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IRS Penalty Study: A Call for Objective Standards

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I. Introduction

While practitioners bickered over the relative merits of the substantial understatement penalty,¹ the IRS undertook a comprehensive study of the civil penalty system. In November 1987 then-IRS Commissioner Lawrence Gibbs established the Executive Task Force on Civil Penalties, comprised of IRS employees from offices throughout the country.² The task force worked closely with the American Bar Association Section of Taxation, 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.³

According to the task force, a thorough examination and reconsideration of the penalty system was desperately needed to make sense of more than a decade of penalty legislation. Congress had added penalties for various reasons, including: to create a downside risk to overaggressive tax reporting positions; to offset declining IRS audit coverage; to alter taxpayer behavior and encourage tax compliance; to raise revenues; to educate taxpayers about their tax obligations; to punish noncompliant behavior and maintain fairness from the perspective of compliant taxpayers; and to ensure that noncompliant taxpayers ultimately paid for IRS enforcement

programs.⁴ “The very multiplicity of possible rationales,” the task force said, “shows the piecemeal way in which penalties have evolved over the years.”⁵ The ad hoc and frenzied development of the penalty system had confused taxpayers, practitioners, and administrators.

The task force issued three reports. They were remarkable documents, analyzing the civil penalty system from philosophical, economic, political, and administrative vantage points. The purpose of the studies, Gibbs said, was threefold: to identify principles around which “to build a sound framework for the administration of penalties”; to identify penalties requiring “modification, consolidation or repeal”; and to identify IRS practices that could be changed or improved “to facilitate or make more equitable our administration of the penalty provisions.”⁶ While the task force adopted a systemic, holistic approach to its analysis and examination, it spent an inordinate amount of time on what task force member Daniel Wiles called “the most controversial civil penalty,” section 6661.⁷

II. A ‘Philosophy’ of Penalties

The first report, released in June 1988, outlined a general philosophy on civil tax penalties. The method provided the basis for the analytical approach used by the task force in its two subsequent reports.

It was of vital importance to distinguish between the consequence of violating a tax rule (that is, the penalty) and the rule itself. Substantive tax rules described, for instance, the computation of income and allowable deductions as well as how to file a tax return. Tax penalties were imposed as a consequence of violating those substantive rules. “This is a seminal distinction,” the task force said, “since it negates the proposition that a penalty has an end in itself.”⁸ Penalties were levied only regarding abuses of substantive tax rules, and thus “should be enacted and evaluated based on their relationship” to those rules.⁹

Civil penalties served two primary purposes. First, they established norms of taxpayer conduct. Second, they preserved and enhanced voluntary compliance with the tax laws. Penalties should keep compliant taxpayers in line and induce noncompliant taxpayers to alter their behavior. “Each penalty has two goals — a goal of

¹See 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.

²Executive Task Force, Commissioner’s Penalty Study, IRS, “Report on Civil Tax Penalties” (Feb. 21, 1989), at 1.

³Lawrence Gibbs, Commissioner of Internal Revenue, testimony before 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, 1988, and July 28, 1988), at 9.

⁴Executive Task Force, Commissioner’s Penalty Study, IRS, “A Philosophy of Civil Tax Penalties,” Discussion Draft (June 8, 1988), at 1.

⁵*Id.* at 2.

⁶Gibbs, *supra* note 3, at 9.

⁷Michael Moriarty and George Guttman, “IRS Official Discusses New Penalty Study,” *Tax Notes*, June 20, 1988, p. 1371.

⁸Executive Task Force, *supra* note 4, at 5.

⁹*Id.*

general deterrence (establishing and preserving the norm of conduct for compliant taxpayers in general) and a goal of specific deterrence (changing the behavior of the noncompliant taxpayer at whom the penalty is targeted).¹⁰ While the task force embraced the normative and compliance objectives of civil penalties, it rejected other possible purposes, including raising revenue, punishing noncompliant behavior, and reimbursing the government for the cost of compliance programs.¹¹

A. Criteria for Evaluating Penalties

Given the relative dearth of empirical data on the application and ultimate effectiveness of civil penalties,¹² the task force offered broad evaluative guidelines that included four criteria: Penalties should be fair, simple, administrable, and effective.

Regarding fairness, both compliant and noncompliant taxpayers should perceive a particular penalty as “fair,” a term the task force defined under three additional standards: culpability, equity, and severity.¹³ “A penalty should be rationally related to the culpability of the taxpayer who is penalized.”¹⁴ It should treat similarly situated taxpayers similarly. And it should influence the behavior of compliant and noncompliant taxpayers without being unduly harsh.

Penalties should also be simple. They should be “both understandable and understood.”¹⁵ It should be clear what kind or level of conduct fell below the threshold and resulted in imposition of the penalty. Undue com-

plexity in the penalty regime mitigated against a taxpayer’s “ability to understand the consequences” as well as the IRS’s “ability to administer the system effectively and fairly.”¹⁶

Effective tax administration required, at the very least, that administrators interpret and impose penalties “with reasonableness, responsiveness, and reproducibility.”¹⁷ Needless complexity in statutory language made that impossible. Tax rules had to distinguish clearly between compliant and noncompliant behavior. But they also had to allow for administrative discretion. The statutes and regulations should permit administrators to make decisions that were reasonable (and necessary) under constantly changing, factually nuanced circumstances.

Finally, a penalty could be fair, simple, and administrable, yet still ineffective at encouraging compliant behavior. Thus, a penalty also had to achieve specific as well as general deterrence. Penalties that merely punished noncompliant conduct without correcting that conduct should be redesigned and “improved.”¹⁸ The last criterion of effectiveness also suggested changes to existing administrative procedures and data collection. Determining the effectiveness of a penalty might require ongoing research efforts and increasingly strict penalties on recidivistic behavior.¹⁹

B. Goals in Administering Penalties

Quite apart from the rulemaking aspects of administration, the task force offered a set of criteria for administrative discretion. Administrative guidelines, as much as statutory and regulatory rules, had grown in an incoherent fashion since the 1970s.

