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Achieving Meaningful Civil Tax Penalty Reform and Making It Stick

Jeremiah Coder

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ACHIEVING MEANINGFUL CIVIL TAX PENALTY REFORM AND MAKING IT STICK

*Jeremiah Coder**

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I. INTRODUCTION

The use of penalties in the tax code seems to be drifting away from long-held and well-established policy principles, with the gradual erosion resulting in both unintended consequences and increasing administrative challenges. The current disarray of penalties in the

* Contributing Editor, Tax Analysts. The author is deeply indebted to Chris Rizek for his insightful guidance on this subject, and thanks the many practitioners of the tax bar who continue to serve as mentors.

present tax code is obvious. Critics rightly condemn the present penalty regime as confusing, draconian, and unfair. But despite growing calls for action, so far Congress does not seem very receptive to the message and continues to propose penalty provisions at odds with accepted goals.

The last successful attempt at bringing order to a chaotic structure of penalty provisions in the tax code occurred in 1989. Like today, segments of the tax community in the 1980s became vocal over the growing erratic formation of civil tax penalties, complaining about the ad hoc nature of penalty enactment, use of penalties as revenue raisers, and penalty stacking. As a result, an IRS task force and the Joint Committee on Taxation produced several reports outlining the main theoretical goals behind a tax penalty system. Among all the various rationales and purposes possible in a penalty regime, their primary conclusion was that tax penalties should exist solely to encourage voluntary compliance.

With that goal in mind, the IRS's task force enumerated three guiding principles in its penalty policy statement: (1) helping taxpayers understand what constitutes acceptable conduct; (2) deterring noncompliance by imposing costs on that behavior; and (3) ensuring the perception that the tax system was fair. Congress in 1989 reacted with legislation—the Improved Penalty Administration and Compliance Tax Act—that implemented changes to simplify accuracy-related penalties and information reporting penalties. Since then, minor attention to additional penalty reform was given a decade later, at the end of the 1990s, but no significant legislation resulted. The first decade of the twenty-first century has only seen further movement away from fundamental penalty rationales and a piling up of incoherent penalties, with many tax observers questioning whether the current system adheres to the voluntary compliance goal.

This essay examines the historical use of penalties within the tax code, reviews a number of reports that led to the last round of significant penalty reform legislation, and considers existing problems of penalty administration. Several proposals are outlined to ensure that if and when Congress acts to simplify and revise the penalty regime, the reforms will have lasting impact. Part II covers the growth of penalties in the tax system from its original simple form through its significant expansion to the time that the IRS and Congress worked to cut back the complexity of the civil tax penalty regime in the late 1980s. Part III considers how legislative actions over the past decade have created new penalties that stand out from the outlined policy goals of the IRS Task Force, and the resulting negative impact on administering the tax code. Part IV looks at

possible reforms to the penalty system that would institute measures to help constrain penalties from drifting from defined policy goals.

II. BACKGROUND

A. *Penalties Historically*

Penalties were few in number and simple in application during the first few decades following enactment of a permanent income tax regime. In 1955, after the adoption of the 1954 tax code, there were only fourteen penalty provisions.¹ Today, the number of penalty provisions has grown rapidly to more than 130.² Penalties in the 1954 tax code centered on enforcing basic filing and understatement obligations through failure to file, failure to pay, negligence, and fraud penalties.³ These penalties were designed as simple tools to encourage voluntary compliance by taxpayers with our self-assessing tax system.

Between 1955 and 1989, however, Congress put into place a number of new penalties, including sanctions on employee plans, exempt organizations, and return preparers⁴—measures not necessarily targeted at increasing voluntary compliance.⁵ The spate of individual tax shelters that came to the fore in the 1980s led to even more rules crafted by Congress and the IRS aimed at greater disclosure and punitive consequences for perceived taxpayer abuse of the tax code.⁶ Shelter-related penalties covering promoter registration, substantial underpayments, and information reporting were added or refined.⁷ The current penalty regime we face today has moved well beyond basic filing and understatement penalties and now encompasses a wide swath of behavior that seems concentrated on punishing certain taxpayer action, including information reporting failures and valuation misstatements.

1. TAXPAYER ADVOCATE SERV., INTERNAL REVENUE SERV., NATIONAL TAXPAYER ADVOCATE: 2008 ANNUAL REPORT TO CONGRESS VOL. 2, at 7 (2008), *available at* http://www.irs.gov/pub/irs-utl/08_tas_arc_vol2.pdf (last visited February 19, 2011) [hereinafter 2008 NTA Report].

2. *Id.*

3. U.S. DEPT. OF THE TREASURY, OFFICE OF TAX POLICY, REPORT TO THE CONGRESS ON PENALTY AND INTEREST PROVISIONS OF THE INTERNAL REVENUE CODE 19 (1999) [hereinafter Treasury Report].

4. *Id.* at 21-25.

5. *Id.* at 21.

6. *Id.* at 22-23.

7. *Id.* at 23-25.

It was at the height of congressional reaction to combat tax shelter activity through penalties that the IRS and Joint Committee on Taxation undertook extensive studies of the penalty system. The review was necessary because “the absence of a systematic approach to the enactment, assertion and abatement of penalties is a serious problem.”⁸

B. 1989 Reforms

The IRS Task Force put together by then-IRS Commissioner Lawrence Gibbs was a broad-based effort involving research and feedback from nearly all divisions of the Service and was intended to address “complaints about the design and administration of sanctions [that] required principled responses based on the role of penalties in the tax system rather than symptomatic treatments.”⁹ After significant study, the final IRS Task Force report outlined a comprehensive basis for an equitable penalty regime in the tax code and set out fundamental characteristics of any such scheme to guide future legislative efforts.¹⁰

Foremost among the IRS’s conclusions was that tax penalties should exist solely to encourage voluntary compliance.¹¹ Because the U.S. tax system is based on self-assessment, using penalties to bolster voluntary compliance can work to make the system efficient, accurate, and less intrusive.¹² Furthering voluntary compliance could best be achieved by setting out acceptable standards of conduct, imposing costs to deter noncompliance, and establishing a sense of fairness.¹³

The IRS delineated four core pillars of sound tax penalty policy: fairness, effectiveness, comprehensibility, and ease of administration.¹⁴ According to the IRS, in order to imbue the tax system with a perception of fairness, the tax code must treat similarly situated taxpayers the same (horizontal equity).¹⁵ Otherwise, taxpayers will lose respect and support for the tax system if they don’t think a penalty is consistently applied.¹⁶ IRS policy states that a proper penalty regime must exhibit fairness and proportionality so that the penalty imposed bears the right relationship to

8. See EXECUTIVE TASK FORCE FOR THE COMMISSIONER’S PENALTY STUDY, INTERNAL REVENUE SERV., REPORT ON CIVIL TAX PENALTIES 30 (1989) [hereinafter IRS Task Force Report].

9. *Id.* at acknowledgements section.

10. *Id.*

11. *Id.* at 19.

12. *Id.*

13. *Id.* at 33-34.

14. IRS Task Force Report, *supra* note 8, at 19.

15. *Id.* at 39; see also I.R.M. 1.2.20.1.1 (June 29, 2004).

16. IRS Task Force Report, *supra* note 8, at 40.

the taxpayer's culpability and resulting harm to the tax system.¹⁷ The penalty system must operate on procedural fairness so that taxpayers are penalized only if they deserve it.¹⁸

Under a second IRS goal of effectiveness, a penalty must balance the need to eliminate noncompliance without becoming disproportionate or unfair. Essentially, effectiveness is driven by imposing costs at just the right level to deter violations. One measure of effectiveness is basing the sanction on the level of benefit the taxpayer expects to receive from his noncompliance.¹⁹ On the other hand, a taxpayer should likewise be motivated to take remedial action upon discovering noncompliance. So, a penalty should potentially offer a way for the IRS to use it while still encouraging voluntary correction.²⁰ A graduated penalty system is an example of these factors interacting to produce an effective result, tying the level of sanction imposed to the length or severity of a taxpayer's noncompliance.

The IRS also believes that taxpayers must understand the conduct expected of them in a penalty regime (comprehensibility). This principle is one of the most difficult to achieve because of the wide variety of knowledge and skills among taxpayers. A penalty should provide for the appropriate standard of behavior based on the taxpayer's sophistication, expecting a base level of conduct for average taxpayers while perhaps allowing for more gradation toward those with a greater grasp of complexity.²¹

Finally, penalty administration must allow sufficient means for imposing a sanction while retaining the ability for the IRS to exercise discretion in appropriate circumstances.²² Setting out a clear and appropriate standard of behavior requires properly categorizing taxpayers based on possible noncompliant conduct. But the level of detail that allows the tax administrator to follow written rules in determining if a sanction is applicable can come into conflict with ease of administration. Ambiguous guidelines give the IRS the ability to deal with new or unusual factual situations, but can frustrate taxpayers when standards are not adequately defined. On the other hand, an excessive

17. *Id.* at 41

18. *Id.* at 40.

19. *Id.* at 41-42.

