommittee on Oversight, which conducted a series of hearings on the structure and administration of the penalty system, "is the natural outgrowth and necessary follow-up to the Tax Reform Act of 1986, as well as the accumulating complexities that have developed through the years."¹ The congressional effort revealed widespread discontent with the penalty system among taxpayers and tax practitioners, legislators and administrators. Much of the ire was directed at the substantial understatement penalty.

II. Penalty Hearings: A Chorus of Complaints

The code's collection of more than 150 civil penalties reflected a "morass of inconsistency and irrationality that often discourages, rather than encourages, compliance," announced Sen. David Pryor, chair of the Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, which conducted the Senate's penalty hearings.² Pickle expressed similar senti-

ments from the other chamber. The "hodgepodge" of civil and criminal tax enforcement provisions were added by Congress in "piecemeal fashion," he said, resulting in penalties that were "too complex to administer, too complex to understand, too numerous, and too harsh."³ Taxpayers and tax practitioners were "feeling frazzled" with a penalty system that "may well deter, rather than enhance, voluntary compliance."⁴

Beginning in the early 1980s, Congress had added a "heavy battery of penalties" to curb runaway noncompliant behavior.⁵ The audit rate had been falling, the use of tax shelters was exploding, and as a result, legislators "began to add penalty after penalty"⁶ and encouraged the IRS to use those penalties to punish or deter noncompliance.⁷

But the penalty regime had grown out of control and lacked coordination. Individual penalties were enacted "without any view to an overall scheme."⁸ Penalties overlapped, resulting, for instance, in the imposition of the substantial understatement penalty on top of negligence or fraud penalties for the same tax deficiency.⁹ Penalties were applied unevenly, creating regional differences.¹⁰ Also, the system could not distinguish between negligent or intentional noncompliance and good-faith

³1988 Hearings, *supra* note 1, at 6 (Pickle). Others echoed the theme of undue complexity. *See, e.g., id.* at 81 (Charles W. Hall, chair of the American Bar Association Section of Taxation, calling the penalty system "too complex"); *id.* at 189 (Fred Goldberg: "too complex"); *id.* at 224 (Ken Gideon: "too complex").

⁴*Id.*

⁵*Id.* at 177 (Mortimer Caplin).

⁶*Id.* at 151 (Roscoe Egger).

⁷*Id.* at 8 (Lawrence Gibbs).

⁸*Id.* at 161 (Jerome Kurtz). *See also id.* at 81 (Hall: "not coordinated"); *id.* at 151 (Egger: "done in less than coordinated fashion"); *id.* at 224 (Gideon: "not integrated"); ABA Tax Section, Committee on Civil and Criminal Tax Penalties, "Penalties Study Report," (July 28, 1988), at 7, reprinted in 1988 Hearings, *supra* note 1, at 362 (the "cumulation" of penalties "have been added to the Code or existing penalties have been modified without any integrated or coherent plan").

⁹*See, e.g., 1988 Hearings, supra* note 1, at 81 (Hall); *id.* at 189 (Goldberg); *id.* at 356 (Michael Saltzman); "Penalties Study Report," *supra* note 8, at 24.

¹⁰Thorndike, *supra* note 2, at 11 (quoting Pryor). *See also id.* (quoting Jennie S. Stathis, General Accounting Office associate director of tax policy and administration, as saying that "there really is some variation" between districts); Karin M. Skadden, "Substantial Understatement Penalty Centers Debate on Practitioner's Role in the Tax System," *Tax Notes*, Oct. 17, 1988, p. 253 (describing additional regional differences).

¹*Review of the Civil Penalty Provisions Contained in the Internal Revenue Code: Hearings Before the H. Comm. on Ways and Means, Subcomm. on Oversight (hereinafter 1988 Hearings)*, 100th Cong. 6 (1988) (testimony of Rep. J.J. Pickle). *See also id.* at 16 (testimony of Dennis Ross, noting that "Congress has just completed a fundamental reform of the substantive tax rules, and a comprehensive assessment of the role of the tax penalties is a natural second step.").

²Joe Thorndike, "Regional Differences in Penalty Application Highlighted," *Tax Notes*, Oct. 3, 1988, p. 10.

disputes and errors, often punishing the latter more severely than the former.¹¹ A taxpayer's punishment, in many instances, did not fit the crime.¹²

While there were many examples of such irregularities and injustices, the classic example was the substantial understatement penalty.¹³ First, it lacked proportionality — it was levied at a price that was 500 percent of the rate of the negligence penalty (25 percent versus 5 percent).¹⁴ Second, it punished inadvertent errors, which, because of increased complexity in the tax code, were commonly made even by sophisticated taxpayers.¹⁵ Third, it often imposed tax liabilities that bore no relationship to taxpayer conduct.

