

## **UC Davis**

### **UC Davis Previously Published Works**

#### **Title**

Vices and Virtues of an Objective Reporting Standard

#### **Permalink**

<https://escholarship.org/uc/item/5547k8d5>

#### **Author**

Ventry, Dennis J

#### **Publication Date**

2022-12-16

Peer reviewed

## Vices and Virtues of an Objective Reporting Standard

By Dennis J. Ventry Jr.

Dennis J. Ventry Jr. is an assistant professor of law at American University Washington College of Law. Comments are welcome at [dventry@wcl.american.edu](mailto:dventry@wcl.american.edu).

Copyright 2006 Dennis J. Ventry Jr.  
All rights reserved.

### I. Introduction

The substantial understatement penalty lay at the heart of the protracted controversy over practice standards in the 1980s. Practitioners objected to Treasury Department efforts to align professional standards with reporting requirements 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.<sup>1</sup> Practitioners recoiled. Prevailing ethical guidelines of the major professional organizations merely required tax practitioners to render advice in good faith evidenced by a realistic possibility of success if litigated; prevailing guidelines did *not* require them to insure against potential tax liabilities.<sup>2</sup> Unified and vocal practitioner opposition forced Treasury to twice extend the comment period for its proposed amendments.<sup>3</sup>

The apparent impasse belied feverish activity among the protagonists. In many ways, the parties were working toward a compromise. The American Bar Association Tax Section appointed a special task force in the summer of 1987 to undertake a comprehensive review of civil and

<sup>1</sup>Treasury Department, Notice 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.

<sup>2</sup>American Bar Association Section of Taxation, Committee on Ethics and Professional Responsibility, Formal Opinion 85-352 (July 7, 1985); American Institute of Certified Public Accountants Federal Taxation Executive Committee, Statements on Responsibilities in Tax Practice No. 1, "Tax Return Positions" (rev. 1988).

<sup>3</sup>Treasury Department, Extension of Comment Period, 51 *Fed. Reg.* 30510 (Aug. 27, 1986); Treasury Department, Solicitation for Extended Comments, 51 *Fed. Reg.* 40340 (Nov. 6, 1986).

criminal penalties;<sup>4</sup> in November 1987 IRS Commissioner Lawrence Gibbs established an Executive Task Force on Civil Penalties, comprising IRS employees from offices around the country.<sup>5</sup> Moreover, both houses of Congress were preparing to conduct their own investigations into the penalty regime with a series of high-profile hearings.<sup>6</sup> Those investigations did not proceed independently, but rather involved significant cooperation. The IRS task force, for instance, worked closely with and consulted the ABA Tax Section, the American Institute of Certified Public Accountants Tax Division, the Tax Executives Institute, the National Society of Public Accountants, and the National Association of Enrolled Agents, in addition to other professional, academic, and business groups.

The next three installments of Policy and Practice will explore the activity surrounding the penalty system in the late 1980s. This installment examines the love-hate relationship between the substantial understatement penalty and practitioners; the next installment evaluates the remarkable documents produced by the IRS task force on civil penalties; and the third chronicles the politics of penalty reform and congressional hearings on the penalty system. Thereafter, this series on the historical relationship between standards of tax practice and tax compliance — now in its ninth installment — will culminate in a final column that summarizes the "lessons" of the last 40 years. In the process, it offers several suggestions on the appropriate role and combination of professional guidelines, administrative regulations, and statutory penalties in facilitating compliance and curbing overaggressive reporting activity.

### II. Hate the Substantial Understatement Penalty

Practitioners urged repeal of the section 6661 substantial understatement penalty.<sup>7</sup> The rate of the penalty, at 25

<sup>4</sup>ABA Tax Section, Committee on Civil and Criminal Tax Penalties, "Penalties Study Report" (July 28, 1988), reprinted in U.S. Congress, House, Committee on Ways and Means, Subcommittee on Oversight, Hearings on "Review of the Civil Penalty Provisions Contained in the Internal Revenue Code" (Mar. 31 and July 28, 1988), at 362.

<sup>5</sup>Executive Task Force, Commissioner's Penalty Study, Internal Revenue Service, "Report on Civil Tax Penalties" (Feb. 21, 1989).

<sup>6</sup>See, e.g., "Review of Civil Penalty Provisions Contained in the Internal Revenue Code," *supra* note 4.