20. *Id.*

21. *Id.*

22. See AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, PENALTY REFORM TASK FORCE, REPORT ON CIVIL TAX PENALTIES: THE NEED FOR REFORM 3 (2009) ("Penalties should treat similarly situated taxpayers similarly and have sufficient flexibility to account for differences in the particular facts and circumstances of each case.") [hereinafter AICPA Report].

level of specificity binds the IRS's hands or creates impractical administrative hurdles.²³ Administrability is also affected by the penalty amounts at issue; if too high, either the taxpayer engages in tactics (sometimes questionable) to avoid it, or the IRS fears to impose it. Limited resources as well impact the extent to which the IRS can engage in administering the penalty regime.

The IRS Task Force specifically rejected other rationales that, while permissible in a penalty regime, were ultimately deemed inconsistent with the primary goal of encouraging voluntary compliance. The rejected purposes included raising revenue, punishing noncompliant behavior, and reimbursing the government for the cost of compliance programs.²⁴ For example, although penalties raise revenues collaterally, acceptance of revenue raising as grounds for a penalty regime "confuses the different roles of substantive tax rules and penalties."²⁵ If the goal of a penalty is to grow the fisc through collection, the penalty cannot be considered as motivated by enhancing voluntary compliance. Indeed, a truly effective penalty in design would collect little or no additional revenue because the increase in taxpayer compliance would negate the need for penalty assertion.

Pursuing penalties as a way to reimburse an administrative program also conflicts with enhancing voluntary compliance, as the level of resources necessary to administer the program "is not necessarily synchronized with the severity required to obtain maximum compliance—it may be either too high or too low."²⁶

The IRS Task Force report recognized punishment as a coterminous mechanism for achieving voluntary compliance, but not as an independent goal in itself.²⁷ Devising penalties to punish noncompliance can lead to severe results best dealt with in a criminal context. To the extent the consequences of a penalty go beyond what is appropriate in a civil context, the resulting severity will likely have "an adverse impact on taxpayer attitudes" about the system's fairness.²⁸ In other words, a penalty should "deter bad conduct without deterring good conduct or punishing the innocent."²⁹

23. IRS Task Force Report, *supra* note 8, at 45 ("Either the administrator becomes a parser of complex rules, substituting the result required by the rule for the judgment that the case may require; or he bends the written rule to reach the result that he feels is reasonable.")

24. *Id.* at 35.

25. *Id.*

26. *Id.* at 36.

27. *Id.*

28. *Id.*

29. See AICPA Report, *supra* note 22, at 1.

The report made several significant recommendations for tax administrators to follow: adopt a single penalty policy statement recognizing the purpose of civil tax penalties to encourage voluntary compliance; develop a comprehensive penalty handbook; revise training programs; improve taxpayer communication regarding penalties; review IRS letters and notices; improve informational capabilities on penalty administration; and develop a comprehensive database capable of providing penalty administration statistical information.³⁰

The work of the IRS Task Force spurred Congress to take up wholesale reform of the civil tax penalty system. As a result, the 1989 Improved Penalty Administration and Compliance Tax Act³¹ (IMPACT) simplified and rationalized the penalty structure, as well as spurred administrative changes. One of the most significant modifications was the reorganization of all the accuracy-related penalties into one single code provision, section 6662, at a single rate (except for gross valuation misstatements).³² Prior to the act, penalties for negligence, substantial understatements, and valuation under- and overstatements had been in separate provisions, making it possible and likely for multiple sanctions to apply to one infraction. A reasonable cause exception was incorporated in section 6664 and made applicable to all of the accuracy-related penalties. Furthermore, the legislation created a uniform definition of underpayment, and crafted rules so that an accuracy-related penalty only applied to the applicable portion of an underpayment.

C. *Post-1990*

After the major 1989 penalty overhaul, the early 1990s brought mostly minor legislative penalty revisions to the tax code. In addition to modifying estimated tax payment rules, Congress adjusted the accuracy-related penalty disclosure standard from “not frivolous” to “reasonable basis,” imposing a heightened standard to discourage taxpayers from taking unreasonable return positions.³³ Congress also took away an exception to the substantial understatement penalty in the case of

30. *Id.*; see also I.R.M. 20.1.1.1.1(2) (Feb. 22, 2008).

31. Enacted as part of the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106 (1989).

32. See *id.* § 7721(a).

33. See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (1993).

corporate tax shelters by only allowing a penalty to be avoided in the case of reasonable cause.³⁴

But only a decade after the IMPACT reforms, the Treasury returned to the issue of possible penalty reform. As part of the IRS Restructuring and Reform Act of 1998, which drastically changed the organization and operations of the Service, Congress mandated that the Treasury and the JCT again study penalty and interest provisions in the tax code.³⁵ The Treasury report³⁶ made a number of recommendations regarding various types of penalty provisions. Of particular note was that the Treasury encouraged Congress to harmonize the substantial understatement and negligence penalties to better distinguish which portions of an understatement each related to.³⁷ The report also recommended imposing the same accuracy standards on taxpayers and return preparers.³⁸ The Treasury suggested that the IRS take steps to “ensure greater consistency in the application of penalty abatement criteria.”³⁹

D. IRS Efforts

Following the enactment of IMPACT, the IRS moved to develop consolidated guidelines regarding penalties that captured in formal administrative form the policy rationales established by the IRS Task Force in encouraging voluntary compliance. The IRS’s primary handbook for administering penalties is set forth in the various subsections of IRM 20.1, which outline the criteria and procedures for asserting, not asserting, and abating penalties. The IRS says the IRM penalty is designed to be both an “everyday reference guide” as well as a “training document.”⁴⁰

As reflected in IRM 20.1, the IRS also eventually took the step of trying to establish a central coordination point within the Service to handle penalty policy and administration. The IRS Office of Servicewide Penalties (OSP) was created and placed within the Small Business/Self-Employed Division’s Exam Policy branch.⁴¹ The OSP is

34. See Uruguay Round Agreements Act of 1994, Pub. L. No. 103-465, 108 Stat. 4809 (1994).

35. See IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3801, 112 Stat. 685, 782 (1998).

36. Treasury Report, *supra* note 3.

37. *Id.* at 109.

38. *Id.* at 6.

39. *Id.* at 8.

40. See I.R.M. 20.1.1.1.2 (Dec. 11, 2009).

41. See *id.* I.R.M. 20.1.1.1.3 (Dec. 11, 2009).

overseen by a program manager that presumably reports up the SB/SE chain.⁴² Yet aside from aspirational goals set out in the IRM, little is known about the structure and operations of the OSP.⁴³

The OSP is supposed to act as the clearinghouse and approval source for penalty guidance—at least on paper.⁴⁴ In an effort to ensure consistency in penalty administration, the office has “overall responsibility” for penalty programs and updating IRM 20.1.⁴⁵ But according to a 2009 GAO study,⁴⁶ the OSP has not been fulfilling its obligation of comprehensively evaluating civil tax penalty administration and corresponding voluntary compliance efforts. The office seems to have been focused more on short-term analytical goals while neglecting to collect the information necessary to determine the effectiveness of penalties. In fact, the GAO report rapped the OSP for not having “a plan for fulfilling its responsibilities.”⁴⁷ The GAO recommended that the IRS develop a plan to “focus [OSP’s] efforts” on its mandate.⁴⁸

The failure to collect sufficient data prevents the IRS, Treasury, and Congress from evaluating how penalties are operating, whether there is consistent application of penalties, and the effect current penalties have on voluntary compliance. The GAO said a plan should be developed to lay out feasible research goals and identify resource requirements for the OSP.⁴⁹ Particular data that the OSP does not currently collect includes the level of assessment and abatement rates for penalties, differences in penalty application to taxpayers based on size or representation, and geographical disparities in application rates.⁵⁰

42. The AICPA Report, *supra* note 22, at page 16, suggests the OSP should be taken out from under SB/SE and placed under the oversight of the Deputy Commissioner of Service and Enforcement.

43. I.R.M. 20.1.1.1.3 (“Servicewide Penalties is charged with coordinating policy and procedures concerning the administration of penalty programs, ensuring consistency with the penalty policy statement, reviewing and analyzing penalty information, researching taxpayer attitudes and opinions, and determining appropriate action necessary to promote voluntary compliance.”).

44. I.R.M. 20.1.1.1(4) (Dec. 11, 2009) (While IRS functions “may develop additional guidance or reference materials for their specific functional administrative needs,” those materials “must receive approval from the Servicewide Penalties group.”).

45. *Id.* I.R.M. 20.1.1.1.2.1, 20.1.1.1.3 (Dec. 11, 2009).

46. See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-09-567, IRS SHOULD EVALUATE PENALTIES AND DEVELOP A PLAN TO FOCUS ITS EFFORTS (2009) [hereinafter GAO Report].