Both taxpayers and tax administrators had expectations concerning the resolution of tax disputes. The task force summarized the expectations of administrative procedure with three goals for administering the penalty system, the same goals that guided administrative rulemaking. “Penalties should be imposed, contested, and resolved,”²⁰ the task force said, under conditions that were responsive,²¹ reasonable,²² and reproducible.²³ As part of the process, the task force would examine current dispute resolution procedures, policy statements, training programs, and deficiency notices and publications.²⁴

¹⁰*Id.* at 8.

¹¹*Id.* at 6-7. The task force rejected the alternative purposes for two reasons. “First, as a normative matter, the task force believes that penalties should be rationally related to the substantive rules protected by the penalties and should foster positive beliefs in the fairness and effectiveness of the tax system because this rationality and these beliefs are good in and of themselves. Second, the task force believes that penalties most effectively aid voluntary compliance if they foster positive beliefs in the fairness and effectiveness of the tax system, since these positive beliefs encourage compliance in areas that cannot be reached through audits, penalties, or other programs.” *Id.* at 6.

¹²The task force acknowledged that its views derived more from philosophy than from data. “The task force believes that interested parties should have an opportunity to comment on its direction because it cannot show an adequate empirical basis for its views. Many of the views of the task force derive from assumptions regarding the proper role of the IRS. Others arise from assumptions regarding the likely impact of sanctions on taxpayer attitudes and behavior.” *Id.* at 2. The lack of empirical data on civil tax penalties was a widely recognized problem. *See, e.g.,* Pat Jones, “Pickle Panel Prepares for Penalty Proposals,” *Tax Notes*, Feb. 20, 1989, p. 905 (citing a Senate source as arguing that a pending General Accounting Office study on the penalty regime was of vital importance because other efforts “until now lacked any clear data on how these penalties were brought and who they were brought against”; also citing GAO source as stating, “We’re the only people looking at the empirical evidence and deciding whether the horror stories we’re hearing are isolated instances or part of a pattern”).

¹³*Id.* at 9-11.

¹⁴*Id.* at 10.

¹⁵*Id.* at 11.

¹⁶*Id.*

¹⁷*Id.*

¹⁸*Id.* at 12.

¹⁹*Id.* at 12-13.

²⁰*Id.* at 15.

²¹“Responsive” administration required procedures to “hear the taxpayer’s case (and make the taxpayer aware of this hearing), give proper weight to the taxpayer’s point of view, and resolve penalty cases, all without unnecessary effort on the taxpayer’s part.” *Id.*

²²“Reasonable” administration meant “written rules should be applied to reach the substantively correct result in light of their purpose and the scope of administrative discretion granted.” *Id.*

²³“Reproducible” administration indicated that “a particular set of facts should give rise to the same outcome, regardless of what office or individual makes the final decision.” *Id.*

²⁴*Id.* at 16.

C. The Substantial Understatement Penalty

After laying out its general philosophical approach, the task force offered its thoughts on the major penalty groups. It identified six groups of penalties: understatement; failure to file and pay; information returns; preparer, promoter, and protestor; exempt organizations; and employee plans.²⁵ The task force concentrated on the understatement penalties, and in particular on the section 6661 substantial understatement penalty.

Before 1982 and the enactment of section 6661, classic tort theory defined noncompliant behavior. Taxpayers were penalized only if their behavior rose to the level of negligence. Section 6661, however, introduced an objective numerical threshold: understated items exceeding the greater of \$5,000 for individuals (\$10,000 for corporations) or 10 percent of the correct tax owed. Below those thresholds, taxpayers were subject to penalty regardless of culpability. Section 6661 introduced a second objective criterion by prohibiting taxpayers from asserting positions lacking “substantial authority.” The penalty could be abated on a showing of reasonable cause and good faith, but discretionary abatement occurred, if at all, after automatic application of the penalty. The task force noted that policymakers had justified the objective standard as a way to introduce tangible downside risk to aggressive reporting and to discourage taxpayers from playing the audit lottery.²⁶

There was one problem with an elevated objective standard: It conflicted with a taxpayer’s right to litigate a proposed deficiency before paying it. A taxpayer was permitted by law to take an aggressive position as long as that position was litigable or nonfrivolous. Policymakers solved the incongruity by providing a disclosure alternative in section 6661. A taxpayer could assert a position as long as she demonstrated substantial authority or provided for adequate disclosure of the position.

The task force noted that while section 6661 preserved a taxpayer’s right to assert aggressive positions, it “raise[d] questions as to the standard of conduct that should be expected.”²⁷ Prohibited conduct under section 6661 captured a taxpayer exercising her legal rights to a prepayment litigation forum, thereby creating “illogical results.”²⁸ While section 6661 penalized a taxpayer for taking an undisclosed position, it conflicted with other penalty provisions (such as section 6694) that allowed a tax practitioner to advise that this prohibited behavior was perfectly legal. Thus, section 6661 conflicted with one of the task force’s guiding principles — that only noncompliance should produce penalties.

Given those inconsistencies, the task force posited several broad questions for further review. Should taxpayers be forced to disclose aggressive positions? Should the tax system penalize negligent or intentional failure to make disclosures? Should the taxpayer’s obligations under the substantial understatement penalty be aligned with the tax practitioner’s duties and rights under the

preparer penalty? Also, was the section 6661 penalty rate too high at 25 percent? To what extent should it be coordinated with other understatement penalties? And, how could the tax system better distinguish between negligent or intentional noncompliance and good-faith disputes and errors so that the latter were not punished more severely than the former? Those and other questions animated the task force’s review of the substantial understatement penalty and its proper role in the civil penalty system.

III. An Elevated Reporting Standard

At the December 1988 meeting of the Commissioner’s Advisory Group, the IRS translated its civil penalty philosophy into a proposal with specific recommendations. In the process, it dropped a bombshell.