<sup>7</sup>In its study on civil and criminal penalties, the ABA Tax Section concluded that the substantial understatement penalty should be eliminated. Meanwhile, the Tax Section recommended that a taxpayer's intentional failure to understate tax owed should be punished under an increased negligence penalty. "Penalties Study Report," *supra* note 4, at 24. See also Treasury Tax Correspondence, "TEI Submits Proposals for Civil Penalty Tax Reform," 89 *TNT* 127-26 (June 19, 1989); Pat Jones,

(Footnote continued on next page.)

percent, was “unconscionable.”<sup>8</sup> Critics charged that Congress had raised it from 10 percent to 25 percent in 1986 to generate revenue rather than to deter noncompliant behavior.<sup>9</sup> To the extent the IRS wanted to preserve the penalty’s original purpose as a no-fault audit charge, it had to lower the penalty rate substantially to 5 percent or 10 percent. Also, detractors noted that the IRS continued to apply the penalty mechanically without determining whether taxpayers acted in good faith, which by statute would have absolved taxpayers of wrongdoing. “There are a lot of people making an honest effort,” argued Gerald Portney of Peat Marwick Main, a former IRS chief counsel, “and the fact that they fall short shouldn’t cause the IRS to unleash its arsenal.”<sup>10</sup> The section 6661 penalty was “seriously flawed” from both a “policy standpoint” and a “legislative standpoint.”<sup>11</sup>

#### A. No-Fault Penalty Paints With Too Broad a Brush

The ABA Tax Section challenged the fundamental premise of a no-fault, objective penalty. Taxpayers and their tax advisers should not be subject to official sanction unless they demonstrated, at the least, negligent behavior. “There is no legitimate reason,” opined the Tax Section task force charged with studying civil and criminal penalties, why a taxpayer “should be penalized on the basis of additional tax the taxpayer may owe because of nonnegligent reasons, such as frank difference of opinion about the law or because the taxpayer filed his return late.”<sup>12</sup> Not content merely condemning the no-fault, objective approach, the Tax Section recommended a three-tier penalty structure to replace the current array of accuracy penalties and better reflect differing levels of misconduct. Under its proposal, a 25 percent penalty would apply to negligent underpayments, a 50 percent penalty would cover reckless or intentional conduct, and a 75 percent fraud penalty would apply to willful intent to evade tax.<sup>13</sup> The Tax Section plan also would have repealed interest-based additions to tax as well as the presumptive negligence penalty under former section 6653.

Under the revised penalty structure, the section 6661 substantial understatement penalty would be eliminated. Intentional understatement of tax owed would be punished under the new 25 percent negligence penalty. The

Tax Section urged that if the substantial understatement penalty was not eliminated, it be coordinated with other accuracy penalties. To that end, the Tax Section recommended, the penalty should be amended to exclude any portion of an understatement already subject to fraud, negligence, or delinquency penalties. Moreover, imbuing the penalty with “a sense of proportionality” required lowering the rate to “no higher than 10 percent.” Also, the definition of substantial authority should be broadened and defined to give “fair warning” to aggressive taxpayers and to include “the kinds of information that tax practitioners would use in advising clients.” Further, there was “no need to retain a special rule for tax shelters” under a substantial understatement penalty in the post-tax-reform era.<sup>14</sup> And finally, a disclosure exception should be retained.<sup>15</sup>

#### B. ‘Stacking’ Penalties on One Deficiency

Much of the ABA Tax Section’s proposal reflected the desire among practitioners to eliminate the perverse effects of a penalty regime enacted in piecemeal, incoherent fashion. Section 6661 was the poster child of the perversity. The IRS often applied the substantial understatement penalty to portions of understatements that had already been subject to fraud, negligence, or delinquency penalties. That “stacking,”<sup>16</sup> “pyramiding,”<sup>17</sup> or “overlapping”<sup>18</sup> of penalties — whereby the IRS piled several penalties atop one tax deficiency to derive a total penalty that often exceeded the deficiency — resulted in punishments considerably more severe than Congress intended when it enacted the individual penalty provisions.<sup>19</sup> Practitioners also charged that stacking provided

<sup>14</sup>Regarding tax shelter items, section 6661 allowed taxpayers to avoid the penalty by demonstrating substantial authority and a reasonable belief that the return treatment was more likely than not correct when asserted.

<sup>15</sup>“Penalties Study Report,” *supra* note 4, at 24-25.

<sup>16</sup>*See, e.g., supra* note 7, at 678; Skadden, *supra* note 8, at 257; J. Andrew Hoerner, “Taxpayers Are Mired in Penalty Bog, Says FBA Panel,” *Tax Notes*, Mar. 27, 1989, p. 1546 (quoting former IRS Commissioner Jerome Kurtz); Lane Davenport (Lee Shepard contributing), “Hallelujah Chorus Greets Civil Penalty Reform Bill,” *Tax Notes*, June 12, 1989, p. 1317, at 1319.

<sup>17</sup>*See* Michael I. Saltzman, testimony before the Oversight Subcommittee, *supra* note 4, at 356 (recommending coordination of penalties to “avoid pyramiding”); “Penalties Study Report,” *supra* note 4, at 24 (discussing how the substantial understatement penalty could “pyramid” with other penalties); Michael Moriarty and George Guttman, “IRS Official Discusses New Penalty Study,” *Tax Notes*, June 20, 1988, p. 1371 (quoting Daniel Wiles, IRS Office of Associate Chief Counsel, Tax Litigation Division).