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.*

Analyses of trends in penalty data could help IRS identify areas that need further

In discussions with former IRS officials familiar with the operations of the OSP, those individuals highlighted several key deficiencies of the office.⁵¹ While the OSP was at one time expected to engage in sophisticated research, that skill is not in place. The focus of the office needs to be rebalanced to include more policy concerns, as the primary concentration is currently on administrative functions. Also, because the OSP is meant to serve as the contact point for policy coordination and changes to penalty guidance, there is a need to centralize approval processes among the various IRS functions. The OSP should conduct more servicewide training on applying penalty provisions, in order to reinforce throughout the organization that penalties are never meant to be used as revenue raisers.⁵²

As will be seen in the next section, the IRM and the OSP, acting as formal structures within the IRS to handle and coordinate administrative penalty issues, have not fulfilled their design in helping implement the fundamental policy goals expressed by the IRS Task Force. Better attention needs to be paid to adhering to the written intent of the penalty handbook and conforming administrative efforts to those guidelines.

III. THE CURRENT PROBLEMS

A. *A Call to Action*

A white paper produced by the American Institute for Certified Public Accountants cites concerns that Congress has experienced a “loss of direction” in the underlying theory of penalties, characterizing some legislative approaches as “ad hoc efforts to craft penalties and an increase in the use of penalties, rather than the substantive tax laws, to drive tax policy.”⁵³ That admonition rings clear in light of the dearth of sound policy justifications for recently enacted and proposed penalty measures.

investigation and when penalties may not be applied consistently and fairly. For example, a low assessment rate could indicate that a penalty is effective deterring noncompliance and that the infrequency of its assessment is appropriate. However, a low assessment rate might also indicate that a penalty has become outdated or is deemed too burdensome to assess. Similarly, a high abatement rate could indicate that IRS officials are hesitant to sustain a penalty because they deem it too harsh for the infraction.

Id.

51. February 2, 2010 telephone interview conducted by author with two former IRS senior leadership officials who requested anonymity to speak freely on OSP.

52. *Id.*

53. See AICPA Report, *supra* note 22, at 1.

Given the widespread recognition that penalties have drifted from the fundamental principles set out in 1989, proponents of civil tax penalty reform have been increasing the intensity of their calls for action in the past several years. In the twenty years since the last major legislative overhaul of the penalty regime, critics have become increasingly dismayed by congressional efforts to craft penalties that no longer conform to a penalty structure rooted in the core goal of voluntary compliance.

Several trade groups have bolstered the effort to draw attention to the situation by publishing new white papers on the topic.⁵⁴ The reports have highlighted what is perceived to be a trend away from penalty provisions that encourage voluntary compliance and instead toward penalties that lack clear standards, have disproportionate impact, erode basic procedural due process, and are automatically assessed.⁵⁵ Part of the problem, according to the AICPA report, stems from Congress's "tendency to enact new and higher penalties rather than determine how to maximize the impact of existing laws and penalties."⁵⁶

Disproportionate penalties—those where the imposition amount is not related to the degree of misconduct at issue or the resulting degree of harm—as well as stacking of penalties through overlapping provisions, threatens to “undermine faith in the fairness of the system,” the AICPA has warned.⁵⁷ The American Bar Association Section of Taxation also produced a recent policy statement in favor of penalty reform that cautioned against moving away from the principles that generated the 1989 reform legislation.⁵⁸ “Nothing has changed in the past twenty years to change our views on these guiding principles,” the white paper stated.⁵⁹ In particular, the paper said that creating new penalties that apply on top of existing penalties leads to increased complexity, produces multiple sanctions, and diminishes the perception that the tax system is reasonable.⁶⁰ According to the ABA tax section, since the

54. For news coverage, see Jeremiah Coder, *News Analysis: Waiting for Penalty Reform*, TAX NOTES TODAY 131-4 (2009).

55. See AICPA Report, *supra* note 22, at 1.

56. *Id.* at 4.

57. *Id.* at 9. That view is also relayed by Richard Lavoie, *Analyzing the Schizoid Agency: Achieving the Proper Balance in Enforcing the Internal Revenue Code*, 23 AKRON TAX J. 1, 2 (2008) (“[T]axpayer compliance is linked to perceptions regarding the overall fairness of the tax system. When taxpayers perceive the [IRS] as overreaching, they lose faith in the system and voluntary compliance is harmed.”).

58. See AMERICAN BAR ASSOCIATION, SECTION OF TAXATION, STATEMENT OF POLICY FAVORING REFORM OF FEDERAL CIVIL TAX PENALTIES (Apr. 21, 2009) [hereinafter ABA Report].

59. *Id.* at 5.

60. *Id.* at 4.

passage of IMPACT, what has developed is a “confusing array of vague definitions and overly complicated rules.”⁶¹

A telling review several years ago of all 130 penalty provisions in the tax code by the National Taxpayer Advocate showed that a good number of existing penalties are merely deadweight. A 2007 listing of penalty assessments by statutory provision reveal that thirty-five code provisions had no penalty assessments in that year, and that another eight provisions had fewer than five assessments.⁶² Thus, roughly one-third of current penalty provisions are having no effect on tax administration.

The IRS task force report warned that the “absence of a unified approach” to the penalty regime “encourages views of penalties as a panacea for all compliance problems, with increases in severity substituting for more thoughtful attempts to solve existing compliance problems.”⁶³ That admonition rings true in today’s chaotic penalty environment.

B. *Strict Liability*

One problematic feature of recent penalties is the frequency with which they contain strict liability components. Essentially, attaching strict liability to a traditional penalty removes the ability for taxpayers to counter the penalty by showing that their action or return position should be excused because of reliance on accepted factors (i.e. reasonable cause).

In attempting to push back against the wave of corporate tax shelter transactions that arose in the 1990s and led to the tax shelter litigation wars in the early 2000s, Congress increasingly relied on new penalty provisions that attempted to attack the perceived abusive behavior by restricting traditional penalty defenses. These rules moved away from a factual inquiry-based approach with proportionate sanction amounts, and instead manifested “strict liability” features by disallowing reasonable cause relief, prohibiting judicial review, limiting waiver authority, or introducing narrow rescission provisions.⁶⁴ Currently, there are eight strict liability penalty provisions in the tax code,⁶⁵ including the section

61. *Id.* at 6.

62. See 2008 NTA Report, *supra* note 1, at 40, Appendix A, Table 4 (The Number of FY 2007 Assessments for Selected Civil Tax Penalties by Internal Revenue Code Section).

63. IRS Task Force Report, *supra* note 8, at 30.

64. See AICPA Report, *supra* note 22, at 9.

65. See Clinton Stretch, Matthew Lay & John Galotto, *Economic Substance and Strict Liability Do Not Mix*, TAX NOTES 1357, 1359 (2009). Also, in March 2010, the Health Care and

6695A valuation penalties and section 6662(d) accuracy-related penalties for tax shelters, but the number seems to be growing as time passes.

The rise in the number of penalties with strict liability provisions has garnered scrutiny among practitioners and academics. When Congress reacts by penalizing abusive behavior, the resulting strains to good tax administration can overshadow and diminish much of the original intent behind a penalty system. One commentator has stated that strict liability penalties “by definition punish taxpayers with mitigating circumstances, including those who attempt to comply with the law in good faith.”⁶⁶ In binding the IRS’s hands, Congress has created “little agency flexibility” to fashion relief should a penalty provision lead to harsh unintended consequences. The notion behind strict liability seems to be “in direct conflict with the reform principles offered by [many] important stakeholders.”⁶⁷

In the case where “taxpayers frequently violate the rule” and thus incur a strict liability penalty, “the penalty may not be promoting voluntary compliance very effectively.”⁶⁸ The fact that so-called strict liability penalties are contested on a frequent basis also gives pause in considering whether the design of such penalties is appropriate. Because a successful penalty should probably not be proposed or litigated very often, “frequent litigation could be a sign that taxpayers are not satisfied with the fairness of a penalty.”⁶⁹ Strict liability “also negatively affects tax administration because it requires a higher expenditure of governmental resources to defend the imposition of the penalty.”⁷⁰

One strict liability penalty provides a telling example of the unintended severe impacts on penalty administration. As part of the 2004 American Jobs Creation Act,⁷¹ Congress enacted a new information reporting penalty, section 6707A, for failing to disclose reportable transactions. As originally enacted, unless a required disclosure of a reportable transaction described in reg. section 1.6011-4 is made on a Form 8886, Reportable Transaction Disclosure Statement, taxpayers could have been assessed a \$10,000 penalty for each instance of

Education Reconciliation Act, Pub. L. No. 111-152, 124 Stat. 1029 (2010), added section 6662(b)(6) and (i) for transactions lacking economic substance.

66. Stretch et al., *supra* note 65, at 1359.

67. *Id.* at 1358.

68. See 2008 NTA Report, *supra* note 1, at 15.

69. *Id.* at 13.