The task force recommended that taxpayers should be expected to file accurate returns. It defined “trying” as exercising reasonable care, and an “accurate” return as one in which each item was either disclosed or was more likely than not to prevail if challenged.²⁹ Also, the task force proposed repealing the existing accuracy penalties — including the substantial understatement penalty — and replacing them with three new penalties:

- A *negligence penalty* would apply if the taxpayer took an undisclosed position that was *not* more likely than not to prevail, *and* the taxpayer took the position intentionally or without exercising reasonable care.
- A *gross negligence penalty* would apply if the taxpayer took a position that did not have at least a realistic possibility of success of prevailing if challenged, *and* the taxpayer took the position intentionally or without exercising reasonable care.
- A *fraud penalty* similar to the existing penalty under section 6653(b) would apply if the taxpayer evinced actual or willful intent to evade tax owed.³⁰

In determining whether an item or position met the “more likely than not” standard, the task force further recommended that practitioners be allowed to rely on an expanded list of sources in determining relevant authority.³¹ In particular, the task force proposal permitted

²⁹Executive Task Force, Commissioner’s Penalty Study, IRS, Working Draft, chapters 1-4, at 8, “Report on Civil Tax Penalties” (Dec. 1989), at Executive Summary. See also Karin M. Skadden, “Commissioner’s Advisory Group Previews Replacement for Substantial Understatement Penalty,” *Tax Notes*, Dec. 12, 1988, p. 1151.

³⁰The 1986 Internal Revenue Code did not define fraud under section 6653(b). Historically, the 1939 code contained a similar penalty defining fraud as intent to evade tax. While the 1954 code dropped the language “with intent to evade tax,” it was widely accepted throughout the postwar period that behavior subject to the fraud penalty required “actual, intentional wrong-doing, and the intent to be required is the specific purpose to evade a tax believed to be owing.” *Mitchell v. Commissioner*, 118 F.2d 308, 310 (5th Cir. 1941).

³¹Treasury regulations restricted authorities under existing section 6661. 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.

²⁵*Id.*

²⁶*Id.*

²⁷*Id.* at 17.

²⁸*Id.* at 18.

practitioners to reference proposed regulations, letter rulings, Joint Committee on Taxation Blue Book definitions, and even legal periodicals, treatises, and the practitioner's own review and analysis of the facts of asserted items and reporting positions.

The December 1988 report recommended coordinating standards for practitioners with standards of behavior for taxpayers. To finalize outstanding amendments to Circular 230 issued in 1986, the task force proposed harmonizing the professional standards for practitioners under the recommended Circular 230 modifications with the proposed accuracy penalty for taxpayers. The 1986 proposal prohibited practitioners from advising or recommending reporting positions or preparing or signing tax returns unless they could determine that a substantial understatement penalty would not apply — a considerably higher level of certainty than the prevailing negligence standard under section 6694(a).³²

A. Familiar Themes

The December report incorporated many of the philosophical underpinnings and analytical approaches of the June report. It emphasized the need to make sense of the “mind-numbing assortment of civil penalties,” which had jumped from 64 in 1975 to 150 in 1989.³³ It set out to describe, moreover, “the underlying reasons” for existing penalties, “a way of evaluating them, goals for their administration,” and “recommendations for improvement.”³⁴ Also, the December report identified supporting voluntary compliance as the most important goal of individual penalties, while rejecting the alternative goals of raising revenue, punishing noncompliant behavior, and funding the cost of compliance programs.³⁵

The December report also adopted the June report's criteria for evaluating tax penalties: fairness, simplicity, administrability, and effectiveness.³⁶ Despite similar categories of relevant criteria, the December report gave significantly more attention to the role of administrative discretion (including the power of abatement) in drafting effective tax penalties,³⁷ as well as the potentially benefi-

cial role of objective standards in an environment of limited administrative resources.³⁸

B. A No-Fault, Objective Standard vs. Negligence

The IRS had made clear that it was not wedded to preserving section 6661.³⁹ But practitioners would have to meet it halfway. “We are willing to put the substantial understatement penalty on the table,” Gibbs said, “provided taxpayers and practitioners are willing to talk about raising the standard in terms of the accuracy level.”⁴⁰ The IRS would not countenance repeal of section 6661 without reciprocal compromise on behalf of taxpayers and practitioners. As far as the IRS saw it, the choice was between maintaining the existing no-fault, objective standard under section 6661 and elevating the level of accuracy for reporting positions to approach more likely than not, while applying penalties on levels of care that fall below negligence.⁴¹ But if taxpayers and practitioners wanted a negligence standard rather than the current hybrid no-fault/negligence standard, they would have to accept a level of accuracy that was closer to more likely than not than to realistic possibility of success.

Practitioners expressed little interest in compromise. The “preferred cure” for most practitioners regarding debates over practice and reporting standards required a return to a simple negligence standard and a minimum

³⁸*Id.* at 17 (“The IRS’s pursuit of efficiency and the reality that the law must be administered with limited resources has implications for the design of penalties. Increasing fairness by making fine gradations of proportionality or adding specific penalties for specific failures to comply, defining standards of behavior based on more fair subjective criteria rather than objective criteria, using penalties as a way to educate taxpayers, maximizing effectiveness by considering assertion of penalties in cases of marginal noncompliance, and encouraging a proactive investigation of possible cases for waiver or abatement of penalties all require that resources be devoted to the administration of penalties and not to other areas that compete with penalties.”).

³⁹Indeed, according to some observers, the IRS task force had turned back the clock and transformed the substantial understatement penalty into a simple negligence penalty, avoidable through reliance on the opinion or advice of a tax practitioner. The task force recommendation would produce “the same outcome that historically resulted from the application of the existing (and seemingly much lower) negligence standard.” Jerome Kurtz, “Penalty Revision and the Case for Section 6661,” *Tax Notes*, Mar. 27, 1989, p. 1617. Moreover, it permitted a taxpayer to avoid the penalty on a showing of due care in reaching the conclusion that she would more likely than not prevail even though she did not ultimately prevail and even though she was mistaken in concluding that she would ultimately prevail. Thus, the negligence standard entered through the backdoor and reduced the effectiveness of the proposal. It turned a powerful no-fault objective penalty into a hybrid no-fault/negligence penalty. That criticism, while perceptive, was overly harsh. The task force, after all, recommended raising the level of accuracy to more likely than not certainty.

