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The Need for Reform Under an Imperfect System

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I. Introduction

Civil tax penalties are an important tool for encouraging taxpayer compliance with tax laws. Tax penalties must be administered properly and penalties must be effective in order to encouraging compliance. However, despite this clear notion of encouraging compliance, many have argued the need for civil tax penalty reform. In 1954, the penalties were simple and few, with the Internal Revenue Code of 1954 only containing 13 penalties.\(^1\) The number of penalties grew to 25 in 1967 and in 1975, it was said that the sheer number of penalties were “mind-numbing.”\(^2\) At that time, there were 64 penalties counted.\(^3\) Enactments of new tax legislations from 1981 through 1986 added numerous penalties and modified existing penalties.\(^4\) By 1986, the constant increase in the number of tax penalties had become a serious problem. The Treasury Department reported that:

> The penalty provisions under existing law are overly complex and often result in inconsistent treatment of similar violations. Penalties have been added piecemeal to the Code as new filing and reporting requirements has been legislated. The inconsistencies in the present penalty structure undermine horizontal equity among taxpayers and make the penalty provisions difficult to administer.\(^5\)

Regardless of this report, the number of penalties continued to grow and by 1987, more than 150 penalties existed. Statistics show that the IRS asserted 15.4 million penalties totaling $1.3 billion in 1978 and asserted 27 million penalties totaling $14.0 billion by 1987.\(^6\) Over the years, penalties have been added to the Code and existing penalties have been modified without any integrated or coherent plan, allowing for an accumulation or “stacking” of several different penalties.\(^7\) Furthermore, many penalties have been added to the Code with several different standards of imposition and abatement.\(^8\) For example, one study of penalties indicated that there were thirteen standards incorporated in the civil tax penalty structure of the Code.\(^9\) With these many standards, it added complexity and confusion to an area where clarity was needed to encourage compliance.

Today, as the growth of tax penalties continue, specific issues need to be addressed in order to improve upon the civil tax penalty structure. Over the years, Congress has addressed issues and problems dealing with the civil tax penalty structure and has tried to find ways to improve upon the structure. Many have submitted reports and their findings, including recommendations on ways to improve upon a system that needs to be reformed.

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3. Id.
6. Id.
7. Id.
8. Id.
One recent report was submitted by the AICPA which addressed concerns about the current state of the civil tax penalty structure and the need for improvement. The report pointed to 12 specific issues that should be addressed under the current civil tax penalty structure. This paper is intended to expand on those 12 specific issues laid out by AICPA. This paper begins with a comprehensive historical analysis of the civil tax penalty structure. This paper then briefly discusses the common civil tax penalties under the current structure. This paper then focuses on the 12 specific issues presented in the AICPA report, providing a more in depth analysis and discussion on these issues.

II. Historical Analysis

Since the enactment of the first revenue acts, penalties were almost insignificant in tax administration. It was not until 1976 that Congress began to focus on penalties due to noncompliance within the income tax system. Over the years, most of the legislative and administrative activity with respect to penalties was centered on dealing with specific tax problems, which led to an increase in the number and harshness of penalties. In order to discuss and analyze penalties under the current tax structure, an understanding of IRS's current penalties and administration requires a historical perspective. A historical perspective provides a useful context for an understanding of the current-law penalty and interest regime. Though this analysis does not describe every change in the penalty provisions and penalty administration that has occurred over time, it is intended to capture the main components of those changes since 1954.

A. 1954

1. The Code

Civil tax penalties date as far back as the Civil War era. For instance, one of the earliest penalty provision enacted for an income tax was a criminal sanction designed to effectuate the collection of tax. It was not until 1918 that major civil tax penalties were imposed under the Revenue Act of 1918 (hereinafter the “1918 Act”). Under the 1918 Act, there were very few civil penalties in place and the Act included penalties for (1) failure to pay or collect taxes; (2) failure to make such a return or supply information; and (3) any willful attempt in any manner to defeat or evade the taxes. The major civil tax penalties under the 1918 Act included penalties of 5-percent for negligence and a 25-percent for a false or fraudulent return.

As the years past, the number of civil tax penalties continued to grow in number. The Internal Revenue Code of 1954 (hereinafter “1954 Code”) was the first comprehensive revision of the federal income tax system since its origin in 1913. The 1954 Code altered the organization of the income tax system and addressed many of the deficiencies that had plagued the income tax system for years, by consolidating and clarifying the existing provisions of the

14 Id.
15 Id.
1939 and 1953 Tax Codes. In 1954, the penalties were simple and few and the 1954 Code only included 13 penalties.\footnote{Task Force Report \textit{supra} note 11.} Some of the penalties under the 1954 Code included failure to file a return,\footnote{I.R.C. \S\S 6651 (1954) (The failure to pay penalty was enacted in the Revenue Code of 1928 and was later changed by the Revenue Act of 1936. The penalty was originally a flat 25\% of the tax but once the changes were made in 1936, the penalty changed to 5\% per month with a maximum of 25\%).} failure to pay estimated taxes,\footnote{I.R.C. \S\S 6654 \& \S 6655 (1954) (Penalties were provided for taxpayers who failed to comply with the estimated tax payments. However, after finding that it may be difficult to make accurate estimates during the year, the Revenue Act of 1943 provided an exception based on income of the taxpayer).} and failure to use the federal depository system.\footnote{I.R.C. \S\S 6656 \& \S 6656 (1954) (These penalties were imposed on a taxpayer who failed to deposit any amount of tax required to be paid to a depository. These penalties were considered time sensitive).} It also included penalties for negligence and fraud due to underpayments of tax as well as penalties for limited information reporting and failure to comply with its requirements.\footnote{I.R.C. \S 6652(a) – (b) (1954).} Even though the 1954 Code allowed the IRS to impose the penalties without first contacting the taxpayer, the penalty structure was easily understood by the taxpayers and the IRS due to little overlap among the penalties and understanding of the standards of behavior that was expected.\footnote{\textit{See supra} note 16.}

2. Administration in 1954

Since fewer penalties existed in 1954, the administration of penalties was a simple process.\footnote{Id. at 59.} The system was labor intensive, from receipt of returns to collection of delinquent accounts. No service centers or computer processing existed in 1954 and the taxpayer had to file his or her tax return with the District offices.\footnote{Id. In 1954, there were 1400 IRS offices nationwide.} These District offices were responsible for the assessment of penalties and the processing of returns. Under this process, penalties were assessed manually based on individual reviews of a taxpayer’s return. There were, however, issues that arose in 1954 from the use of this process. For example, due to the fact that a manual system was used, refunds took much longer, there was inconsistency in administration due to inconsistent determinations by employees in processing the returns, and limited resource to ensure adequate compliance.\footnote{Id. at 60.} The system relied heavily on paper returns, extracts of accounts, and correspondence, all of which had to be controlled.\footnote{Id.}

B. 1955 – 1974

1. Compliance Issues

Many of the changes to penalties and their administration between 1954 and the mid-1970s were due to compliance issues and/or concerns with computerization of IRS. The issues relating to compliance were due to either a violation of existing law for which the remedy seemed inadequate or the addition of a new statutory rule that required the support of a sanction or penalty.\footnote{Id.} The primary changes to penalties during this period reflected a mixture of approaches...
in four areas: international transactions, the underreporting of income, exempt organizations, and employee benefits. A brief analysis of these four important areas is needed to show major changes in the penalties enacted and their administrations during this time.

a. International Transactions

In 1961, President John F. Kennedy appealed to Congress for a change in the tax treatment of foreign income due to changes in economic conditions at home or abroad. President Kennedy proposed a restructuring of the foreign tax rules and new reporting requirements noting that:

“Recently more and more enterprises organized abroad by American firms have arranged their corporate structures -- aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices which maximize the accumulation of profits in the tax haven -- so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities completely both home and abroad.”

Taking the President’s message in consideration, action was taken in support of new reporting requirements. Under the Revenue Act of 1962, penalties were enacted for failure to file information returns with respect to foreign trusts, corporations and partnerships.

b. Underreporting of Income

For years, the underreporting of income from interest and dividends remained a constant concern at the IRS. Statistics indicated that a substantial percentage of dividends paid out by corporations in the United States were not declared as taxable income. For example, the net cash dividends paid out by corporations in 1947 were about $6.5 billion, while the net cash dividend reported by individuals and fiduciaries in that year were only $5.3 billion, a difference of $1.1 billion. Since there was a large increase in dividend payment after 1947, statistical predications pointed to the net cash dividend amount unreported could equal $1 billion annually or more in the future.

President Kennedy called for a repeal of the dividend credit and exclusion rules, proposing a 20% withholding penalty on interest and dividend payments. However, instead of the proposed 20% withholding, the proposed withholding percentage was substituted by a provision for

27 Id.
30 House Ways and Means Committee Report No. 2319 (June 23, 1950).
31 Id. (Only $300 million of the $1.1 billion outstanding accounted for dividends paid to tax-exempt institutions and to individuals with incomes below the filing requirement).
32 Id.
33 See supra note 28.
expanded information reporting on interest and dividends. As a result, individuals would be required to use a taxpayer identification number and payors were required to file copies of information returns with the IRS.\textsuperscript{34} Due to these changes, a penalty was enacted for $10 for each failure to provide a correct number on a return or to an employer or any other covered payors.\textsuperscript{35} Also, the penalty for each failure to file a required statement was amended to $10 for each failure, subject to a $25,000 per year maximum.\textsuperscript{36}

c. Exempt Organizations

There are different types of exempt organizations described in the tax code. Exempt organizations include private foundations, benefit trusts, and public charities, and many others. These organizations receive a benefit based on the purpose for which they are organized and operated. Penalties for exempt organizations are administered to encourage organizations to operate in an exempt manner and to correctly and completely report on their operations. Since exempt organizations are absent tax liability, there was a concern as to the management of the organization’s funds and the prevention of financial abuse.\textsuperscript{37}

The only penalty available during this period for financial abuse of the exemption by public charities was the termination of exempt status.\textsuperscript{38} On the other hand, the penalties available for financial abuses for private foundations were subject to special rules. For violations of the requirements of private foundations, a specific set of civil penalties were enacted under the Tax Reform Act of 1969.\textsuperscript{39} A series of excise taxes, operating as civil penalties, were established to govern the way foundations handled their resources and dealt with insiders and other persons.\textsuperscript{40} Under this tax construct, taxes were imposed based on conduct.\textsuperscript{41} An initial tax was imposed on the impermissible conduct and then a second level tax of intentionally severe magnitude was imposed.\textsuperscript{42} However, the tax imposed on foundations managers who participated in the noncompliant acts was similar but much smaller.\textsuperscript{43} Under the Tax Reform Act of 1969, the following provisions were enacted\textsuperscript{44}:

1. \textit{Section 4941}. Self-dealing. Direct or indirect transactions in which the foundation assets are transferred to or used for the benefit of disqualified persons.

2. \textit{Section 4942}. Insufficient distribution. Distributions that fail to satisfy the Code’s minimum requirements for distribution for charitable purposes.

\textsuperscript{34} See Senate Report No. 1881 (1962).
\textsuperscript{35} P.L. 87-397, 75 Stat 828 (1961).
\textsuperscript{36} Id.
\textsuperscript{37} Task Force Report, \textit{supra} note 11 at 240.
\textsuperscript{38} Id. at 241.
\textsuperscript{39} Id.
\textsuperscript{40} Id.
\textsuperscript{41} Id.
\textsuperscript{42} Id. (The initial taxes for the organizations or self-dealers vary between 5 and 15 percent of the amount involved. The second level taxes vary between 100 and 200 percent).
\textsuperscript{43} Id.
\textsuperscript{44} Id. \textit{See} pages 241-242 for an expanded discussion and for a detailed description for penalties enacted for benefits trusts and political/lobbying activities.
3. **Section 4943.** Excess business holdings. Generally, ownership by a foundation and disqualified persons of more than 20% of an enterprise.