70. See Stretch et al., *supra* note 65, at 1359.

71. American Jobs Creation Act, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

nondisclosure if an individual, or \$50,000 if a business entity.⁷² The penalty was even higher if the transaction was a listed transaction, in which case the applicable penalty is \$100,000 for individuals and \$200,000 for other returns. The statute allowed the IRS Commissioner to abate non-listed reportable transaction penalties, but not for listed transactions.⁷³

The primary effect in applying the old section 6707A penalty so far has been to assess enormous penalty amounts against taxpayers who failed to file Form 8886 yet recognized little to no tax benefit from a deemed reportable transaction. For example, a small business owner who started a pension plan for her employees and paid \$13,000 in taxes on the plan, was assessed a \$1.4 million penalty for failing to disclose the transaction.⁷⁴ Other similar instances were also documented in hearings before Congress in 2009.⁷⁵

Even in spite of widespread and bipartisan congressional support to limit application of the section 6707A penalty to truly abusive transactions, efforts to pass legislative modifications took a long time to come to fruition. After numerous letters from congressional members were sent to the IRS complaining of the unintended harsh consequences the penalty was having on individuals and small businesses, the IRS announced that it was temporarily suspending collection of the section 6707A penalty in instances where the annual tax benefit was less than the amount of the penalty that would have been imposed.⁷⁶ The temporary collection suspension was extended several times by the IRS in hopes that Congress would eventually take concrete action on proposed legislation to reform the penalty.⁷⁷

Finally, as part of the Small Business Jobs Act of 2010, section 6707A was amended to retroactively reduce the nondisclosure penalty for reportable and listed transactions to 75 percent of the nondisclosure's tax benefit, with a minimum \$10,000 penalty and maximum of \$50,000

72. I.R.C. § 6707A (2006).

73. *Id.*

74. See Small Business Council of America, *Submission for the Record, Ways & Means Subcommittee on Oversight Hearing on IRS Operations: The Unintended, Draconian Impact of Code Section 6707A – Examples In “Real Life” From Taxpayers Residing Throughout The Country*, TAX NOTES TODAY 106-36 (2009).

75. See *Internal Revenue Service Operations and Fiscal Year 2010 Budget Proposals: Hearing before the Comm. on Ways & Means*, 111th Cong. 17 (2009) (statement of Ga. John Lewis, Chairman, Comm. on Ways & Means).

76. See Letter from IRS Commissioner Douglas Shulman to House Ways and Means Committee (July 6, 2009), in TAX NOTES TODAY 128-15 (2009).

77. See the Small Business Penalty Relief Act of 2009, H.R. 4068, 111th Cong. (2009).

per reportable transaction, or maximum \$200,000 for a listed transaction.⁷⁸ The minimum penalty in the case of an individual would be \$5,000. There have also been legislative proposals to add a reasonable cause exception to section 6707A for failure to disclose a reportable transaction, but no significant recent movement has been seen on those proposed bills.⁷⁹

As noted in the GAO report, penalty amounts have to be set at appropriate levels to positively affect taxpayer behavior. “Some penalties may be too low to change behavior but others may be so high that examiners are reluctant to assess them.”⁸⁰ The IRS Task Force warned that severe sanctions “tend to be neutralized by nonimposition” because taxpayers fight back harder.⁸¹ According to anecdotal reports from practitioners, that seems to be the case in many instances where section 6707A could be applied. Because the penalty amount is so high and the consequences so severe if asserted, IRS personnel have been hesitant to apply the penalty in as many cases as it might be applicable. Uncertainty regarding the amount of the penalty that might be imposed for a simple foot fault also causes high taxpayer anxiety.

According to the GAO report, as of January 2009, the Service had asserted the section 6707A penalty in only ninety-eight cases for a total of \$13.7 million.⁸² The inherent bind present in such circumstances is that penalties do little good if they are not used out of fear of swinging a sledgehammer to slice bread.⁸³ As the NTA put it, “IRS employees may find reasons not to enforce penalties perceived to be unfairly harsh.”⁸⁴

One problem with strict liability penalties is that the intent behind such provisions seems to be a desire to punish taxpayers for perceived abusive behavior, rather than to encourage compliance.⁸⁵ Yet, the tax law is extremely complex, made even more so by the addition of new tax code provisions that Congress regularly passes. Aside from any attempts by some taxpayers to game the system to avoid paying taxes,

78. Small Business Jobs Act of 2010, Pub. L. No. 111-240, 124 Stat. 2504.

79. See S. 765, 111th Cong. (2009); H.R. 2143, 111th Cong. (2009).

80. See GAO Report, *supra* note 46, at 9.

81. See IRS Task Force Report, *supra* note 8, at 46 (“Taxpayers, perceiving the penalty as unfair, tend to contest it, leading to more appeals, complaints, adverse publicity and bad relations between IRS and practitioners.”).

82. See GAO Report, *supra* note 46, at 14-15.

83. See Richard Stark, *A Principled Approach to Collection and Accuracy-Related Penalties*, TAX NOTES 124 (2001). “There is little to be gained from a penalty that is not or cannot be used effectively by the IRS.” *Id.*

84. See 2008 NTA Report, *supra* note 1, at 10.

85. See ABA Report, *supra* note 58, at 10; Stretch et al., *supra* note 65, at 1359.

many taxpayers in regular circumstances can be uncertain of how the law treats certain transactions.⁸⁶ Taking away the ability to show why certain conduct was pursued, and the motives behind it, forces taxpayers to shun self-correction and avoid transparency with the government—actions directly in contrast with the stated goals of the penalty regime. This can lead to what policy observers characterize as “playing the audit lottery.” As the ABA tax section recognized, strict liability penalties “eliminate the opportunity, and the incentives, to remediate and to become compliant.”⁸⁷

Moreover, many of the enacted strict liability penalties have been focused on penalizing reporting errors rather than improper behavior. Sticking with section 6707A as an example, many taxpayers find it difficult to determine if a transaction they engaged in is “substantially similar” to another transaction deemed reportable or listed by the IRS.⁸⁸ This can especially be the case if the transaction is considered to be “run of the mill” or otherwise follows generally accepted practices within the tax community. Thus, a penalty for failure to properly disclose the transaction on a Form 8886 attached to a return and also sent to the Office of Tax Shelter Analysis is not a result of the substance of the underlying transaction, but rather is based solely on guessing that compliance with a special information reporting regime is required. A policy that creates “traps for the unwary”⁸⁹ seems to plainly violate horizontal equity.⁹⁰

Consistent with good tax policy, taxpayer return disclosures should be narrowly tailored and designed to root out specific information. Yet congressional focus on tax shelters has produced statutory and regulatory language—such as that under sections 6662 and 6011—that requires additional information disclosure by a taxpayer without clearly defining the terrain it wants disclosed.⁹¹ The lack of transparency in this area regarding clearly articulated standards of behavior for taxpayers to

86. See Lawrence M. Hill & Alexandra Minkovich, *Tax Policy Gone Wild: Penalties as Revenue Raisers*, TAX NOTES 4 (2007). “A strict liability penalty is an especially harsh, if not inequitable, punishment in cases in which there is significant doubt as to whether the person is subject to liability for the penalty.” *Id.*

87. See ABA Report, *supra* note 58, at 10.

88. See AICPA Report, *supra* note 22, at 5 (bemoaning the fact that “neither the term ‘tax shelter’ nor ‘a significant purpose’ has been clearly defined.”).

89. *Id.*

90. See 2008 NTA Report, *supra* note 1, at 23 (“Because the penalty is not subject to a reasonable cause exception, it does not treat taxpayers who made similar efforts to comply similarly—those who fail through no fault of their own are penalized to the same extent as those who intentionally fail disclose a transaction—arguably failing to achieve horizontal equity.”).

91. See Stark, *supra* note 83, at 127.

follow leads to this disparity of treatment. That is why the AICPA report knocked the current penalty system for failing to “treat similarly situated taxpayer similarly [with] sufficient flexibility to account for differences in the particular facts and circumstances of each case.”⁹²

A result many tax policy observers see flowing from strict liability provisions is increased litigation. If there is no avenue or mechanism for taxpayers to present mitigating circumstances or evidence to the IRS in the face of an asserted penalty, taxpayers are more likely to take the issue to court to battle over the correctness of the underlying transaction.⁹³ As one practitioner has noted, “strict liability is arguably appropriate only when taxpayers have violated known legal standards, not amorphous principles.”⁹⁴ Such actions impose a greater cost on tax administration from having to defend the penalty assertion in a judicial setting. This is not a good outcome for sound tax policy.⁹⁵

C. *Limiting Reasonable Cause*

Another troubling occurrence that puts the current penalty regime at odds with time-honored penalty policy goals is the trend toward limiting the ability of taxpayers to present a defense when a penalty is imposed. The reasonable cause exception for accuracy-related penalties, section 6664(c), was added to the tax code in 1989 as part of IMPACT.⁹⁶ In order to avoid an accuracy-related penalty, a taxpayer must be able to show that there was a reasonable cause for the tax underpayment and that there was a good faith belief surrounding the taxpayer’s conduct or position. Removing the defense diminishes fundamental fairness, and Treasury has noted that the availability of reasonable cause waivers “is generally sound tax policy.”⁹⁷ Indeed, a reasonable cause defense has

92. See AICPA Report, *supra* note 22, at 3.

93. See 2008 NTA Report, *supra* note 1, at 13. According to the NTA 2008 annual report, the accuracy-related penalty was the fifth most litigated issue, accounting for about nine percent of the cases, where taxpayers prevailed in 43 percent such cases when represented by counsel. The NTA also noted that “frequent litigation could be a sign that taxpayers are not satisfied with the fairness of a penalty.” *Id.*

94. See Hill & Minkovich, *supra* note 86, at 5.

95. See Stretch et al., *supra* note 65, at 1359 (“Strict liability also negatively affects tax administration because it requires a significant higher expenditure of governmental resources to defend the imposition of a penalty. A penalty such as the proposed economic substance penalty will ensure and increase litigation as taxpayers are unable to compromise the underlying issue administratively with the IRS without payment of the large penalty amount.”).