⁴⁰Karin M. Skadden, “Gibbs Outlines Challenges for Tax Administration in 1989,” *Tax Notes*, Dec. 19, 1988, p. 1258 (paraphrasing Gibbs).

⁴¹Skadden, *supra* note 29, at 1152.

³²For a discussion of the 1986 proposal, see *id.*

³³Executive Task Force, *supra* note 29, chapter 1, Introduction, at 1.

³⁴*Id.*

³⁵*Id.* chapter 2, at 6. The task force was particularly critical of using tax penalties to raise revenue. “Of course, penalties raise revenues collaterally,” the report said. “But as an independent objective, revenue raising is not rationally related to compliance objectives.” *Id.* at 6-7.

³⁶“Simplicity” became “comprehensibility” in the December report, reflecting a stronger emphasis on understanding the penalties rather than merely making them less complex structurally.

³⁷See Executive Task Force, *supra* note 29, chapter 3, at 16 (“The job of administration is to determine when [a standard of behavior] has been breached and whether the breach should be excused. The designer of a penalty can be of help to the administrator in making such determinations by setting forth factors that the administrator should take into account, but the designer should resist the temptation to establish hard and fast rules requiring the assertion of a penalty in particular circumstances.”).

level of reasonable care.⁴² Never mind that this standard had proven unworkable, and facilitated noncompliance.⁴³ Further, there was little indication that practitioners would compromise even if their demands were met. For years, practitioners had argued for an expanded definition of authorities under section 6661. The IRS acquiesced, providing a broader definition in its December report, but many practitioners criticized the gesture, switching gears completely and charging that the expanded list of acceptable sources of authorities “perpetuate[d] the unadministrability” of the section 6661 penalty and that weighing authorities was a fundamentally impossible endeavor.⁴⁴ That criticism, even if true in some respects, was unfair and disingenuous. Weighing authorities, after all, animated all aspects of tax practice.

Although willing to compromise, the IRS envisioned a penalty regime that elevated reporting standards and encouraged disclosure of questionable items. The tax return was not a first offer in an adversary process. Moreover, a taxpayer should not be permitted to assert a position, even if it possessed substantial authority, if the position was more likely than not to lose if challenged on merits. Rather, the taxpayer, with the help of her adviser, should make every effort with reasonable diligence to calculate her tax accurately. Moreover, the taxpayer standard “should be properly coordinated with the traditional role” of tax practitioners, “whose obligation is to advise their clients under the law.”⁴⁵ Also, while that standard “should be resolved through the political process and that unilateral adoption of a standard by the IRS would be inappropriate,” the task force was quick to emphasize that the view of the IRS should count for something.⁴⁶ In particular, its role as administrator of the tax system meant that it had “an important perspective on what approach is most likely to result in the best balance between effective administration, taxpayers’ rights, and simplicity.”⁴⁷

C. Defining the Standard of Behavior for Accuracy

The task force carefully presented its case for an elevated reporting standard. It astutely observed that much of the controversy surrounding the accuracy penalties — particularly the substantial understatement penalty — reflected “a lack of consensus as to the standard of conduct that a taxpayer should observe in reporting undisclosed items. That issue,” the task force said, “goes far beyond the existence of this penalty to the question of what the taxpayer’s duty should be in completing a tax return.”⁴⁸ Thus, the new reporting standard had to

address three essential issues: the level of care expected of taxpayers, the level of accuracy expected of taxpayers, and the role of disclosure.

1. Level of care. The level of care required of taxpayers involved the traditional due care standard of negligence versus the objective standard in section 6661.

The negligence standard had much to commend it. The code already relied on negligence as the touchstone of due care for taxpayers (that is, in the section 6653(a) negligence penalty) as well as tax practitioners (that is, in the section 6694 preparer penalty). Also, the negligence standard could be “flexibly applied under varying factual circumstances.”⁴⁹ Equally important, it was “implicitly the standard for professional advice,” which the task force very much wanted to align with the standards for taxpayer reporting.⁵⁰

The objective standard, however, while administratively cleaner, suffered from numerous shortcomings. First, the bright-line standard was unrelated to due care standards and punished taxpayers even when they exercised reasonable care in preparing and filing tax returns. Second, it was not based on conduct that was “subjectively culpable,” and therefore “lack[ed] moral and ethical force.”⁵¹ As a result, it relied “for its efficacy exclusively upon the size of the economic sanction,” which as a practical matter had an upper-bound limit, and also on “the likelihood of discovery,” which was abysmally small, given audit coverage of less than 2 percent.⁵² The task force noted that those deficiencies were not sufficiently alleviated by authority to waive the penalty on a showing of reasonable cause and good faith.

In the end, the task force concluded that the level of care expected of taxpayers should reflect a negligence standard. Reasonable care was widely understood by taxpayers and practitioners, it provided administrative flexibility, and it played no significant role regarding

⁴⁹*Id.* chapter 8, at 8.

⁵⁰*Id.*

⁵¹*Id.*

⁵²*Id.* at 9. The task force report noted quite accurately that effective deterrence of noncompliant conduct required that the penalty rate account for the probability of audit times the probability of discovery on audit. Given low audit rates, “the rates for penalties need to be fairly high.” The task force also astutely observed that “moral and ethical dimensions of filing an accurate return would indicate that this determination [that is, the appropriate penalty rate] need not be based solely on an economic analysis. The statement of an expected standard of conduct as a normative rule may have the effect of increasing the moral and ethical support for voluntary compliance, thus decreasing the need to raise the penalty rates.” *Id.* at 25. Despite the thoughtful commentary on the relationship between effective penalty rates and normative standards of conduct, the task force may have ascribed too much power to normative rules. If we assume an audit rate of 2 percent, for example, and we further assume that the IRS always (and only) catches noncompliance on audit, the penalty rate sufficient to deter underpayment must be 4,900 percent of the tax due! (The relevant formula can be expressed as $P = (1-d)/d$, where P is the penalty per dollar of underpayment and d is the probability of detection.)