The American Bar Association Section of Taxation illustrated the excessively harsh treatment. The Tax Section's Charles Muller offered the following example.¹⁶ An individual taxpayer files a timely return and pays her self-assessed liability in full. On audit, however, the IRS assesses a 25 percent substantial understatement penalty on a \$30,000 understatement that qualifies for no-fault treatment under section 6661. The 5 percent negligence penalty also attaches to the entire \$30,000 deficiency because the IRS attributes a portion of the understatement to the taxpayer's failure to maintain adequate records to support some expense deductions. Thus, for a tax deficiency of \$30,000, the taxpayer incurs a penalty of \$9,000 plus interest. Perversely, if the taxpayer asserted and proved that the allegedly negligent bookkeeping was attributable to fraud rather than negligence, her penalty would decline because the 75 percent fraud penalty attached only to the fraudulently claimed item while the 5 percent negligence penalty attached to the entire deficiency. Even more perversely, if the taxpayer filed her return one month late, penalties on her \$30,000 deficiency would jump to \$19,500 plus interest: a 5 percent delinquency penalty assessed on \$30,000 (\$1,500); a 5 percent negligence penalty assessed on \$60,000 (\$3,000); and a 25 percent substantial understatement penalty on \$60,000 (\$15,000). If the taxpayer delayed more than a year in filing her return, her total tax penalty would continue to climb because of increases in the delinquency penalty, and it could eventually exceed her initial tax deficiency.¹⁷

¹¹1988 *Hearings*, *supra* note 1, at 223 (Gideon). *See also id.* at 161 (Kurtz: "We have lesser offenses that will attract big penalties and major problems that attract small penalties. The entire system needs to be rationalized.").

¹²*Id.* at 151 (Egger).

¹³*Id.* at 222 (Gideon).

¹⁴*Id.*

¹⁵*Id.* at 18 and 152 (Ross, highlighting "whether the understatement penalty in practice penalizes taxpayers who have made errors merely that are inadvertent" and saying that "even sophisticated taxpayers make inadvertent errors in calculating their tax. While fewer no-fault automatic penalties are attractive from an administrative point of view, it is important to balance these considerations with the need for a fair system.").

¹⁶*See 1988 Hearings*, *supra* note 1, at 423-425 (Charles J. Muller). The examples in this paragraph largely reflect Muller's testimony.

¹⁷Former IRS Commissioner Sheldon Cohen defended the imposition of automatic penalties. If Congress did not want the

(Footnote continued in next column.)

Extreme tax fines indicated to many observers that the penalty regime had little to do with deterring noncompliance. Critics charged that tax penalties, particularly section 6661, were being used to punish taxpayers¹⁸ and were deployed as a bargaining tool in negotiating settlements.¹⁹ Worse, according to many practitioners, Congress had come to view tax penalties as a convenient way to generate revenue. Between 1978 and 1987, assessed penalties jumped from \$1.3 billion to \$14.2 billion.²⁰ "Penalties should not be used to raise revenues," said former IRS Commissioner Roscoe Egger.²¹ "The perfect penalty system would enhance voluntary compliance to the extent that no penalties would ever be imposed. Therefore, no direct revenue would be collected. Using the penalty system to raise revenue brings about disrespect and distrust of the tax."²² In fact, according to Gerald Portney of Peat Marwick Main, penalties were the primary cause of increased tension between the IRS and the public.²³

Section 6661 fueled the tension. Its penalty rate of 25 percent was excessive; its overlap with other penalties was unfair; its no-fault standard was overinclusive; and ultimately, it undermined the compliance objective. Moreover, critics charged that the provision's "marked increase in severity" from a 5 percent penalty in 1982 to a 25 percent penalty in 1986 "cannot be plausibly attributed to compliance needs."²⁴ If there was any doubt that legislators viewed section 6661 as a revenue-raising instrument rather than a compliance measure, critics noted that Congress made the penalty retroactive in 1986 to capture deficiencies dating to 1982 (the provision's year of enactment). Retroactivity, Kenneth Gideon, Treasury's assistant secretary for tax policy, observed, "could not

IRS to apply no-fault penalties, it should refrain from enacting them. And if Congress did not want penalties to overlap, it should coordinate newly enacted penalties with existing penalties. Either way, the IRS had a duty to enforce the penalties as written. *See 1988 Hearings*, *supra* note 1, at 171 ("In order to get uniformity you have to apply [penalties]. In order to get discretion, you move up the line. If you enact a penalty you have to assume it is going to be broadly applied, not narrowly applied. . . . In order to enforce a mass tax in a decentralized system, as we do, to get any uniformity, you have to instruct your staff to apply it across the board broadly. If these are the facts, apply it. If they meet mechanical tests, apply it." If Congress wanted the IRS to exercise discretion, it must understand that it would be "putting a heavy administrative burden on the IRS to look for justifications after those first qualifications apply.").

¹⁸*See, e.g., 1988 Hearings*, *supra* note 1 (Caplin); Thorndike, *supra* note 2, at 11 (quoting Gerald Portney as asserting that the 1980s witnessed a shift in emphasis from voluntary compliance and self-assessment to "detection and punishment").

¹⁹*See, e.g., 1988 Hearings*, *supra* note 1, at 11 (statements of Caplin and Rep. Richard Schulze).

²⁰*Id.* at 6 (Pickle).

²¹*Id.* at 152 (Egger).

²²*Id.*

²³Thorndike, *supra* note 2, at 11.

²⁴Thomas R. Hoffman, "Studies of the Code's Tax Penalty Structure: A Fitful Step Toward Reform," 43 *Tax Law.* 201 (Fall 1989).

possibly deter conduct that had already occurred.²⁵ Like so many other features of the “revenue-driven penalty system,”²⁶ the substantial understatement penalty unduly punished taxpayers.²⁷ In fact, the “penalty sticks” were “beginning to outweigh the carrots” in the administration of the tax system, according to former IRS Commissioner Mortimer Caplin.²⁸ “Such a policy,” Caplin said, “poses a threat to the fabric of our tax system.”²⁹ “Stricter, more expensive penalties,” posited Rep. Richard Schulze, produced tax avoidance and resulted in diminished collections.³⁰ Reducing penalties would increase compliance as well as revenue.³¹

Budget politics prevented much reduction in the severity of existing tax penalties. The Gramm-Rudman Deficit Reduction Act of 1985 — although largely defanged by a 1986 Supreme Court ruling³² — and deficit reduction commanded the attention of Congress. Penalty reform did not generate enough congressional interest for lawmakers to accept the kind of revenue losses demanded by critics of the existing penalty regime.³³ Any reform would have to be revenue neutral.³⁴ That meant,

²⁵1988 *Hearings*, *supra* note 1, at 223 (Gideon).