96. See Pub. L. No. 101-239, § 7721(a), 103 Stat. 2398, 2399 (1989) (repealed).

97. See Treasury Report, *supra* note 3, at 125.

been a central component of most penalty provisions since the 1954 tax code.⁹⁸

One example of a penalty provision that has been introduced, with reasonable cause stripped away, is the recently codified economic substance doctrine. As part of the reconciliation fixes to the healthcare reform bill,⁹⁹ Congress enacted a new underpayment penalty for transactions that lack economic substance. Section 6662(b)(6) makes noneconomic substance transactions subject to a 20 percent underpayment penalty, and section 6662(i) increases the penalty to 40 percent if the transaction was not separately disclosed. Of significant importance is that sections 6664(c)(2) and (d)(2) were added to remove the reasonable cause exception for any penalty applied to noneconomic substance transactions, including reportable transactions described in section 6662(b)(6). These restrictions on providing a penalty defense come despite considerable taxpayer uncertainty on when the economic substance doctrine will apply. Valuation penalties and tax shelters are other areas where reasonable cause is similarly lacking.¹⁰⁰

The ABA tax section white paper strongly condemned congressional attempts to foreclose the opportunity for taxpayers to present mitigating evidence when faced with a penalty assessment. “All penalties should be subject to a reasonable cause and good faith defense and no penalty should be imposed without affording an opportunity to the party who may be sanctioned to defend the conduct,” the paper said.¹⁰¹ The concern is that removing reasonable cause does not address abusive transactions or increase voluntary compliance, while at the same time it greatly increases compliance costs.¹⁰² The paper further declared that “fundamental fairness requires that taxpayers be permitted an opportunity to contest penalties, and to demonstrate why penalties are not appropriate in a particular situation.”¹⁰³

There is worry that Congress could go even further in placing limits on the reasonable cause defense. Although not adopted as part of the healthcare reform legislation that also codified the economic substance doctrine, H.R. 3962 proposed to make some corporations subject to a more likely than not standard for avoiding penalties on tax

98. *Id.* at 120.

99. *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (as signed into law on March 30, 2010).

100. *See, e.g.*, I.R.C. §§ 6664(c)(3), 6695A, 6662(d)(2)(B) (2006).

101. *See* ABA Report, *supra* note 58, at 9.

102. *Id.* at 10.

103. *Id.* at 9.

underpayments.¹⁰⁴ The proposed legislation would have changed section 6664(c)(3)(A) to make the standard subsection (c)(1) reasonable cause exception for underpayments inapplicable to certain companies unless the entity met the more likely than not standard for any given return position. The affected companies—“specified persons”—would be corporations that have more than \$100 million in gross receipts in any tax year or that are publicly traded entities with filing requirements under the Securities Exchange Act of 1934. Those conditions encompass a large number of corporate taxpayers with long, complicated returns as a result of normal business activity, and the provisions could lead to related problems for companies subject to FIN 48 accounting rules.

Section 6662(d)(2) would also have been amended under the bill to prevent application of the “substantial authority” and “reasonable basis” standards to reduce underpayments for any specified person. This undermines recent efforts to increase taxpayer transparency. The legislation would affect underpayments arising from transactions entered into after the enactment date, providing companies with scant time to implement adequate internal control procedures before any guidance from the Service could be issued.

While Congress should be concerned about motivating proper taxpayer behavior, the circumstances addressed by H.R. 3962 have little to do with compliance. The broad sweep of proposed section 563 of the bill would affect all corporate transactions, not just those considered tax shelters under section 6662. Routine non-tax-motivated transactions that encompass unsettled legal issues would be prime targets. A legitimate worry is the effect the proposed penalty will have on non-shelter transactions, as it is not uncommon for large corporations to be unable to reach the more likely than not standard if there are multiple possible interpretations of the law.¹⁰⁵ For example, if a taxpayer in a common capitalization issue took a deduction rather capitalizing a repair expense, and if the IRS felt the entity took the wrong return position, the company could wind up facing underpayment penalties with no reasonable cause or other defense.¹⁰⁶ And with corporate reporting obligations under FIN 48, the IRS could put companies on the hook for penalties if it

104. See Affordable Health Care for America Act, H.R. 3962, 111th Cong. (2009).

105. See Jeremiah Coder, *News Analysis: Corporate Penalties in House Healthcare Bill Cause Concerns*, TAX NOTES TODAY 218-1 (2009) (quoting Michael Desmond, former Treasury legislative counsel).

106. *Id.*

questioned whether financial reserves were based on a more likely than not standard.

In this instance, Congress has found easy money in potentially collecting penalties for any mistakes large or public corporations make by simply raising the applicable standard regardless of conduct, while allowing smaller, shelter-motivated transgressors to avoid enhanced penalty standards. The administration and Congress should be considering appropriate penalties, but in the context of wholesale reform, in order to improve tax system administration. Focusing on discrete penalty provisions that raise revenue but add complexity, while singling out a subset of taxpayers because of their ability to pay, is the wrong approach. Policy is important when it comes to penalties and the lack of a cognizant rationale for proposed penalties, such as those in H.R. 3962, will only weaken the system.

Limiting penalty defenses as part of a rules-based system will also only serve to increase unintended consequences. One commentator has observed that removal of the IRS's authority to waive penalties can be seen as a lack of confidence in the government's ability to properly weigh when waiver is appropriate.¹⁰⁷ Carving out particular penalties to which reasonable cause does not attach runs counter to what Congress identified in IMPACT as key rationales for having such a defense.¹⁰⁸ It was expected that a reasonable cause exception would help taxpayers "more easily understand the standards of behavior that is required" of them, and that the defense would "simplify the administration of these penalties by the IRS."¹⁰⁹

D. *Lack of Procedural Rights*

Another feature of several recently enacted penalty provisions is the elimination of judicial review of certain penalty determinations. Section 6707A is an example in this regard, as taxpayers cannot challenge in court the IRS Commissioner's refusal to abate the penalty.¹¹⁰ Yet, "judicial review of an IRS decision to impose a penalty or to deny waiver is an important constitutional check on executive authority."¹¹¹ Congressional reaction to IRS lapses regarding tax shelters by removing

107. See Stark, *supra* note 83, at 121. "[It] reflects a lack of faith (perhaps self-fulfilling) in the ability of the IRS and the courts to administer discretionary waivers." *Id.*

108. See Treasury Report, *supra* note 3, at 37-39.

109. See H.R. REP. NO. 247, 101st Cong., 1st Sess., at 1392-93 (1989).

110. I.R.C. § 6707A(d)(2) (2006). However, taxpayers can still contest application of the penalty in the first place.

111. See AICPA Report, *supra* note 22, at 11.

certain traditional procedural rights reflects “the height of hubris to think that an occasional mistake in the administration of penalties warrants the elimination of the opportunity for administrative judgment calls.”¹¹²

Fairness is one of the underlying concerns at play here. Outside of the strict liability context, when mitigating circumstances exist, taxpayers are afforded the chance to present those facts to the IRS for its discretion in administering penalties.¹¹³ If a taxpayer is no longer able to rely on that discretion, the IRS is deprived of the ability to exercise consistency and impartiality across the board to all taxpayers.¹¹⁴ It also harms the effectiveness of the tax system when the penalty must be applied in inappropriate circumstances but mitigation is foreclosed. The discretion available to the IRS should be “appropriately calibrated” so that “IRS personnel have neither too much nor too little discretion.”¹¹⁵ There is tension between noncompliance resulting from honest taxpayer mistakes and willful noncompliance, and a similar incongruence between administrative simplicity and complexity. If the IRS doesn’t pay attention to either penalty design or administration, “the penalties may be unfair in their application to situations involving different underlying causes.”¹¹⁶

Policy advocates also are distressed by the fact that penalties can be imposed on taxpayers for transactions entered into and reported on a return before the IRS makes a determination that a transaction is reportable.¹¹⁷ For example, in the case of reportable transactions, the IRS can issue a notice that a particular transaction is “listed” and thus subject to specific disclosure standards or else a penalty applies.¹¹⁸ But it can be several years after a taxpayer’s transaction occurs that the IRS determines it is abusive and crafts rules to clamp down on such

112. See Stark, *supra* note 83, at 142. Stark also warned that “removing waiver authority creates a Procrustean bed that can and will deflect energy from regulating overly aggressive conduct and toward debate regarding the perceived procedural unfairness of abolishing traditional defenses and ambiguously defining critical terms.” *Id.* at 147.