⁴²See Karin M. Skadden, “Practitioners Ponder IRS Penalty Reform Recommendations,” *Tax Notes*, Apr. 3, 1989, p. 13.

⁴³See, e.g., Dennis J. Ventry Jr., “Reasonable Basis and Ethical Standards Before 1980,” *Tax Notes*, May 29, 2006, p. 1047, *Doc 2006-9503*, 2006 TNT 104-54.

⁴⁴See Skadden, *supra* note 42, at 14 (quoting Gerald Portney of Peat Marwick Main).

⁴⁵Executive Task Force, *supra* note 29, chapter 8, at 7.

⁴⁶*Id.*

⁴⁷*Id.*

⁴⁸*Id.* chapter 3, at 9.

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recent problems of noncompliance. The level of accuracy, however, was a different matter altogether.

2. Level of accuracy. Determining the level of accuracy that taxpayers should, in the exercise of reasonable care, achieve in the absence of disclosure had animated compliance efforts for at least a decade. The task force examined the familiar alternatives: the litigation standard, substantial authority, more likely than not, and certainty of success.

The task force conceptualized the litigation standard as including both the old reasonable basis standard and the relatively new realistic possibility of success standard. A level of accuracy founded on the litigation standard contained three primary benefits: It coincided with the ethical expectations of the major professional organizations; it was a familiar and uncontroversial standard; and it preserved a taxpayer's legal right to litigate questionable positions before payment of asserted tax deficiencies.

But the litigation standard as applied to reporting standards had a checkered past. It did little to encourage compliance; facilitated the audit lottery; provided "a climate in which problems such as abusive tax shelters can flourish"; encouraged "an adversarial approach to tax matters"; and stimulated the understatement of probable tax liabilities.⁵³ The task force argued that a harsher regime of understatement penalties would be needed to counterbalance the serious shortcomings of the litigation standard.

A substantial authority standard required a higher basis for a reporting position than the litigation standard, but required less probability than more likely than not. The virtues of substantial authority included reducing opportunities for playing the audit lottery and facilitating higher levels of compliance. Its vices were significant, however, and included its complexity, lack of a comprehensive definition, and permissive influence on the assertion of positions that the taxpayer knew or should have known were inaccurate.

The task force searched for a reporting standard that better protected the integrity of the tax system. The litigation standard was too porous, substantial authority was too confusing, and the strict liability standard of "certainty of success" was unrealistically high given the inherent complexity and constantly changing nature of the nation's tax laws. The more likely than not standard, however, sufficiently discouraged overaggressive positions. Also, it was easily explained to the unrepresented, nonprofessional taxpayer as a reasonable belief that her tax return was correct. If a particular position was not more likely than not to prevail, it would have to be disclosed. The shortcomings of the standard — ever-changing tax laws preventing more likely than not determinations, excessive disclosure requirements, and direct conflict with prevailing practice guidelines of the professional organizations — were real but surmountable.⁵⁴

⁵³*Id.* at 10.

⁵⁴Ultimately, the task force was not persuaded by arguments that complexity prevented more likely than not determinations, or that the level of disclosure would be excessive. It also

(Footnote continued in next column.)

3. The role of disclosure. Elevated levels of care and accuracy for undisclosed positions exceeding the threshold requirements of a litigable position (that is, reasonable basis or realistic possibility of success) had to preserve the taxpayer's right to a prepayment litigation forum. The task force "strongly believe[d]" that the "desirable level of accuracy is higher than that required for the litigation of a position."⁵⁵ Consequently, it retained the taxpayers' legal right to litigate an arguable position before payment by permitting taxpayers to assert those positions only if they were sufficiently disclosed on the tax return or accompanying documents.⁵⁶

D. 'Accurate' Returns and a Three-Tier Penalty

The task force concluded that only a level of accuracy reaching more likely than not "truly supports the goals of a voluntary compliance system."⁵⁷ "Given limited audit coverage and the complex factual situations of today," the task force said, "any other level of accuracy will necessarily encourage taxpayers to underreport their liabilities and leave the IRS in the position of policing a perfectly legal 'catch me if you can' standard of behavior."⁵⁸ Thus, taxpayers should be expected to file an "accurate" tax return, which entails exercising reasonable care in filing a return on which each reporting position was more likely than not to prevail. Taxpayers could assert positions falling short of the more likely than not standard, but only if they were litigable positions that were also disclosed. Litigable under the task force recommendation required that the position have a realistic possibility of success if challenged, a considerably higher standard than the traditional nonfrivolous definition of litigable.⁵⁹

A three-tier accuracy penalty could reflect the requirements of the new reporting standard. A 20 percent negligence penalty would apply if an undisclosed position failed to meet the more likely than not standard, and the taxpayer took the position intentionally or without exercising reasonable care. A 50 percent gross negligence penalty would apply if a reporting position failed to meet the realistic possibility of success standard, and the

believed that an elevated standard of accuracy could be reconciled with prevailing ethical guidelines "by providing that the level of care expected in filing a return is one of reasonable care — the classic negligence standard." *Id.* at 11.

⁵⁵*Id.* at 10.

⁵⁶The task force argued that disclosure was "a reasonable tradeoff for one of the higher standards." *Id.* at 11.