4. **Section 4944.** Jeopardy investment. Nonprogram-related investments that are made without due regard to prudent investment standards.

5. **Section 4945.** Taxable expenditures. Outlays of funds that is non-charitable or otherwise contrary to specified statutory purposes.

6. **Section 6684.** Acts that are willful and flagrant or willful and repetitive. Subjects the foundation to a tax equal in amount to the value of its entire assets unless it is able to establish from its records the aggregate tax benefit it has derived from its status.

7. **Section 6684** adds a penalty equal to the chapter 42 status subject to a chapter 42 tax or where the acts are both willful and flagrant.

d. **Employee Plans/Benefits**

A major piece federal legislation that was enacted in 1974 was the Employee Retirement Security Act of 1974 (“hereinafter ERISA”). ERISA strengthened the existing law that aimed at protecting employees’ pension benefits, setting minimum standards of conduct in pension law and providing for penalties to elicit appropriate behavior.\(^{45}\) Prior to the enactment of ERISA, the Committee on Corporate Pension Funds identified a number of abuses in the financial management of pension funds and the discriminatory treatment of beneficiaries.\(^{46}\) Though immediate legislation did not result from these findings, these findings were considered in hearings conducted by the House Committee on Education and Labor in 1971 that later led to the enactment of ERISA in 1974. To ensure participants would be able to understand both the terms of their plans and to enforce rights under ERISA, reporting and disclosure rules were added to the Code, some of which operated as sanctions or penalties.

2. **Administration of Penalties**

During this period, there were two principal developments in penalty administration, the first being the modernization of IRS’s processing capabilities and second being the increasing centralization and specialization of the IRS staff.\(^{47}\) The use of new technology and emphasis on efficient use of resources were ultimately the driving forces during this period.

As early as 1943, the IRS began to recognize the potential benefits of centralized modern data processing. However, the first step to modern data processing was not taken until 1948 when the IRS introduced the punch card equipment to process notices.\(^{48}\) In 1955, modernization and centralization took another step forward when the punch card technology was used to process

\(^{45}\) Id. at 214.

\(^{46}\) See President’s Committee on Corporate Pension Funds and Other Private Retirement Welfare Programs, “Public Policy and Private Pension Programs: A Report to the President on Private Employee Retirement Plans” (Jan. 1965).

\(^{47}\) Task Force Report *supra* note 11 at 62.

\(^{48}\) Id.
returns in only 10 districts.\textsuperscript{49} Between 1956 and 1957, more centers were established to serve larger areas to aid in the processing of returns using the punch card technology. The benefit of the punch card technology was that it enabled a larger number of returns to be processed by a smaller number of people and this allowed savings in processing costs.\textsuperscript{50} As a result of the success of the punch card technology, the system was implemented nationwide over the next four years.\textsuperscript{51}

With the success and efficiency of the punch card technology, the IRS began to recognize that computerized processing was needed. In 1959, the IRS prepared a plan for the development of computerized data processing and Congress approved the plan in 1959.\textsuperscript{52} The plan objectives were:\textsuperscript{53}

1. To provide the capability for a systematic uniform nationwide check on delinquent taxpayers.

2. To facilitate the mathematical verification of tax returns.

3. To check for unpaid taxes or duplicate claims for refunds prior to issuing refund checks.

4. To match data provided on information documents with corresponding data reported on tax returns.

5. To enable the Service to determine the taxpayers current tax status at any time.

6. To classify returns for audit.

7. To develop information needed for statistics of income and magnetic media reporting.

In addition the computerized system, it was determined that an adoption of a numeric account system for each taxpayer was needed.\textsuperscript{54} Therefore, in 1961, legislation was passed requiring each individual taxpayer to use a Social Security number as a taxpayer identification number and business taxpayers to use a number assigned by the IRS.\textsuperscript{55} The rationale was that the use of account numbers would improve the efficiency of the tax system. The use of account numbers with the computerized processing would allow the IRS to maintain a single file containing information relative to all tax transactions involving an individual taxpayer including references with whom a taxpayer is involved from a tax standpoint, details as to current and past income and deductions information, information reporting on withholdings, dividends, interest, etc., and tax balances, payments, and estimated payments and withholdings.\textsuperscript{56} The use of account numbers

\textsuperscript{49} Id.
\textsuperscript{50} Id.
\textsuperscript{51} Id.
\textsuperscript{52} Id. at 64.
\textsuperscript{53} Id.
\textsuperscript{54} See Senate Finance Committee Report No. 1102 (Sept. 21, 1961).
\textsuperscript{55} P.L. 87-397, 75 Stat 828 (1961).
\textsuperscript{56} See supra note 46.
would also allow the IRS to detect cases where a taxpayer failed to file a return, mathematically verify the amount of tax owed or refundable to the taxpayer, improve on the audit selection process, and consolidate financial transactions with taxpayers.\textsuperscript{57}

With Congress’ approval of the plan and the legislation passed requiring taxpayer identification numbers for the numeric account system, the IRS established the first master file system – the business master file system (BMF) – in 1962 at NCC.\textsuperscript{58} The computerized processing of returns, however, did not begin until 1963 and the BMF processing did not become operational nationwide until 1965.\textsuperscript{59} While this system continued to expand nationwide, IRS implemented the individual master file system (IMF) in 1967. However, the IRS faced major problems as the processing was centralized across the region. The centralization caused retrieval of archived documents and transition to the new system to be difficult, leading to increased taxpayer correspondence requesting adjustment or correction of accounts.\textsuperscript{60} Accordingly, accessibility of taxpayer data under the new system became a major issue.

With this new computerized system, compliance programs became much easier and cheaper to run and the IRS began to use service centers as a compliance tool.\textsuperscript{61} By 1964, the IRS had over 1400 offices assisting taxpayers to ensure compliance and fully implemented a year-round assistance program at the service centers by 1965.\textsuperscript{62} To eliminate errors and maintain efficiency within the system, the IRS implemented other programs. Due to increased responsibility at service centers, including billing and account maintenance, taxpayers were not able to resolve their problems face to face. To alleviate this problem, the IRS instituted the account referral system in 1987 to provide explanations and feedbacks to taxpayers.\textsuperscript{63} This program was established nationwide in 1974.

C. 1975 – 1988

Prior to 1976, the statutory focus on compliance problems had been in relatively narrow areas: international transactions, exempt organizations, information reporting, and employee plans. However, beginning in 1976, broader compliance issues were attacked legislatively, and the pace of tax legislation picked up considerably.\textsuperscript{64} The first major legislation enacted in 1976 was the Tax Reform Act of 1976 (hereinafter “1976 Act”). The 1976 Act focused on two specific areas that proved to be of long-term importance to the study of penalties: the rules governing preparers and tax shelters.\textsuperscript{65}

\begin{footnotesize}
\textsuperscript{57} Id.
\textsuperscript{58} Task Force Report \textit{supra} note 11 at 65.
\textsuperscript{59} Id.
\textsuperscript{60} Id. at 66.
\textsuperscript{61} Id.
\textsuperscript{62} Id.
\textsuperscript{63} Id.
\textsuperscript{64} Id. at 69.
\textsuperscript{65} Id.
\end{footnotesize}
1. Preparer Penalties

Upon a review of preparer activities from 1967 through 1987, the IRS determined that a substantial number of taxpayers relied upon the assistance of paid preparers, many of whom were engaging in abusive practices.\(^6^6\) It was estimated that one-half of all individual taxpayers who filed returns had sought some professional advice, for which a fee was paid, in connection with the preparation of a tax return.\(^6^7\) The only penalty that existed at that time against a preparer was criminal sanctions against one that willfully aided or assisted in the preparation of a tax return.\(^6^8\) The penalty assessed a fine of up to $5,000 or jail sentence of no more than three years.\(^6^9\) Due to the increasing number of paid preparers and limited penalties in that area, the IRS, Congress and many tax professionals concluded that rules and regulations were needed to deal effectively with preparers who were abusing the tax system and the taxpaying public. Therefore, the 1976 Act was enacted.

The 1976 Act imposed penalties on preparers that engaged in certain types of conduct. The 1976 Act added or amended many provisions dealing with regulating paid preparers, including the following:\(7^0\)

1. **Section 6107.** Required a copy of a return to be provided to the taxpayer, and the preparer must also retain a copy.

2. **Section 6109.** Required the preparer to enter his/her taxpayer identification number on the return.

3. **Section 6694 and Section 6695.** Civil penalties for understatement of taxpayer’s liability by preparers and other assessable penalties applicable to preparers.

Since IRS began assessing the preparer penalties in 1977, it proved to be a valuable tool and the penalties remained unchanged through 1988.

2. Tax Shelter Penalties

During this period, the use a tax-advantaged strategies and abusive schemes was a widespread problem. There was an increase in tax shelters in the 1970s and 1980s and many of the tax shelters were aimed at high-tax bracket individuals.\(^7^1\) Congress recognized that tax shelters continued to be a lingering problem and enacted various forms of legislation to combat the tax shelters.

The first comprehensive action taken to combat tax shelters came in the Tax Reform Act of 1976. Under the 1976 Act, new concepts dealing with tax shelters were added into the Code,

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\(^6^6\) Commissioner’s Annual Report to Congress (1972).
\(^6^7\) Id.
\(^6^8\) I.R.C. §7206 (1975).
\(^6^9\) Id.
\(^7^1\) Department of the Treasury, “The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals,” 81 (July 1, 1999).
which included a minimum tax and “at-risk” rules. The “at-risk” rules were later extended by
1978 (hereinafter the “1978 Act”) tightened the “at risk” rules enacted in 1976, made procedural
changes for partnerships, and modified the minimum tax provisions. The Economic Recovery
Tax Act of 1981 (hereinafter “ERTA”) extended the at-risk rules still further to the investment
tax credit, strengthened rules regarding tax straddles, imposed a new penalty for valuation
overstatements, and increased both the penalty for negligence and the interest rates that apply to
tax deficiencies.

Following the enactment of EFTA, tax shelters still continued to be a widespread problem. As of
September 30, 1981, the IRS found that there were 248,828 returns containing tax shelter issues
in the examination process, representing an increase of 74,584 returns over the prior fiscal year. Congress concluded that the penalty provisions of prior law were ineffective to deal with the
growing phenomenon of abusive tax shelters and abusive tax shelters must be attacked at their source. Therefore, in 1982, Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982 (hereinafter “TEFRA”).

TEFRA was the most important piece of legislation concerning penalties since the Revenue Act
of 1918 and made a number of contributions to the battle against tax shelters. First, it replaced
the minimum tax enacted in 1969 with an alternative minimum tax. The legislation also
provided for penalties for substantial understatements of income tax and imposed harsher rules
for tax shelters and for knowingly aiding third parties in understating income tax. TEFRA also
authorized the imposition of heavy penalties on promoters for organizing or selling abusive tax
shelters. Finally, in order to aid the IRS in attacking large tax shelters, centralized procedures
for audits and litigation were implemented so that the various procedural rules relating to such
audits and litigation.

Of all the penalties under TEFRA, the single most important and most publicly discussed was the
substantial understatement penalty. Under its terms, a taxpayer whose return was examined
could be subject to a penalty of 10 percent of any understatement which was the result of an
issue not disclosed on the return if the taxpayer did not have substantial authority for the position
taken. This penalty imposed a different standard of conduct than the standard underlying the
negligence and fraud penalties. It was not as dependent on the acts or omissions of the taxpayer
but, instead, on the strength of the position reported on the return and whether the position was
disclosed. With tax shelters, in addition to the substantial authority standard, a second

72 See supra note 70.
   Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility
77 Id.
78 Id.
79 Id.
80 Id.
81 Task Force Report supra note 11 at 78.
82 Id.
requirement was imposed that the taxpayer reasonably believed that the tax treatment was “more likely than not” the proper treatment. The penalty could be waived on a showing by a taxpayer of a reasonable cause for the understatement and that the taxpayer acted in good faith. The substantial understatement penalty rate was later raised in 1986 from 10 percent to 25 percent.