²⁶*Id.*

²⁷But see Calvin Johnson, “‘True and Correct’: Standards for Tax Return Reporting,” *Tax Notes*, June 19, 1989, p. 1521 (“Enforcing high standards governing tax return reporting positions is the fairest way to raise revenue.”).

²⁸1988 *Hearings*, *supra* note 1, at 177 (Caplin).

²⁹*Id.*

³⁰Lane Davenport (Lee Sheppard contributing), “Hallelujah Chorus Greets Civil Penalty Reform Bill,” *Tax Notes*, June 12, 1989, p. 1317 (paraphrasing Schulze). But see Johnson, *supra* note 27, at 1525 (arguing that raising the reporting standard under section 6661 — that is, making the penalty stricter, more expensive — “might raise very substantial amounts of revenue. The difference between, say, a reasonable basis, 5 to 10 percent chance of success, and a 50 percent standard on every issue in which there is any doubt could mean a lot of revenue.”).

³¹But see 1988 *Hearings*, *supra* note 1, at 40 (Gibbs: “The thesis behind most penalties is that they encourage voluntary compliance. To the extent you affect compliance, you clearly affect revenues. I think this indirect impact on revenue that penalties have is really the more important thing to keep in mind.”).

³²In 1986 the Supreme Court ruled that the Gramm-Rudman Deficit Reduction Act of 1985 was unconstitutional. See *Bowsher v. Synar*, 478 U.S. 714 (1986). Congress passed a revised version in 1987, but it proved much less effective in reducing deficits. Another revision in 1990 reduced its effectiveness even further by emphasizing less controversial spending caps rather than deficit reduction.

³³See, e.g., Pat Jones, “Where Congress Stands on Penalties; ABA Tax Section Retreats,” *Tax Notes*, May 22, 1989, p. 935 (“A major sticking point for any penalty legislation is the revenue lost with penalty reform.”).

³⁴See Davenport, *supra* note 30, at 1317 (reporting that “both congressional and Administration participants noted the importance of this bill having a neutral effect on revenues”); Pat Jones, “Pickle Panel Prepares for Penalty Proposals,” *Tax Notes*, Feb. 20, 1989, p. 905 (reporting that “it is debatable whether Congress, in approving many of the penalty provisions in the Code, had revenue-raising foremost in mind. However, it is almost certain that revenue considerations will be paramount when Congress looks at proposals to soften or eliminate some of these provisions.”).

observers said, toning down the severity of the reforms, and increasing rather than decreasing the penalty rates. Repealing the substantial understatement penalty was off the agenda. Reforming section 6661 would have to emphasize simplification rather than rate reduction, with revenue estimates assuming that increasing the penalty’s simplicity and fairness would lead to greater “good feeling” among taxpayers and, in turn, higher compliance and more revenue.³⁵

Critics of section 6661 noted the political realities of penalty reform. The ABA Tax Section, for instance, backed off its earlier recommendation for repeal of the substantial understatement penalty, concluding that “proposing repeal would probably weaken, if not eliminate, the ABA’s voice” in the debate over reform.³⁶ In fact, during hearings on penalty reform, Pickle pressed ABA Tax Section representatives hard on their organization’s outspoken criticism of section 6661. Pickle pointed out that all former IRS commissioners testifying before the oversight subcommittee’s hearing had urged Congress to retain section 6661 and said that “it is the very hallmark” of effective return processing.³⁷ “Their position,” Pickle said disapprovingly, “is the opposite of yours with respect to that particular recommendation.”³⁸ A consensus had emerged that while the substantial understatement penalty had its flaws, and while it required significant modification, it should be preserved in any prospective penalty legislation.

III. Penalty Reform and New Section 6662

Penalty reform began in mid-1989. On June 2 Pickle and six other members of the oversight subcommittee introduced H.R. 2528, the Improved Penalty Administration and Compliance Tax Act (IMPACT) of 1989.³⁹ The bill revised several major groups of civil penalties in the code, including information reporting penalties; accuracy penalties; preparer, promoter, and protester penalties; and delinquency penalties. According to Pickle, the legislation’s provisions represented “a natural extension of tax reform” and tax simplification.⁴⁰ IMPACT provided “a fairer, less complex, more effective and more rational civil tax penalty system” that was less harsh and easier to administer than the existing system⁴¹ and that would aid tax compliance by “ensuring that there are proper penalties for those who fail to comply with our Federal tax laws.”⁴²

IMPACT eliminated the much-criticized stacking problem and consolidated the negligence, overvaluation,

³⁵Davenport, *supra* note 30, at 1317.

³⁶See Jones, *supra* note 33, at 935 (paraphrasing Saltzman, principal author of the ABA report on civil and criminal penalties).

³⁷1988 *Hearings*, *supra* note 1, at 455 (Pickle).

³⁸*Id.*

³⁹The cosponsors included Reps. Richard Schulze, Beryl Anthony, Ronnie Flippo, Byron Dorgan, D-N.D., Harold Ford, and E. Clay Shaw, R-Fla.

⁴⁰135 *Cong. Rec.* H5153 (Aug. 4, 1989) (statement of Pickle).

⁴¹*Id.* at H5154.