113. See Treasury Report, *supra* note 3, at 38 (“administrative discretion also is exercised in evaluating the facts and circumstances weighing for or against imposition of a penalty”).

114. *Id.* (“Fairness requires that this discretion be exercised with consistency and impartiality such that similar situations are not treated differently.”).

115. *Id.* (“Fairness also involves providing taxpayers with opportunity to have their interests heard and considered.”).

116. *Id.* at 37.

117. See AICPA Report, *supra* note 22, at 6 (“In the case of listed transactions and transactions of interest, ‘participation’ may be defined in the notice identifying the transaction as a listed transaction or a transaction of interest. These notices can be issued years after the tax year in which the transaction occurred, compounding the problem of complying up front with vague standards.”).

118. See I.R.C. §§ 6011, 6111, 6112 and accompanying regulations (2006).

transactions. The retroactivity of applying new rules to completed transactions flies in the face of fair notice to the taxpayer of what conduct is acceptable.¹¹⁹

More and more, the IRS is using automated processes to assess penalties on taxpayers.¹²⁰ These administrative mechanisms put taxpayers in a tough position if they are not afforded the ability to contest penalties before payment is expected by the Service.¹²¹ Automatic penalty application should still allow the taxpayer “an opportunity to demonstrate why the penalties are not applicable to a particular situation.”¹²² And inconsistencies regarding which penalties have pre-assessment rights makes it unfair for a taxpayer to dispute one penalty but not another. The ABA tax section white paper warned that “the perception of fairness in the administration of civil tax penalties is *critical* to fostering taxpayer’s respect for the tax law.”¹²³

The fear is that it is possible for the IRS to abuse its position when a taxpayer has no direct recourse to dispute a penalty determination.¹²⁴ Without adequate oversight or instruction, examining agents can have relative immunity for taking an aggressive interpretation that a taxpayer did not have authority to take a certain return position and thus is subject to an accuracy-related penalty. While widespread abuse by the IRS is unlikely, even a few isolated examples of egregious circumstances can cause substantial damage to the tax system’s reputation.¹²⁵ The 1999 Treasury report cautioned that “the manner or methods by which the IRS collects taxes and deals with taxpayers may be as important as the penalty and interest provisions in affecting compliance.”¹²⁶

Penalty abatement is a longstanding and frequent occurrence by the IRS, as borne out by IRS data. For example, numbers supplied by the

119. See AICPA Report, *supra* note 22, at 6.

120. See 2008 NTA Report, *supra* note 1, at 16.

121. See AICPA Report, *supra* note 22, at 11. “In general, this would include the right to an independent review by the IRS Appeals office, as well as access to the courts. Pre-assessment rights are particularly important where the underlying tax provision or penalty standards are complex, the amount of the penalty is high, or fact-specific defenses such as reasonable cause are available.” *Id.*

122. See ABA Report, *supra* note 58, at 8.

123. *Id.* at 7 (emphasis added).

124. See Hill & Minkovich, *supra* note 86, at 4 (noting that the lack of “protection against potentially arbitrary or capricious actions by the commissioner” are “objectionable from a fundamental due process standpoint as well as on sound tax policy grounds.”).

125. See Stretch et al., *supra* note 65, at 1361 (“A similar cynicism caused by application of the [codified economic substance] penalty to sympathetic taxpayers would have a corrosive effect on compliance.”).

126. See Treasury Report, *supra* note 3, at 40.

annual IRS data book for years 2007 through 2009 show that the IRS regularly abates roughly 30 percent of penalties for individual taxpayers, including accuracy-related penalties, and has abated penalties for corporate taxpayers in the range of 45 to 70 percent each year.¹²⁷ Stark has described this as a picture of “virtually inevitable administrative reversal of proposed accuracy-related penalties.”¹²⁸ And the NTA has said that “frequent penalty abatements could reflect a problem in the underlying tax assessment process.”¹²⁹

E. Penalties as Revenue Raisers

By their nature, penalties have the incidental effect of raising revenue by imposing a cost on noncompliance. But using penalties as a direct tool to raise money is inapposite to the goals of a properly functioning penalty system as it puts the focus on offsetting other tax changes rather than encouraging voluntary compliance.¹³⁰ Yet that seems to be a motive—indirect, if not perhaps direct—behind some of the recent penalty enactments and proposals.¹³¹

Critics have spoken frequently on the dangers of using penalties as revenues raisers, warning that such use leads to serious damage to the underlying principles of IRS penalty policy. As noted by the ABA tax section, “looking to penalties to offset tax expenditures risks incentivizing the Service to impose and to sustain penalties—particularly large dollar penalty amounts—wherever it can be done, regardless of whether penalties are appropriate in a particular case, and regardless of the consequences for the tax system that can result from even the perception of random or unfair application of tax penalties.”¹³²

One practitioner has characterized revenue raising through the use of strict liability penalties as “poor tax policy and an unsatisfactory rationale.”¹³³ Indeed, the same practitioner has openly criticized

127. See Jeremiah Coder, *Data Book Snapshot: 2009 Civil Penalties and Chief Counsel Workload*, TAX NOTES 1454 (2010).

128. See Stark, *supra* note 83, at 139.

129. See NTA 2008 Report, *supra* note 1, at 15.

130. See Treasury Report, *supra* note 3, at 36. “Penalties may raise revenue collaterally but this should not be a deliberate objective of penalty design and doing so can create perverse incentives.” *Id.*

131. See Mik Shin-Li, *Strictly Wrong As a Tax Policy: The Strict Liability Penalty Standards in Noneconomic Substance Transactions*, 78 FORDHAM L. REV. 17 (2010-2011) (“Tax penalties as revenue raisers at best involve mixed motives and at worst become arbitrary punishment of the taxpayers, which is not within the role of tax penalties.”).

132. See ABA Report, *supra* note 58, at 11.

133. See Hill & Minkovich, *supra* note 86, at 2.

Congress for its “avowed and all-too-transparent purpose for enacting strict liability penalties without judicial recourse [in order] to raise revenue.”¹³⁴

Government officials have privately admitted that money inflows expected from certain penalty proposals are part of a penalty’s attraction. In regard to attempts to codify the economic substance doctrine, with its attached strictly liability penalty, Joshua Odintz, former tax counsel to the Senate Finance Committee, remarked at a 2007 conference that “whether economic substance codification is good policy or not, it’s money on the table.”¹³⁵ Former Treasury tax legislative counsel Michael Desmond likewise acknowledged that economic substance codification and penalties have been popular among congressional members because there is “a lot of money associated with [it].”¹³⁶

But one of the problems in looking at penalties as a means for budget offsets is the inherent difficulty of placing a monetary value on them. The attempt to codify the economic substance doctrine is a prime example of valuation uncertainties. A proposal in the 109th Congress to codify the economic substance doctrine was scored by the Joint Committee on Taxation at around \$17 billion.¹³⁷ Subsequent legislative proposals have progressively seen the associated revenue score drop measurably. In 2007, a JCT score of a codification proposal was estimated at \$10 billion. The JCT estimate for the 2010 reconciliation package that finally enacted economic substance codification was pegged at only \$4.5 billion.¹³⁸ The inherent difficulty of predicting taxpayer behavior makes revenue-guessing quite speculative in the area of penalties.¹³⁹ As previously alluded to in the beginning background section of this essay, “the best penalty would be the one that is so

134. *Id.* at 6.

135. See Lee A. Sheppard, *News Analysis: Economic Substance Codification Coming*, TAX NOTES TODAY 196-3 (2007).

136. See Jeremiah Coder, *Desmond Says Legislative Outlook Driven by Pay-Go*, TAX NOTES TODAY 107-2 (2007).

137. See *JCT Scores Senate-Passed Tax Relief Act* (JCX-9-06), TAX NOTES TODAY 27-14 (2006).

138. See *JCT Estimates Budget Effects of Combined Housing Healthcare Reform Legislation* (JCX-17-10), TAX NOTES TODAY 55-22 (2010).

139. See 2008 NTA Report, *supra* note 1, at 5 n.11 (“Revenue generated directly from new penalties can be taken into account in connection with the federal budget ‘scoring’ process, but any resulting effect on voluntary compliance can probably not be taken into account given the lack of quantitative research in this area.”).

effective it virtually eliminates noncompliance and thus results in no penalty revenues.”¹⁴⁰

It is particularly discouraging that, on Capitol Hill, some lawmakers have forsaken essential penalty principles and now believe that penalties should be pursued simply because they raise revenue. Congress needs lots of money to fund its long list of legislative priorities, but subverting tax policy to get that money is wrong. As already stated, there is scant support for the theory that efforts to put a dollar amount on what penalty provisions might raise are even reasonable. The 2008 National Taxpayer Advocate report lamented that “policymakers lack the information they need . . . to accurately estimate the budget effect of changes to the penalty rules.”¹⁴¹ What is certain is that corporate costs will increase as companies try to meet higher standards of authority—whether at a more likely than not or some other threshold—because sometimes it just simply is not possible for a company to get to more likely than not on certain tax positions when the tax law is not clear. So corporations subject to the proposed penalty provisions would either have to expend significant resources trying to cover themselves with strong opinions, or not even try out of a sense of futility.