After TEFRA, Congress enacted the Deficit Reduction Tax Act of 1984 (hereinafter the "1984 Act"). The 1984 Act continued to add compliance provisions targeting tax shelters. The 1984 Act provided for registration of tax shelters with the IRS and maintenance of a list of investors. Prior to the 1984 Act, there was no requirement that tax shelters register with the IRS. As a result, the IRS lacked complete and systematic information on which to base its decisions about which shelters should be audited. The registration requirements enabled the IRS to prescreen shelters and take appropriate action under the injunction statute enacted in TEFRA.

The 1984 Act also imposed penalties for failure to comply with the registration requirements. A penalty was in place for failure to furnish information regarding, or to timely register, tax shelters, or filing false or incomplete information. This penalty was modified by the Tax Reform Act of 1986 (hereinafter the “1986 Act”). There was also a penalty for failure to furnish a tax shelter identification number and the penalty was increased by the 1986 Act. There was also a penalty for the failure to maintain lists of investors in potentially abusive shelters and this penalty was also modified by the 1986 Act. The 1984 Act raised the penalty for promotion of an abusive tax shelter and increased the rate of interest for any underpayment which was considered a “tax motivated transaction.” Prior to the 1984 Act, Congress enacted the new penalty for promotion of an abusive tax shelter.

3. Administration Changes in 1980s

While the IRS implemented a computerized processing system in 1961, it was recognized that it had many deficiencies including hardware issues, problems in controlling workflow and increase in the amount of paper used. Upon becoming aware of these problems in late 1968, the IRS began to plan for changes to the system. The IRS sought to improve the system by decentralizing taxpayer accounts and allowing each service center to have access to the taxpayer.

83 Id.
84 Id.
87 Id.
89 See supra note 81.
90 See supra note 86.
91 Id.
92 Prior to enactment of this penalty, the Code contained no penalty provisions specifically directed toward promoters of abusive tax shelters and other abusive tax avoidance schemes. In appropriate cases, the promoter might be subject to civil or criminal penalties for false or fraudulent return preparation or willful attempts to evade tax. See S. Rep. No. 97-494, at 266 & 268 (1982).
93 Task Force Report, supra note 11 at 85.
information. This access was not allowed under the previous system. The new plan known as the Tax Administration System was approved in 1977 but was deferred from further development due to concerns about taxpayer privacy.\textsuperscript{94} As a result, the IRS continued to use the computerized system set in place in 1962. The IRS continued to improve upon this system by implementing programs such as the Equipment Replacement Program, the Automated Examination System and the Automated Collection System.\textsuperscript{95}

D. 1989

Over the years, the IRS continued to find ways to improve upon the tax system. In 1989, the IRS conducted a multi-year study of the then-current penalty provisions.\textsuperscript{96} The report set forth a number of specific recommendations to Congress for consideration. Upon issuing a report on its findings in the study, Congress undertook a major review of the penalty structure under the then-existing tax system. Congress was concerned about the rapid growth in the number of penalty provisions and penalty assessments. Upon reviewing the report, Congress enacted the Improved Penalty Administration and Compliance Tax Act (IMPACT), which was incorporated into the Omnibus Budget Reconciliation Act of 1989.\textsuperscript{97} IMPACT is one of the most important pieces of legislations enacted in the tax system and its importance lends itself to a greater depth of discussion in this paper.

The purpose of the IMPACT was to provide a fairer, more effective and rational civil tax penalty system for all taxpayers.\textsuperscript{98} The IMPACT legislation completely revamped various penalty provisions relating to the accuracy of tax returns, and established a new penalty “structure that operates to eliminate any stacking of the penalties.”\textsuperscript{99} This legislation made principal changes in the following categories: document and information return penalties; preparer, promoter, and frivolous return penalties; accuracy-related penalties; and penalties for failures to file or pay. Along with the changes to these penalty provisions, IMPACT also provided general administrative recommendations for improving the tax penalty system.

1. Document and Information Return Penalties

With respect to document and information reporting penalties, the IMPACT legislation was to improve the penalties applicable to information reporting by treating those who attempt to comply with the law less harshly than those who do not.\textsuperscript{100} Prior to the enactment of IMPACT, the penalty provisions existing under the present law for document and information returns stated that:

“Any person that fails to file an information return with the Internal Revenue Service on or before the prescribed filing date is

\begin{footnotesize}
\begin{itemize}
\item\textsuperscript{94} Id. at 86.
\item\textsuperscript{95} Id.
\item\textsuperscript{96} Id.
\item\textsuperscript{98} Id.
\item\textsuperscript{99} Id.
\item\textsuperscript{100} Id.
\end{itemize}
\end{footnotesize}
subject to a $50 penalty for each failure, with a maximum penalty of $100,000 per calendar year. In addition, any person that fails to provide a copy of an information return (a “payee statement”) to a taxpayer on or before the prescribed due date is subject to a penalty of $50 for each failure, with a maximum penalty of $100,000 per calendar year. If a person fails to include all of the information required to be shown on an information return or a payee statement or includes incorrect information, then a penalty of $5 may be imposed with respect to each such failure, with a maximum penalty of $20,000 per calendar year. Stricter penalty provisions apply in the case of interest and dividend returns and in the case of intentional failures to comply with the information return requirements. A penalty may also be imposed for each failure to include a correct taxpayer identification number on a return or statement and for each failure to furnish a correct taxpayer identification number to another person. The amount of the penalty that may be imposed is either $5 or $50 for each failure, depending on the nature of the failure.”

a. Failure to File Correct Information Returns

The IMPACT legislation modified the penalty for failure to file correct information returns in order to calibrate the penalty on the basis of when, if at all, the correct information return was filed. This modification was made to encourage persons to file correct information returns even though such returns are filed after the prescribed filing date. The new penalty provisions under IMPACT for failure to file correct information returns provided that:

“This person that fails to file a correct information return with the Internal Revenue Service on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, a correct information return is filed. If a person files a correct return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is $15 per return, with a maximum penalty of $75,000 per calendar year. If a person files a correct information return after the date that is 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is $30 per return, with a maximum penalty of $150,000 per calendar year. If a correct return is not filed on or before August 1 of any year, the amount of the penalty is $50 per return, with a maximum penalty of $250,000 per calendar year.”

IMPACT provided for an exception to the rule for failure to file correct information returns. Under IMPACT, there was a de minimis exception that applied to corrected returns on or before

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103 Id.
a particular date. Under the exception, if there was an incorrect information return but the incorrect information return was corrected on or before August 1, then the original return was treated as having been filed with all the correct information. However, the number of information returns qualifying for the exception was limited. Impact did not change the rules for failures due to intentional disregard of the filing requirement.

b. Failure to Furnish Correct Payee Statements

IMPACT imposed a penalty of $50 per statement with a maximum penalty of $100,000 per calendar year for failure to furnish a correct payee statement on or before the prescribed due date. IMPACT also imposed a penalty of $100 per statement or, if greater, 10 percent of the amount required to be shown on the statement, with no limitation on the maximum penalty per calendar year where the failure to furnish a correct payee statement to a taxpayer is due to intentional disregard of the requirement.

c. Failure to Comply with other Information Reporting Requirements

Under IMPACT, when a person fails to comply with the other information reporting requirements on or before the prescribed date, a penalty of $50 for each failure would be imposed. The maximum penalty for failure to comply with other information reporting requirements is $100,000 per calendar year.

d. Waiver, Definitions and Special Rules

IMPACT further provided for a waiver of information reporting penalties where it is shown that the failure to comply was due to reasonable cause and not to willful neglect. Reasonable cause, in this sense, would exist if there were significant mitigating factors present. IMPACT also repealed the penalty provisions dealing with special information reporting requirements that apply payments of interest and dividends and made those payments subject to the same rules as the other types of information returns. The information reporting provisions under IMPACT were applicable after December 31, 1989.

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104 Id.
105 The number of information returns that may qualify for this de minimis exception for any calendar year is limited to the greater of (1) 10 returns or (2) one-half of one percent of the total number of information returns that are required to be filed by the person during the calendar year.
106 See supra note 97.
107 Id.
108 Id.
109 Id. The other information reporting requirements include any requirement to include a correct taxpayer identification number on a return or statement and any requirement to furnish a correct taxpayer identification number to another person.
110 Id.
111 Id.
112 Id.
2. Preparer, Promoter, and Frivolous Return Penalties

IMPACT amended the penalty provisions for return preparers. Prior to IMPACT, an income tax preparer was only subject to a penalty of $100 for understatements or claim for refund due to the preparer’s negligent or intentional disregard of rules and regulations, and a $500 penalty if it was due to willful attempt. Additionally, there was a $25 penalty for each failure to (1) furnish a copy of a return or claim for refund to the taxpayer; (2) sign the return or claim for refund; or (3) furnish his or her identifying number. Under IMPACT, a $250 penalty was imposed if any part of an understatement of tax on a return or claim for refund is attributable to a position for which there was not a realistic possibility of being sustained on its merits. This also applied if any person who is an income tax return preparer with respect to such return or claim for refund knew (or reasonably should have known) of such position. Where there was willful attempt or any reckless or intentional disregard to income tax law by a preparer, IMPACT increased the penalty to $1,000.

With regards to penalties for abusive tax shelters, the penalty was equal to the greater of $1,000 or 20% of the gross income derived. This penalty applied to persons who organized, assisted in the organization of, or participated in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement. Under IMPACT, the amount of the penalty imposed for promoting abusive tax shelters equaled the lesser of $1,000 or 100 percent of the gross receipts derived or to be derived by the person from such activity. For the aiding and abetting the understatement of tax liability, a penalty of $1,000 for each return or document was imposed. The penalty applied in certain cases where the person aided, assisted in, procured, or advised with respect to the preparation or presentation of any portion of a return or other document under the tax laws.