<sup>18</sup>*See* Fred T. Goldberg, testimony before the Oversight Subcommittee, *supra* note 4, at 189 (criticizing “overlapping sanctions”).

<sup>19</sup>*See* “Penalties Study Report,” *supra* note 4, at 7 (noting that for single instances of noncompliance “the aggregate civil penalty can be greater than the tax itself and certainly far greater than the amount of any civil penalties that have historically been imposed on taxpayers for acts of noncompliance with the revenue laws”). To help remedy that problem regarding the section 6661 penalty, practitioners suggested requiring that before a penalty would apply, the understatement of individual

(Footnote continued on next page.)

“ABA Presents Penalty Reform Study to Pickle Subcommittee,” *Tax Notes*, Aug. 1, 1988, p. 457; Washington Roundup, “ABA Tax Section Penalties Task Force Advocates Repeal of Substantial Understatement Penalty and Greater Focus on Levels of Culpability,” *Tax Notes*, Aug. 15, 1988, p. 678.

<sup>8</sup>Karin M. Skadden, “Substantial Understatement Penalty Centers Debate on Practitioner’s Role in the Tax System,” *Tax Notes*, Oct. 17, 1988, p. 253, at 257 (quoting unidentified tax practitioner source). *See also* Pat Jones, “Pickle Panel Prepares for Penalty Proposals,” *Tax Notes*, Feb. 20, 1989, p. 905 at 907.

<sup>9</sup>*Id.* Practitioners also expressed outrage that Congress had authorized retroactive application of the 25 percent penalty to returns filed before the effective date of the rate change.

<sup>10</sup>Jones, *supra* note 8, at 907.

<sup>11</sup>Gerald Portney, testimony before the Oversight Subcommittee hearings, *supra* note 4, at 478.

<sup>12</sup>“Penalties Study Report,” *supra* note 4, at 20.

<sup>13</sup>*Id.*

the IRS a powerful tool when negotiating with taxpayers and that revenue agents “ha[d] not been shy about stacking penalties to coerce settlement.”<sup>20</sup>

Even supporters of a no-fault substantial understatement penalty acknowledged the potential unfairness of section 6661. Former IRS Commissioner Jerome Kurtz, a vocal proponent of preserving the substantial understatement penalty, noted that because of stacking, the applicable penalty “may bear little relation to the seriousness of the act or omission being penalized.”<sup>21</sup> For example, Kurtz explained, if a taxpayer overvalued her property and the overvaluation was due to negligence, she would be subject to both the section 6653 negligence penalty and the section 6659 overvaluation penalty. If, however, the taxpayer’s overvaluation created a substantial understatement that would otherwise incur a section 6661 penalty, only the overvaluation penalty would be applied.<sup>22</sup>

### C. The Thorny ‘Substantial Authority’ Standard

While arbitrary in its application, the substantial understatement statute was incoherent on its face. Short of repealing section 6661, Congress or Treasury should clarify the statute, particularly the definition of “substantial authority.” Practitioners continued to complain about Treasury’s restrictive conception of authority, which excluded commonly used sources of tax information and guidance such as proposed regulations, letter rulings, and general explanations of tax legislation prepared by the Joint Committee on Taxation (that is, “Blue Books”).<sup>23</sup>

items on a taxpayer’s return would have to exceed the threshold rather than cumulating understatements of all reporting positions to determine whether a violation had occurred. See Skadden, *supra* note 8, at 257.

<sup>20</sup>See Mortimer Caplin, testimony before the Oversight Subcommittee, *supra* note 4, at 178-179 (“There is evidence that revenue agents are being heavy handed in applying this 25 percent penalty,” and that agents were using the penalty as “a bargaining chip,” thereby putting taxpayers “in an unfavorable position in negotiating a fair settlement”); Rep. Richard Schulze, R-Pa., *id.* at 178 (positing that imposition of penalties and subsequent high rates of abatement “would also lead one to believe that this is being done by the IRS as a bargaining tool. It is to say that we are going to overstep a little bit so that — then they are willing to negotiate back.”); Jones, *supra* note 8, at 906.

<sup>21</sup>Jerome Kurtz, “Penalty Revision and the Case for Section 6661,” *Tax Notes*, Mar. 27, 1989, p. 1617, at 1618. See also Roscoe L. Egger Jr., testimony before the Oversight Subcommittee, *supra* note 4, at 151 (emphasizing “proportionality,” that “the punishment ought to fit the crime”); Goldberg, *id.* at 189 (stating that the penalty system and section 6661 “imposes liabilities that bear no reasonable relationship to the conduct in question”); Ken Gideon, *id.* at 224 (noting that “penalty severity often bears no relationship to the seriousness of the noncompliant behavior”).

<sup>22</sup>See (former) section 6661(b)(3).