⁴²*Id.*

and understatement penalties into a single accuracy-related penalty.⁴³ A new 20 percent levy would apply to the portion of any underpayment attributable to negligence, any substantial understatement of income tax, any substantial valuation overstatement, any substantial overstatement of pension liabilities, and any substantial estate or gift tax valuation understatement. Importantly, the new, unified penalty did not apply to any portion of an underpayment attributable to fraud (the penalty for which was accounted for in a separate section, unlike under existing law, which incorporated both negligence and fraud penalties under section 6653). As importantly, a negligence assessment would apply only to the part of the underpayment attributable explicitly to negligence rather than, as under existing law, to the entire underpayment of tax.

The most significant change offered in Pickle's legislation involved the substantial understatement penalty. IMPACT made three principal modifications. First, it lowered the penalty rate from 25 percent to 20 percent, less than what critics had hoped for but more than expected given the atmosphere of revenue neutrality. Second, the bill expanded the list of authorities on which taxpayers could rely in determining whether a reporting position met the substantial authority standard. In particular, it included proposed regulations, private letter rulings, technical advice memorandums, actions on decisions, general counsel memorandums, information or press releases, notices, any additional documents published by the IRS in the Internal Revenue Bulletin, and the Joint Committee on Taxation's Blue Book explanations. Third, the bill required the IRS to publish an annual list of positions it believed lacked substantial authority to "assist taxpayers in determining whether a position should be disclosed" to avoid the substantial understatement penalty.⁴⁴

The proposed penalty reform allowed taxpayers to avoid the coordinated levy on a showing of reasonable cause and good faith. And the bill repealed the presumptive negligence penalties (sections 6653(f) and (g)) as well as the increased interest rate on tax-motivated transactions (section 6621(c)).

IMPACT received widespread support. The ABA praised it for facilitating "fairness" and "simplicity" in the tax system, the American Institute of Certified Public Accountants called it "an excellent piece of legislation," and the National Society of Public Accountants considered it "a significant congressional contribution to the American taxpayer." Tax administrators also liked the bill. Dana L. Trier, Treasury's tax legislative counsel, called it a "major improvement," words echoed by former IRS Commissioner Lawrence Gibbs, who called it a "significant improvement." Then-Commissioner Fred Goldberg said that it was "one of the most significant improvements to the tax system" and that he hoped it was "expeditiously enacted," while Gideon urged law-

makers to enact it quickly. Support for the plan also extended beyond government agencies and professional tax organizations to individual taxpayers and businesses.

Given the bill's broad support, it is unsurprising that it survived the legislative process nearly untouched. Congress incorporated H.R. 2528 into the Revenue Reconciliation Act of 1989,⁴⁵ which in turn became part of the Omnibus Budget and Reconciliation Act of 1989 (OBRA '89).⁴⁶ The accuracy-related penalty emerged as section 6662, and the substantial understatement penalty became section 6662(d)(2).⁴⁷ The consolidated accuracy-related penalty "significantly improved the fairness, comprehensibility, and administrability" of the civil penalty system.⁴⁸ The final product reflected nearly two years of congressional investigation and study, three detailed IRS reports, and innumerable studies, communication, and input received from the major professional tax organizations. By all accounts, the restructuring of the penalty regime in 1989 was a legislative achievement.

IV. Epilogue: A Recipe for Disaster

Taxpayers, tax practitioners, and tax administrators entered the 1990s with a far more coherent tax compliance and enforcement system than their counterparts faced 10 years earlier. The statutory penalty regime had been rationalized; practice standards had been elevated; and various antiavoidance tools had been institutionalized. It remained to be seen, however, whether the changes would result in increased compliance. Already there was cause for concern.

A. Legalizing Noncompliance

OBRA '89 rewrote section 6694 along with section 6662. Under prior law, section 6694(a) imposed a penalty on tax return preparers for negligent or intentional disregard of the code or regulations.⁴⁹ Revised section 6694 replaced the negligence standard with the realistic possibility of success standard. In particular, it penalized a preparer for any understatement of tax on a taxpayer-client's return resulting from a position that lacked a realistic possibility of being sustained on the merits. For understatements due to unrealistic positions, if any part of any understatement of liability on a return or claim for

⁴³H.R. Rep. No. 101-247, "Explanation of Revenue Reconciliation Act of 1989" (H.R. 3299) (Sept. 22, 1989); S. Rep. No. 101-56, "Explanation of Revenue Reconciliation Act of 1989" (H.R. 3299 and related bill S. 1750) (Oct. 12, 1989).

⁴⁶P.L. 101-239 (Dec. 19, 1989).

⁴⁷The substantial understatement penalty has undergone little revision since 1989. The most notable changes involve relief from the penalty and the minimum reporting standard that taxpayers must meet before adequate disclosure can absolve a position from the substantial understatement penalty that is unsupported by substantial authority. This change is discussed *infra* at IV.D. Congressional Myopia.

⁴⁸S. Rep. No. 101-56, *supra* note 45.

⁴⁹Former section 6694(a) read: "If any part of any understatement of liability with respect to any return or claim for refund is due to the negligent or intentional disregard of rules and regulations by any person who is an income tax return preparer with respect to such return or claim, such person shall pay a penalty of \$100 with respect to such return or claim."

⁴³See Joint Committee on Taxation, Description of H.R. 2528, "Improved Penalty Administration and Compliance Tax Act of 1989," (JCX-11-89) (June 5, 1989).