Any person who filed a frivolous income tax return was subject to a penalty of $500. However, this penalty was increased under IMPACT from $500 per return to $1,000 per return. IMPACT also amended the provisions for sanctions and costs awarded by the courts. Before IMPACT, the Court could award damages not to exceed $5,000 in instances where it appears to the Tax Court that (1) proceedings before it have been instituted or maintained primarily for delay, (2) the taxpayer’s position is frivolous, or (3) the taxpayer has unreasonably failed to pursue administrative remedies. However, under IMPACT, the penalty was increased and the Tax Court could award damages not to exceed $25,000. Additionally, IMPACT authorized the Tax Court to require any attorney or other person permitted to practice before the Court to

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113 Id.
114 Id.
115 Id.
116 Id.
117 Id.
118 Id. It is unclear under present law whether the term "activity" refers to each sale of an interest in a tax shelter or whether the term activity refers to the overall activity of promoting an abusive tax shelter.
119 Id. In calculating the amount of the penalty, the organization of an entity, plan or arrangement and the sale of each interest in an entity, plan, or arrangement constitutes a separate activity.
120 Id.
121 Id.
122 Id.
123 Id.
pay excess costs, expenses, and attorney's fees that are incurred because the attorney or other person unreasonably and vexatiously multiplied any proceeding before the Court.\textsuperscript{124}

3. Accuracy-Related Penalties

IMPACT reorganized the accuracy penalties into a new structure that operated to eliminate any overlap of the penalties. These penalties related to five areas: (1) negligence; (2) any substantial understatement of income tax; (3) any substantial valuation overstatement; (4) any substantial overstatement of pension liabilities; and (5) any substantial estate of gift tax valuation understatement.

a. Negligent and Fraud Penalty

Prior to IMPACT, there was a 5 percent penalty imposed on the total amount of an underpayment of tax required to be shown on a return if it was due to negligence or disregard of rules or regulations.\textsuperscript{125} IMPACT amended this provision and only applied the penalty to the portion of the underpayment that was attributable to negligence rather than the underpayment of tax as a whole.\textsuperscript{126} If any part of an underpayment of tax was due to fraud, the penalty imposed was equal to 75 percent of the portion of the underpayment that was attributable to fraud. Under IMPACT, the 75 percent penalty was imposed on any part of the underpayment, not just the portion attributable to fraud.\textsuperscript{127}

b. Substantial Penalty

If a substantial understatement of tax existed, a penalty was imposed equal to 25 percent of the underpayment of the underpayment of tax attributable to the understatement.\textsuperscript{128} When trying to determine whether a substantial understatement existed, the amount of the understatement was reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return.\textsuperscript{129} However, when IMPACT was enacted, there were three major changes to the substantial penalty. First, the penalty rate was lowered to 20 percent.\textsuperscript{130} Second, it provided for the expansion of the list of authorities that taxpayers may rely upon.\textsuperscript{131} Third, it provided that the Internal Revenue Service

\textsuperscript{124} Id.
\textsuperscript{125} I.R.C. §6653 (1986).
\textsuperscript{126} See supra note 97.
\textsuperscript{127} Id.
\textsuperscript{128} I.R.C. §6661 (1986).
\textsuperscript{129} See supra note 97.
\textsuperscript{130} Id.
\textsuperscript{131} Id. The list of authorities would include proposed regulations, private letter ratings, technical advice memoranda, actions on decisions, general counsel memoranda, information or press releases, notices, and any other similar documents published by the Internal Revenue Service in the Internal Revenue Bulletin. In addition, the list of authorities is to include General Explanations of tax legislation prepared by the Joint Committee on Taxation (the `Blue Book').
to publish not less frequently than annually a list of positions for which the Internal Revenue Service believes there is no substantial authority.\textsuperscript{132}

c. Valuation Penalty

Where there was an underpayment of income tax by $1,000 or more as a result of a valuation overstatement, a penalty was imposed based on the amount of the underpayment that is attributable to the valuation overstatement.\textsuperscript{133} The valuation penalty varied between 10, 20 and 30 percent of the underpayment attributable to the valuation overstatement. It depended on the percentage by which the valuation claimed exceeds the correct valuation. IMPACT made five modifications to this penalty as follows:\textsuperscript{134}

1) It extended the penalty to all taxpayers.

2) A substantial valuation overstatement existed if the value or adjusted basis of any property claimed on a return is 200 percent or more of the correct value or adjusted basis.

3) The penalty was to apply only if the amount of the underpayment attributable to a valuation overstatement exceeds $5,000 ($10,000 in the case of most corporations).

4) The amount of the penalty for a substantial valuation overstatement was 20 percent of the amount of the underpayment if the value or adjusted basis claimed is 200 percent or more but less than 400 percent of the correct value or adjusted basis.

5) It provided that this penalty was doubled if the value or adjusted basis claimed is 400 percent or more of the correct value or adjusted basis. Also, it provided for similar modifications to the penalty for overstatements of pension liabilities and the penalty for estate or gift tax valuation understatements.

4. Delinquency Penalties

IMPACT law also modified the delinquency penalties which included penalties for failure to file and failure to make timely deposits. There was a 5 percent penalty of the net amount of tax due for each month of an unfiled return was imposed on a taxpayer who failed to file a tax return on a timely basis.\textsuperscript{135} IMPACT modified this provision by assessing a 15 percent penalty of the net amount of tax due for each month the return is not filed, up to a maximum of five months, or 75 percent. This change applies where there is a case of a fraudulent or intentional failure to file a return.\textsuperscript{136}

\textsuperscript{132} Id. The purpose of this list is to assist taxpayers in determining whether a position should be disclosed in order to avoid the substantial understatement penalty.

\textsuperscript{133} I.R.C. §6659 (1986).

\textsuperscript{134} See supra note 97.

\textsuperscript{135} Id.

\textsuperscript{136} Id.
For failure to make timely deposits, a penalty of 10 percent of the amount of the underpayment was imposed, unless there was a showing that the failure was due to reasonable cause and not willful neglect. IMPACT modified this penalty to where penalties were imposed based on the date that the failure was corrected. For instance, there is a 2 percent penalty of the underpayment if the failure is corrected on or before the date that is 5 days after the prescribed due date.\textsuperscript{137} Also, there is a 5 percent penalty of the underpayment amount if the failure is corrected after the date that is 5 days after the prescribed due date but on or before the date that is 15 days after the prescribed due date.\textsuperscript{138}

5. Administrative Recommendations

Not only did IMPACT amend the penalty provisions, it also provided administrative recommendations to the Internal Revenue Service. IMPACT laid out 3 sets of administrative recommendations to enhance the civil tax penalty system.

a. General Administrative Recommendations

IMPACT provided that\textsuperscript{139}:

a. The IRS develops a policy statement emphasizing that civil tax penalties exist for the purpose of encouraging voluntary compliance.

b. The IRS should develop a handbook on penalties for all employees. This handbook should be sufficiently detailed to serve as a practical guide for most issues of penalty administration.

c. The IRS should provide clear guidance to its employees on how to compute penalties. This guidance should be incorporated into the penalty handbook.

d. The IRS should revise existing training programs to reflect the purpose for penalties and their administration.

e. The IRS should examine its communications with taxpayers to determine whether these communications do the best possible job of explaining to taxpayers why they received the penalty and how they can avoid the penalty in the future. These communications include penalty notices and publications.

f. The IRS should finalize its review and analysis of the quality and clarity of machine-generated letters and notices used in the Adjustments and Correspondence Branches of the IRS service centers and report to Congress by July 1, 1990.

g. The IRS should consider ways to develop better information concerning the administration and effects of penalties. The IRS should develop a master file database.

\textsuperscript{137} Id.
\textsuperscript{138} Id.
\textsuperscript{139} Id.
to provide statistical information regarding the administration of penalties. The IRS should continuously review information for the purpose of suggesting changes in compliance programs, educational programs, penalty design and penalty administration.

h. In the application of penalties, the IRS should make a correct substantive decision in the first instance rather than mechanically assert penalties with the idea that they will be corrected later.

b. Information Reporting Penalties

IMPACT provided that140:

1. The IRS should adopt a clear policy of working with the third party payor community to assure accurate and timely filing of information, in a format that is usable by the IRS and the taxpayer without unduly burdening the third-party that is required to provide this information.

2. The IRS should maintain an ongoing effort to develop, monitor, and revise programs designed to assist taxpayers in complying with legal requirements and avoiding penalties. The IRS should develop publications for various businesses, exempt organizations, and governmental units enumerating all information reporting requirements, sanctions for noncompliance, whom to call with questions, and where to file. The IRS should also provide speakers on information reporting to industry meetings and programs.

3. The IRS should consider the creation of an advisory group comprised of representatives from the payor community and practitioners interested in the information reporting program that meets on a regular basis to discuss improvements to the system. This advisory group would be useful to discuss problems and the feasibility of complying with, or the economic impact of, rules and regulations affecting the reporting industry.

4. The Information Returns Master File (IRMF) should be managed under the jurisdiction of a single function within the IRS. This function should have responsibility not only for the magnetic media filing program and the processing of data to the IRMF, but also for penalty assertion and abatement programs in this area, processing paper documents, payor education programs, and examination and other compliance programs. This function should also have operational responsibility for the issuance of regulations and ruling.

5. Penalty case work in the information reporting area, including administrative appeals, should be centralized and the procedures for handling the abatement of information reporting penalties should be streamlined.

140 Id.
6. The IRS should better use its limited enforcement resources to ensure that taxpayers who continually fail to comply with the reporting requirements are identified and penalized, rather than focusing only on taxpayers who are working with the IRS in an attempt to comply with the law.

7. The IRS should provide to a taxpayer upon request, or to a financial institution with the taxpayer's authorization, within 30 days, a list of the names the IRS has (in its computer matching program file) under the taxpayer's identification number. This information could be used by the taxpayer to reconcile or determine the reason for any mismatches between the information the taxpayer has supplied a financial institution, the information the financial institution has supplied to the IRS, and the information the IRS has in its master file.

c. Preparer, Promoter, and Protester Penalties

IMPACT provided that

1. Disciplinary sanctions by the Director of Practice should not be viewed as an adjunct to the civil tax penalty system as it applies to tax return preparers. In matters involving non-willful conduct, the IRS should only refer cases to the Director of Practice in instances where the IRS can establish a pattern of failing to meet the required standards. An isolated instance in which a penalty may apply should not, in and of itself, require a referral unless willful conduct is involved.

2. The Department of the Treasury should issue regulations related to the section 6700 penalty for promoting abusive tax shelters and the section 6701 penalty for aiding and abetting understatement of tax liability to the extent these provisions may apply to activities which could be subject to the section 6694 and 6695 tax return preparer penalties. Guidance on these matters should be issued in a timely fashion.

3. The IRS should instruct its employees that they cannot threaten the use of preparer penalties during an examination, appeals conference, or other proceedings involving a tax advisor.

4. The Director of Practice should publish more information about the basis for being disciplined and warnings in appropriate cases. Questions and answers prepared in conjunction with input from practitioners would be helpful to the tax practitioner community.

E. 1990s

After IMPACT, there have been a number of legislative enactments has had an effect on the tax penalty system. Between 1990 through 1997, many of these legislative enactments had tightened

\[\text{141 Id.}\]
the accuracy penalties and modified the existing tax penalties. The most important legislations during this time are discussed below.

In 1990, Congress enacted the Omnibus Budget Reconciliation Act of 1990.\textsuperscript{142} This legislation modified the deposit rules and modified the accuracy-related penalty with respect to Code section 482 adjustments.\textsuperscript{143} Later, Congress enacted the Omnibus Budget Reconciliation Act of 1993.\textsuperscript{144} This legislation modified some of the penalty provisions. Under this Act, the accuracy penalty was modified by changing the standard for accuracy related penalties, changing the “not frivolous” disclosure standard to a “reasonable basis” standard.\textsuperscript{145} The standard was modified because it was viewed that the “not frivolous” standard “did not sufficiently discourage taxpayers and preparers from taking unreasonable return positions.”\textsuperscript{146} It was also modified due to the fact that as originally proposed, the heightened standard would have applied both to the accuracy penalties and the preparer penalty but, as enacted, applied only to the accuracy penalties.\textsuperscript{147}

One year later, Congress enacted the Uruguay Round Agreements Act of 1994.\textsuperscript{148} This legislation made an important modification to the accuracy-related penalty with respect to corporate tax shelters. Under this Act, the exception to the substantial understatement penalty for items for which the taxpayer had substantial authority and reasonably believed its position was more likely than not to prevail was eliminated.\textsuperscript{149} As a result of the modification, the penalty could be avoided only upon a showing of reasonable cause.\textsuperscript{150}

In 1996, the Taxpayer Bill of Rights 2 was enacted.\textsuperscript{151} The Taxpayer Bill of Rights 2 contained numerous provisions which were intended to provide increased protections of taxpayer rights in complying with the Internal Revenue Code and in dealing with the Internal Revenue Service.\textsuperscript{152} This legislation made a number of changes to the penalty provisions. One of the changes made by this legislation was the authority to waive the deposit penalty for first time depositors.\textsuperscript{153} Also, it provided that the deposit penalty could be abates for first time depositors if the deposit was inadvertently sent to the IRS rather than to the required government depository.\textsuperscript{154} Another penalty provision that was modified under the Taxpayer Bill of Rights 2 was the failure to pay penalty. Under the prior law, taxpayers who filed delinquent returns showing a balance due were assessed a failure to pay penalty from the due date of the return, whereas if the IRS filed a substitute return for non-filers, the penalty was assessed ten days after notice and demand for payment.\textsuperscript{155} Under the Taxpayer Bill of Rights 2, this inequity between voluntarily-filed