F. *Tax Shelter Effects*

Many of the changes in the past decade to the tax code regarding penalty provisions have been driven by the government’s increasing desire to combat tax shelters. Indeed, reportable transactions and strict liability penalties that have radically changed the penalty system are the result of an overreaction by Congress to a small segment of taxpayers abusing the tax code to avoid paying taxes. But are tax shelter-driven reforms good for the tax system? The author believes not.

The creation of tax shelter penalties in particular tend to arise from lack of enforcement of current penalty provisions and so often end up producing a “stacked” effect. The main effect of stacking—whereby multiple penalties overlap in applying to a particular transaction—is to produce aggregate penalty amounts that are disproportionate to the degree of misconduct or harm.¹⁴² Another result is over-disclosure,

140. See Stark, *supra* note 83, at 121. That view is mirrored by former IRS commissioner N. Jerold Cohen. See Jeremiah Coder, *Tax Shelter Penalties are Unclear and Weakly Enforced, Panelists Say*, TAX NOTES TODAY 145-3 (2008) (quoting Cohen, “But the best penalties are those that don’t raise any revenue because they encourage the conduct that the penalty is designed to encourage.”).

141. See 2008 NTA Report, *supra* note 1, at 5.

142. See AICPA Report, *supra* note 22, at 7.

which causes taxpayers to have to report positions for which they have adequate authority and only swamps the IRS with additional forms to process.¹⁴³

Fundamentally, the underlying policy goals of tax administration devoted to voluntary compliance are sound and should not be jettisoned in response to the attacks emanating from tax shelters.¹⁴⁴ The overarching goals of fairness, comprehensibility, effectiveness, and ease of administration remain and can stand up to the challenges posed by tax law manipulations. Just as in the past, our tax system will weather this cycle of shelter activity, but it should do so while staying true to the fundamentals of its penalty regime.

IV. POSSIBLE REFORMS

The problem with any reform of the civil penalty tax system is making it stick so that future penalties do not go astray from promoting voluntary compliance. Although restructuring may work for a while, history has shown that the trend is for Congress to eventually go back to instituting new penalties misaligned with overall policy goals, and for the IRS to craft a complicated compliance regime. That certainly has been the fact after the past several attempts at major penalty reform. As Tax Court Judge Robert Wherry acknowledged in conference remarks in 2010, past efforts have only borne short-term fruit: even with the great strides of IMPACT, the last round of penalty reform “didn’t get the job done.”¹⁴⁵

Some will view the following ideas as far-fetched and impractical. Both are potentially valid criticisms, but the proposals at least serve as an initial framework for (hopefully) serious discussion about the issue of comprehensive penalty reform.

A. *Penalty Review*

Increasing the frequency or scope of review of penalties by Congress and the IRS/Treasury is not necessarily a new or unexpected

143. See Coder, *supra* note **Error! Bookmark not defined.**, at 4 (quoting Tom Ochsenschlager as saying that over-disclosure will not be effective because the IRS can’t handle the volume, and taxpayers shouldn’t have to disclose transactions for which they have adequate support. “Substantial authority is an appropriate standard.”).

144. However, for a bleaker assessment, see *id.* (quoting a practitioner as saying: “In my practice, I’ve never seen penalties be a deterrent factor in any action taken by a taxpayer.”).

145. See Jeremiah Coder, *Practitioners, Officials Debate Prospect of Civil Penalty Reform*, TAX NOTES TODAY 16-5 (2010).

proposal. Legislation enacted in 2010 requires annual reports by the IRS to Congress on penalties assessed for undisclosed reportable transactions—the section 6707A penalty—as well as other tax shelter penalties, including sections 6662A, 6700(a), 6707, and 6708.¹⁴⁶ Stakeholder groups also recognize the value that comes from having better penalty information available, calling for the IRS to provide “periodic and increased analysis and reporting on effectiveness of penalty administration.”¹⁴⁷

The NTA has been particularly vocal regarding the necessity of an improved penalty reporting system. The 2008 NTA report took the IRS to task for having “no significant quantitative data to show how penalties affect voluntary compliance.”¹⁴⁸ The report lamented the fact that:

the IRS either does not assess or does not track assessment of many current penalties, much less study them in a comprehensive manner. As a result, policymakers lack the information they need to structure and administer tax penalties to maximize voluntary compliance or even to accurately estimate the budget effect of changes to the penalty rules.¹⁴⁹

The “dearth of information” surrounding penalties frustrate effective review of the system. “The Service does not regularly make public reports of its efforts to comply with [IRS Policy Statement 20-1],” the ABA paper complained.¹⁵⁰ The information provided by the IRS, mainly through its annual data book, is helpful only to a limited degree because of the aggregation format into broad penalty categories. Further, mining the data and delivering more targeted reports would be of tremendous assistance to tax policymakers.¹⁵¹ The National Taxpayer Advocate has asked Congress to direct the IRS to “conduct an empirical study to quantify the effect of each penalty on voluntary compliance.”¹⁵²

More comprehensive reporting of penalty data would significantly enhance the ability of Congress and tax administrators to evaluate how penalties, as applied in practice, are affecting tax administration.

146. See Small Business Jobs Act, Pub. L. No. 111-240, § 2103, 124 Stat. 2504 (2010).

147. See ABA Report, *supra* note 58, at 13.

148. See 2008 NTA Report, *supra* note 1, at 5.

149. *Id.*

150. See ABA Report, *supra* note 58, at 13.

151. See Stark, *supra* note 83, at 120. “[N]ot much has been done to follow penalties more closely. Penalty statutes, like the substantive law, have been constantly amended and updated, drawing into question the comparability of data from year to year.” *Id.*

152. See 2008 NTA Report, *supra* note 1, at 6.

B. *Increasing Certainty*

Many of the heated discussions stemming from the recently enacted accuracy-related and information reporting penalties in sections 6662, 6662A, 6707, 6707A, and 6694 are a direct byproduct of Congress's inability to write clear rules for taxpayers and practitioners to follow. A good number of tax literature pages have been devoted to complaining about the difficulty in following the tax law because of perceived ambiguity. Thus, part of the solution to an unmoored penalty regime needs to be a greater emphasis within Congress, and by extension, the IRS, in creating regulations on producing guidance to clarify the vast pools of tax law uncertainty.¹⁵³

Many tax return positions result from uncertainty about the law, especially when it comes to recently enacted code provisions. Because there may be contradictory judicial interpretations or no guidance in a particular area of tax law, corporations engaged in complicated business transactions may lack confidence about treatment of a tax issue. As one practitioner noted, "taxpayers should not be punished for taking good-faith tax positions."¹⁵⁴ Yet the proposed legislation in H.R. 3962 would also have eliminated the penalty protection afforded taxpayers for specifically disclosing an uncertain tax position to the IRS, running in direct contrast to government efforts to increase transparency and bring about more disclosure of uncertain tax positions.

In recognition of those compliance difficulties, the IRS seems to be shifting toward greater willingness to issue "pretty good" guidance to resolve some issues in a timely manner instead of taking years to comprehensively tackle all compliance uncertainties for a particular tax issue.¹⁵⁵

C. *Graduated Penalties*

Establishing more penalties with a graduated structure could help solve some of the problems associated with strict liability. As Stark puts it, "stepped" penalties respond so that "the more egregious conduct and the less responsive taxpayers are penalized more seriously."¹⁵⁶ The

153. See Stretch et al., *supra* note 65, at 1359. "[T]he factors identified by Treasury and the IRS in guidance are able to drive taxpayer or preparer behavior." *Id.*

154. See Jeremiah Coder, *News Analysis: Corporate Penalties in House Healthcare Bill Cause Concerns*, TAX NOTES TODAY 218-1 (2009).

155. See Amy S. Elliott, 'Pretty Good' Guidance Should Be Good Enough for IRS, *Official Says*, TAX NOTES TODAY 233-4 (2010).