<sup>23</sup>See (former) reg. section 1.6661-3(b)(2). For a fuller discussion of this criticism, see Ventry, *supra* note 1, at 698-699. The ABA Tax Section captured practitioner discontent in its study of civil and criminal penalties. Treasury’s “description of the acceptable authority is not satisfactory because practitioners use information in their practices which either are not included in the legislative history list or are specifically excluded in the

(Footnote continued in next column.)

More importantly, practitioners complained that existing guidance left them at sea with an unwieldy qualitative standard for a rudder.<sup>24</sup> The term “substantial authority” was undefined in section 6661, “a serious omission in a penalty statute.”<sup>25</sup> Treasury regulations provided only slightly more guidance. The regulations loosely defined the substantial authority standard as “less stringent than a ‘more likely than not’ standard (that is, a greater than 50-percent likelihood of being upheld in litigation), but stricter than a reasonable basis standard (the standard which, in general, [would] prevent imposition of the [negligence] penalty under section 6653(a)),” and which practitioners pegged at 10 percent to 20 percent likelihood of success.<sup>26</sup> Moreover, in evaluating whether or not authority for a particular reporting position was “substantial,” the practitioner was required to balance authorities. Substantial authority existed “only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary positions.”<sup>27</sup> The weight of authorities for the treatment of an item, moreover, was determined “by the same analysis that a court would be expected to follow in evaluating the tax treatment of the item. Thus, the weight of authorities depends on their persuasiveness and relevance as well as their source.”<sup>28</sup>

regulations.” Moreover, there was particular dissatisfaction with the exclusion of letter rulings from the list of acceptable authority “when practitioners would consider a letter ruling in predicting what the Service position would be on a particular issue. It is especially difficult to justify this exclusion when IRS personnel themselves use letter rulings in developing positions for other rulings or positions they may take.” “Penalties Study Report,” *supra* note 4, at 23.

<sup>24</sup>Indeed, Treasury regulations emphasized “the qualitative, rather than quantitative, nature of the substantial authority determination.” T.D. 8017, 50 *Fed. Reg.* 12012 (Mar. 27, 1985), at Supplementary Information.

<sup>25</sup>“Penalties Study Report,” *supra* note 4, at 22. The Tax Section elaborated. “The only way a taxpayer would be able to know what the term might mean is to have recourse to the committee reports on the statute, as interpreted and modified by Treasury regulations. It is unsatisfactory . . . for the statute itself not to independently give a description of the occasion on which the sanction will be imposed. A taxpayer and lawyer alike should not have to depend on legislative materials in order to discover what a statutory term may mean. When the statutory reference to substantial authority is undefined in any way, it simply does not give a taxpayer fair warning of the kind of conduct expected of him if a taxpayer is to avoid penalty.”

<sup>26</sup>(Former) reg. section 1.6661-3(a)(2). For “reasonable basis” standard as reflecting a 10 percent to 20 percent likelihood of success, see 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 (December 1988); Calvin Johnson, “‘True and Correct’: Standards for Tax Return Reporting,” *Tax Notes*, June 19, 1989, p. 1521, at 1525; J. Timothy Philipps, Michael W. Mumbach, 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).

<sup>27</sup>(Former) reg. section 1.6661-3(a)(2)(a)(1).

<sup>28</sup>(Former) reg. section 1.6661-3(a)(3).

Under that standard, there could be substantial authority for more than one position regarding the same item.

Without sufficient guidance to help taxpayers and practitioners negotiate the “complex” substantial authority standard, it was “impossible to predict” the probability of a reporting position.<sup>29</sup> Tax practitioners challenged the IRS to provide a more precise standard, without which a practitioner was “an oddsmaker at best, a divine at worst.”<sup>30</sup> They also challenged the IRS to abide by its own standard, charging that much of the IRS’s guidance failed to meet the substantial authority test under Treasury regulations.<sup>31</sup> Practitioners recommended clarifying the standard to reflect “substantial legal authority” so that the penalty would apply only if the position lacked legal authority rather than merely when the facts were in dispute.<sup>32</sup>

While critics found much to hate about the section 6661 penalty, some of them acknowledged that it probably discouraged taxpayers from taking aggressive reporting positions and playing the audit lottery.<sup>33</sup> According to Ken Gideon, former IRS chief counsel and Treasury assistant secretary for tax policy, the penalty “has had a role in improving compliance behavior.”<sup>34</sup> But, Gideon added quickly, that role was shrinking. “It is less true today than it was, say, 10 years ago,” Gideon said in 1989, “that the return is viewed as an opening bid.”<sup>35</sup> The substantial understatement penalty had overstayed its welcome.

<sup>29</sup>“Penalties Study Report,” *supra* note 4, at 22. Soon-to-be Commissioner Goldberg argued that in its present form, section 6661 “may well have been OBE’d, overtaken by events. For many taxpayers the dominant reality they must deal with today is the need to comply with highly technical provisions in the absence of any guidance from Treasury. The law may generate Draconian results you may not have intended.” It should be noted that Goldberg endorsed retaining the penalty with modifications, including lowering the rate to 5 percent, and not applying the penalty when the statute was the only existing authority. Goldberg, testimony before the Oversight Subcommittee, *supra* note 4, at 191-192.