\textsuperscript{143} Id.
\textsuperscript{145} Id. \textit{See also} H.R. Rep. No. 111, 103rd Cong., 1st Sess. 754 (1993).
\textsuperscript{147} Id.
\textsuperscript{149} Id.
\textsuperscript{150} Id.
\textsuperscript{152} Id.
\textsuperscript{153} Id.
\textsuperscript{154} Id.
delinquent returns and substitute returns was rectified. The failure to pay penalty was applied to substitute returns in the same manner as for delinquent filers, that is, from the due date of the return. The time period permitted for payment upon notice and demand was extended and the change provided for new disclosure rules.\textsuperscript{156}

The Taxpayer Relief Act of 1997 was later enacted and made certain modifications to the penalty provisions.\textsuperscript{157} Under this legislation, modifications were made to the accuracy-related penalty and registration requirements in the context of corporate tax shelters. Particularly, the definition of a tax shelter was broadened from an arrangement having the evasion or avoidance of federal income tax as “the principal purpose” to one with evasion or avoidance as “a significant purpose.”\textsuperscript{158} Also, under this legislation, the reasonable basis exception was restricted and reasonable cause exception also was added for certain penalties.\textsuperscript{159}

A legislation that made major changes to penalty-related provisions was the IRS Restructuring and Reform Act of 1998.\textsuperscript{160} These provisional changes were made to further mitigate penalties in certain circumstances. For instance, the failure to pay penalty is mitigated during the period that an installment agreement is in effect between a taxpayer and the IRS, provided the tax return was timely filed. In this case, the penalty is reduced by one-half.\textsuperscript{161} Additionally, the deposit penalty was amended to eliminate the effect of cascading penalties.\textsuperscript{162} Also, this legislation provided that notices imposing a penalty must include certain information about the penalty and amended the burden of proof where imposition of a penalty was appropriate.\textsuperscript{163}

III. Current Tax Penalty Structure

Today, there are more than 150 tax penalties. Civil tax penalties found in the Code fall into six basic groups. However, for purposes of this paper, the discussion in this section will only address some of the common civil penalties asserted by the IRS.

a. Failure to File Penalty

The Internal Revenue Code imposes a delinquency penalty for failure to timely file a tax return.\textsuperscript{164} The penalty is equal to 5 percent of the net amount of tax due on the return for each month the return is delinquent, up to a maximum of 25 percent.\textsuperscript{165} Under section 6651, a minimum penalty equal to the lesser of $100 or 100 percent of the tax required to be shown on

\begin{enumerate}
\item See supra note 151.
\item Id.
\item Id. Prior to this Act, deposits of payroll taxes were allocated to the earliest period for which a deposit was due and, if a deposit was missed or was insufficient, later deposits were first applied to satisfy shortfalls for earlier periods. Cascading penalties would result as payments that would otherwise be sufficient to satisfy current liabilities were applied to earlier shortfalls.
\item Id.
\item Id. I.R.C. §6651(a)(1). (A taxpayer seeking to avoid the failure to file penalty must establish the existence of reasonable cause and that the failure to file was not due to willful neglect).
\item Id.
\end{enumerate}
the return will be imposed if the return is not filed within 60 days of the due date.\textsuperscript{166} The IRS may assess the penalty based upon the tax shown on the return without first issuing a Notice of Deficiency. However, if the IRS asserts the penalty based on an additional deficiency in tax, it must issue a Notice of Deficiency before the penalty may be assessed.\textsuperscript{167} Where the IRS determines that a failure to file was due to fraud, the failure to file penalty is increased from 5 percent per month to 15 percent per month, up to a maximum of 75 percent of the tax due.\textsuperscript{168}

b. Failure to Pay Penalty

There is a delinquency penalty imposed for failure to pay tax shown to be due on a return.\textsuperscript{169} The failure to pay tax penalty is equal to $\frac{1}{2}$ of 1 percent of the tax per month, up to a maximum of 25 percent. For any month in which the failure to file and failure to pay penalties both apply, the amount of the failure to pay penalty reduces the amount of the failure to file penalty.\textsuperscript{170} The Code also imposes a delinquency penalty for failure to pay tax on tax required to be shown on a return (deficiency/after audit) which is not paid within 21 days after notice and demand for payment (10 days if the amount is $100,000 or more).\textsuperscript{171}

c. Failure to Timely Deposit Penalty

Under section 6656, the Code imposes a time sensitive failure to deposit penalty. The penalty ranges from 2 percent to 10 percent based on days elapsed after the due date. A 15 percent penalty rate may apply if payment is not made subsequent to notice and demand.

d. Accuracy-related Penalty

The accuracy-related penalty only applies where a return is filed with the IRS and the penalty does not apply when the IRS prepares substitute returns.\textsuperscript{172} The accuracy-related penalty includes negligence, a substantial understatement of tax and a substantial valuation misstatement. The accuracy-related penalty is 20% of the amount of the underpayment of tax that is attributable to negligence or disregard of the rules and regulations. If more than one type of misconduct exists, the penalty is still only 20%. However, if there is a gross valuation misstatement, the penalty may double to 40%.

e. Fraud Penalty

The civil fraud penalty is equal to 75 percent of the underpayment attributable to fraud.\textsuperscript{173} When applying this penalty, it is presumed that the entire underpayment is attributable to fraud unless the taxpayer can establish otherwise by a preponderance of the evidence.\textsuperscript{174} Also, the IRS cannot

\begin{footnotesize}
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\item\textsuperscript{166} Id.
\item\textsuperscript{167} I.R.C. § 6665(b)(1).
\item\textsuperscript{168} I.R.C. § 6651(f).
\item\textsuperscript{169} I.R.C. §6651(a)(2).
\item\textsuperscript{170} Id.
\item\textsuperscript{171} I.R.C. §6651(A)(3).
\item\textsuperscript{172} I.R.C. §6662.
\item\textsuperscript{173} I.R.C. §6663(a).
\item\textsuperscript{174} I.R.C. §6663(b).
\end{itemize}
\end{footnotesize}
impose the civil fraud penalty unless a return has been filed.\textsuperscript{175} However, as discussed above, the fraudulent failure to file penalty may be imposed if no return is filed.\textsuperscript{176}

IV. 12 Issues with Civil Tax Penalties under the Current Tax Structure
A. Shortcomings in Current Penalty Provisions
1. Voluntary Compliance

According to its mission statement, the purpose of the IRS is to collect the proper amount of tax revenues at the least cost to the public, and in a manner that warrants the highest degree of public confidence in our integrity, efficiency and fairness.\textsuperscript{177} To achieve that purpose, the IRS’s mission is to encourage and achieve the highest possible degree of voluntary compliance in accordance with the tax law and regulations.\textsuperscript{178} Due to reliance on this concept of voluntary compliance in the tax system, penalties constitute an important tool for the IRS to encourage voluntary compliance. In fact, the IRS believes that penalties are positively related to the accomplishment of IRS's mission only if they operate to encourage voluntary compliance.\textsuperscript{179} Also, the IRS believes that penalties can and should be evaluated solely on the basis of whether they do the best possible job of encouraging compliant conduct.\textsuperscript{180} Therefore, the core goal of penalties is to encourage compliance.

In order to determine how well a penalty works, four criteria were developed: fairness, comprehensibility, administrability and effectiveness.\textsuperscript{181} Since our system relies on voluntariness of compliance, fairness becomes an important factor. When analyzing fairness with respect to penalties, fairness encompasses culpability, equity, and severity.\textsuperscript{182} The culpability concept addresses the state of mind of the taxpayer. A penalty should be rationally related to the culpability of the taxpayer who is penalized and only conduct that is noncompliant should be penalized.\textsuperscript{183} The quality of the taxpayer’s intent in not complying should be weighed

\textsuperscript{175} I.R.C. §6664(b).
\textsuperscript{176} See supra note 168.
\textsuperscript{177} Task Force Report, supra note 11 at 34.
\textsuperscript{178} Id.
\textsuperscript{179} Id.
\textsuperscript{180} Id.
\textsuperscript{181} Id. See also Booz, Allen & Hamilton, Inc., Management Consultants, Results of Focus Group Sessions on Civil Penalty Provisions of The Internal Revenue Code (July 1988).
\textsuperscript{182} Id.
\textsuperscript{183} Executive Task Force for the Commissioner's Penalty Study, Internal Revenue Service Discussion Draft, A Philosophy of Civil Tax Penalties, 10 (June 8, 1988).
with general and specific deterrence objectives in determining whether a penalty should be imposed.\textsuperscript{184} Equity addresses the fact that a penalty should treated similarly situated taxpayers alike.\textsuperscript{185} Severity addresses that a penalty should be severe enough to accomplish the goal without being overly burdensome.\textsuperscript{186}

Comprehensibility contributes to all of the voluntary compliance purposes of penalties. To encourage voluntary compliance, penalties need to be both understandable and understood by a variety of taxpayers.\textsuperscript{187} Comprehensibility may mean different things for different groupings of taxpayers i.e., it may mean one thing to a professional tax practitioner but mean something else to an average citizen.\textsuperscript{188} Comprehensibility may deal with the standard of behavior expected of a taxpayer or the rules governing the imposition and computation of the penalty.\textsuperscript{189} As comprehensibility of standards and penalties is important on the administration of penalties, the optimum goal is to achieve simple and understandable rules that everyone, including the average citizen, is able to follow.\textsuperscript{190}

Administrability requires that each penalty be designed to maximize the certainty that it will be imposed when it should be and not imposed when it shouldn't be and is therefore, a key factor when considering deterrence.\textsuperscript{191} This includes the role of administrators and the use of their discretion in applying certain penalties. Therefore, penalties should be administered for voluntary compliance. Effectiveness means that the penalty must ultimately encourage compliance. A penalty is effective if the costs that it imposes and the method of computation seem likely to deter violations of a standard of behavior both by the taxpayer who is penalized and those who are not.\textsuperscript{192}

While the purpose of penalties is to encourage compliance, the AICPA had pointed out that there is a worrisome trend that new penalties are being proposed and existing penalties are being enhanced for purposes other than to for voluntary compliance.\textsuperscript{193} It addresses the fact that while penalties exist to support voluntary compliance and be evaluated solely for voluntary compliance, penalties are being used to raise revenue, to punish noncompliant behavior, and to reimburse the government for cost of compliance programs.\textsuperscript{194} Over the years, the increase in the use of penalties to encourage

\textsuperscript{184} Id.
\textsuperscript{185} Id. at 11.
\textsuperscript{186} Task Force Report, supra note 11 at 40.
\textsuperscript{187} This requires knowledge of facts relevant to noncompliance and a judgment as to whether taxpayers’ situations are similar or dissimilar. Among the facts that one might reasonably take into account are past histories of compliance, the aggressiveness of the noncompliance that occurred, how hard the taxpayer tried to comply, the number of instances of noncompliance on any one return, how much the taxpayer can reasonably be expected to understand (perhaps based on the taxpayer’s educational level), the standard of behavior that was breached, the general compliance levels of any natural grouping within which the taxpayer might find himself (e.g., should noncompliance in the area of tip reporting be treated differently than instances of noncompliance in reporting interest and dividend income), and the complexity of the required conduct.
\textsuperscript{188} \textit{See supra} note 170 (explaining that a penalty should be severe enough to have the desired impact on compliant and noncompliant taxpayers but should not be unnecessarily severe).
\textsuperscript{189} Id.
\textsuperscript{190} Id.
\textsuperscript{191} Id. at 44.
\textsuperscript{192} Id. at 41.
\textsuperscript{193} Id. at 41.
\textsuperscript{194} AICPA Report, supra note 10 at 4.
\textsuperscript{194} Id.
compliance has allowed the IRS to have a substantial gain. For instance, in the fiscal year 1995, the IRS assessed more than 29.8 civil penalties totaling more than $10 billion compared to the fiscal year 2007, where the IRS assessed more than 37.6 civil penalties totaling 29.5 billion. Also, the high revenue score of the proposed strict liability penalty associated with the codification of economic substance has varied between a 30 percent to a 40 percent penalty. This makes the penalty provision an attractive revenue raiser to offset the cost of other changes.