⁴⁴*Id.*

refund was attributable to a reporting position for which there was not a realistic possibility of being sustained on its merits, and if the tax practitioner knew or reasonably should have known of that position, and the position was not adequately disclosed or was frivolous, the practitioner would be subject to penalty absent a showing of reasonable cause and good faith.⁵⁰

While the new standard was higher than the old, it did not require the tax practitioner to conclude that a reporting position possessed substantial authority, the standard imposed on taxpayers under the accuracy-related penalty. It allowed practitioners to prepare tax returns and advise reporting positions that subjected clients to penalty if the IRS discovered the position.

“Realistic possibility of success” required that a reporting position have a 33 percent probability, while “substantial authority” reflected a stricter standard, requiring that a position have somewhere from 40 percent to 51 percent probability of success.⁵¹ Thus, for positions falling between one-third and one-half probability of success, the tax practitioner could meet his obligations — both under the tax law and under the ethical guidelines promulgated by the major professional organizations⁵² — and at the same time encourage his taxpayer-client to violate her obligations under the tax law. Some commentators expressed surprise that Congress, after painstakingly reconstructing the substantial understatement penalty, did not take the time to align the penalty standard for taxpayers with the penalty standard for tax preparers.⁵³ Instead, Congress mimicked the reporting standards of the professional organizations, adopting the realistic possibility of success standard of the ABA and the AICPA.

To many observers, realistic possibility of success was not an enforceable standard.⁵⁴ It allowed tax practitioners to advise reporting positions based on a reversal or modification of existing law and therefore prevented self-assessment under any enforceable standard, and further prevented the IRS from fulfilling its mission to collect the correct tax.⁵⁵ Ultimately, realistic possibility of success amounted to a fundamental bar to better tax administration.⁵⁶

ingly reconstructing the substantial understatement penalty, did not take the time to align the penalty standard for taxpayers with the penalty standard for tax preparers.⁵³ Instead, Congress mimicked the reporting standards of the professional organizations, adopting the realistic possibility of success standard of the ABA and the AICPA.

B. Litigation Norms Facilitating Noncompliance

The realistic possibility of success standard reflected litigation norms. At 33 percent, it required a higher probability than a pure litigation standard of nonfrivolous, which was typically pegged at 5 percent to 10 percent probability.⁵⁷ But it was still “built up on the faulty premise that the filing of an income tax return is like a brief or complaint in a lawsuit” and that the filing of a tax return “is merely the opening round”⁵⁸ or the “first offer”⁵⁹ in an adversarial setting.⁶⁰ In the typical adversarial context, both parties appeared before an independent party or tribunal to advocate their positions. The context in which taxpayers filed tax returns looked very different. One of the parties — the IRS — was given an opportunity to review or challenge the assertions of

⁵⁰Section 6694(a).

⁵¹For realistic possibility of success requiring a 33 percent chance of success, see J. Timothy Philipps, Michael W. Mum-bach, and Morgan W. Alley, “What Part of RPOS Don’t You Understand?: An Update and Survey of Standards for Tax Return Positions,” 51 *Wash. & Lee L. Rev.* 1163, 1193 (Fall 1994) (pegging reasonable possibility of success if litigated at 33.33 percent or somewhat less); Sheldon I. Banoff, “Dealing With the ‘Authorities’: Determining Valid Legal Authority in Advising Clients, Rendering Opinions, Preparing Tax Returns and Avoiding Penalties,” 66 *Taxes* 1072, 1128 (Dec. 1988) (pegging realistic possibility of success at 30 percent to 35 percent); IRS Notice 90-20, 1990-1 C.B. 328 (considering realistic possibility of success as “approximately a one in three, or greater, likelihood of being sustained on its merits”). For substantial authority requiring a 40 percent probability, see Philipps et al., at 1193 (“around 40 percent”). For substantial authority requiring as high as 51 percent probability, see IRS Executive Task Force, Commissioner’s Penalty Study, “Report on Civil Tax Penalties,” chapter 8, at 43 (Feb. 21, 1989) (stating that substantial authority should approach 51 percent but could be as low as 45 percent). Some commentators dropped the probability for substantial authority to 35 percent. See Banoff at 1128 (between 35 percent and 40 percent).

⁵²By 1989 both the ABA and the AICPA had adopted the realistic possibility of success standard. See ABA Committee on Ethics and Professional Responsibility, Formal Opinion 85-352 (July 7, 1985); AICPA Federal Taxation Executive Committee, Statements on Responsibilities in Tax Practice (SRTP) No. 1, “Tax Return Positions” (rev. 1988). Specifically, Opinion 85-352 permitted an attorney to advise a reporting position so long as he had a “good faith belief” evidenced by “some realistic possibility of success if the matter is litigated,” while SRTP No. 1 allowed a CPA to recommend a position as long as she had a good-faith belief that it had a realistic possibility of being sustained administratively or judicially on its merits if challenged.

⁵³See, e.g., Kenneth L. Harris, “Resolving Questionable Positions on a Client’s Federal Tax Return: An Analysis of the Revised Section 6694(a) Standard,” *Tax Notes*, May 21, 1990, p. 971 (“One might have expected that Congress, having amended the taxpayer penalty standard to provide for an expanded (and more reasonable) definition of substantial authority, would have incorporated a similar reporting standard for return preparers.”).

⁵⁴Johnson, *supra* note 27, at 1528.

⁵⁵*Id.*

⁵⁶Professors of Tax and Professional Responsibility (Calvin Johnson, Joseph M. Dodge, Patricia Cain, Mark P. Gergen, John Dzienkowski, Robert Peroni, and Tom Evans), University of Texas Law School, Position Paper on IMPACT (H.R. 2528) Section 302: “Realistic Possibility of Success’ Is Too Low a Standard for a Tax Return,” (July 5, 1989).