<sup>30</sup>Philipps, et al., *supra* note 26, at 1175.

<sup>31</sup>Jones, *supra* note 8, at 907

<sup>32</sup>Skadden, *supra* note 8, at 257. Emphasis added. *See also* “Penalties Study Report,” *supra* note 4, at 25 (recommending that Treasury revise the substantial authority standard “to make clear that the penalty applies only when the taxpayer lacks ‘substantial legal authority’ for his or her position. In other words, the substantial understatement penalty is not properly addressed when the dispute is factual rather than legal” (emphasis in the original)).

<sup>33</sup>*See generally* “Penalties Study Report,” *supra* note 4, at 25 (stating that “substantial minority sentiment” among Tax Section members opposed repeal of section 6661 largely on grounds that “the Code would contain no sanction against aggressive positions short of negligence other than deficiency interest”).

<sup>34</sup>Jones, *supra* note 8, at 907.

<sup>35</sup>*Id.*

### III. Love the Substantial Understatement Penalty

Tax penalties were the “belts and suspenders” keeping the self-assessment U.S. tax system from falling down.<sup>36</sup> Of all the belts and suspenders, some commentators believed the substantial understatement penalty most critical. According to Kurtz, the section 6661 penalty represented “the most important improvement in the penalty provisions in decades — perhaps ever.”<sup>37</sup> Its enactment reflected “a departure from prior law,” “depend[ing] not on the belief of the taxpayer but on objectively determinable facts.”<sup>38</sup> Before section 6661, only the negligence penalty provided defense — minimal, at that — against aggressive or abusive reporting positions. Indeed, section 6653 required the IRS to establish the taxpayer’s state of mind, a tricky proposition. Moreover, in practice, a taxpayer could avoid the penalty if she reasonably relied on a tax professional’s advice.<sup>39</sup>

Section 6661 discouraged tax shelter activity. In fact, at the time, knowledgeable observers ventured into counterfactual and posited that if section 6661 were part of the

<sup>36</sup>Skadden, *supra* note 8, at 255 (quoting Gibbs). *But see* Caplin, testimony before the Oversight Subcommittee, *supra* note 4, at 179 (arguing that “[e]xpanded audit coverage is a far better approach than a regime of penalties for improving voluntary compliance”).

<sup>37</sup>Kurtz, *supra* note 21, at 1619.

<sup>38</sup>*Id.*

<sup>39</sup>*See* Dennis E. Ross, Treasury deputy assistant secretary for tax policy, testimony before the Oversight Subcommittee, *supra* note 4, at 17 (“Standing alone, a negligence or fraud standard places relatively little tension on a taxpayer’s decision to take an aggressive position in an area of legal or factual uncertainty, since the taxpayer’s aggressiveness can often avoid penalty in the event of audit and is rewarded if the taxpayer is among the majority of taxpayers not audited.”); Egger, *id.* at 153 (calling the negligence penalty insufficient “as a general deterrent for overly aggressive behavior”); Kurtz, *supra* note 21, at 1622 (“The historical failure of the negligence penalty effectively to deter or punish substandard reporting by taxpayers cautions against a return to a penalty structure that allows reliance on a tax professional effectively to insulate the errant taxpayer from liability for penalties”); Skadden, “Practitioners Ponder IRS Penalty Reform Recommendations,” *Tax Notes*, Apr. 3, 1989, p. 13 (paraphrasing Kurtz as stating that the negligence penalty has failed “to deter or punish substandard reporting by taxpayers [and] cautions against a return to a penalty structure that allows reliance on a tax professional effectively to insulate the errant taxpayer from liability from penalties”); William L. Raby, “The Role of Disclosure in Tax Return Preparation,” 3-89 *The Tax Adviser* 157 (March 1989) (acknowledging that the section 6653 negligence penalty “can normally be avoided, without disclosure, by showing reliance on the practitioner”). *See also* *United States v. Boyle*, 469 U.S. 241, 251 (1985) (“When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice.” (Emphasis in the original.) *But see* “Penalties Study Report,” *supra* note 4, at 17-18 (arguing that the “uncritical acceptance of the statement that reliance on a competent tax adviser is a defense to a negligence or fraud penalty . . . simply is not the law,” and that “[t]here simply is no evidence that taxpayers have, as a matter of law, a greater ability to avoid the negligence penalty than the law properly allows”).

tax code in the 1970s and early 1980s, the much-publicized tax shelter industry would never have materialized.<sup>40</sup> At the least, the code would have been “substantially less complex.”<sup>41</sup> Indeed, former IRS commissioners rallied around the substantial understatement penalty. Sheldon Cohen argued that it had “a valuable place in the Code”; Kurtz identified it as “a critical element in administering a self-assessing system”; and Don Alexander declared during congressional testimony in 1988 that he was appearing primarily “to defend section 6661.”<sup>42</sup> The substantial understatement penalty had proven itself an effective antiavoidance and simplification tool. It had to be saved from overaggressive taxpayers and their advisers.