⁵⁷*Id.*

⁵⁸*Id.*

⁵⁹*Id.* at 11 and 32. See 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) (pegging nonfrivolous at 5 percent to 10 percent and "reasonable possibility of success" at "33.33% 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 frivolous at "less than 10-20%" and "realistic possibility of success" at 30 percent to 35 percent).

taxpayer took the position intentionally or without exercising reasonable care. Finally, a 100 percent fraud penalty would apply if the taxpayer took a position willfully and with the intent to evade tax owed.⁶⁰

In addition to coordinating the new penalties in proportion to the seriousness of the noncompliant conduct through a graduated rate schedule, the task force harmonized the penalties in other ways. First, assertion of one penalty automatically included assertion of each lesser penalty. Second, and despite the lesser included offense, only the most severe applicable penalty could be collected. Third, each penalty was applied only to that part of the understatement applicable to that particular level of noncompliant conduct. Fourth, each penalty bore interest from the same date, which was stipulated to come after notice and demand was made of the taxpayer. Fifth, for delinquent returns filed before commencement of a compliance action, the accuracy penalty did not apply to any portion of liability admitted on the delinquent return. And finally, the task force recommended expanding the list of items constituting adequate disclosure.⁶¹

1. Standard of behavior for tax practitioners. The task force also recommended coordinating taxpayer penalties with tax practitioner penalties by raising the standard of behavior for practitioners. It proposed amending the section 6694 preparer penalty to require that the practitioner exercise reasonable care in determining that the taxpayer-client's return complied with the taxpayer's standard of behavior. Moreover, the task force proposed establishing three levels of penalty under section 6694 reflecting the three accuracy penalties for taxpayers. Practitioners would be subject to the minimum penalty (corresponding to the negligence penalty for taxpayers) if they failed to exercise reasonable care in determining that every undisclosed position was more likely than not to prevail. A more severe penalty would apply (corresponding to the taxpayer gross negligence penalty) if the practitioner failed to exercise reasonable care in determining that every position met a realistic possibility of success standard. And finally, a practitioner would face the most severe penalty (corresponding to the taxpayer fraud penalty) if her conduct was willful or intentional.⁶²

According to the task force, Circular 230 regulations should also reflect the standard of behavior for taxpayers. Under the December plan, practitioners would be prohibited from advising a reporting position unless, in the exercise of reasonable care, the practitioner concluded either that the position would prevail more likely than not if challenged, or that the position had a realistic possibility of prevailing if challenged and the practitioner advised disclosure. Also, a practitioner could prepare or sign a return containing positions that were *not* more likely than not to prevail if challenged only if the positions had a realistic possibility of success *and* they were adequately disclosed. To mollify practitioner concerns that the elevated standards of behavior would

result in increased disciplinary proceedings under Circular 230 regulations, the task force recommended that the director of practice "consider all the facts involved" in cases of alleged misconduct. The purpose of detailed, case-by-case consideration, the task force said, was that "isolated incidences of mere negligence would not result in suspension or disbarment." Rather, those sanctions "would be appropriate only for egregious conduct."⁶³

2. Effective administration, limited resources, and an objective standard. Ultimately, the task force struck a compromise between a negligence standard and an objective standard. It balanced a negligence level of care with an objective level of accuracy. In exercising reasonable care (the negligence standard), the taxpayer was required to achieve more likely than not probability (the objective standard). The objective criteria for penalty assessment was further balanced by a subjective standard for waiver (that is, reasonable care, reasonable cause, and good faith).

Limited administrative resources necessitated objective penalty factors. Given the IRS's perennially restricted appropriations, the task force concluded that it was "appropriate" to infer a taxpayer's conduct "based upon the presence of certain objective factors and rely upon waiver authority to prevent penalizing compliant taxpayers."⁶⁴ While it may have been preferable to administer penalties relying solely on a reasonable care standard, such a standard required investigating all facts and circumstances on a case-by-case basis. It was far too expensive and impractical to expend resources on individualized investigations. Due to the reality of limited resources, the task force determined that the IRS should be given the discretion "to devote its resources" to compliance programs and penalty administration that it believed would have "the most positive impact on voluntary compliance."⁶⁵ An objective standard of accuracy best promoted that goal.

IV. Letting Practitioners Off the Hook

The final report from the task force departed even further from the negligence standard than the December draft. Negligence standards, the IRS had concluded, encouraged noncompliant behavior.⁶⁶ While the December draft required taxpayers to exercise reasonable care that each reporting position was more likely than not correct, the February version proposed a more stringent variation of substantial authority as the analytical touchstone for determining level of accuracy. Also, the final report adopted the task force's earlier recommendation for a three-tier penalty system that applied to negligent, grossly negligent, and fraudulent conduct.

⁶³*Id.* at 34-35.

⁶⁴*Id.* at 31.

⁶⁵*Id.* at 30.

⁶⁶Pat Jones, "IRS Task Force Releases Penalty Reform Proposals," *Tax Notes*, Feb. 27, 1989, p. 1032 (quoting Gibbs as stating that the IRS "could anticipate substantial noncompliance" if it were to rely on negligence penalties to deter aggressive planning).

⁶⁰*Id.* at 32-33.

⁶¹*Id.* at 33.

⁶²*Id.* at 34.

While the final report tightened reporting requirements for taxpayers, it loosened them for tax practitioners. Taxpayers faced an objective reporting standard of substantial authority, but practitioners operated under the considerably less stringent reasonable care standard. The discrepancy between the two standards effectively allowed practitioners to continue advising positions that subjected taxpayer-clients to liability while absolving themselves of any professional or disciplinary wrongdoing.

A. An Objective Substantial Authority Standard

As it did in its two previous reports, the task force's final recommendations emphasized the need for accurate self-assessment of returns. "The interest of IRS and tax administration in the reporting of the tax liability probably due is clear," the task force said.⁶⁷ The combination of aggressive reporting and low audit coverage, "as a practical matter," resolved questionable and even unsupported positions in the taxpayer's favor.⁶⁸ A tax system based on voluntary compliance "through the medium of self-assessment must have as its objective the filing of returns setting forth the probable tax liability."⁶⁹ An elevated level of accuracy, moreover, had to account for a lower level of care (that is, reasonable care) in the preparation of returns and include a disclosure option for taxpayers exercising their right to litigate uncertain positions before payment.

To achieve those goals, the task force advised that accuracy penalties encourage taxpayers to exercise reasonable care in reporting positions that, at the very least, were litigable (defined as having a realistic possibility of success if challenged) and to disclose those litigable positions "that the taxpayer cannot conclude are probably correct."⁷⁰ Thus, disclosure was required for reporting positions "at less than, but close to, 50 percent."⁷¹ But disclosure would not absolve nonlitigable positions, defined as positions falling somewhere on the probability continuum between 0 percent and 25 percent.⁷² In other words, the task force recommended that taxpayers should not be able to assert positions on their returns for items falling below 25 percent likelihood of success, an astonishingly high standard.