AICPA contends that the IRS views penalties as a “revenue source; that a cost-benefit analysis is performed around whether or not to assert penalties, and that only penalties that have high dollar amounts attached to them are worth enforcing.” This leads to a policy that says that penalties most likely to be imposed should be high because the cost of asserting and defending them will be offset by the proceeds of the penalty. This is clearly not consistent with the principles underlying penalty policy as embodied in IMPACT.

The IRS rejected these purposes due to its belief that penalties should be rationally related to the standards of behavior protected by the penalties and that penalties best aid voluntary compliance if they foster positive beliefs in the fairness and effectiveness of the tax system. The IRS contends that penalties can raise revenue collateral; that there is no inherent reason that penalties cannot be used for any of the other purposes due to the fact that the purposes are sometimes consistent with compliance objectives. While the IRS’s position can be respected, it does pose some flaws.

For a system that relies on voluntary compliance, the use of penalties to raise revenues confuses the roles of different substantive tax rules and penalties. Though penalties can also be considered as a source of revenue or as a form of “user fee” to compensate the government for the cost of noncompliance, as an individual objective, penalties should not be created or designed for revenue raising purposes. Raising revenue is not rationally related to the compliance objective. To illustrate absence of this rational relationship and the pitfalls of treating penalties as a revenue source, the negligence penalty can be examined. The negligence penalty increases in proportion to the tax avoided. Therefore, if a 1% increase in the penalty rate induced

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197 Id.
198 Id.
199 Id.
200 Id.
201 Task Force Report, supra note 11 at 35.
202 Id.
203 Id.
204 Id.
205 Id.
an increase in compliance greater than 1%, penalty receipts would actually decline. Yet for any penalty rate less than 100%, total tax and penalty receipts would increase.  

While the use of penalties to punish noncompliant taxpayers is consistent with enhancing voluntary compliance, penalties should only punish when it is necessary to assure both compliant and noncompliant taxpayers of the social value of compliance. During a Senate Hearing, Gerald Portney, a principal in the accounting firm of Peat Marwick Main & Co., commented on the penalty structure. Portney commented that while the tax system's philosophy has traditionally focused on voluntary compliance and self-assessment, the emphasis has shifted to detection and punishment. Moreover, Portney stressed that the traditional adversarial nature of the relationship between taxpayer and tax collector has too frequently become hostile, many individuals becoming alienated by the Service, which some perceive as a bureaucracy dedicated to penalizing taxpayers for the least offense, even if the offense was inadvertent or based on an arguably reasonable mistake. While it is not the contention that punishing noncompliance is not incompatible with the voluntary compliance purpose of civil penalties, independently, purpose of penalties should not be to punish the noncompliant taxpayer.

The use of penalties to reimburse the government for the cost of compliance programs may conflict with enhancing voluntary compliance. Sometimes, the cost of administering a penalty program is not synchronized with the severity required to obtain maximum compliance. If the purpose of penalties were to reimburse the government for the cost of compliance programs, the IRS may administer high penalties to cover the cost of the compliance program. The effect of compliance costs on the tax system is illustrated in Figure 1, showing the economic impact of tax compliance costs versus tax relief from 2001 through 2006.

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206 Id.
207 Id.
208 IRS Penalty Reform: Hearings Before the Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service of the Senate Committee on Finance, 100th Cong., 2d Sess. 166 (1988) (statement of Gregory Portney). See also supra note 11 at 36 (stating that if the severity of a civil penalty exceeds the severity that is appropriate in a civil context, it may have an adverse impact on taxpayer attitudes about the fairness of our self-assessment system).
209 Id.
210 See supra note 11 at 36.
It is clear that the cost of compliance has been increasing since 2001 and there has been much debate on who should bear the costs of tax compliance.\textsuperscript{212} This paper will not discuss the specifics of who should bear the costs of tax compliance, but would like to point out that if the purpose of penalties is to reimburse the government for costs of compliance programs, it would undermine the effectiveness and integrity of the penalty structure.

2. Lack of Clear Standards

Another issue addressed by the AICPA is that penalties do not articulate clear standards. According to the AICPA, penalties should articulate standards of behavior that are clear and understandable so that taxpayers and practitioners know the extent of their obligations, the rules do not become traps for the unwary, and noncompliant taxpayers cannot exploit the lack of clarity to avoid their obligations.\textsuperscript{213} Because our tax system is one that is based on the concept of voluntary compliance, when taxpayers and their advisors do not know what is likely to be penalized, they cannot know what behavior is desirable, or take steps to avoid undesirable behavior. With the number of penalties increasing over the years, there has been “a confusing array of vague definitions and overly complicated rules.”\textsuperscript{214}

\textsuperscript{212} Joseph Bankman, “Who Should Bear Tax Compliance Costs?,” UC Berkeley: Berkeley Program in Law and Economics 1 (2003). Retrieved from: http://www.escholarship.org/uc/item/2tt3c5dr (When discussing compliance costs, they include the time spent filing one’s tax return and maintaining records related to that filing; the time spent learning and negotiating the rules when engaged in various forms of tax planning; and the amounts paid to third parties, such as accountants, lawyers, financial planners or software providers, to that same end. They also include the costs the government incurs to promulgate and enforce the law).

\textsuperscript{213} AICPA Report, \textit{supra} note 10 at 5.

The major areas within the Code that lack clear standards are the accuracy-related penalties. The accuracy penalty imposes four separate standards of conduct on taxpayers. First is the reasonable-basis standard, which requires a twenty percent chance of winning on the merits. Second is the substantial-authority standard, which requires a forty-percent chance of winning. The third is the reasonable-cause-and good-faith standard, which requires both a forty-percent chance of winning and a reasonable belief that there is a greater than fifty-percent chance of winning. The fourth is the strict-liability standard. While there are many standards that could be addressed, this paper limits its discussion of lack of clear standards only to those provisions identified by the AICPA.

The AICPA points specifically to the application of sections 6662, 6662A, and 6694 as penalty provisions that lack clear standards. These Code sections that relate to accuracy and fraud penalties vary when trying to determining whether a transaction is a “tax shelter” or has “a significant purpose” of federal income tax avoidance or evasion. For instance, section 6662(d)(2)(C)(ii) defines “tax shelter” for purposes of the accuracy-related penalty where the transaction is not a reportable transaction as any entity, plan, or arrangement with “a significant purpose” of federal income tax avoidance or evasion. Section 6662A then provides that reportable transactions other than a listed transaction will be subject to the enhanced accuracy-related penalty for reportable transactions if the transaction has “a significant purpose” of avoiding or evading federal income tax. The rules applicable to a tax return preparer also depend on whether the return position relates to a “tax shelter” under section 6662(d)(2)(C)(ii) or “a significant purpose” reportable transaction subject to section 6662A.

The issue that arises with applicability of these Code sections is that it imposes a combination of imprecision and complexity that impairs effective enforcement and does little to encourage compliance. If these Code sections are analyzed, it is not clear as to whether a transaction is a “tax shelter” or “a significant purpose.” For example, the taxpayer and preparers must satisfy the more likely than not standard of the substantial authority standard to avoid a section 6662(b)(2) substantial understatement penalty and a section 6694 preparer penalty. The section 6662A penalty applies only if the transaction is a listed transaction or other reportable transaction with “a significant purpose” to avoid tax. The AICPA highlights that the terms “tax shelter” nor “a significant purpose” have not been clearly defined, making it more difficult and confusing for the taxpayer or the tax preparer to objectively apply the standard. While some parts of these Code provisions may be understandable, when taken collectively as a whole, the lack of clear standards makes it more difficult to apply the Code provisions effectively. The AICPA also addresses the uncertainty involved in the accuracy-related penalties for valuation

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216 Id.
217 Id.
218 Id.
219 Id.
220 AICPA Report, supra note 10 at 5.
221 Id.
222 Id.
223 Task Force Report, supra note 214.
224 Id. at 220.
225 Id.
understatements, where it is not clear when the 40 percent penalty should be applied. While the AICPA contends that the valuation penalty should be applied only to misstatements and not law, the penalty is administered in a different manner.\(^\text{226}\)

While Congress has its reasons for enacting misguided standards, it is difficult to justify their reasoning for doing so. One argument that Congress made for the enactment of the misguided standards was that, under prior law, the only potentially applicable penalties for inaccurate taxpayer assessment were the negligence and fraud penalties.\(^\text{227}\) What this lack of clear standards created was large unregulated area with an "endless array of cases involving reckless or intentional overstatement of deductions or understatement of income which lack the flagrancy necessary for imposition of certain penalties."\(^\text{228}\)

3. Disproportionate Penalties

The amount of a penalty should be proportionate to the degree of misconduct exhibited and to the degree of harm resulting from that misconduct.\(^\text{229}\) Therefore, a penalty should be proportional to the culpability of the noncompliant taxpayer and to the harm caused by the instance of noncompliance.\(^\text{230}\) A penalty that is viewed as excessive undermines voluntary compliance and may be less likely to be imposed, while "stacking" penalties may increase the aggregate penalty amount so that it is disproportionate to the degree of misconduct or the degree of harm.\(^\text{231}\)

There has been concern as to the proportionality of certain tax penalties provisions. AICPA illustrates a clear example of disproportionate penalties under sections 6707, 6707A, and 4965 dealing with the excise tax.\(^\text{232}\) These Code sections relate to information reporting penalties. Under these penalty provisions, the penalties are disproportionate to the conduct and incompatible with other information reporting penalties.\(^\text{233}\) For example, compared with the penalty for failure to file the FORM 5471 of $10,000, the penalty for failure to file a Form 8886 may be as high as $200,000 and the failure to file Form 8918 may be as high as the greater of $200,000 or 75 percent of the fees received by the material advisor.\(^\text{234}\)

AICPA emphasized that the Taxpayer Advocate, Commissioner Shulman, and members of Congress have recently acknowledged that the section 6707A penalty often is excessive and needs to be revised.\(^\text{235}\) According to Senator Grassley, "the penalty should be commensurate with the transgression."\(^\text{236}\) In its Annual Report to Congress, the Taxpayer Advocate states:

\(^{226}\) Id.  
\(^{227}\) See supra note 215 at 147.  
\(^{229}\) AICPA Report, supra note 10 at 7.  
\(^{230}\) Task Force Report, supra note 11 at 41.  
\(^{231}\) See supra note 229 ("Stacking" represents another 'disproportion,' as it involves two or more of these penalties being assessed for a single instance of inaccurate reporting).  
\(^{232}\) Id.  
\(^{233}\) Id.  
\(^{234}\) Id.  
“Notwithstanding the underlying congressional intent in enacting Section 6707A, the statute as written can impose unconscionable hardship on taxpayers. Even the penalty for proven cases of civil fraud is capped at 75 percent of the tax underpayment. Yet this statute allows penalties of up to $300,000 per year to be imposed on taxpayers with no underpayment of tax and no knowledge that they entered into transactions that the IRS has listed.”