### A. Objective Standards Thwart the Audit Lottery

Proponents of section 6661 praised its effectiveness in shutting down the much-publicized audit lottery. For taxpayers motivated to play that game, argued Richard Stark, chair of the IRS task force on civil penalties, the substantial understatement provision was “needed [to uphold] the norm that tax returns should be accurate.”<sup>43</sup> Hugh Calkins of Jones Day asserted that section 6661 provided a “deterrent to skating too close to the line with significant amounts of tax.”<sup>44</sup> The penalty was hardly perfect. But a flawed section 6661 was better than no

<sup>40</sup>Kurtz, *supra* note 21, at 1619-1620 (arguing that the “eagerness of taxpayers to buy into” the tax shelter schemes of the 1970s and 1980s, as well as “the availability of professionals to write opinions, would certainly have been severely dampened if penalties, upon detection and disallowance of the claimed tax benefit, had been substantial and all but inevitable, as is now the case under section 6661” and that “[i]t also seems likely that the shelter industry never would have flourished had section 6661 been a part of the law”).

<sup>41</sup>*Id.* at 1620.

<sup>42</sup>Sheldon Cohen, testimony before the Oversight Subcommittee, *supra* note 4, at 17; Kurtz, *id.* at 162; Donald C. Alexander, *id.* at 166. See also Egger, *id.* at 153 (arguing that the substantial understatement penalty was needed because the negligence penalty had proven insufficient in deterring overaggressive reporting positions); Gibbs, *id.* at 37 (calling section 6661 “necessary” to avoid a return to the audit lottery).

<sup>43</sup>Skadden, *supra* note 8, at 255. See also Jones, “Pickle Urges Treasury and IRS to Offer Tax Penalty Reform Proposals,” *Tax Notes*, Apr. 4, 1988, p. 16 (quoting Gibbs as saying that without a substantial understatement penalty, “you’re back to the audit lottery”); Gibbs, testimony before the Oversight Subcommittee, *supra* note 4, at 37 (stating that “if you don’t have” section 6661, “then to a large extent you are really back to the situation we faced in the 1970s with the audit lottery and so forth, where taxpayers shrug and throw up their hands and say, ‘Well, the adviser says, ‘The law was difficult,’ and so forth, and the penalty or conduct doesn’t get penalized”).

<sup>44</sup>Skadden, *supra* note 8, at 257. Not everyone found the audit lottery argument for section 6661 convincing. See *id.* at 255 (quoting Patricia Burton of Gales Ferry Tax Service and former president of the National Association of Enrolled Agents as opining that the “present penalty structure punishes honest taxpayers who never heard of the ‘audit lottery’ game”); Thomas R. Hoffman, “Studies of the Code’s Tax Penalty Structure: A Fitful Step Toward Reform,” 43 *Tax Law* 201 (Fall 1989) (finding that the audit lottery argument for preserving strict understatement penalties “paints with too broad a brush”).

section 6661. “While both taxpayers and the IRS alike would benefit from reasonable, uniform, and clear rules interpreting this penalty, and its overlap with other penalties should be addressed,” according to Alexander, “a penalty of this nature is a useful and necessary ingredient to effective administration of our complicated tax laws.”<sup>45</sup>

An influential minority of the ABA Tax Section also urged preservation of section 6661. While the official position of the Tax Section recommended repeal of the substantial understatement penalty, a dissenting group of members emphasized that if section 6661 were repealed, “the Code would contain no sanction against aggressive positions short of negligence other than deficiency interest.”<sup>46</sup> Without section 6661, the taxpayer would have “little motivation to disclose aggressive positions supported by an opinion of counsel,” thereby creating a “race to the bottom” in advisor opinions which called forth Congressional action in the first place.<sup>47</sup>

### B. Objective Standards Burdened Taxpayers

Section 6661 imposed an objective standard that made the taxpayer responsible for accurate reporting. If a taxpayer met the understatement threshold (exceeding the greater of \$5,000 — \$10,000 for corporations — or more than 10 percent tax owed), she triggered the penalty regardless of her state of mind. She could avoid the penalty by demonstrating substantial authority for the position, by adequately disclosing the position on the return or on an appropriate disclosure form, or by evincing good faith and reasonable cause. For tax shelter items, the taxpayer could avoid the penalty only by demonstrating substantial authority *and* a reasonable belief that the return treatment was more likely than not correct when she asserted the position.

The elevated reporting standards under section 6661 were meaningful only if the taxpayer was responsible for them. The negligence standard in section 6653 excused taxpayers from culpability simply on showing reliance on a legal opinion. The objective reporting criteria in section 6661 did not allow professional advice to absolve an otherwise overaggressive position. Moreover, the additional objective standards of substantial authority and adequate disclosure under section 6661 “effectively place[d] the responsibility for good faith compliance

<sup>45</sup>Skadden, *supra* note 8, at 255.