To assist taxpayers in determining whether a position was "probably correct," the task force called on the objective standard of substantial basis and its corresponding analytical tool, substantial authority. This threshold, the task force said, "seems peculiarly suited to application with respect to uncertain issues identified by the taxpayer, since it operates as a prod to diligence in the consideration of such issues and does not permit the assertion of subjective defenses."⁷³

While taxpayers and practitioners had come to know — and hate — the substantial authority standard, the task

force tried to change it beyond recognition: It raised the substantial authority determination to approximately 50 percent likelihood of success on the merits. Treasury regulations had defined substantial authority as "less stringent than a 'more likely than not' standard, but stricter than a reasonable basis standard."⁷⁴ Substantial authority under existing regulations afforded practitioners sizeable leeway between reasonable basis and more likely than not. The IRS task force significantly shrunk the wiggle room, pegging substantial authority between 45 percent and 51 percent.⁷⁵ Even at the low end of the range, the task force recommendation was considerably more stringent than the realistic possibility of success standard endorsed by the ABA and AICPA, which was commonly believed to fall somewhere between 30 percent and 35 percent probability.⁷⁶ The task force balanced the higher level of accuracy associated with its formulation of substantial authority by permitting taxpayers "to rely on nonprecedential authorities of a sufficiently legal and institutional nature," including private letter rulings, technical advice memorandum, general counsel memorandum, and the JCT's Blue Book explanations of tax legislation.⁷⁷

The heightened substantial authority standard reflected the task force's conscious effort to institutionalize an objective reporting requirement. Lower standards of behavior, such as reasonable care, generated difficult problems of proof surrounding the assertion and assessment of penalties, and "enabled many noncompliant taxpayers to avoid" penalties based on negligence.⁷⁸ Using an objective standard such as substantial authority as a surrogate for the desired standard of behavior "may prove to be the best approach to this thorny problem," the task force said.⁷⁹ Also, while acknowledging the inherently uncertain and complex nature of the tax law, the task force felt that a reporting position could "reasonably be weighed objectively [by the taxpayer] in most circumstances by considering the existence and reasoning of certain authorities with respect to that position."⁸⁰ Further, the proposed substantial authority standard avoided "false positives" resulting from the imposition of an even stricter more likely than not standard through which taxpayers might be subject to understatement

⁷⁴Reg. section 1.6661-3(a)(2).

⁷⁵Specifically, the task force stated that substantial authority "should approach" 51 percent but could extend as low as 45 percent. Executive Task Force, *supra* note 2, chapter 8, at 43.

⁷⁶See Philipps et al., *supra* note 59, at 1193 (pegging substantial authority at "around 50%," "reasonable possibility of being sustained on the merits" (AICPA) at 33.33 percent, and "reasonable possibility of success if litigated" (ABA) at "33.33% or somewhat less"); Banoff, *supra* note 59, at 1128 (pegging substantial authority at 35 percent to 40 percent and "realistic possibility of success" at 30 percent to 35 percent); IRS Notice 90-20 (considering realistic possibility of success as "approximately a one in three, or greater, likelihood of being sustained on its merits").

⁷⁷Executive Task Force, *supra* note 2, chapter 8, at 40.

⁷⁸*Id.* at 25.

⁷⁹*Id.*

⁸⁰*Id.* at 39-40.

⁶⁷Executive Task Force, *supra* note 2, chapter 8, at 10.

⁶⁸*Id.*

⁶⁹*Id.* at 13.

⁷⁰*Id.*

⁷¹*Id.* at 39.

⁷²*Id.*

⁷³*Id.* at 37.

penalties even though they made diligent efforts to comply.⁸¹ While it is hard to see how a 45 percent to 51 percent substantial authority standard would produce fewer false positives than a greater-than-50-percent standard under more likely than not, the important point is that the task force endorsed the idea of an objective standard that neither relied on negligence nor allowed a legal opinion or subjective intent of the taxpayer to avoid sanction.⁸²

B. Three-Tier Penalty System

The task force carried forward its earlier recommendation for a three-tier penalty system to replace the existing assortment of accuracy penalties of substantial understatement, negligence, fraud, and overvaluation. Under the recommended standard of behavior, a taxpayer was required to exercise reasonable care in preparing and filing her return. Moreover, she would resolve issues in her favor *without* disclosure only if she determined that the reporting position was supported by substantial authority and had not been identified by the IRS as an issue requiring disclosure. In the event of disclosure, she would resolve issues in her favor only if the reporting position was litigable. Failure to achieve the standard of behavior would subject the taxpayer to the three-tier penalty system depending on her level of culpability and the extent of her noncompliant conduct.

A 20 percent negligence penalty would apply either to failures to exercise reasonable care to file a correct return or to make required disclosures. Failure to make adequate disclosure (but not failure to exercise reasonable care) would subject the taxpayer to a *de minimis* rule similar to that in section 6661. A penalty for nondisclosure would not be imposed if the applicable deficiency failed to exceed the greater of 10 percent of the correct tax or \$5,000 (\$10,000 for corporations). Also, penalties could be waived for failure to make a required disclosure on a showing of reasonable care, and that “despite the exercise of such reasonable care, the taxpayer had failed to identify the issue with respect to which the failure to disclose had occurred.” Under no circumstances would waiver apply to failures to exercise reasonable care in the preparation and filing of a tax return.⁸³

Taxpayers faced a 50 percent gross negligence penalty for willfully or intentionally failing to file a correct return or asserting a position that was not litigable (that is, frivolous, compared with the December definition of “realistic possibility of success”). A taxpayer could avoid the second-tier penalty regarding a nonlitigable position

on a showing of good-faith reasonable belief that the position was in fact litigable. A 100 percent fraud penalty applied if the taxpayer took a position willfully and with the intent to evade tax liability owed.⁸⁴