156. See Stark, *supra* note 83, at 124.

section 6651 failure to file penalty is an example of a penalty rate increasing in some proportion to the perceived egregiousness of the noncompliance. The penalty is imposed at a rate of 5 percent per month past the date a return is due, and caps out at a maximum of 25 percent. So a taxpayer filing his return one month late would pay a 5 percent penalty on the net amount of unpaid tax, would pay 10 percent if filing two months late, and so on. The failure to pay penalty operates in a similar fashion. One scholar has opined that graduated rates make a “penalty much milder for many taxpayers.”¹⁵⁷

The 1999 Treasury report recognized that a penalty regime must “distinguish among the different underlying causes of noncompliance.”¹⁵⁸ It recommended that the section 6651 failure to file penalty be further revised to reduce the penalty to 0.5 percent for the first 6 months, and increasing to 1 percent a month beyond that, up to a maximum 25 percent cap.¹⁵⁹ The proposal was based on the belief that getting rid of the front-loading nature of the penalty would “provide continuing incentive for correction” to encourage noncompliant taxpayers to get right sooner rather than later, if at all.¹⁶⁰

The principle of targeting noncompliance through penalty amounts that best correspond to the level of culpability or harm to the system is worth serious consideration, and a graduated system can give effect to that objective. That seems to be part of the calculus in amended section 6707A. Tying the penalty amount for section 6707A in between the minimum floor and maximum cap thresholds to 75 percent of the resulting tax benefit that was not disclosed is a better start than imposing a blanket unreviewable fine.

An even better solution though would be to base the section 6707A penalty amount on some sort of time scale like the one used in section 6651. Currently, the automatic penalty of \$100,000 for individuals with listed transactions provides no motivation for self-correction if the taxpayer discovers post-filing that the transaction should have been reported; the lack of incentive to file amended returns leaves some taxpayers willing to play the audit lottery. Something akin to an increasing penalty rate by month seems to be a more reasonable mechanism to structure the penalty so as to encourage voluntary compliance with the tax code rather than swinging the hammer with no

157. See William A. Drennan, *Strict Liability and Tax Penalties*, 62 OKLA. L. REV. 1, 41 (2009).

158. Treasury Report, *supra* note 3, at 37.

159. *Id.* at 67.

160. *Id.* at 65.

chance of limited relief. Because the noncompliance at issue in section 6707A and other information reporting penalties is disclosure rather than substantive tax law, a graduated arrangement make sense.¹⁶¹

D. *Penalty Sunsets*

A possible mechanism for enhancing the effectiveness of the penalty system is requiring regular congressional review of existing penalty provisions. Essentially, this could be accomplished via a mandatory sunset of most penalties, say every five years.

What this might accomplish is a recurring review of the justification for, and practical administrative effects of, certain civil tax penalties. Far too often, after significant penalty reform is achieved, Congress gums up the system with additional penalties that forsake the voluntary compliance imperative. This leads to the complexity, stacking, and unintended consequences that has consistently occurred over a period of time. Over time, penalties may fall into disuse; legislative review would help remove unnecessary provisions from an already lengthy and complex tax code.

If the IRS, through the OSP or another investigative reporting mechanism, provided detailed analysis of how the penalty regime is operating, Congress could, on a frequent basis, reexamine how to best encourage voluntary compliance and stick to the overarching goals of penalties in tax administration. There are already a number of tax law provisions that expire on a regular basis. For example, a panoply of tax credits (so-called tax extenders) comes up every calendar year for Congress to routinely reauthorize. So renewing penalties on a predetermined cycle is not without precedent.

The author admits that the effectiveness of penalty sunsets is uncertain. After all, in the debate surrounding extension of expiring tax credit provisions each year, the focus of members of Congress are not always on a substantive review of such laws, but rather the aggregate cost and required offsets. However, it is arguably easier to provide for ongoing legislative tinkering with penalty sections rather than relying on the uncertainty of when Congress might have the fortitude to tackle even one or two particular penalty provisions. If the history of recent legislative action on tax provisions is any indicator of the future, it will become more and more difficult for Congress to muster the will to tackle

161. See 2008 NTA Report, *supra* note 1, at 26. As the 2008 NTA report noted in connection with the section 6651 penalty, it is better to make a penalty “more proportionate to the length of the delinquency, without increasing the rate to such an extent that the penalty itself discourages filing.”

changes to the tax code, especially when doing so requires revenue offsets.

A recurring opportunity to review penalty provisions would allow taxpayers and practitioners to make a strong case for tweaking or eliminating penalties that are not working in line with outlined tax policy goals. Requiring Congress to affirmatively vote to continue a particular penalty could provide hope that the penalty system will be purged on repeated intervals so as to avoid the penalty creep that often necessitates wholesale reform. It is better to compel regular flushings than wait for the dam to burst.

E. Penalty Ombudsman

Another suggestion is for Congress to establish a centralized role within the government to handle penalty data and policy. This would be in keeping with a recent trend toward expanding ombudsman functions within the federal government.¹⁶²

Admittedly, the creation of the OSP was supposed to handle such functions.¹⁶³ But if the IRS continues to neglect full utilization of the office, giving some measure of authority to a penalty ombudsman could help ensure better penalty information collection and its distillation to the tax community.¹⁶⁴ While pending legislative proposals would require annual reports to Congress of reportable transaction nondisclosure penalties, regular reports to the legislative branch should encompass the whole penalty regime. A single function devoted to the work necessary to produce this report should be established.

Because of the important role penalties play in the healthy functioning of our voluntary assessment tax system, comprehensive and detailed analysis of how penalties are operating is essential. A useful model is the National Taxpayer Advocate. A penalty point person would not necessarily need to have the visibility or range of authority that the NTA possesses, because the Taxpayer Advocate Service

162. SEE TAXPAYER ADVOCATE SERV., INTERNAL REVENUE SERV., NATIONAL TAXPAYER ADVOCATE: 2009 ANNUAL REPORT TO CONGRESS VOL. 2: RESEARCH AND RELATED STUDIES 107 (2009), available at http://www.irs.gov/pub/irs-utl/09_tas_arc_vol_2.pdf (last visited Feb. 19, 2011) (TAS identified 44 federal ombudsmen offices in 2009, up from 26 identified in 2003).

163. See I.R.M. 20.1.1.1.3 (Dec. 11, 2009).

164. See AICPA Report, *supra* note 22, at 16 (“The IRS should evaluate whether the Servicewide Penalties Group is the best office to have overall responsibility for penalty administration and if so, whether the placement of that office within the IRS organization is optimal to allow that office to perform its mission, including evaluating and coordinating penalty administration throughout the major Operating Divisions.”).

operates on a broad spectrum of assisting taxpayers across all administrative functions. But just as the NTA is able to make a strong case for correcting tax system deficiencies, a penalty ombudsman focused solely on penalty issues could effectively advocate for needed changes to the penalty regime while keeping tabs on the day-to-day functioning of penalties in the tax system.

V. CONCLUSION

The drift over two decades away from solid principles of what should constitute the penalty system, drawn from careful study, has left the current system in a disconcerting place. Despite occasional rumblings of tackling penalty reform, real strides toward that end might not be made until the IRS again takes the lead. As indicated by both the GAO and NTA reports, the real need is for the Service to gather appropriate empirical data on how penalties are working in the current system. The Taxpayer Advocate has emphasized that “policymakers lack the information they need to structure and administer tax penalties to maximize voluntary compliance or even to accurately estimate the budget effect of changes to the penalty rules.”¹⁶⁵

Attempts by both the GAO and the NTA to produce meaningful measurements on penalties were largely unsuccessful, highlighting the need for action by the IRS. Indeed, the NTA report specifically recommended that Congress have the Service “collect and analyze more detailed penalty data on a regular basis” and “conduct an empirical study to quantify the effect of each penalty on voluntary compliance.”¹⁶⁶

It is unlikely that the legislative staffs on Capitol Hill have the data or resources to pull together an exhaustive study on tax penalties. So it will be up to the IRS to initiate a tax penalty project—perhaps a working group similar to the 1980s task force. The question is whether this is a task the Service is willing to take on right now, because there already are substantial new administrative tax programs in play, including IRS projects that regulate tax return preparers and another requiring corporate reporting of uncertain tax positions.

Penalty reform has languished for years despite a critical need for it, but it is uncertain whether the political will to maintain a serious dialogue on the subject exists. An outward commitment by the IRS in reestablishing a penalty reform task force could be an effective mechanism toward eventual legislative overhaul. Despite the

165. See 2008 NTA Report, *supra* note 1, at 5.

166. *Id.* at 6.

considerable resources that such a project would involve, it is a goal worth pursuing. Returning to the fundamental principles expressed by the 1989 IRS Task Force is essential because that probing document was designed to be a “guide for future legislative efforts and administrative actions.”¹⁶⁷ Furthermore, those recommendations still hold true today.

The challenge ahead is that once significant penalty reform is achieved, Congress and the IRS must ensure that it is long-lasting. A number of the proposals in this paper would help focus Congress and the IRS on sustaining the improvements made to the penalty regime. Establishing a process for more detailed reporting of penalty information will aid thoughtful examination of penalty operations within tax administration. A penalty ombudsman to act as a champion for data collection, good administrative practices, and legislative recommendations would help consolidate responsibilities that are currently housed in a variety of agency functions. Requiring Congress to reauthorize penalty provisions on a regular basis might give taxpayers and tax administrators a better opportunity to examine deficiencies in the existing penalty structure and suggest appropriate modifications.

The pursuit to keep our tax penalty system fair, effective, comprehensible, and administrable so as to drive voluntary taxpayer compliance is worth this effort.

167. IRS Task Force Report, *supra* note 8, at acknowledgements section.