<sup>46</sup>“Penalties Study Report,” *supra* note 4, at 25.

<sup>47</sup>*Id.* See also James E. Merritt, member, ABA Tax Section, testimony before the Oversight Subcommittee, *supra* note 4, at 447 (emphasizing the “downside risk” associated with the section 6661 penalty that, unlike the negligence penalty, prevented aggressive positions, and further stating, “I believe it works. I think the substantial understatement penalty is understood by everybody in the tax profession right now. The concept of substantial authority I do not find to be difficult to understand. It is true it is no more defined than negligence, but negligence is understood by people. Substantial authority is understood by people, too, today.”).

where it should lie, with the taxpayer.<sup>48</sup> If the taxpayer was made to care about possible penalties, the tax practitioner would have to care as well. An objective standard made taxpayers responsible for reporting positions and prevented them from claiming ignorance. It also balanced the strategy of attacking aggressive positions by focusing on tax practitioners — employed in Circular 230 amendments issued in 1980 and 1986 — with the strategy of attacking aggressive positions by focusing on taxpayers.<sup>49</sup> Worried about the imposition of the substantial understatement penalty, taxpayers would regulate tax practitioners, who, in turn, would have to consider the possible ramifications of disgruntled clients and malpractice suits.

In the end, even critics of the substantial understatement penalty conceded that the “essentially mechanical standard in section 6661 may be more administrable” than a subjective standard requiring inquiry into a taxpayer’s state of mind, which, at any rate, could be avoided by purchasing a virtual insurance policy against the imposition of penalties with the issuance of a legal opinion.<sup>50</sup>

### C. Objective Standards, Not ‘No-Fault’ Standards

Characterizing section 6661 as a no-fault penalty was a misnomer. “No-fault,” Alexander said, was “the wrong label to put on section 6661.”<sup>51</sup> Rather, the “more accurate description,” suggested Roscoe Egger Jr., also a former commissioner, “would be a penalty on undisclosed aggressive positions that are wrong.”<sup>52</sup> In fact, according to Dennis Ross, Treasury deputy assistant secretary for tax policy, failure to have substantial authority should “be seen as fault on the part of the taxpayer.”<sup>53</sup> While some

predetermined thresholds of tax deficiencies triggered the penalty, several factors mitigated its potential harshness.

First, section 6661 did not target small understatements of tax. The penalty applied only to understatements exceeding the greater of \$5,000 for individuals (\$10,000 for corporations) or 10 percent of the correct tax owed. Understatements of that size should realistically be caught by the taxpayer or her adviser. Indeed, according to Kurtz, “it seem[ed] quite reasonable to require a different and higher standard of care for such items. These are, after all, the items about which taxpayers consult professional advisers.”<sup>54</sup> Moreover, in the event those kinds of understatements went undetected, culpability arguably rose to the level of negligence.

Second, the no-fault thresholds under section 6661 excluded nearly all taxpayers. An understatement of \$5,000 for a taxpayer in the 28 percent bracket (the higher of two brackets in 1989, excluding the 33 percent “bubble bracket”) would have required an understatement of nearly \$18,000, a hefty sum at a time when the median family income reached only \$28,900.<sup>55</sup>

Third, in all cases except those involving tax shelters, disclosure provided amnesty. If the taxpayer or his adviser doubted whether a reporting position met the requisite level of authority, disclosure prevented imposition of the substantial understatement penalty. Admittedly, disclosure reduced the likelihood that the taxpayer would “gain the advantage of having the questionable item overlooked on examination,” but it was an advantage “to which he is not entitled. Tax liabilities,” Kurtz emphasized, “should be determined by the tax law, not the vagaries of audit.”<sup>56</sup>

<sup>48</sup>Skadden, *supra* note 39, at 13. See also Johnson, *supra* note 26, at 1531 (asserting that penalties enforcing taxpayer standards “should fall primarily on taxpayers, rather than on their representatives” and that “if the penalty structure is adequately designed and adequately severe so that it is in the client’s interest to meet a specific standard, the tax adviser will serve the system by informing the client of his self-interest and will help him meet the standard”).

<sup>49</sup>See Johnson, *supra* note 26, at 1531 (arguing that while the tax system “can get some leverage over the taxpayer by threatening to punish the adviser,” the adviser “is paid by the client and has a place in the system only because he is perceived as loyal and competent by the client. If the separate penalties on the adviser get so high as to force the adviser to be disloyal to the client, the adviser will be forced out and the government will have to try to collect tax, under a complicated system, without any help from tax professionals.”).

<sup>50</sup>*Id.*

<sup>51</sup>Alexander, testimony before the Oversight Subcommittee, *supra* note 4, at 166.