AICPA also points to other penalty provisions that prove to be disproportionate. AICPA states that under section 6708, despite the fact that it may involve production of vast quantities of information, some of which may be subject to claims of privilege necessitating communication with clients and their other advisors and creation of a privilege log, material advisors may be subject to a $10,000 a day penalty with no cap if the IRS determines that efforts to timely produce documents are not sufficient. Additionally, the section 6662A penalty and part of the section 4965 excise tax are calculated assuming that the taxpayer is subject to the highest rate of tax under section 1 or section 11 regardless of the rate that actually applies. Further, in the case of taxpayers in a net loss position, section 6662A applies regardless of whether there is any underpayment of tax resulting from the behavior that triggered the penalty.

4. Overbroad Penalties and Penalty Punishment

Some penalties are overbroad, deter remedial and other good conduct, and punish innocent conduct. According to the AICPA, taxpayers trying to do the right thing should not be subject to onerous standards that are ineffective in deterring taxpayers who are intent on evading the law. Moreover, penalties should encourage, not discourage, communication with clients and their other advisors and creation of a privilege log, material advisors may be subject to a $10,000 a day penalty with no cap if the IRS determines that efforts to timely produce documents are not sufficient. AICPA pointed out that overbroad penalties that discourage remedial or other good conduct undermine faith in the fairness of the system. The issue is that overbroad penalties undercut compliance and transparency or cause taxpayers to forgo congressionally intended benefits to avoid possible missteps and the resulting penalty consequences. An example of the penalty provision that is overbroad and punishes good behavior is Code section 6707A.

It has been acknowledged that Section 6707A is excessive and needs to be revised. This penalty provision, dealing with reportable transactions, is being assessed against taxpayers for whom it

238 AICPA Report, supra note 10 at 8.
239 Id.
240 Id.
241 Id.
242 Id.
243 Id.
244 Id.
was not intended, and the penalty has been found to be unfairly harsh. This Code section, along with section 6707, demonstrates the trend towards using penalties merely to punish. Since section 6707A penalty applies without exception to the failure to include disclosure on a return when required, an improper tax benefit is not required as long as the tax return reflects tax consequences or a tax strategy described in public guidance. In fact, this penalty eliminates the opportunity, and the incentives, to remediate and to become compliant. Since the purpose of penalties is voluntary compliance, the AICPA finds that penalties should be crafted and implemented judiciously to ensure that they are more beneficial than harmful to the overall functioning of the tax system.

5. Strict Liability

There has been an exponential increase in the complexity of the tax laws and a proliferation of increasingly severe civil tax penalties over the past several decades. AICPA has expressed that rather than responding by providing the IRS with increased flexibility, the tax laws have experienced a trend toward strict liability. The trend toward strict liability has manifested itself in many ways including: 1) Disallowing reasonable cause relief or waiver outright; 2) providing for limited waiver authority and prohibiting judicial review; and 3) creating a so-called “reasonable cause and good faith” exception that is really an exception based on the level of confidence for the technical position rather than the taxpayer’s particular facts and circumstances.

Strict liability contravenes broader tax penalty policies and is unfair to the taxpayer. In order to be fair, penalty rules should be flexible to differentiate factual circumstances in each case and should distinguish willful from negligent misconduct. By definition, strict liability imposes the penalty regardless of whether the taxpayer substantially complied with the Code or made a good-faith attempt to do so. Therefore, moving toward strict liability would be unfair to the taxpayer as this would cause assessment of higher penalty rates and would discourage voluntary compliance and violate the basic tenets of the Code.

There has been much attention placed on this issue of strict liability, mainly where it relates to the economic substance doctrine. Specifically, there have been a number of penalties considered by Congress to codify the economic substance doctrine and to impose strict liability penalties for transactions found to lack economic substance. Economic substance is a judicial doctrine that is most effective when the facts and circumstances of each case can be individually evaluated.

245 See supra note 237 at 22.
246 ABA Report supra note 214 at 10.
247 Id.
248 Id.
249 AICPA Report, supra note 10 at 9.
250 Id.
251 Id.
252 Id.
253 Id.
255 Id.
257 See supra note 246.
Because it is administered as a bright-line rule, strict liability is seen as useful and appropriate only in areas of the law where the rules are simple and clear. Legislating the definition of economic substance will make the law significantly more complex, will hamstring the government’s ability to challenge questionable transactions, and will encourage exploitation of inevitable statutory loopholes. Therefore, with its complexity and uncleanness, the economic substance doctrine is unsuitable for use with strict liability.

6. Procedural Due Process Concerns

The principle that the government must respect all the legal rights owed to a person under the law is known as due process. In fact, due process -- administrative as well as judicial -- is an important normative value in our democratic system of government. Procedural due process in tax law terms relates to whether or not a taxpayer has received adequate notice, primarily before a penalty assessment is made and judicial review after penalty assessment. AICPA asserts that some penalty provisions do not provide for basic procedural due process.

Penalties should apply prospectively to future conduct and not retroactively to conduct that was appropriate at the time the conduct occurred. Penalties that key off of listed transactions or transactions of interest are examples of penalties that are applied retroactively. Examples of these are stringent accuracy-related penalties (section 6662A), failure to disclose penalties (sections 6707 and 6707A), and the excise tax on tax-exempt entities and entity managers (section 4965). The AICPA points to the section 6707 and section 6707A penalties are prime examples of situations where the statute prohibits judicial review of the Commissioner's exercise of discretion with respect to rescission of these penalties.

There are circumstances under the tax code where penalties can be assessed using automated processes to identify and compute additional tax due, penalties, and interest without the benefit of pre-assessment rights to pursue reasonable cause and other defenses. According to IRS statistics, 77.7 percent of the total of 1,540,771 audits (or 1,110,211 audits) were correspondence audits. In addition, there were 3.53 million contacts and 2.795 million assessments under the Automated Underreporter Program and 1.5 million contacts and 756,539 assessments under the Automated Substitute for Return Program. Using these automated programs, penalties are normally asserted when the automated notices are sent. Assuming that this is the case and taxpayers were not receiving notices from more than one program that amounts to automated assertion of penalties to over 6 million taxpayers in these programs alone. AICPA finds that in the instances where the penalties are assessed automatically, taxpayers often pay the penalties.

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258 Id.
259 See supra note 254 at 2041.
260 Task Force Report, supra note 11 at 51.
261 AICPA Report, supra note 10 at 11.
262 Id.
263 Id.
264 Id.
266 Id.
267 Id.
even if they are unwarranted because it is so difficult and costly to challenge a penalty once it is assessed.\textsuperscript{268}

Examples are assessment of the section 6662 penalty on notices from matching programs or correspondence audits (even though reasonable cause might apply or the determination of an underpayment is incorrect), the $10,000 penalty in the case of Forms 5471 filed with Forms 1120 filed after the deadline (even though reasonable cause might apply), and the section 6676 penalty if part of a refund claim is denied (even though the penalty does not apply if there is a reasonable basis for the claim).

AICPA also asserts that there is a lack of basic procedural due process in the assessment of international penalties. AICPA finds that there is no pre-assessment review by Appeals for international penalties assessed under Chapter 61 of the Internal Revenue Code, but there is pre-assessment review for international penalties under Chapter 68 of the Code.\textsuperscript{269} There is no policy argument that would support this unfair assessment under the Code. AICPA also addressed additional due procedural issues relating to TEFRA partnerships and preparer penalties.\textsuperscript{270}

Procedural due issues that arise in tax law should not be taken lightly. Automated assessment of penalties can lead to procedural due process issues regarding notice to a taxpayer. Moreover, when applicable, judicial review of an IRS decision to impose a penalty or to deny waiver is an important constitutional check on executive authority. Statutes that prohibit judicial review of agency penalty determinations undermine voluntary compliance by undercutting taxpayers’ faith in the system and eliminating an essential and expected avenue of potential redress.\textsuperscript{271}

7. Inconsistencies with standards and roles of tax professionals

Penalties must be consistent. Consistency in the penalty regime encourages compliance and makes administration easier and more readily understandable by those whose conduct is governed by such penalties.\textsuperscript{272} Issues regarding consistency are apparent under the current provisions in the Code that penalize taxpayers and tax professionals for failure to comply with conflicting or contradictory standards. AICPA addressed the importance of the standards applicable to tax professionals stating that the standards applicable to tax professionals must reflect the fact that the role of tax professionals differs from the role of taxpayers.\textsuperscript{273} While the taxpayer is ultimately responsible for the positions taken on the return, tax compliance increases and our self-assessment system benefits when taxpayers seek the assistance of a competent tax professional.\textsuperscript{274}

\textsuperscript{268} AICPA Report, \textit{supra} note 10 at 12. (Examples are assessment of the section 6662 penalty on notices from matching programs or correspondence audits (even though reasonable cause might apply or the determination of an underpayment is incorrect), the $10,000 penalty in the case of Forms 5471 filed with Forms 1120 filed after the deadline (even though reasonable cause might apply), and the section 6676 penalty if part of a refund claim is denied (even though the penalty does not apply if there is a reasonable basis for the claim).

\textsuperscript{269} Id. \textit{Also see}, See e.g., the penalty for failing to timely file a Form 5471 under section 6038(b); the penalties under sections 6038A, 6038B, 6038C, and 6038E and the penalties under sections 6652, 6677 6679, and 6712.

\textsuperscript{270} Id.

\textsuperscript{271} Id.

\textsuperscript{272} ABA Report, \textit{supra} note 214 at 6.

\textsuperscript{273} Task Force Report, \textit{supra} note 10 at 13.

\textsuperscript{274} Id.
A review of third-party civil tax penalties reveals that they are flawed and in their current form, are unfair, ineffective, incomprehensible, and incapable of being properly administered.\textsuperscript{275} AICPA looks to a few sections under the Code to point to the inconsistencies with the penalty standards applicable to tax professionals. One such example deals with the standards provided for a preparer under section 6694. Section 6694 requires a preparer to identify whether a transaction is a tax shelter under section 6662(d)(2)(C)(ii) or the preparer would be subject to penalties under 6662A.\textsuperscript{276} AICPA contends that a preparer would not be in the best position to know the taxpayer’s purpose for entering into a particular transaction and therefore would not assess whether the taxpayer’s purpose was significant.\textsuperscript{277} This particular standard is inconsistent with the role of the tax preparer because it provides for assessment of penalties where there is no clear standard in place. The section does not provide guidance to assist the preparer in determining when a taxpayer’s purpose is significant. AICPA suggests that preparer should be able to avoid the penalty with respect to a tax position by preparing the return with adequate disclosure if the position has at least a reasonable basis.\textsuperscript{278}

AICPA also looks to the different standards for taxpayers and preparers under section 6662 and 6694 respectively. AICPA contends that these differing standards create a potential conflict of interest.\textsuperscript{279} For instance, under section 6662(d), the taxpayer is not subject to an understatement penalty unless the understatement is substantial.\textsuperscript{280} There is no such floor before the preparer penalty applies.\textsuperscript{281} Additionally, in the case of the penalty for disregard of a rule, the provider that in certain cases the section 6662 penalty will not apply if the position has at least a realistic possibility of success, whereas section 6694 provides that the position must be supported by substantial authority for the preparer to avoid the penalty.\textsuperscript{282} AICPA points out that due to these differing standards, potential conflicts arise between a taxpayer and a preparer due to the higher standards applied to preparers and these conflicts lead taxpayers to choose not to seek the assistance of a tax professional in preparing returns.\textsuperscript{283}

Penalties imposed on tax professionals should be based on facts and circumstances known (or which should be known) by the professional and over which the tax professional has control. The standards applicable to tax professionals should not create a conflict with taxpayers. Penalties should not discourage taxpayers from seeking tax advice from a professional.\textsuperscript{284} Through both examples, AICPA finds that these inconsistencies in the standards diminish the goal of preparer penalties to encourage preparer compliance and moves more towards a goal of using the

\begin{itemize}
  \item [275] Jay A. Soled, “Third-Party Civil Tax Penalties and Professional Standards,” 2004 Wis. L. Rev. 1611, 1628. (When referring to third party penalties for purposes of this discussion, the term includes tax professionals, tax practitioners, tax preparers and tax advisors).
  \item [276] I.R.C. §6694.
  \item [277] See supra note 273.
  \item [278] Id.
  \item [279] Id.
  \item [280] Id. An understatement for this purpose is substantial if the amount exceeds the greater of 10 percent of the tax shown on the return or $5,000, or in the case of a corporation, the amount exceeds the lesser of 10 percent of the tax shown on the return ($10,000 if greater) or $10 million. See section 6662(d)(1).
  \item [281] Id.
  \item [282] Id.
  \item [283] Id.
  \item [284] Id.
\end{itemize}
preparer as an extension of the IRS to enforce taxpayer compliance. Moreover, through these inconsistencies, it appears that the preparer penalty standards “deputize” preparer and shift the responsibility for enforcing the tax laws away from the IRS to the preparer. Through the use of penalties, tax professionals should not be an enforcement arm of the IRS and their professional advice should be one that is compliant with a clear and concise Code to encourage compliance of taxpayers. Preparers should not be held accountable for taxpayer transactions and decisions. In doing so, this responsibility is misplaced, ignores the fundamental rule (or limitations) of the preparer as an advisor, and created the potential of conflict of interest.