C. A Standard of Double Standards

The task force attempted to coordinate its recommendations for taxpayer reporting standards with those for tax practitioners. “Any standard of behavior adopted,” the task force said, “should be properly coordinated with the traditional role of attorneys, accountants, and others who undertake to advise their clients under the law.”⁸⁵ To that end, it recommended three levels of penalties for return preparers under section 6694 corresponding to the three-tier penalty system faced by taxpayer-clients.⁸⁶ Also, the task force expressed a desire to end the anomalous situation in which a tax practitioner could advise a client, without sanction, to assert a reporting position that subjected the taxpayer-client to civil penalties.⁸⁷ Such a penalty, the task force recognized, “would, of course, need to be conditioned on culpability of the preparer for the taxpayer’s noncompliance.”⁸⁸

Despite efforts to converge the reporting standards for taxpayers and tax practitioners, the task force accomplished more in the way of divergence. In particular, it proposed more lenient standards of care for practitioners than for taxpayers, subjecting practitioners to a negligence standard while holding taxpayers’ feet to the fiery objective standard. The task force required practitioners only to exercise reasonable care in determining that the taxpayer-client’s return complied with the taxpayer standard of behavior, which was grounded in the significantly more stringent standard of substantial authority. Thus, while the practitioner could absolve himself of wrongdoing by demonstrating reasonable care regarding the return, the taxpayer-client could be subject to penalty if she asserted a position, for example, without disclosure and relying on the practitioner’s advice that the position met the substantial authority standard. Similarly, a taxpayer-client who reported a position on the advice of a practitioner could face a penalty for taking that position if it was deemed nonlitigable, while the practitioner could be determined to have satisfied the low threshold of reasonable care and thus escape penalty.

The task force seemed to be saying that while the tax adviser served a vital role in the preparation and submission of accurate returns, ultimate responsibility rested with the taxpayer. That perspective conflicted with Treasury’s long-standing effort to place the onus on practitioners for accurate reporting, as well as with the joint

⁸¹*Id.*

⁸²Commentators also wondered, “If 45 percent, why not more likely than not?” “If a taxpayer after reasonable effort falsely believes that he has reported correct tax,” Calvin Johnson said, “he still will be penalized under the 45-percent weight standard if he fails it. The five-percent relaxation in chance of prevailing only rarely will make a difference. Why, then, not try to enforce correctness?” Indeed, as Johnson said, “Objective defenses do not have to be laxer standards.” Calvin Johnson, “‘True and Correct’: Standards for Tax Return Reporting,” *Tax Notes*, June 19, 1989, p. 1521.

⁸³Executive Task Force, *supra* note 2, chapter 8, at 42-43.

⁸⁴*Id.* at 44-45.

⁸⁵*Id.* at 10.

⁸⁶*Id.* at 46.

⁸⁷*See id.* at 26 (stating that because the task force considered disclosures “an integral part of the return” and the proposed taxpayer penalty “based on a minimum standard of acceptable taxpayer behavior,” “it would seem appropriate to provide a sanction for preparer conduct that places the taxpayer in a penalty condition”).

⁸⁸*Id.*

effort of Treasury and Congress to make practitioners co-stewards of accurate reporting and tax compliance.

Also, the task force visibly retreated from Treasury's 1986 proposed amendments to Circular 230. The 1986 proposal prohibited a practitioner from advising or recommending a reporting position or preparing or signing a tax return unless she could determine that a penalty would not apply. The task force proposed lowering perceptibly the practice standard under Circular 230, prohibiting a practitioner from advising a reporting position unless she could conclude that the position was either supported by substantial authority and did not otherwise require disclosure, or had a realistic possibility of success if challenged and the practitioner advised that disclosure was required. The same standard applied to preparing a tax return, but in the absence of a realistic possibility of success, the position had to be disclosed.⁸⁹ In other words, the task force recommended lowering the standard from more likely than not to realistic possibility of success, a decrease in probability or likelihood of success from 50 percent to 33 percent. And, as described above, the practitioner could escape penalty on an even lower showing of reasonable care, which dropped the probability threshold to no more than 20 percent.

Further, the task force severed a tax practitioner's culpability for an inaccurate return from that of her taxpayer-client. While its proposal confined the taxpayer to an objective standard, the task force recommended subjecting that taxpayer's adviser to a standard that considered only whether the adviser exercised reasonable care regarding her own behavior, not the taxpayer's.⁹⁰ Mere negligence under the task force recommendation, moreover, would not result in referral of the

practitioner to the IRS director of practice for violation of professional standards under Treasury Circular 230.⁹¹ However, mere negligence *could* result in a 20 percent penalty for the taxpayer under the task force's first-tier penalty.

V. Conclusion

Despite the task force's relaxed practice standards for practitioners, the IRS had not abandoned the idea of using practitioners to facilitate compliance. On the contrary, the IRS envisioned a cooperative effort involving taxpayers and practitioners to root out noncompliant behavior. For example, the task force recommended that the IRS publish a list of questionable positions that taxpayers had to disclose on their returns, a requirement that reflected a desire to include taxpayers and their advisers in identifying audit issues. Arguably, this effort struck a middle ground regarding the proper role for tax advisers in the tax system as taxpayer-advocate versus IRS agent. Slightly relaxing the rules applicable to practitioners may have been the IRS's way of deputizing practitioners without branding them government toadies. Without sufficiently serious prodding, however, practitioners would remain at best reluctant deputies, and at worst insubordinate lieutenants.

In the next installment of Policy and Practice: Tax Politics and a New Substantial Understatement Penalty.

⁹¹Some commentators endorsed the idea of heightened culpability before suspension or disbarment proceedings could commence. See, e.g., Johnson, *supra* note 82, at 1531 (supporting higher culpability requirements and calling suspension or disbarment "tantamount to loss of livelihood"); Karin M. Skadden, "CAG Considers Penalty Study, Resources, Filing Season," *Tax Notes*, Apr. 3, 1989, p. 11 (quoting Johnson as arguing that suspension or disbarment was "tantamount to capital punishment" for tax practitioners).

⁸⁹*Id.* at 46.

⁹⁰*Id.*