⁵⁷For “not frivolous” as falling between 5 percent and 10 percent probability, see Philipps et al., *supra* note 51, at 1193.

⁵⁸Professors of Tax and Professional Responsibility, *supra* note 56. Commentators were aghast that Congress would base the reporting standard on the professional standards of the major tax organizations, which had historically been reluctant to “police themselves” and “whose members benefit from low standards.” *Id.*

⁵⁹Karin M. Skadden, “CAG Considers Penalty Study, Resources, Filing Season,” *Tax Notes*, Apr. 3, 1989, p. 11 (paraphrasing Johnson).

⁶⁰*But see id.* (paraphrasing Leonard Podolin of Arthur Andersen as arguing that the amount of disclosure required on a tax return merely reflected one’s duty to an opposing party in a court of law).

the opposing party — the taxpayer — only slightly more than 1 percent of the time.⁶¹ That is, one of the parties filed her complaint knowing that 99 percent of the time the other side would never learn of her asserted position. She would “win” 99 percent of the time.

Yet taxpayers had an obligation to report according to the existing tax law, not according to the potential reversal of existing law. Despite pronouncements from both supporters and detractors of the federal income tax, the levy was not a “voluntary” tax. Rather, in the famous words of Judge Learned Hand, it was “a forced extraction.”⁶² The familiar jurat on the Form 1040 required taxpayers to attest “under penalties of perjury” that they had examined the return, including the accompanying schedules and statements, and that to the best of their knowledge and belief it was true, correct, and complete. Section 7206, moreover, made it a felony for an individual to willfully make and subscribe to a tax return “which he does not believe to be true and correct as to every material matter.” Aggressive reporting positions violated the “true and correct” requirement. Prof. Calvin Johnson argued that any reporting standard falling below “more likely than not” — including realistic possibility of success — was inconsistent “with the meaning of ‘correct and true’ tax required by the current felony provisions and tax return affirmation.”⁶³ The taxpayer should not be able to elude those reporting obligations through her tax practitioner. Or, stated differently, the taxpayer should not be able to accomplish through agents what she cannot accomplish directly.⁶⁴ Yet that is exactly what section 6694(a) permitted. It imposed lower standards on

the tax practitioner reporting tax liabilities for the benefit of his client than on the taxpayer herself.

The tax practitioner who was also a lawyer had a duty to advise the taxpayer-client to fulfill her reporting obligations under the law. Indeed, as Kenneth Harris has observed, the tax lawyer’s duty “flows from his general obligation, as a professional, to encourage compliance with the law.”⁶⁵ The preamble to the ABA Model Rules requires that “as advisor, a lawyer provides a client with an informed understanding of the client’s legal rights and obligations and explains their practical implications.”⁶⁶ In fact, all tax practitioners — lawyer, accountant, and enrolled agent — should step into the shoes of the taxpayer-client when rendering tax return and reporting advice. As agent of the taxpayer-client, the tax practitioner derives his legal duties from the taxpayer’s duties.⁶⁷ Nothing in the practitioner-client relationship “contracts the client’s duties to, nor expands his rights against outsiders.”⁶⁸ The practitioner “is an agent of the taxpayer and as an agent, no matter how zealous, he is bound by the client’s duties to outsiders.”⁶⁹ Importantly, one of those outsiders is the government.

If the government wanted practitioners to uphold high reporting standards, moral suasion would not suffice. The model rules were not disciplinary rules, but merely aspirational goals. The threat of sanction did not exist in any practical sense. It was “moralistic cant” to suggest that tax practitioners owed an aspirational duty to follow standards more strict than those required under legal rules.⁷⁰ At all costs, tax practitioner James Holden argued, the “weasel-word ‘should’ needs to be avoided.”⁷¹ The goal in articulating effective guidelines for tax practitioners “is not to tell the lawyer what we would like for him or her to do — the goal is to define for him or her what must be done if risk of sanction is to be avoided.”⁷² If Congress wanted to collect the correct tax or enforce some standard of reporting the correct tax on returns, agreed Johnson, “it will have to do so by enforcement of stated legal obligations and not by ‘moral suasion’ or ‘aspirational’ goals.”⁷³ The disciplinary rules under the code or Circular 230 had to reflect higher reporting standards. But they didn’t. Taxpayers were bound by “substantial authority,” while tax practitioners could fulfill their legal obligations under the considerably more generous realistic possibility of success standard.⁷⁴ The standards had to be aligned, and they had to

⁶¹See George Guttman, “The IRS and Audit: How Likely and How Much,” *Tax Notes*, May 2, 1988, p. 557 (reporting audit coverage of 1.09 percent for 1987).

⁶²*Commissioner v. Newman*, 159 F.2d 848, 851 (2d Cir. 1947) (J. Hand, dissenting), cert. denied, 331 U.S. 859 (1947). The IRS Executive Task Force, created in 1987 and charged with studying the civil penalty system, offered an intelligent summary of “voluntary” compliance: “The term ‘voluntary compliance’ is sometimes misinterpreted to suggest that a taxpayer can choose to comply or not, as he or she wishes. Of course, this is incorrect. Once the country as a whole agrees through the political process to levy and collect a tax, the tax itself becomes an enforced exaction from the populace and the willful failure to self-assess and pay over these taxes is a criminal offense. Voluntary compliance means merely that the citizens and other taxpayers of the country do voluntarily, and without direct compulsion from the tax administrator, that which they are required by law to do.” IRS Executive Task Force, Commissioner’s Penalty Study, Working Draft, chapters 1-4, 8, “Report on Civil Tax Penalties,” chapter 2, at 5 (Dec. 1989).