B. Shortcomings under Current Penalty Administration

The Commissioner of the IRS is responsible for ensuring effective administration of the civil tax penalty system. Administration of civil tax penalty policy by the Treasury Department and the Service is driven by the penalties enacted by Congress. Sound penalty administration can be achieved only if Congress clearly and expressly articulates its goals when deciding whether to retain, amend or add civil tax penalties to the Code; and only if Congress carefully and thoroughly evaluates the impact of any civil tax penalty change on the overall penalty regime. During the proposed IMPACT legislation, there were specific objectives laid out which the IRS should follow as it handles each penalty case.

a. Automated Assessment of Penalties

The IRS uses tools other than examinations to identify and resolve taxpayer errors. In addition to receiving information about taxpayers’ self-reported income and tax on returns that are filed, the IRS gathers independent information about income received and taxes withheld on information returns, such as Forms W-2 and 1099 from employers and other third parties. The IRS uses automated programs to gather information is later used for assessment of tax penalties. After gathering independent information, in the Automated Underreporter Program, the IRS matches information returns to tax returns and contacts taxpayers to resolve discrepancies. In the Automated Substitute for Return Program, the IRS uses information returns to identify persons who did not file a return, constructs tax returns for certain non-filers based on that third-party information, and assesses tax, interest, and penalties based on the substitute returns.

AICPA asserts that there are facts and circumstances particular to a taxpayer that is sufficient to warrant abatement of certain tax penalties. However, many taxpayers end up paying incorrect and unwarranted penalties than challenge them. This is due to the time and money necessary to

285 Id. at 14.
287 See supra note 285.
288 Id.
289 ABA Report, supra note at 4.
290 See supra note 97.
291 See supra note 265.
292 Id.
293 Id.
work through the complex and often incomprehensible process of challenging penalties.\textsuperscript{294} AICPA points out that when taxpayers do challenge incorrect penalty assessments, there is a waste of time of both the IRS and the taxpayer resources.\textsuperscript{295} While automated programs assist the IRS in enforcing its voluntary compliance principle, these programs are not always effective. Sometimes automated assessment places the taxpayer in a position where penalties are paid merely because it is less costly to do so.\textsuperscript{296} Moreover, some automated assessments are found to be ineffective due to the assessment of penalties based on incorrect gathering of taxpayer information. For instance, the U.S. Government Accounting Office (GAO) reviewed the Internal Revenue Service’s (IRS) automated program for detecting and pursuing individuals with income over $100,000 who failed to file required tax returns.\textsuperscript{297} The GAO found that under the automated program, IRS did not fully investigate or assess taxes for high-income non-filers who did not respond to its notices on unfiled tax returns.\textsuperscript{298} Furthermore, GAO found that there was less scrutiny from IRS in its evaluation and assessment than those who filed returns on time.\textsuperscript{299} When penalties are imposed automatically, there is no mechanism in place to first determine whether the taxpayer’s error was the result of particular conduct of a type that warrants a penalty – or whether the penalty to be imposed is proportional to the misconduct.\textsuperscript{300} While the importance of automated programs are noted, increasing use of these programs to assess penalties without immediate changes can detrimentally impact perceptions regarding fairness and proportionality, which does little to enhance the cause of voluntary compliance.\textsuperscript{301}

b. Coordination and Oversight of Penalty Administration

Effective penalty administration is an important tool in ensuring voluntary compliance. However, absent IRS oversight of penalty administration and the data such oversight can provide, it becomes difficult to accurately evaluate the effectiveness of penalties in encouraging voluntary compliance.\textsuperscript{302} Studies have concluded that there is significant room for improvement with respect to IRS oversight and collection of data regarding penalty administration.\textsuperscript{303} The GAO suggest that in order to ensure the most efficient, fair, and consistent administration of civil tax penalties, and that penalties are achieving their purpose of encouraging voluntary compliance, there must be an evaluation of penalty administration and penalties’ effect on

\textsuperscript{294} AICPA Report, \textit{supra} note 10 at 15.
\textsuperscript{295} Id.
\textsuperscript{296} Id.
\textsuperscript{298} Id. at 3.
\textsuperscript{299} Id.
\textsuperscript{300} See \textit{supra} note 289 at 8.
\textsuperscript{301} Id. at 9.
\textsuperscript{302} See \textit{supra} note 294 at 16.
voluntary compliance. AICPA urged that there should be immediate steps taken to ensure that this is done.

AICPA asserts that one particular area in need of evaluation by the IRS involves the use of penalties to enforce data collection. For example, questions have been raised regarding whether penalties are effective in encouraging compliance with information gathering efforts and whether the data collected is actually being used by the IRS to actively promote sound tax administration. AICPA believes that evaluation of this area would go a long way to increasing compliance and perceptions of fairness in penalty administration.

Another area the AICPA identified in need of evaluation by the IRS involved which office would have the overall responsibility for penalty administration. This is of extreme importance as the IRS must be certain whether that office can perform its mission, including evaluating and coordinating penalty administration, accurately and efficiently. The office with the overall responsibility of penalty administration should be prominent within the IRS and have the authority to influence penalty policy.

c. Bias

Due to the enactment of the IMPACT legislation, the IRS developed the Penalty Policy Statement, which states that the “Service will design, administer, and evaluate penalty programs solely on the basis of whether they do the best possible job of encouraging voluntary compliance.” AICPA asserts that over the years, the philosophy of the penalty policy statement has moved more towards increased assessment of penalties than encouraging voluntary compliance. AICPA points out the penalty policy statement qualifies the goal of encouraging voluntary compliance by stressing the importance of efficiency in penalty administration and the need for penalties to serve as an economic deterrent in “abusive” transactions.

AICPA provides two examples of the bias in favor of assessing penalties. First, AICPA looks to current IRS policies that prohibit increases in penalties in exchange for an increase in tax or assessment of penalties for a reduction of tax. This process is referred to as “trading of penalties.” Second, AICPA considers some penalties that require separate consideration of certain penalties (e.g., accuracy-related penalties) and written justification when the penalties are not asserted. While the AICPA contends that these two policies are reasonable on their face,
together they create an unfair bias in favor of assertion of penalties which undermines the appearance of impartiality.\textsuperscript{316}

d. IRS Guidance and Training

Because the overall tax system is very complex, guidance and training is imperative in the success of the system. Penalties cannot be administered unless there is understanding of the rules and policies for administering them.\textsuperscript{317} In order to understand the rules and policies relating to tax penalties, there must be distribution of internal IRS guidance and training well before the effective date of a penalty provision.\textsuperscript{318}

AICPA found two penalty provisions where internal IRS guidance and training should be improved – section 6694 penalty and section 6696 penalty. Under section 6694, AICPA points out that although the IRS has taken steps to train employees on the penalty standards, evidence indicates that many IRS employees in the field do not understand the rules or how to protect the preparer’s section 6103 information from the taxpayer.\textsuperscript{319} Under section 6676, AICPA contends that the IRS has not provided sufficient training and therefore it resulted in inappropriate assertions of the penalty.\textsuperscript{320} Also, AICPA contends that penalties under section 6676 are being imposed automatically and regularly, attributable to the fact that the IRS has yet to publish regulations or other guidance with respect to these penalties.\textsuperscript{321}

When the IRS sets out to provide adequate internal guidance and training for administration of tax penalties, the IRS must make sure that the training materials and internal guidance focus on differences in administration based on the type of taxpayer and industry, the policy reason for the penalty, and the relationship between that policy and the underlying substantive tax provision.\textsuperscript{322} Moreover, equal emphasis should be placed on training IRS personnel not to use penalties as a “lever” and on the skills necessary for dealing effectively with taxpayers and their representatives as is placed on not trading penalties and requiring a penalty adjustment that is separate from the underlying substantive tax adjustment.\textsuperscript{323}

e. Educating the taxpayer and tax professional

AICPA maintain that the IRS should help taxpayers and tax professionals understand penalties and related procedural rights, such as appeal rights and the ability to go to the Taxpayer Advocate for assistance.\textsuperscript{324} AICPA contends that the IRS should issue clear, concise, and timely guidance when there are changes in laws or policies that impact penalties.\textsuperscript{325}

\textsuperscript{316} Id. See also Memorandum from Larry R. Langdon, Commissioner, Large and Mid-Size Business Division, to Large and Mid-Size Business Division Executives, Managers, and Examiners, (Dec. 20, 2001).
\textsuperscript{317} Id.
\textsuperscript{318} Id.
\textsuperscript{319} Id. at 18.
\textsuperscript{320} Id.
\textsuperscript{321} Id. at 17.
\textsuperscript{322} Id. at 18.
\textsuperscript{323} Id.
\textsuperscript{324} Id. at 18.
\textsuperscript{325} Id.
While the IRS has provided some guidance for some penalty provisions, other provisions are left without guidance and explanations. An area identified by AICPA, where guidance is needed, is the penalty provisions dealing with estate and gift taxes. Estate and gift tax return preparers need guidance on how to apply new concepts such as disclosure, the "more likely than not" and "substantial authority" standards, and "tax shelter" to their practice. AICPA finds that it is unfair that there has been no guidance issued concerning how these rules impact estate and gift tax, and yet practitioners in this area are nonetheless subject to penalty.

AICPA pointed to additional outreach for the IRS to consider in educating the taxpayer and the tax professional. They are:

1. Publish a summary of common penalties, including how to challenge each and the philosophy underlying each penalty;
2. Leverage existing outreach and liaison efforts to educate taxpayers and tax professionals on penalties;
3. Establishing a single point of contact for taxpayers and practitioners within the IRS to answer questions about penalties and how to troubleshoot case-specific issues.
4. Use IRS website to provide penalty guidance by organizing guidance on penalties

V. Conclusion

Civil tax penalties are important in our tax system in that it is designed to encourage voluntary compliance and discourage intentional or reckless noncompliance. When properly developed and applied, penalties assist the IRS in promoting sound tax administration by increasing the economic costs of noncompliance. It has been too long since the penalty structure has been reformed, and with continuing changes to the tax penalty structure, failure to enact comprehensive reform may have serious adverse consequences to enhancing voluntary compliance, which should be the goal of all federal tax penalties. AICPA urges reform of the civil tax penalty structure and identified the 12 specific issues discussed above in areas that call for improvement. While the issues addressed by AICPA are not exhaustive, but if taken into consideration, they can serve as a roadmap to the start of the civil tax penalty reform.

326 Id.
327 Id.
328 Id.