<sup>52</sup>Egger, *id.* at 153.

<sup>53</sup>Ross, testimony before the Oversight Subcommittee, *supra* note 4, at 38. See also Gibbs, *id.* at 37 (stating that section 6661 forced taxpayers to examine whether “they believe that the position is correct,” and “if they are not sure, have they disclosed the position that they are taking on the returns. And at some point, if what they do causes a tax deficiency to be determined above a certain amount, it is difficult for me to understand how that is no-fault.”).

<sup>54</sup>Kurtz, *supra* note 21, at 1623.

<sup>55</sup>Median income data from Table H-6, Regions — All Races by Median and Mean Income: 1975 to 2003, available at <http://www.census.gov/hhes/income/histinc/h06ar.html>, retrieved on Sept. 4, 2006.

<sup>56</sup>*Id.* The IRS denied that it screened returns for section 6661 disclosures. According to IRS Assistant Commissioner (Examination) David Blattner, the Service did not pick up such disclosure until the return had been selected under the discriminant information function. Skadden, *supra* note 8, at 254. Others argued that it was irrelevant whether or not the IRS was screening disclosure returns because disclosure itself was insufficient as an antiavoidance device. Section 6661 absolved a disclosed reporting position as long as the position itself was not frivolous, a much lower standard than that required under substantial authority. “Until the IRS can come closer to contesting all disclosures [through audit],” Johnson wrote, “the standard for disclosures needs to be higher than nonfrivolous.” In fact, “[w]ithout 100-percent response to disclosures, the disclosure system alone is inadequate to prevent abuses. Even clear disclosures commonly are not picked up by the IRS.” Johnson, *supra* note 26, at 1528. Johnson got his wish in 1993 when Congress began requiring taxpayers who relied on adequate disclosure to avoid the substantial understatement penalty to demonstrate a reasonable basis for their positions. As the JCT described in its explanation of the 1993 change, for taxpayers unable to demonstrate substantial authority, the substantial understatement penalty could be avoided “by adequately disclosing a return position only if the position has at least a

(Footnote continued on next page.)

Finally, even if the taxpayer did not demonstrate substantial authority nor disclose the position, section 6661 provided for waiver of the penalty when the taxpayer could demonstrate reasonable cause for the understatement and that she acted in good faith.

#### D. An Objective 'More Likely Than Not' Standard

Reformers dreamed of an objective more likely than not standard. Forget substantial authority. Forget realistic possibility of success. If a taxpayer and her adviser could not in good faith assert that a reporting position would more likely than not be upheld in a court of law or during an administrative proceeding, that position should not be reflected on a tax return.<sup>57</sup>

But predicting a position's ultimate success or failure is uncertain business. Moreover, it would be unfair to hold practitioners to unreasonably elevated standards of practice in a professional setting that often involved a coin flip even after careful review of authorities on both sides of an issue, and even if the "sides" and "authorities" were clearly identifiable and sufficiently defined.

Some advocates of the objective substantial understatement penalty had an answer for those concerns: Make it even tougher by prohibiting the negligence standard from influencing its application. As written,

---

reasonable basis." Joint Committee on Taxation, Summary of the Revenue Provisions of the Omnibus Budget Reconciliation Act of 1993 (H.R. 2264) (JCX-12-93), Doc 93-8635, 93 TNT 167-7, Aug. 10, 1993.

<sup>57</sup>Practitioners, of course, argued just as vehemently that taxpayers, without threat of penalty or disclosure, had a right to assert positions meeting the realistic possibility of success standard. See, e.g., Skadden, *supra* note 39, at 14 (paraphrasing Richard M. Glennon of Peat Marwick Main).

section 6661 allowed a taxpayer to avoid the penalty by showing substantial authority, which, in practice, meant reasonably relying on a few recognized authorities to support a position. It also meant that a court could find that a taxpayer possessed substantial authority for a position even if the court ultimately decided not to follow that authority. However, under the elevated more likely than not standard, it would be nearly impossible for a court to find against a taxpayer and at the same time acknowledge that the taxpayer's position was more likely than not correct. Some commentators pushed the potential virtues of an objective more likely than not standard even further, arguing that it facilitated quantifiable predictive analysis in that it was "certainly simpler to 'count' authorities than it [was] to 'weigh' them."<sup>58</sup>

In their enthusiasm for an objective more likely than not standard, advocates may have overstated its powerful simplicity. A numerical *minority* of authorities, after all, could conceivably support a position that met the more likely than not standard in the same way that a numerical *majority* of authorities might not provide enough support to meet the more likely than not standard. Not all authorities, in other words, were created equal. Despite occasional overstatement, it was clear that advocates of an objective reporting standard were prepared and duly armed for the imminent fight over resolution of the appropriate standard for taxpayers and tax practitioners.

*In the next installment of Policy and Practice:* The IRS Task Force on Civil Penalties — A Call for Objective Standards

---

<sup>58</sup>*Id.*