⁶³Johnson, *supra* note 27, at 1523. Under the same logic, it was inaccurate to view civil tax penalties — such as the accuracy-related penalty — as simply a benefit/charge provision “offering taxpayers the option of disclosure as the price of a penalty-free climate.” James P. Holden, “Constraining Aggressive Return Advice: A Commentary,” 9 *Va. Tax Rev.* 771, 774 (Spring 1990). The statutory minimum disclosure standard for the accuracy-related penalty required that the tax return position be not frivolous, an even lower standard (5 percent to 10 percent probability) than realistic possibility of success.

⁶⁴Professors of Tax and Professional Responsibility, *supra* note 56.

⁶⁵Harris, *supra* note 53, at 976.

⁶⁶Preamble, ABA Model Rules of Professional Conduct (2002).

⁶⁷Professors of Tax and Professional Responsibility, *supra* note 56.

⁶⁸*Id.*

⁶⁹*Id.*

⁷⁰Johnson, *supra* note 27, at 1525.

⁷¹Holden, *supra* note 63, at 775.

⁷²*Id.* at 777.

⁷³*Id.*

⁷⁴Of course, the taxpayer could avail herself of the lower not-frivolous standard if she adequately disclosed a reporting position that did not rise to the level of substantial authority. But adequate disclosure required filing Form 8275, which many

(Footnote continued on next page.)

be grounded not only in aspirational obligations to the client but also in legal obligations under the tax law. Much to the detriment of the tax system and tax compliance, the divergence in standards soon grew wider rather than narrower.

C. Treasury Capitulation

From 1986 to 1992, tax practitioners had rejected Treasury's efforts to make them costewards of the tax system by aligning practice standards with the penalty provisions for taxpayers. Proposed amendments to Circular 230 released in 1986 would have prohibited practitioners from advising or recommending a reporting position or preparing or signing a tax return unless they could determine that the section 6661 substantial understatement penalty would not apply.⁷⁵ Ultimately, practitioner defiance to that proposal proved effective, and Treasury withdrew its proposed amendments to Circular 230 in 1992.⁷⁶ In fact, practitioner efforts to eschew responsibility for regulating overaggressive reporting positions were so successful that Treasury ultimately adopted the industry standard of realistic possibility of success as its own.

In 1992 Treasury offered new amendments to Circular 230. The proposal explicitly recommended a standard of conduct that "more closely reflects the realistic possibility standards adopted by the professional organizations and the preparer penalty provisions of section 6694 of the Code and the regulations thereunder."⁷⁷ According to the new standard, a practitioner could not advise a client to take a position on a return or prepare a return with a position unless he determined (1) that there was a realistic possibility of success that the position would be sustained on its merits, or (2) that the position was not frivolous and the practitioner advised his client to adequately disclose the position.⁷⁸ Furthermore, a practitioner was prohibited from signing a return if he determined that it contained a position that failed to satisfy the realistic possibility standard or that was frivolous and not adequately disclosed.⁷⁹ The 1992 amendments defined realistic possibility as "approximately a one in

three, or greater, likelihood of being sustained on its merits,"⁸⁰ and frivolous as "patently improper."⁸¹

In addition to eschewing the substantial authority standard for realistic possibility of success (and thereby imposing a different reporting standard on practitioners than on taxpayers), inadvertent deviations from the new standard did not qualify as prohibited conduct under Treasury's 1992 Circular 230 proposal. Noting that the role of Circular 230 in regulating practitioner conduct differed from the role played by the ABA and AICPA guidelines and code penalties, the proposed amendments provided that a practitioner would be subject to discipline only if a failure to comply with the realistic possibility standard was willful, reckless, or a result of gross incompetence.⁸² That leniency created the perverse result of a practitioner who advised an undisclosed position that failed to meet the realistic possibility standard of being subject to section 6694 penalties (which, recall, also employed a realistic possibility standard) but not to Circular 230 sanctions.

D. Congressional Myopia

In 1993 Congress again added to the inconsistency between the standards for taxpayers and those for practitioners. The Omnibus Budget Reconciliation Act of 1993 (OBRA '93) raised the minimum reporting standard — from "not frivolous" to "reasonable basis" — that taxpayers had to meet before adequate disclosure could absolve a position from the substantial understatement penalty unsupported by substantial authority.⁸³ At the same time, Congress retained the "not frivolous" reporting standard for tax practitioners under section 6694.

Interestingly, the House version of OBRA '93 raised the minimum reporting threshold for both taxpayers and tax practitioners. A Ways and Means Committee report said, "The Committee intends that 'reasonable basis' be a relatively high standard of reporting," a "tougher standard" than the former not-frivolous standard, which failed to "sufficiently discourage taxpayers and preparers from taking unreasonable return positions."⁸⁴ The Senate-passed version of the bill imposed the "tougher standard" on taxpayers, but retained the less stringent not-frivolous standard for tax practitioners. House and Senate conferees ultimately agreed to the Senate version, thereby creating the double standard of reasonable basis for taxpayers and "not frivolous" for tax practitioners.⁸⁵

taxpayers, tax practitioners, and tax commentators referred to as the "please audit me now" form. See, e.g., Philipps et al., *supra* note 51, at 1187.

⁷⁵Notice of Proposed Rulemaking, Tax Practitioners, 51 *Fed. Reg.* 29113 (Aug. 14, 1986). For a discussion of the 1986 proposed modifications to Circular 230, see Dennis J. Ventry Jr., "Filling the Ethical Void: Treasury's 1986 Circular 230 Proposal," *Tax Notes*, Aug. 21, 2006, p. 691, *Doc 2006-14952*, 2006 *TNT* 162-25. For a discussion of practitioner reaction to that proposal, see Dennis J. Ventry Jr., "Vices and Virtues of an Objective Reporting Standard," *Tax Notes*, Sept. 18, 2006, p. 1085, *Doc 2006-18619*, 2006 *TNT* 181-35.

⁷⁶Notice of Proposed Rulemaking and Withdrawal of Proposed Rule, Regulations, Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries Before the Internal Revenue Service, 57 *Fed. Reg.* 46356 (Oct. 8, 1992).

⁷⁷*Id.* at explanation of provisions.

⁷⁸*Id.* at section 10.34(a)(1).

⁷⁹*Id.* at section 10.34(a)(1)(i) and (ii).

⁸⁰*Id.* at section 10.34(a)(4)(i).

⁸¹*Id.* at section 10.34(a)(4)(ii).

⁸²*Id.* at explanation of provisions. See also *id.* at section 10.52.

⁸³P.L. 103-66, section 13251 (Aug. 10, 1993).

⁸⁴Staff of H. Comm. on Ways and Means, 103d Cong., Fiscal Year 1994 Budget Reconciliation Recommendations of the Comm. on Ways and Means, (Comm. Print 1993), at 317, *Doc 93-5805*, 93 *TNT* 108-8 through 93 *TNT* 108-32.

⁸⁵H.R. Rep. No. 103-213 (1993) (Conf. Rep.), at 669, as reprinted in 1993 U.S.C.C.A.N. 1088, 1358. See S. 1134, 103d Cong., 1st Session (1993); Rita L. Zeidner, "Conferees' Double Standard Is Good News for Preparers, Not Taxpayers," *Tax Notes*, Aug. 9, 1993, p. 689; Joint Committee on Taxation, Summary of the Revenue Provisions of the "Omnibus Budget Reconciliation Act of 1993" (H.R. 2264) (JCX-12-93) (Aug. 10,

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V. Conclusion

To many observers of the U.S. tax system at the end of the 1980s, the decade-long battle against tax shelters was over. And the government had won. A coherent penalty regime, elevated practice standards, sweeping tax reform legislation, reduced marginal tax rates, a broadened tax base, and alternative minimum taxes stoked the confidence of compliance reformers who boasted of an end to the era of tax shelters.⁸⁶ Their confidence was absolute. "I submit that the war is essentially over for abusive tax shelters," asserted former Commissioner Caplin.⁸⁷

In 2006, with the perspective of more than a decade of aggressive tax shelter activity, those boasts ring hollow, even naïve. Perhaps it is unfair to criticize those who were prematurely optimistic. They were, after all, speaking primarily of syndicated tax shelters that essentially ceased to exist after enactment of the passive loss rules in 1986, rather than of the more recent wave of corporate tax shelter schemes that did not depend on the tax advantages of the limited partnership. At the time, however, other commentators had warned of undiscovered methods of tax avoidance and the need to remain vigilant.⁸⁸ Thus, the passage of time, while offering its usual perspective on the meaning and origin of action and inaction, was not in this case necessary to understanding why tax shelter activity continued unabated — albeit in different forms — throughout the 1990s and 2000s.

Despite notable advances against noncompliance during the 1980s, fundamental problems persisted, including:

- the indefensible gulf between reporting standards for taxpayers and tax practitioners that allowed practitioners to advise overaggressive reporting positions without fear of sanction;

- the insidious litigation norms shared by taxpayers and tax practitioners and embedded in practice standards and penalty provisions; and
- the acquiescence of Treasury and Congress to low reporting standards, opportunistic levels of accuracy, and paltry audit coverage.

Inconsistent reporting obligations, litigation norms, and inadequate practice standards — all culprits in the first tax shelter wave — aided the second wave. And, if left uncorrected, the same fundamental shortcomings in our compliance system will enable the next wave of as yet undiscovered tax avoidance devices.

In the next installment of Policy and Practice: Forty Years of Tax Ethics and Tax Compliance: Lessons Learned, Lessons Lost.

1993), *Doc 93-8635*, 93 *TNT* 167-7. "At best," commentators said, the double standard "will engender confusion and, at worst, may result in conflicts of interest between taxpayers and practitioners." Philipps et al., *supra* note 51, at 1188-1189.

⁸⁶1988 *Hearings*, *supra* note 1, at 190 (Goldberg). See also *id.* at 9 (Gibbs, stating, "We have eliminated tax shelters or virtually so.").

⁸⁷*Id.* at 177 (Caplin).

⁸⁸The IRS task force that studied the civil penalty system in the late 1980s offered sage advice on preserving antishelter tools: "With the passage of the Tax Reform Act of 1986, one may well ask if it is necessary that those anti-shelter or promoter penalties are still required. In the view of some, the enactment of provisions limiting the use of passive losses to offset non-passive income has eliminated the need for those provisions. They argue that the specificity with which such penalties as the tax shelter registration rules are drawn leads to the logical conclusion that repeal is appropriate. Others counter that there are new methods of tax avoidance and new schemes to dupe gullible and unsophisticated taxpayers into thinking that they can 'save taxes' waiting in the wings. The general populace needs the protection afforded by the current system, including the 'aiding and abetting' penalties, and compliance needs require that the IRS have the power to curb the unscrupulous promotion of any dubious scheme." IRS Executive Task Force, Commissioner's Penalty Study, "A Philosophy of Civil Tax Penalties" (discussion draft), at 24 (June 8, 1988).